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Featured G

Deja Vu

The New Year kicked off with a steep correction in stock prices, a continued surge in the U.S. dollar, a meltdown in oil, and persistent strength in bond prices. We consider the recent market activity as a continuation of last year's major trends. Of course, the new year will present unique twists and turns, but we continue to look at the experience of the second half of the 1990s as a roadmap for what may happen across major asset classes and financial markets.

Similarities

Stunning similarities exist between today's economic conditions and those which prevailed some 20 years ago:

- In the second half of the 1990s, U.S. real growth advanced at a rate faster than 4%, while the rest of the world was either mired in financial crisis or economic recession. Today, a similar pattern has emerged: the U.S. economy has clearly reached escape velocity, while the rest of the world's economies are either stagnating or growing at a sub-trend rate.
- In the 1990s, the Federal Reserve (Fed) was the first and only central bank to start hiking rates, while the Bundesbank and the Bank of Japan (BOJ) either held rates steady or cut. Monetary cycles between the U.S. and the rest of the world clearly diverged. This dynamic is being repeated today, with the Fed ending its bond purchase program at a time when both the BOJ and the European Central Bank (ECB) are contemplating intensifying their respective quantitative easing (QE) programs.
- Back in 1997, Japan was the first major industrialized economy to fall into price deflation. Excess savings from Japan deluged world financial markets, dragging down bond yields everywhere. Today, it is the euro zone's turn to deflate. German Bund yields have almost converged to Japanese government bond (JGB) yields and excess savings from the euro zone have been fuelling the bond market rally around the world.

Market Actions

What happened to financial markets back then?

The strong dollar dominated global financial markets in the second half of the 1990s. In trade-weighted terms, the dollar broke out in 1995 and soared. The first up-leg of the dollar bull market was centered on a falling yen. The second was driven by then-collapsing emerging market (EM) currencies, alongside a falling deutschemark. During the course of that entire bull market the dollar appreciated 54% in trade-weighted terms.

The strong dollar created the so-called "bond market conundrum": yields on 30-year Treasury bonds fell by 400 basis points (bps) between 1994 and 1998, even though the U.S. economy was booming. In hindsight, a strong dollar compressed U.S. inflation and brought down bond yields, which in turn stimulated consumption to spark a massive U.S. growth boom.

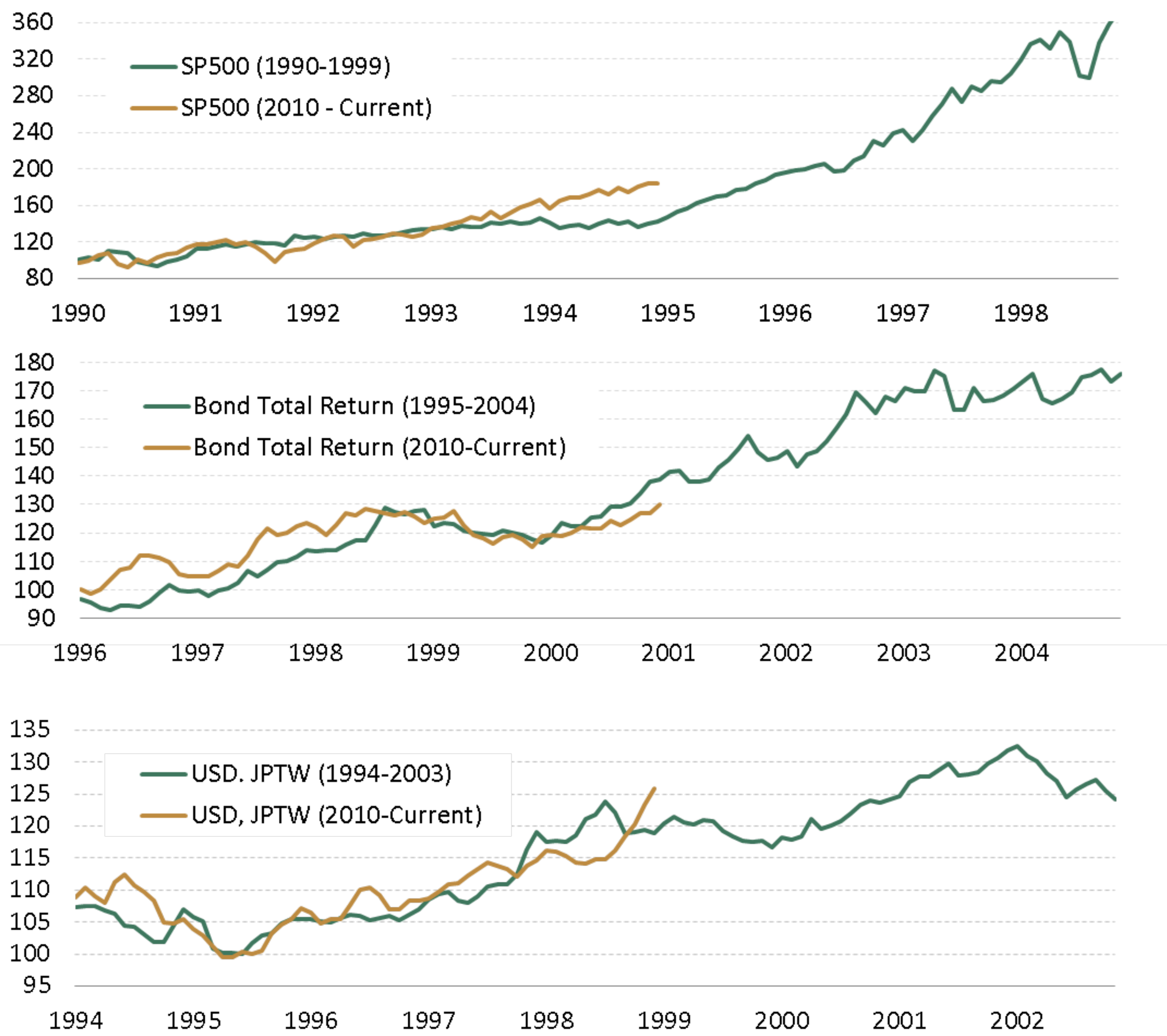
Outside the U.S., however, a major bear market in EM equities unfolded in 1995 on the back of a surging dollar. Mexico was the first EM country that fell into crisis and deep recession. The bear market in EM stocks and currencies quickly spread and eventually degenerated into a full-blown crash in EM assets toward the latter part of the decade.

Finally, the combination of weakening global demand and a strong dollar destroyed commodities, pushing oil to a low of $10/barrel.

What’s Next?

Going forward, we are looking for, essentially, a similar replay. Chart 1 shows how global financial markets have tracked their previous paths of the second half of the 1990s and therefore, could be regarded as a rough roadmap:

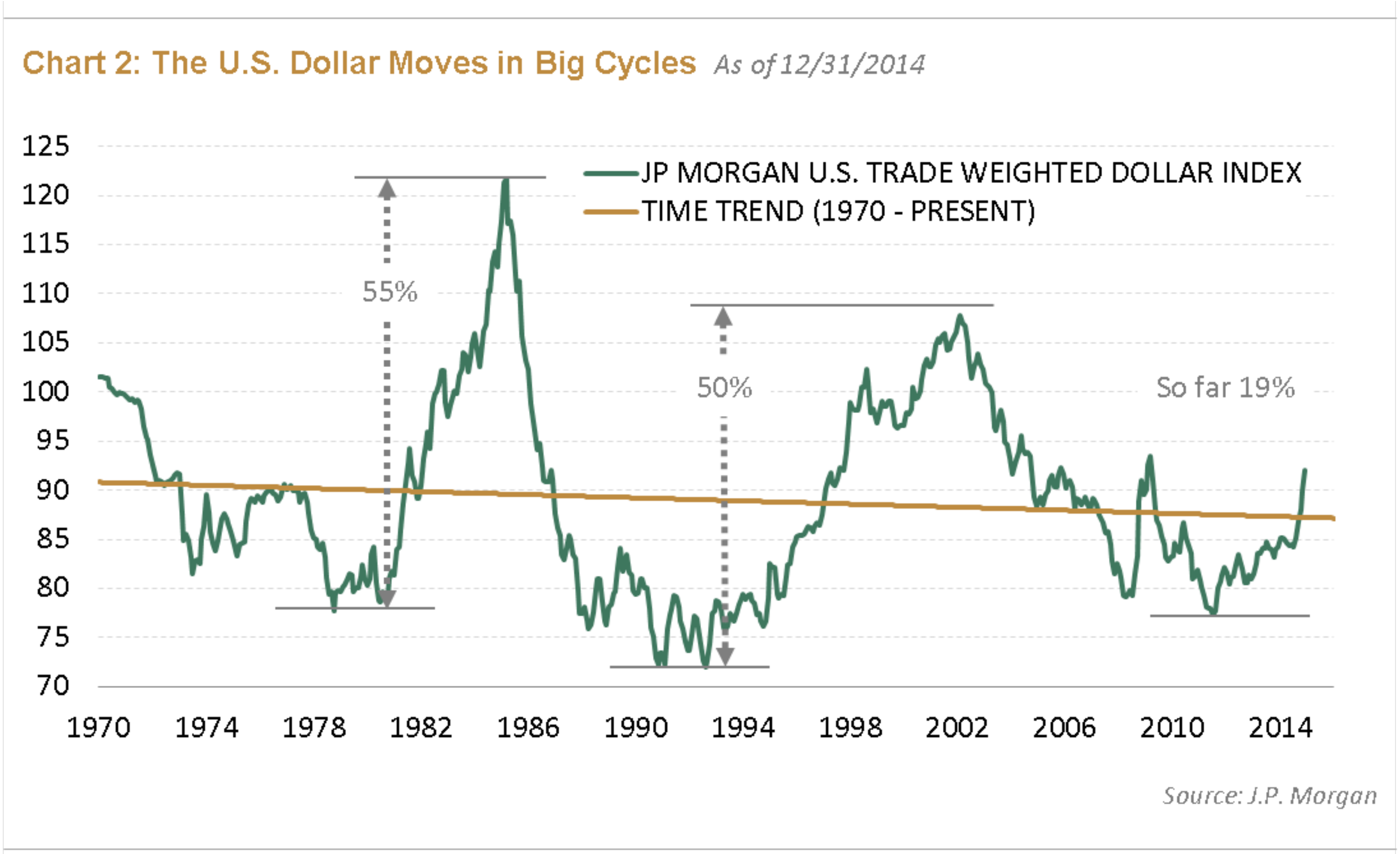
Chart 1: The Financial Market Today versus the 1990s *As of 12/31/2014*



Source: J.P. Morgan

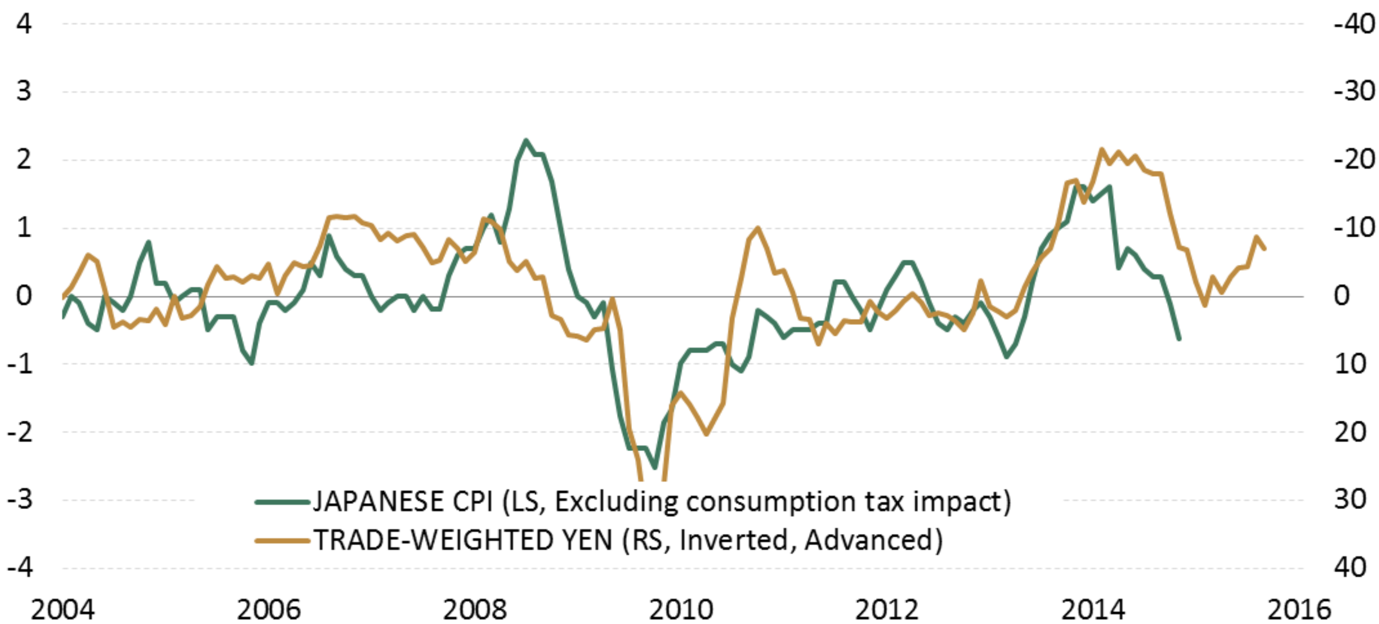
First, although the dollar has rallied 23%, the bull market is probably halfway through in both magnitude and

duration. Historically, a dollar bull market has usually lasted for about five years, with the trade-weighted index rising by more than 50% (Chart 2). In other words, we see continued dollar strength this year on the back of major policy divergence between the U.S. and the rest of the world.



The ECB has been long on words but short on action. With the euro-zone economy slipping deeper into deflation, the central bank likely will be compelled into more aggressive easing with an aim of pushing down the euro. Similarly, the BOJ's efforts to reflate the Japanese economy also seem to be failing, with the inflation rate falling back into negative territory (Chart 3). Should the Abe government make good on its headline campaign promise of generating 2% inflation, more weakness in the yen seems inevitable.

Chart 3: Japanese CPI vs. Trade-Weighted Yen *Annual % Change; As of 12/31/2014*



Source: J.P. Morgan

Although it remains debatable whether the Fed will raise rates this year, it is clear the U.S. central bank will not restart its QE program. Therefore, a continued policy divergence between the U.S. and the rest of the world will remain the key force driving global financial markets, and the natural consequence of this divergence will be a strong U.S. dollar. Second, a strong dollar is unambiguously bullish for the U.S. bond market. A strengthening dollar has and will continue to act as a global growth redistributor: it restrains the U.S. economy by depressing pricing power and siphoning growth, but subsidizes countries with depreciating currencies. This simple dynamic, in our view, explains why U.S. bonds have had a "surprise" rally since 2014, a phenomenon that will likely continue to play out in the months ahead.

Similarly, a strong dollar is disinflationary for the U.S. economy and thus diminishes the chance of a rate hike by the Fed this year. A rough rule of thumb explains the link between a strong dollar and U.S. Treasury bond yields: for every 10% move in the trade-weighted index, a 100 basis point drop in bond yields is triggered to offset the disinflationary impact of a strengthening dollar. Should the dollar continue to gain substantial ground this year, the Fed may have to delay its rate hike to 2016.

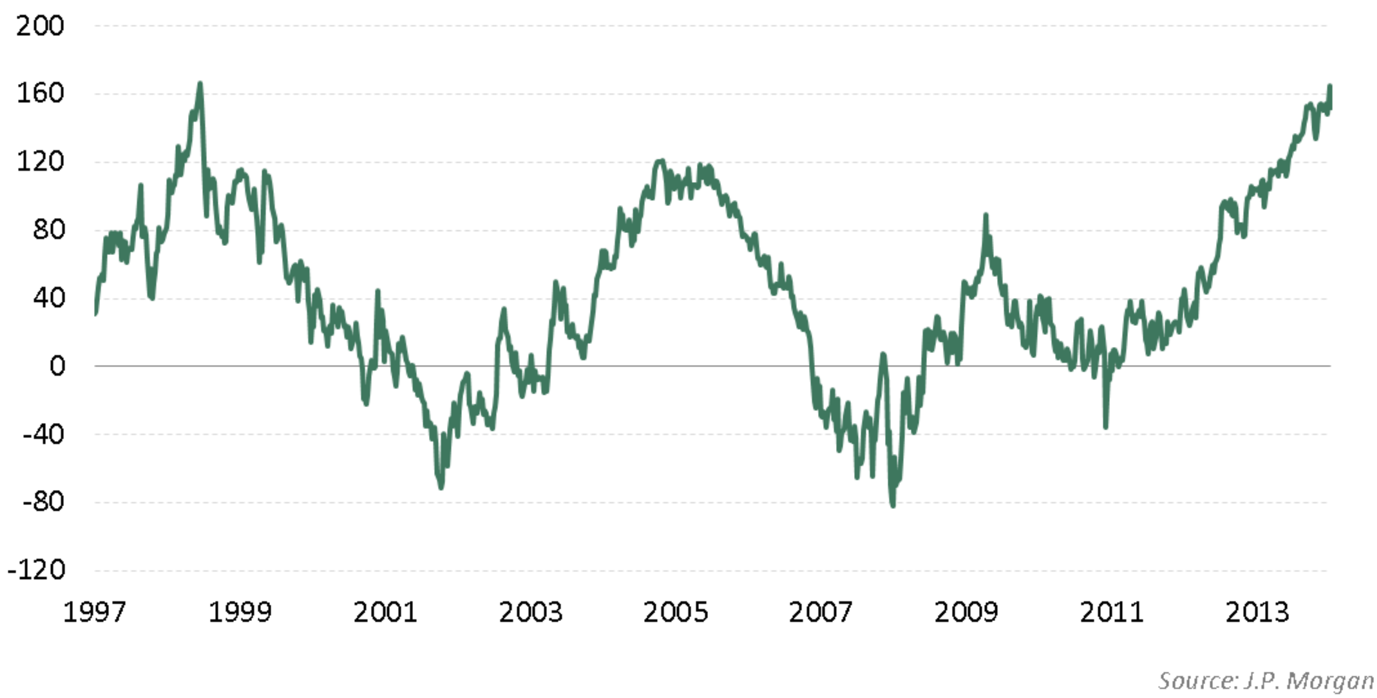
Third, a strong dollar is usually bad news for EM assets. This is because a strengthening dollar usually goes hand-in-hand with falling commodity prices, which depresses commodity producers' profits. In addition, a strong dollar usually puts downward pressure on EM currencies, undermining their efforts to reflate.

Since 2013, the prospect of reduced dollar liquidity from, first, the taper tantrum and second, pulled-forward rate hike expectations, has brought excessive weakness in EM currencies, especially those challenged by large and persistent current account deficits. Many EM central banks fought currency depreciation with higher interest rates, and some have stabilized. Although the cyclical outlook for EMs looks challenging, we believe risk premiums are attractive enough to own select EMs. From a structural standpoint, too, EMs are in much better shape today than in the crises of the 1990s to navigate a period of dollar strength, lower global growth, commodities dislocation, and rising market volatility.

Some EM countries also offer the benefit of being at or near the top of rate hike cycles. As global inflation cools, we expect many EM central banks will start cutting interest rates this year. EM Inflation was already rolling over at the end of the third quarter and has continued to weaken. But the break in oil prices is a win-win for these economies. The EMs are far more oil intensive than the developed world so lower prices and lower inflation could pave the way for a turnaround in their economies. This is a key catalyst for jump-starting global growth and we expect it to develop by early spring.

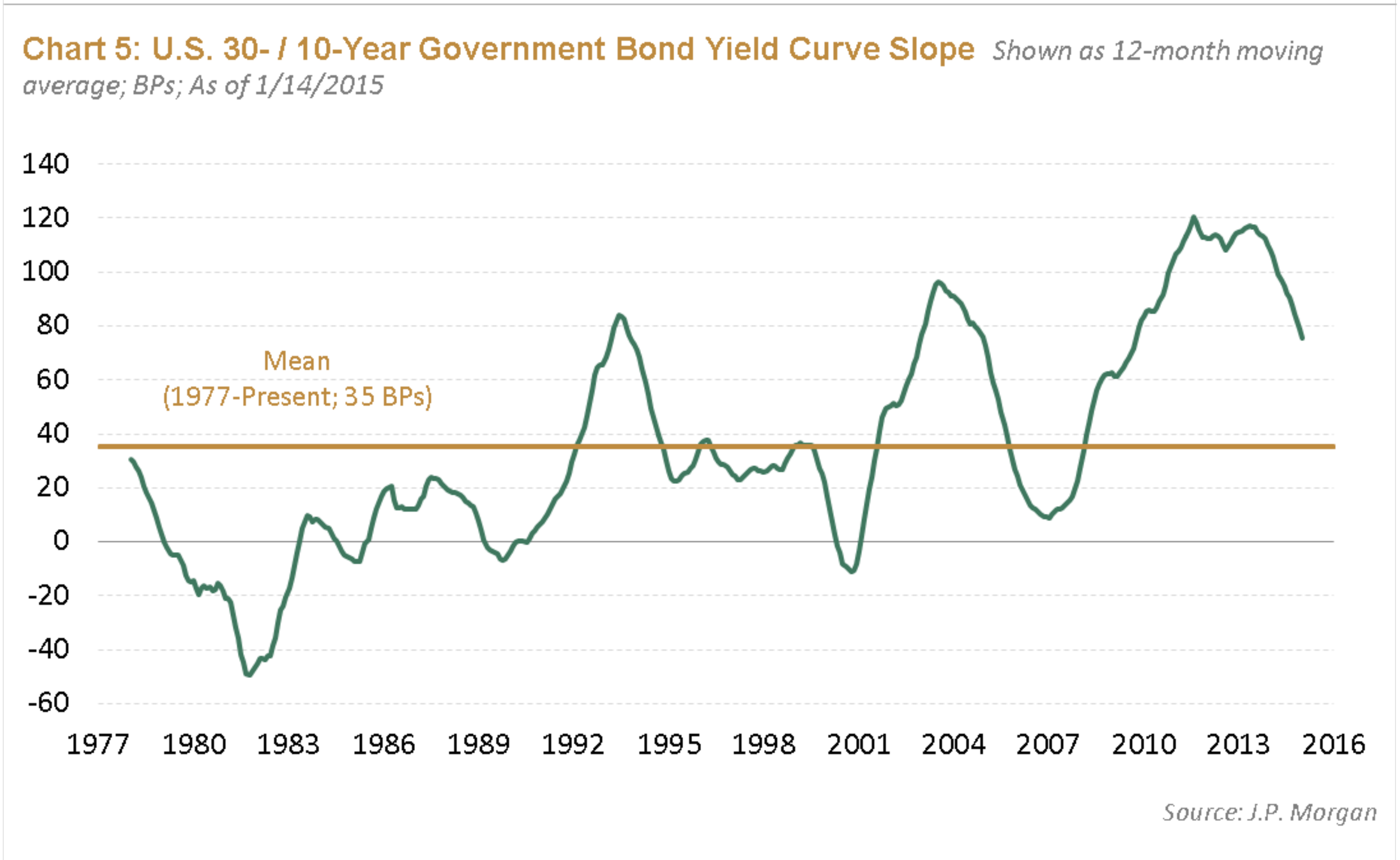
The spread between U.S. Treasurys and German Bunds is at an historical extreme. With the dollar gaining additional ground versus the euro, the spread should start to narrow. This is because a strong dollar should help depress U.S. inflation, while a weakened euro should help reflate the euro-zone economy (Chart 4). A long position in U.S.-German spreads is consistent with a strong dollar view.

Chart 4: U.S. 10-Year Treasury Minus German 10-Year Bond *BPs; As of 1/15/2014*



A curve flattener is a long position in 30-year Treasurys and a short position in 10-year Treasurys. The spread between the two markets has averaged 35 basis points since the first issue, while it is approximately 58 basis points today.

Chart 5 shows that two periods of dramatic curve flattening exist: one occurred in the second half of the 1990s and the other occurred in the second half of the last decade. In the 1990s, the yield curve experienced a “bull” flattening environment—when long yields fall faster than short yields, typically beneficial to long-only bond investors—due to deflation, excess savings, and a strengthening dollar. In the 2000s, the yield curve experienced a “bear” flattening—when short yields rise more quickly than long yields, typically harming long-only bond investors—due to Fed monetary tightening.



With the dollar being strong and overflows of excessive savings, we bet the curve flattening will continue, with 30-year bonds continuing to outperform the shorter end of the curve until the abnormally large term premium is eliminated.

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