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Analyst Article February 21, 2017

HUMBLE STUDENT OF THE MARKETS

***e*Research Corporation** is pleased to feature an article by Cam Hui, who offers investment and trading insights on his website, **HumbleStudentOfTheMarkets.com**

Mr. Hui posts a market comment on the weekend plus one or two articles of interest during the week.

His subscription service includes annual, monthly, or daily pass options, and is focused on building a community of like-minded individuals with a common interest in investing and trading.

The article begins on the following page, and is entitled:
Are Negative Real Yields An Equity Sell Signal?

You can access his website and subscribe to his service at the following link:
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Director of Research

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Monday, February 20, 2017

Are Negative Real Yields An Equity Sell Signal?

A reader asked me my opinion about this tweet by Nautilus Research. According to this study, equities have performed poorly once the inflation-adjusted 10-year Treasury yield turns negative. With real yields barely positive today, Nautilus went on to ask rhetorically if the Fed is behind the inflation fighting curve.

Since the publication of that study, the January YoY CPI came in at 2.5%, which was surprisingly high. The higher-than-expected inflation rate pushed the 10-year real yield into negative territory. So, is this a sell signal for equities?

Well, it depends. The interpretation of investment models often depends a great deal on their inputs. In this case, the question is how do we adjust for inflation? Do we use the headline Consumer Price Index (CPI), core CPI, which is CPI excluding volatile food and energy prices, or some other measure?

As I go on to show, how we adjust for inflation dramatically alters the investment conclusion for a variety of asset classes, like equities, gold, and the USD.

As is the case in the application of any quantitative model, the devil is in the details.

Real Yields and Equity Returns

Consider the evidence. As the FRED chart below indicates, history shows real yields indeed either lead or are coincidental with equity returns. If we adjust for 10-year Treasury with headline CPI, the outlook is equity bearish. On the other hand, adjusting with core CPI leads to a bullish conclusion.

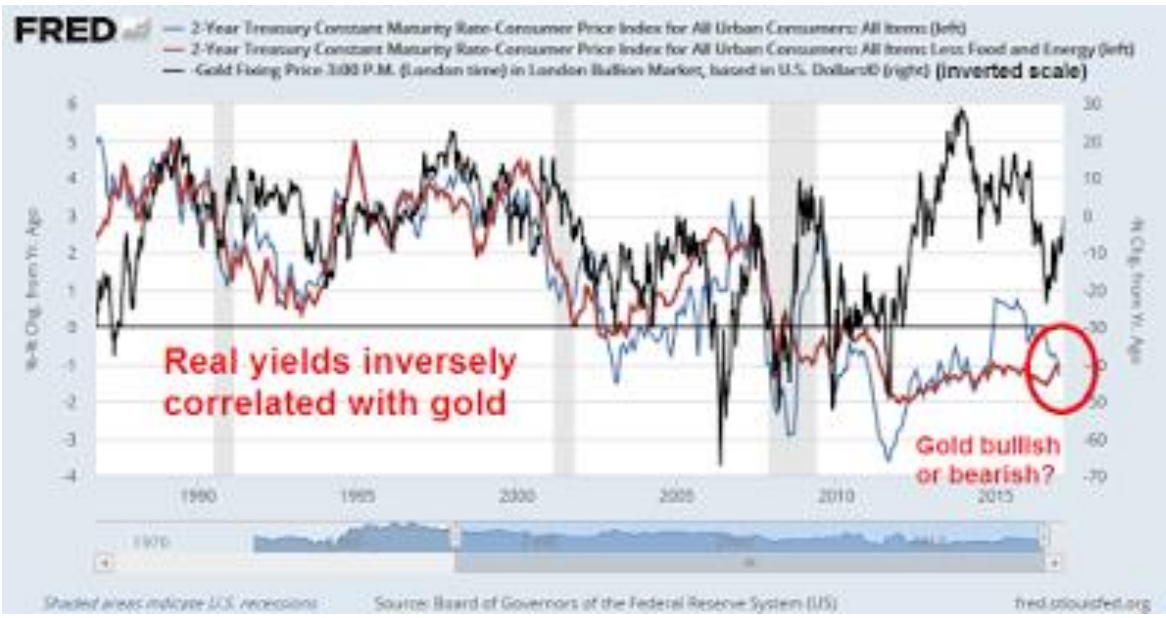
Which inflation measure should we use?

Real Yields and the USD

There is a more direct empirical relationship between real yields and the level of the U.S. Dollar. As real yields rise, it puts upward pressure on the USD. So, which inflation rate should we use?

Real Yields and Gold

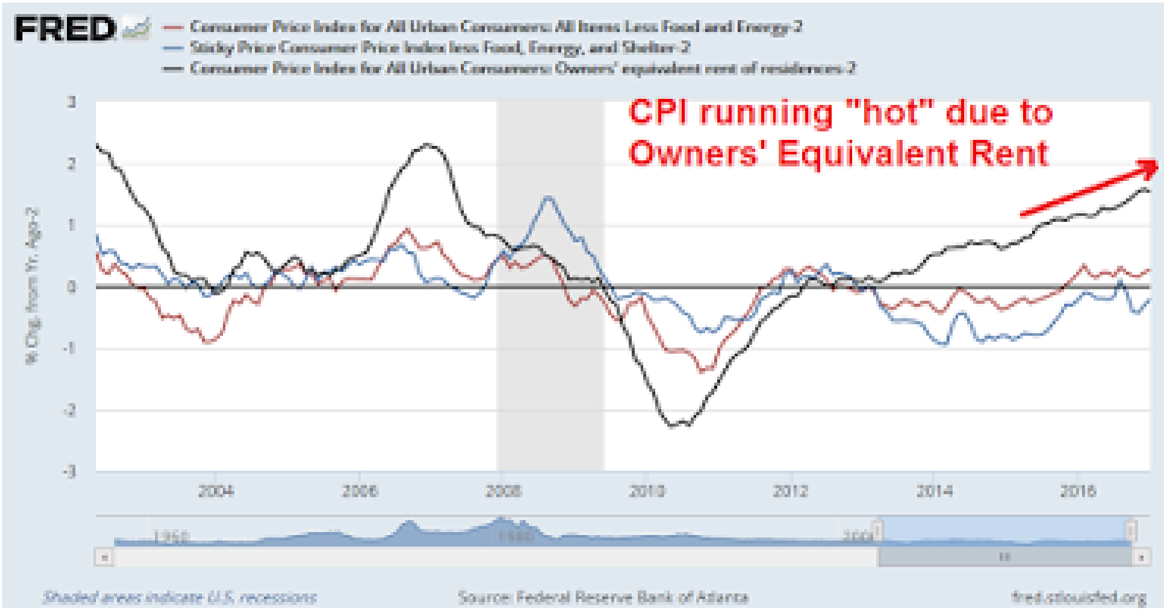
Historically, the price of gold has been inversely correlated with the USD. Since gold is thought of as an inflation hedge, it is therefore no surprise that low real yields are gold-bullish and high real yields are bearish (note the inverse scale for the gold price, right axis).



Our intermediate-term outlook for these asset classes, therefore, crucially depend on the correct interpretation of the inflation adjustment factor. Do we use headline CPI, or the less volatile core CPI?

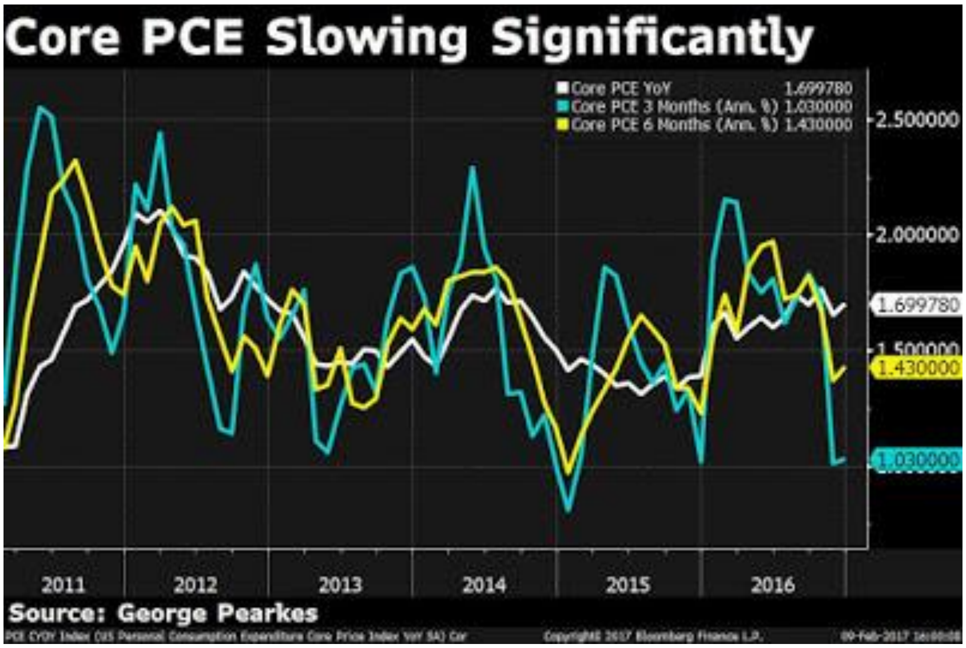
A "Hot" CPI Print

The CPI print last week came in ahead of expectations. YoY CPI was 2.5% (vs. 2.4% expected), and core CPI was 2.3% (vs. 2.1% expected). As I showed in my previous post (see Watch what they do, not just what they say), most of the strength in CPI was attributable to rising Owners' Equivalent Rent (OER), which comprises 25% of the weight of CPI and 31% of core CPI, according to the latest BLS figures. (Note that the chart subtracts 2% from each CPI metric so that we can easily see whether each is above or below the Fed's 2% inflation target.)



Much of the recent boost to headline CPI compared to core CPI is attributable to surging gasoline prices. As the chart below shows, YoY gasoline prices are due to peak and headline inflation should start to moderate in the months ahead.

After dissecting the components of CPI, my conclusion is that inflation remains tame after stripping out the more volatile components and OER, which can be ignored for the purposes of this analysis. I have also highlighted past analysis from George Pearkes that core PCE, which is the Fed's preferred inflation metric, has been slowing.



In conclusion, investors should not panic about negative real yields based on an erroneous interpretation of inflation. Unless conditions change dramatically, the intermediate-term outlook for the USD and equities is bullish. Conversely, gold bulls will face headwinds from positive real yields.

Regards,

Cam Hui

Humble Student of the Markets, Inc.

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