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Strategy Update: The return of the reflation trade is near 7 November 2011

Mario Draghi did not disappoint as he reduced the key ECB interest rates by 25bps after only two days in office last week. As we argued back on August 5 in "Strategy Update":

> *"The ECB's resolve will be tested by rising yields of Italian and Spanish bonds in coming weeks. The ECB has tapped the brakes too hard from a policy perspective, and this is resulting in a crash in money supply growth and hence, causing funding issues for these sovereigns at present."*

As a result of tightening monetary policy, European banks were under pressure as the value of their equity dropped dramatically, interbank lending ceased as funding shortages developed, which also sent measures of risk such as the Bund asset swap spread surging.

Following a period where US money market funds moved into Europe in search of yield higher than the Fed's ZIRP range, they were quick to rotate away from and reduce their European exposures again in Aug/Sep when the crisis intensified. This rotation of capital back to the perceived safety of the US supported the USD substantially in an environment where USD money supply continues to grow at a clip near 20% annualised, according to Fed data.

Back in August we pointed out the acceleration of US money supply growth, predicting its consequences by saying that:

> *"In the US, M2 sa annualized money supply growth has accelerated to levels of 8-9% since the start of June after being range bound between 4-5% from Jan to late May. The current money growth can be described as "QE3 by other means." It will keep the Fed weary of another round of QE right away. With money supply growth accelerating, we may see a decided improvement in headline US economic data in Q3 and Q4. Coupled with strong earnings results seen recently, this is bullish for US stocks despite the recent poor economic data. Price inflation momentum will stay to the topside."*

We did not envisage the extent of Trichet's hawkishness at the ECB - that he would let the Eurozone economy approach collapse and let malinvestments liquidate, including bad loans to periphery governments. This resulted in an overshooting of our target for the US 10yr yield on the downside and also a deeper correction on the S&P 500 than we foresaw of 2.40% and 1,200 points respectively.

Turning to the USD, we expect to see the marginal demand for the reserve currency that was born of the rotation away from Europe fall away, and that this decline in demand, in light of the very strong supply growth of the USD in recent months, will take a solid support structure out from underneath the currency. The USD is expected will slide sharply against particularly EM currencies in coming months. This will also be supportive of rising commodity and equity prices.

We argued back in August that US growth will surprise in its strength in Q3 and Q4. We have already seen a relatively strong GDP number for Q3, while labour indicators, PMI's, and price inflation data show that the US is not headed for a double-dip recession in the coming quarter or two. The short-term cyclical growth recovery we spoke about is here, and may grow in strength in coming months.

Looking abroad, the BOE, BOJ and SNB have all upped the ante with more QE, and once the ECB joins in by purchasing assets without sterilising these purchases, all the major central banks of the world will be engaged in substantial monetary loosening. This is where one wants to be long commodities and equities, and short core G4 bonds, but long junk bonds and European periphery debt once again. The wave of monetary inflation we have been waiting for is upon us, and it is time to position accordingly.

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