Northern Trust | Katie Nixon: The Reflation Trade: Not Dead Yet

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We've heard some investors question whether or not the reflation trade works anymore, given the recent action in the stock, bond, commodity, and currency markets. Here's our take. The reflation trade describes investors positioning starting in late 2016 when the combination of higher growth and inflation forecast, particularly in the US, propelled risk assets and commodities higher.

Yield curve steepened and inflation expectations rose under the assumption that both the US and China were growing again, setting the stage for a global virtuous cycle of higher growth and inflation. In the US, there was the potential for additional fuel to the reflation fire in the form of fiscal stimulus and deregulation under the new Republican majority in Washington.

Yet, some of the core elements of the story have softened recently, leading investors to question whether we remain in this reflationary environment. While we have seen an increase in the price of oil from its bottom in February of 2016, prices have fallen from the peak, as robust US shale production has offset the OPEC supply constraint. Not surprisingly, inflation expectations tend to be tightly correlated to the price of oil, so have seen those expectations globally fall.

On the growth side, while we continue to see robust soft or survey data, the hard data is less conclusive. For example, despite soaring consumer confidence, retail sales remain weak, and it appears that the US economy will likely print a relatively weak first quarter GDP report. The combined lower growth and inflation data has been reflected in lower bond yields in the US, and equity prices that have drifted off their highs.

So what does this mean for investors? We believe investors should continue to position for higher growth and inflation with exposure to global equities, natural resources, and inflation-protected securities. The gap between the hard and soft data will close with improved hard economic data as we head into the rest of 2017. Potential for stimulus out of Washington could provide additional economic momentum.

The softness in the oil market is more about flexible and growing supply, rather than slowing demand, and we believe the tight labor markets will pressure wage inflation. In addition, we believe that the recovery in corporate earnings will continue. And, importantly, this is a global phenomenon. The synchronous global recovery continues, and global diversification will be a key element to investor success. The inflation trade may be down, but it's not dead yet.

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