Lines in the Sand

The Reflation of Deflation

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Background

- The topic of deflation has been receiving much more airplay of late, adding to a chorus of central bankers who have highlighted the risks of deflation at various points during this calendar year.

- While growth in the US, Canada and the UK grinds along, uncertainty dominates emerging markets, China and Japan, while the outlook for the Eurozone is extremely downbeat.

- This has cast a pall over commodity markets, with downward pressure on prices amplified by the recent explosive rally in the US dollar.

- We examine some of the key commodity relationships that are feeding into the deflationary scenario, extrapolating this dynamic to the outlook for global breakeven rates and long bond yields in the fixed income space.

- We find that there is some validity in the concept of USD strength triggering weaker commodity prices which, in turn, lead to reduced inflation expectations via lower global 10-year breakeven rates and depressed 30-year bond yields.

- The so-called “commodity currencies” have also suffered in this context.
Crude reality….. Brent is bent

- Our deflation analysis begins with crude oil markets and the outlook for West Texas Intermediate (WTI) and Brent.
- We note that WTI is testing a key 5-year support trendline at 88.67 on the weekly chart (the upper blue chart).
- A weekly close below this level would trigger a bearish long-term trend reversal that would target the 2014 low at 84.30 and the 2013 low at 80.41 on the downside, thereby adding to deflationary risks.
- Resistance is located at 89.78 and 94.50, with a close above 101.55 required to trigger a bullish breakout from the triangle pattern.
- Brent (lower red chart) has undergone a sharp move lower after posting a bearish trend reversal below a 4-year support trendline at 110.12 in July.
- A weekly close below the 2013 low at 91.01 would add to bearish sentiment, targeting 87.02 and 80.20 ahead of key long-term support at 75.64 (a 5-year trendline).
- This scenario would also add to deflationary risk, with resistance located at 97.69 and 104.88.

Source: Bloomberg, RBC Capital Markets
Weak metals complex underscores growth/deflation worries

Resistances:
- Iron ore: 7038 and 7212
- Aluminum: 2099 and 2231
- Copper: 6503 would target 2014 low @ 6321, followed by 6038
- Aluminum: 7038 and 7212

Dr. Copper looks sick: weekly close below 50% Fibonaci retracement level @ 6503 would target 2014 low @ 6321, followed by 6038.

Weekly close below 1875 would resume the downtrend in aluminum, targeting the 2014 low @ 1671.

China domestic steel rebar prices probe 2006 low @ 2755 after bearish trend reversal in 2013. Points to Chinese slowdown and deflation risk.

Close below 2755 would target 2004 low @ 2600.

Iron ore price returns eye 100 threshold after piercing a double bottom @ 128. Points to possible Chinese slowdown and deflation risk.

Source: Bloomberg, RBC Capital Markets
Break of key double bottom in gold would amplify deflation theme

- We have repeatedly highlighted the importance of the 1179 level in gold prices in various publications over the last two weeks.
- This level is crucial to directional bias as it denotes where the downtrend has stalled via the formation of a double bottom in 2013.
- The key take-away is that a daily close below this level would uphold not only our bearish stance for the metal but also amplify an increase in deflationary expectations.
- The increase in negative sentiment would then shift the focus down to 1136 and 1097 initially.
- Additional support is located at 1058 and 1041, followed by the 1000 threshold (just above 76.4% retracement of the 2008-2011 rally at 990).
- Although the daily studies have moved to oversold levels, the downtrend in place suggests that valuation-driven retracements to resistance at 1242 and 1294 will attract renewed selling interest.
- A daily close above 1347 is required to nullify our bearish stance.

Source: Bloomberg, RBC Capital Markets
Gold, TIPS and the DXY: A deflation risk?

- Gold prices have generally displayed a negative 60-day correlation with US 10-year TIPS over the past year.
- We note that the negative correlation has been increasing steadily since July.
- What stands out to us are the breakouts that took place in August-September, when gold prices posted a bearish breakout below 1274 right after TIPS posted a breakout above 0.24.
- We are now watching the recent high in TIPS at 0.58 – as a break above this level would likely cause gold prices to re-test the key double bottom at 1179 based on this relationship.
- The inverse relationship between these two instruments suggests that there is currently no overt concerns with regard to inflation.
- If we add FX to the mix, it can be said that the rising USD is contributing to depressed global commodity prices, which in turn may be presenting deflationary risks.

Source: Bloomberg, RBC Capital Markets
US 10-year breakevens corroborate deflationary risks

The last four slides discussed growing deflation risks based on bearish developments in various global commodity markets.

If we extrapolate this theme to the fixed income area, global breakeven rates would serve as a good barometer for inflation expectations.

In the case of US 10-year breakeven rates, downside momentum increased dramatically in mid-September when a bearish long-term trend reversal took place below 2.10.

Note that this was just after important price breakouts took place for gold, TIPS and the DXY (see the previous slide).

While yesterday’s bullish key reversal day favours a bounce higher in breakevens as the daily studies resolve a divergence that formed from oversold levels, the downtrend in place suggests that moves to resistance at 2.06/2.10 and the 200-day moving average at 2.17 will present an opportunity to enter short positions.

A daily close below the 2013 low at 1.92 would add to downside risks, exposing 1.86 and 1.81 ahead of the 2011 low at 1.71.

A close above the old triangle top at 2.23 is required to trigger a bullish long-term trend reversal.

Key Support & Resistance Levels:

<table>
<thead>
<tr>
<th>Support</th>
<th>Resistance</th>
</tr>
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<tbody>
<tr>
<td>1.92</td>
<td>2.10</td>
</tr>
<tr>
<td>1.86</td>
<td>2.17</td>
</tr>
<tr>
<td>1.81</td>
<td>2.23</td>
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</tbody>
</table>

Source: Bloomberg, RBC Capital Markets
The long-term downtrend in CA 10-year breakeven rates was reasserted in mid-September, when prices posted a bearish trend reversal below a trendline at 1.94.

This development indicated that inflation concerns were beginning to dissipate as the contemporaneous rally in the USD pushed commodity prices lower.

While the prospects of a correction have increased as the daily studies trace out a divergence, the trend reversal suggests that valuation-driven retracements to resistance at 1.96 and 2.01 will attract renewed interest in short positions.

Initial support is located at 1.85 and 1.81 - with a close below the latter level opening up 1.76 and 1.72 on the downside.

We note that the 2013 low and descending channel base come in below here at 1.68 and 1.65 respectively.

A daily close above the channel top at 2.08 is required in order to trigger a bullish trend reversal and suggest that inflation concerns are becoming more prevalent.
UK 10-year breakevens hit new 2014 low

- Deflationary risks are also present when looking at 10-year UK breakeven rates.
- Of note, the recent close below 61.8% Fibonacci retracement of the 2012-2013 advance at 2.72 has pushed breakevens to their lowest level this year.
- The bearish breakout shifts the focus down to the 2013 low at 2.65 as the next downside target – with a break below here opening up 2.60 ahead of the 76.4% retracement level at 2.57.
- Additional support is located below here at 2.50.
- The current backdrop suggests that valuation-driven retracements to resistance at 2.76, 2.81 and 2.87 are expected to attract interest in short positions.
- A daily close above the trendline that is flush with the 200-day moving average at 2.93 is required in order to trigger a bullish long-term trend reversal and indicate that inflation concerns are increasing again.

Key Support & Resistance Levels:

<table>
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<tr>
<td>Resistance</td>
<td>2.76</td>
<td>2.81</td>
<td>2.87</td>
</tr>
</tbody>
</table>

Source: Bloomberg, RBC Capital Markets
Eurozone 10-year breakeven rates re-test secular low

- Deflationary risks are most prevalent in the Eurozone relative to other core markets, as stagnant economic growth and ECB policy actions have pushed EZ 10-year breakeven rates to secular lows (breakeven rates in most other core markets are above their crisis lows).
- The 2014 low at 1.11 is now in play again in this regard after a brief correction – with a close below here adding to downside momentum.
- This outcome would target the descending channel base at 1.07, followed by the psychological 1.00 threshold.
- It is difficult to pinpoint well-established support levels below here as we move into “uncharted territory”, causing “round numbers” such as 0.95 and 0.90 to come into focus.
- Resistance at 1.20 and 1.27 is expected to attract interest in short positions based on the downtrend in place.
- A close above 1.33 is required at a minimum in order to suggest that the long-term downtrend is faltering, with the resulting bullish trend reversal indicating that inflation concerns are beginning to percolate again.

Key Support & Resistance Levels:

<table>
<thead>
<tr>
<th>Support</th>
<th>1.11</th>
<th>1.07</th>
<th>1.00</th>
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</thead>
<tbody>
<tr>
<td>Resistance</td>
<td>1.20</td>
<td>1.27</td>
<td>1.33</td>
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Source: Bloomberg, RBC Capital Markets
AU 10-year breakevens display a more neutral profile

Although they have displayed a more subdued profile this year, AU 10-year breakeven rates are probing the 2014 lows denoted by double bottom support at 2.40 (interestingly, this also corresponds to 61.8% Fibonacci retracement of the 2013-2014 uptrend).

A clean daily closing break below this key level would resolve a descending triangle pattern to the downside, targeting the September 2013 low at 2.34 next, followed by 2.30.

We note that the 2013 low is nestled just below here at 2.28 – which would also correspond to the measured move objective of the triangle pattern should it be resolved to the downside.

The bearish backdrop suggests that moves to resistance at 2.48 and a triple top near 2.52 will attract interest in short positions.

A daily close above a long-term resistance trendline dating back to 2006 at 2.56 will have to be seen in order to trigger a bullish trend reversal and suggest that inflation concerns are returning on the radar again.

Key Support & Resistance Levels:

| Support: | 2.40 | 2.34 | 2.28 |
| Resistance: | 2.48 | 2.52 | 2.56 |

Source: Bloomberg, RBC Capital Markets
A structural take on low inflation: depressed 30-year yields

Source: Bloomberg, RBC Capital Markets
USD interplay with inflation dynamic

- We first introduced the USD to the inflation discussion on page 7.
- We pointed out that the recent sharp appreciation in the USD has contributed to weakness in global commodity prices.
- This dynamic, in turn, may be feeding into reduced inflation expectations.
- The chart to the left illustrates this dynamic and the impact on the so-called “commodity currencies”.
- Note that the Bloomberg Commodity Index (blue chart) registered a bearish trend reversal just ahead of a bullish trend reversal for the DXY (red chart).
- The breakout in the DXY was accompanied by a simultaneous bearish breakout in AUD/USD (black chart) and bullish breakout in USD/CAD (burgundy chart).
- USD/ZAR was the only laggard in this context, but even this pair eventually registered a bullish breakout (green chart).
- The bottom line is that the rally in the USD has triggered commodity price weakness which in turn, has led to lower inflation expectations as illustrated by lower global 10-year breakeven rates and depressed global 30-year yields.
- This dynamic should be monitored going forward.

Source: Bloomberg, RBC Capital Markets
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