***The Last Shoe Drop:*** **Westminster Asset Management Investment Strategist Peter Lucas considers the difference between bond yields and inflation and what this implies for asset prices.**

In my last article ("Mind the gap", October 2021) I warned that a lot of assets were seriously mispriced if inflation proved to be more persistent than many were thinking at the time. I highlighted precious metals and value equities as potential winners, and bonds, the US dollar, and growth shares as likely losers. I concluded by saying that I favoured the persistent inflation scenario and that markets were "starting to behave in a way that was consistent with this scenario". Since then, things have moved my way, but I have not yet got a full house: bond yields and gold have gone up, but the US dollar has gone up rather than down. In this article we examine why the dollar has strengthened, why this strength won't last, and what its impact on markets will be when it finally turns lower.

For the purposes of this article, I will focus on the euro-US dollar exchange rate. The consensus view on EURUSD is that US inflation is higher than Eurozone inflation and therefore the Fed will tighten sooner and further than the ECB. Indeed, investors are so concerned about the extent to which the Fed will tighten that the very long end of the yield curve has inverted. Yes, that's right, the bond market is pricing in a Fed policy error before it has even started to raise interest rates! In short, the strength of the dollar is being driven by widening nominal bond yield differentials and growing fears of a deflationary bust. In turn, the strong dollar is reassuring bond investors that inflation will not career out of control, which in turn is reassuring growth investors that higher bond yields will not spoil their party.

In my view, the bear case for the dollar versus the euro is as follows:

1. Although bond yield differentials have widened in the dollar's favour, real bond yields have narrowed because inflation has risen further in the US.
2. Similarly, the Taylor rule (which estimates where interest rates should be given the current levels of inflation and unemployment) has US interest rates further below equilibrium than their Eurozone equivalents. The Fed needs to tighten just to catch up.
3. The breakout by the gold price tells us that investors are becoming increasingly worried about inflation. If this continues, at some point the focus will shift to real (rather than nominal) interest rates.
4. The Fed is likely to err on the side of caution given overvalued financial markets and high debt levels. In other words, the risks of Fed over-tightening and a deflationary bust are overstated.
5. The general vulnerability of the euro stems from the deflationary risks that have plagued the likes of Italy and Spain. Generally higher inflation removes that deflationary risk and makes the euro less fragile (for the time being at least).

Technically, the dollar looks to have unfinished business on the upside. However, I expect the next major move to be on the downside. And if the dollar weakens, it will heighten investors' inflation concerns, and the developing uptrends in bond yields and gold will go into overdrive. Furthermore, deteriorating inflation expectations and the weak dollar could feed on each other, leading to a 70's style currency crisis. Higher bonds would be the trigger for the value-growth rotation to begin in earnest.

Meanwhile, keep an eye on the US dollar-Chinese yuan exchange rate. Some months ago, I cited this as a key chart to watch. Despite all the bad news about government meddling in the economy and the collapse of Evergrande, the yuan has remained remarkably stable. In fact, it has strengthened a little against a generally strong dollar. It is always encouraging when an asset fails to fall in the face of bad news. The yuan is sitting on an eight-year trend line – a break here would open the way to further strength. Is China about to start exporting its own inflation problem to the West?

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