



The goods-services divide suggests the Fed and ECB are misdiagnosing underlying inflation; low goods inflation is a global phenomenon that reflects the dollar up and commodity down cycles, which are accelerated by monetary policy divergence; services inflation is running much stronger and rising. Core goods inflation (25% weight in the US; 38% weight in Europe) consistently runs well below core services inflation. In the US, core goods inflation has been running slightly negative for three years, while core services a much stronger 2.5% for the last four years and recently moved to a new cycle high. In the Euro area, core goods inflation is running higher than in the US reflecting the depreciation of the euro, while core services has been moving up and is running at 1.4%. Core goods inflation in the US is strongly correlated with import price inflation. Zero or slightly negative core goods inflation in the US can also be thought of as foreign inflation less the dollar's appreciation. Core services inflation in the US has moved up over the last three months and has a fair degree of catch up to do with the decline in unemployment relative to the NAIUR and rental vacancies.

The dollar up cycle should have 10% to go medium term, but speed breakers are now in place to slow the pace. The US trade-weighted dollar rose 23% during Jun 2014-Mar 2015, the fastest pace ever with about three years of appreciation in a typical dollar up cycle packed into nine months. The rapid appreciation erected two speed breakers which should slow the pace: lower core goods inflation prompted the Fed to push out rate guidance in April (marking a top in the dollar for next seven months); the drag on US growth and earnings has seen a big reallocation (\$-150bn) out of US equities into Europe.

Historically turns in productivity are led by the dollar: typical lag implies we are at the cusp. Historically, over the post-World War II period, productivity has grown at a trend rate of 2.1% per year, with long multi-year cycles in the level of productivity around this trend. The current level is near the bottom of the trend channel, a level last seen in 1995. Incentives matter: the dollar looks to have been an important driver of productivity historically. There has been a relatively strong correlation between the lagged level of the trade weighted dollar and productivity. The average lag looks to have been about three years.

Cyclical asset allocation: large over-allocation to fixed income at the expense of equities persists. Around recessions, flows overweight bonds over equities. Asset allocation re-normalizes around Fed hiking cycles. This time various QEs, calendar guidance and Twist prompted investors to put even more money into bonds long after the recession. Despite equity inflows resuming in 2013 (especially after the taper) cumulative overweight in bonds is still \$748bn and underweight in equities \$1.4 trn. Each episode of rising rates over the last five years saw robust reallocations from bonds to equities.

The cross asset rates minder:

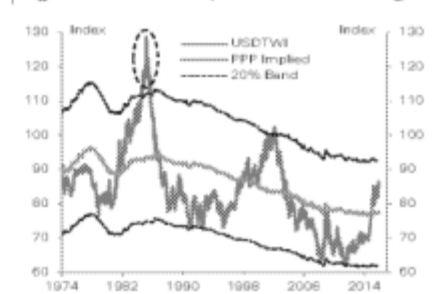
Rate normalization cycles have long been associated with significant price losses on the 10y. Previous rate hiking cycles each saw long-lived capital losses on the 10y, averaging -11%. We estimate that a catch back up of market expectations to the Fed's guidance is worth +150bps in the 10y implying a significant potential re-pricing. The current divergence two years ahead is comparable with historical experience near turning points in rate cycles.

Figure 5: Trend like global growth



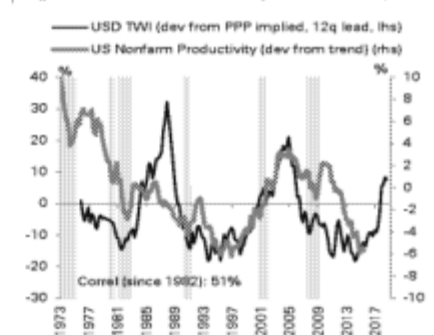
Source: IMF, Deutsche Bank Research

Figure 6: Dollar cycle has 10% to go



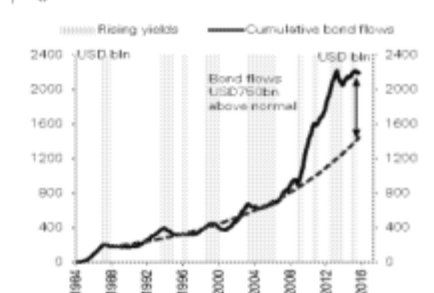
Source: Bloomberg Finance LP, Deutsche Bank Research

Figure 7: Dollar leads productivity



Source: BLS, Deutsche Bank Research

Figure 8: Over allocation to bonds



Source: ICI, Deutsche Bank Research