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Weekly Commentary

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Macro View

By Hubert Marleau

The Marketeers Doubt the Seriousness of the Monetary Authorities

Submitted March 21, 2021

A Snapshot of the Market for the Week Ended March 19, 2021:

There was suspicion looming in the bond market. Powell unequivocally says that he is serious about implementing the Fed's new thinking, but the marketeers are skeptical about its determination. At this point, even the ones who are adept at calling markets are clearly just making guesses because we are travelling on a new road and trying to outsmart the Fed is a fool's errand. Nevertheless, it is important to characterize this ongoing tug of war and make an effort to reconcile the forces that are creating bond market anxiety.

Heisenberg wrote, the bottom line is "the Fed doesn't know where interest rates are going to be in two years and neither do the participants. It's just the blind leading the blind, only because the Fed is often the slave to market pricing, it's not always clear which blind man is in front and which one is trailing behind". Little wonder investors are experiencing diversification desperation which is not uncommon when bond markets are at odds with central banks. Bond vigilantes who are known to shoot first and ask questions later are fighting the monetary authorities known for their patience and prudence. The match is not over, and many participants are wondering if the Fed's stubbornness will head the vigilantes at the pass. But this week the red trunks won the round.

While the Fed is calming investors' concerns over a sooner than expected interest rate hike, it is not calming traders' fears over inflation. On this one, I do not believe the Federal Reserve will adopt an irresponsible stance which would bring about an inflation scourge resembling the ones that marked the 1970s and 1980s. The redistribution aspects of Biden's rescue package will help the Fed to keep its stance on hold or maybe even provide comfort by reducing some of the accommodation. On Friday, the Fed announced that the supplementary leverage ratio relief will expire on March 31, meaning that the looser bank capital rules introduced at the start of the pandemic are over. Bank stocks reacted badly because the end of the emergency capital relief will remove some

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lending power. The reinstatement of the 5% capital ratio weighed down money rates to zero, clearly manifesting that the Fed is kosher with the recent bond rout.

Except for the very hot surge in the Philadelphia Manufacturing index, the highest since 1973, all the other macroeconomic prints were very disappointing to a point that the Atlanta Fed GDPNow forecasting model is predicting the real business activity to rise 5.7% in Q1 compared to 10.0% a few weeks ago. The Citi US Economic Surprise Index, which measures how the actual data compared to consensus, dropped to 31.3--it was 92.2 at the start of the month. Additionally, the Conference Board Index of leading indicators hardly moved.

Meanwhile the apprehension that inflation may run away has compelled investors to put the central banks under a microscope and coerced traders to short government bonds. In this regard, ten-year treasury yields rose 30 bps to end the week at 1.75%, widening the yield curve. The gap between 10 and 2-year treasury yields touched 160 bps for the first time since 2015. Obviously, it would be hard to wage against a steeper yield curve. The Fed is determined to keep rates near zero for the 24 months and the economy should be vibrant on both the inflation and growth fronts. While the excellent economic prospects have been beneficial for commodities, financial stocks and cyclicals, the vulnerability of growth stocks to rising interest rates brought a 0.9% decline in the S&P 500 to 3913. It could have been a lot worse. Some $242 billion was deposited in bank accounts on Wednesday. A helicopter drops which produced (according to BofA) a staggering record $68.3 billion flow into equity funds.

Despite all the agitations in the media going into the FOMC meeting, Chairman Powell had an easy press conference. It was an exercise in hammering the same message over and over that the Fed is committed to its new framework of full employment. The monetary officials will provide the economy, whatever necessary, for as long it takes to make sure the goal is attained. The Fed is arguably more focused on Main Street than Wall Street.

Using the experience of the last two decades, Powell argued that Fed actions won't change inflation going forward. He dismissed the interest rate jitters that have characterized the markets since the last FOMC meeting of December 2020. Yet, he acknowledged that the economic prospects have significantly improved, officially raising its economic forecast to 6.5% for 2021 from an earlier projection of 4.2% but reducing the pace to 3.3% in 2022 and 2.2% in 2023 as the impulse from pent-up demand and fiscal stimulus fades. The bottom line is, the monetary authorities believe that the economy will return to the “two-plus-two” long run scenario which prevailed before the pandemic— that is two percent for growth and two percent for inflation.

However, the composition of the 2% in real growth is shifting from employment growth to productivity gains by at least half a percentage point per year. Efficiencies will permit businesses to produce more goods and services with fewer work hours and material inputs. That is what people are actually talking about when they say the economy is on the verge of a boom. It explains why many investors are sanguine about inflation risk. Barrons’

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Mathew Klein argued, there are clues that the pandemic has pushed firms to unlock cost savings, driving up productivity. During January, Americans bought 10% more goods than before the pandemic, even though the number of people working in product distribution—retail, wholesale, warehousing and logistics were still down 2%. Before the pandemic it was politically unwise for businesses to invoke excuses to reduce excess fat and prove technology could actually work as a replacement for labour overload.

Nevertheless, the officials want accumulating proof of substantial progress on employment and inflation goals before paring back on their asset purchase program, even if it means taking the risk of being behind the curve. They are willing to rewrite Friedman's monetary history and declare his theory dead, avoiding the mistake they think they made after the GFC believing the inflation prediction to be too high.

This whole thing is unfamiliar territory for the bond market participants, obliging them to take protective actions. This is why the bond market has found it difficult to find its bearings because unemployment goals are much more subjective than inflation targets. A situation which is riling bond privateers because they think that the reflation objective has its limits. For example, Fitch and Blackrock expect the Fed to announce a tapering or an easing down of its asset purchase programme as soon as the second half of 2021 before restarting the process in early 2022. A variety of central banks (Brazil, Turkey, Denmark, Russia) are either raising their policy rates or are about to do so.

At this time, the Fed is willing to discard a monetary policy rule of preemptively acting against rising inflation. The monetary authorities believe that they are needed to finance soaring federal debt, to avoid a repeat of the 2013 "taper tantrum" and to shun shock reactions in the currency markets. The state of maximum employment is most important and the imminent increase in the inflation rate is thought to be temporary. It may very well be the appropriate assumption because inflation seems to be concentrated in the supply chains in the form of shortages in delivery capacity, plastics, chips, components which are creating havoc in many assembly plants. Surveys on business outlook are showing that manufacturers intend to boost capital spending over the next six months to correct this inflationary bottleneck and take advantage of the humongous volume of private savings which are idly lodged in bank accounts.

In other words, the Fed is of the opinion that the bulk of the rise in ten-year Treasury yields results from an increase in term premia and not inflation expectations. Bloomberg reported on Friday, "the breakeven inflation curve is looking super-distorted right now, with a smorgasbord-sized overhang at the front. Inflation will be higher as pent-up spending is unleashed, and with the help of stimulus checks. But rates further out suggest that inflation will return to the Fed's 2% target."

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Accordingly, the FOMC anticipate no hike until at least 2024 and says it is still too soon to think about scaling back the QE program. However, traders are not completely buying the Fed's narrative, hedging themselves with short bond sales, just in case the Fed ends up wrong and a nasty surprise becomes an outcome. Speculators see many risks. Inflation might not be a big deal right now, but what we have in front of us is a Fed, trying to reverse decades of deflationary psychology. They are expressing the view that the exercise could blow up in the Fed's face bracing themselves for a lift-off in money rates as soon as the first quarter of 2023.

Herein arises the big question. Will the Fed change its mind sooner than projected and take its foot off the monetary accelerator if inflation overshoots too much, too quickly. Officially, inflation is expected to jump to 2.4% as a one-time bulge in 2021 but shift back down to 2% in 2022. Given the theoretical validity of the notion that changes in N-GDP can explain most of the movements in ten-year Treasury yields, it is surprising to see investors opting to shy away from making bond purchases. There is empirical evidence that ten-year Treasury yields tend to be equal to 50%-55% of the anticipated growth rate in N-GDP. In this regard, ten-year Treasury yields could trade up to the 1.90% - 2.20% range without an increase in the Fed's policy rates. Keep in mind, a too fast or a too large increase in the Fed's policy rate could easily lead to a decrease in longer term bond yields and have an opposite effect to that which is heralded in the press.

In my view the outlook for inflation rests on what households are going to do with their personal savings and what corporations do with their cash flows. Two weeks ago, we argued in one of these weekly commentaries that a large part of the past and future government transfers is more of a transposal of wealth than a spending substitution. So what is not spent is saved and what is saved is invested. According to Market Watch, studies have shown that the propensity to spend out of savings is just 5%, while the propensity to spend out of new income ranges from 10% to 50%.

The threat of inflation getting out of control is unrealistic. Indeed, reflation is not inflation. BCA's Dhaval Joshi made a revealing observation stating that inflation expectations are positively correlated with rising commodity prices, even though actual inflation tends to drop when commodity prices are high. Reflect on this—10-year Treasury yields during the worst of the pandemic were at 0.54% and the S&P 500 was 2237. Now these yields are 1.75% and the S&P 500 is 3913. Beware! Pre-pandemic the safe-haven 10-year yields were very close to 2.00% and from 2012 to 2019 the range was between 1.50% and 3.00%. In other words, higher rates are not likely to prevent the reflation from generating the upcoming rebound in corporate earnings.

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The Canadian Dollar Is A Question Mark:

The exchange value of the Canadian dollar closed at 80.00 US cents. Coincidently, it's where my estimated purchasing power parity rate (PRPR) happens to be and luckily the forecast which I reluctantly volunteered last May. Forecasting where currency prices are heading is truly hard because they are shock absorbers.

The Loonie has greatly benefited from the pandemic effect on foreign travel. A notable surplus was being registered in travel services in Q/4 because snowbirds have been restricted from flying south. The latest number on the current account balance which was released a week ago showed the deficit narrowed to only 0.5% of N-GDP—the lowest since the GFC. It is very probable that with the recent improvement in the Canadian terms of trade, a notable surplus may be in the cards for Q/1 of 2021.

While the PPPR possesses the property of pulling currency prices toward its rate, they are always below or above it. Exogenous factors like changes in terms of trade, monetary policy and foreign inflow of capital can distort the forex markets and force currencies to trade far away from their fair value or perceived equilibrium rate. It just so happens, at the present time Canadian terms of trade are pretty much where they ought to be, and the Canadian monetary policy is more or less tracking that of the Fed.

From this point on, I think that the future performance of the Loonie will increasingly depend on whether the Canadian economy is able to attract foreign capital. So far, there is little evidence that we are luring capital from abroad. Investments in Canadian securities from overseas fell in January to $1.3 billion, the lowest in six months. Overall, $2.3 billion flowed out of Canada's economy as Canadians acquired $3.6 billion in foreign securities. What is worthy of consideration, is that Canadians have significantly dialed down their purchases of foreign securities—$3.6 billion in January versus $26.9 billion in December. The reversal is likely linked to the world-wide reflation scenario. The Canadian stock market adjusted for the exchange value of the Loonie, is cheap when compared to the S&P 500–the ratio is 3.8x versus 3.5x a year ago. History shows that this ratio could be considerably higher, especially when reflation predominates.

What I do not like is that very large amounts of private savings are wastefully flowing into the residential sector of the economy, preventing needed capital to flow toward productive and profitable business capital formation. According to Credit Suisse's global wealth report, real estate is the largest source of wealth in an economy, especially in Canada. The Teranet-National Bank House Price Index which is built from the price increase observed between two sales of the same property, is an accurate and reliable indicator of what is actually going on with housing prices in Canada. In the top 11 metropolitan areas, prices were up 2.5 times from what they were in the 20 years ago ending in 2019. And, in the past 12 months they were up another 10%. Consequently, household property is taking an enlarged economic role. When one takes this into account with the large government budget

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deficits, hardly any savings are left for business capital formation. Therefore, corporations are very dependent on foreign capital to finance fixed capital formation and spending on public infrastructures. Unfortunately, it takes a lot of investments in the right place to support a productive economy.

The situation is alarming. But we may be saved by Biden's new fiscal relief program and proposed infrastructure package which could total in the trillions of dollars. Canada is a very open economy, exporting 45% of what it produces of which about 80% is destined to the U.S. Theoretically, approximately 35% of the Canadian economy is dependent on Uncle Sam. In the U.S. imports account for 15% of the N-GDP and of that percentage about 20 % comes from Canada. That could add up to $500 billion of extra purchases of Canadian goods and services during the Biden tenure. It's a crude way of showing Biden's potential effect on Canada—but it shows that there is some upside to the Loonie. I intend to keep my Canadian dollars. The chances are good that there could be a few US cents of further appreciation left in it.

P.S. On Thursday last, the U.S. Department of Commerce held a closed-door virtual meeting with miners and battery manufacturers to discuss ways to boost Canadian production of EV materials and build a U.S.-Canada supply chain; much like Europe has been doing and Asia has already done, according to documents seen by Reuters. It's about how Washington can avoid conflicts with conservationists and find ways to get supplies of 13 of the 35 minerals deemed critical for national defense. It's my understanding that Ontario and Quebec are strategically located and a natural fit — given their ample resources of lithium and other key material like niobium. Reuters added that Washington is viewing Canada as a kind of "51st State" for mineral supply purposes and plans to deepen financial and logistics relationships with our country's mining sector—-a partnership that the Canadian government is supporting says Canadian Resources Minister Seamus O'Regan. Mining accounts for 5% of Canada's economy.

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