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PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

Employment, Productivity, Inflation and Excess Savings
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Submitted April 25, 2021

A Snapshot of the Market for the Week Ended April 23, 2021:

The stock market could have had a very lousy week because the taxation risk reared its ugly head. The New York Times spooked the market on Thursday when it revealed that the tax rate for top earners will rise to 39.6% from 37% and the capital-gains tax could increase from 20% to 39.6% for people earning more than $1 million a year. According to Bloomberg, only 0.32% of American taxpayers would be affected. Nevertheless, a wakeup call that higher taxes are coming one way or another, thus ending the "Belle Epoque" for the super-managers and the rentier class. In spite of drawdowns on Monday, Tuesday and Thursday, the S&P 500 lost only 5 points to end the week at 4180-a shade away from its all-time high of 4185.

Once again, the market was saved by an economy which is firing on all cylinders, while the little bond rally kept chugging along. Yields on ten-year treasuries are now off 16 bps from a recent high of 1.72%. Weekly jobless claims came in better than expected, the Chicago Fed National Activity Index beat expectations, new home sales rose 21% to 1,021 million and the IHS Markit's flash PMIs touched 62.2, the highest on record in data back to October 2009. A hodgepodge of superlatives brought about a 1.3% gain in the Conference Board's Leading Indicators. Meanwhile, first-quarter-earnings are massively beating estimates. With a quarter of the S&P 500's market capitalization having reported results, companies' aggregate earnings per share have beaten estimates by 23%, according to data from Credit Suisse. Given the strength of the economy, many strategists think that earnings will continue to exceed bottom-up estimates. That means expensive valuations are cheaper than they look. The findings of Barron's spring Big Money poll of professional investors showed that "67% of the respondents call

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themselves bullish on the outlook for stocks for the next 12 months. About a quarter are neutral and 7% are bearish. Last Fall, 54% were bullish and 13% were bearish”.

UBS’ Mark Haefele, in a featured story in the Barron, observed that there is no relationship between changes in capital-gains tax rates and the performance of the stock market. While changes to the Internal Revenue Code will likely bring volatility, non-taxable investments like retirement accounts, endowments and foreign ones which account for 75% of the stock markets, are likely to be opportunities for these investors to step in like they did on Friday and take advantage of dips. Moreover, the other 25% that are taxable accounts are not all making $1 million a year. The point is that capital gains tax hikes don’t result in prolonged selloffs.

What Happens Next?

It will essentially depend on how the excess savings will be deployed. In this regard, we need to form an idea on the employment situation and status of productivity, and where these two main factors of production are heading.

The Employment Situation:
The unemployment rate may be high, but the job market is not as loose as the 8.4 million shortfall suggests. The reasons behind this assessment are numerous. First, relief cheques and unemployment insurance, which have been extended to gig workers and made more generous, are keeping potential job seekers on the sidelines. Second, millions are not working because they were sick, caring for someone who was, afraid to show up for work and/or needed to stay home to care for children. Thirdly, many are unwilling to show up for work unless there is more money. The WSJ reported that as demand for workers is recovering, the supply is not. “Adjusted for population growth, the labour force--people working or looking for work--is roughly five million smaller than before the pandemic”. Accordingly, wage rates are rising. The Federal Reserve Bank of Atlanta showed that median wage growth, which filters out compositional effects, was up 3.4% in February and rising.

The Status of Productivity:
Presently, output growth is expected to exceed employment growth at least temporarily. The Congressional Budget Office’s most recent forecast predicts labour-force productivity growth of 1.5% per year for the 2021-25 period, up from an average of 1.2% per year between 2008 and 2020. It may end up being much higher. In response to the pandemic, many firms have made strides toward boosting productivity through automation, digitalization and the reorganization of their business models. Surveys conducted by McKinsey & Company and the World Economic Forum showed that business executives in North America and Europe intend to increase investment in new technologies like digitalization, robotics and sophisticated machinery to accelerate the automation of production. The McKinsey Global Institute (MGI) identified opportunities for incremental

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productivity growth in a wide variety of sectors that account for 60% of the economy. These include health care (telemedicine), retail (e-commerce and warehouse automation), manufacturing (robots, digital channels and connected autos), and even the hard-hit travel industry. If all of this potential is realized, MGI estimated that annual labour growth could increase by about a percentage point to 2.0% per year between 2019 and 2024. That would result in an enormous and dramatic supply-side improvement. Incidentally, I'm thankful to Laura Tyson who writes articles for Project Syndicate for pointing all this out to me.

In a thorough piece of research, the Bureau of Labour Statistics' Shawn Sprague demonstrated that the best way to make use of productivity enhancement ideas is through aggregate demand and inflation management. As a rule businesses tend to hold back on investments if they are uncertain whether demand will be sufficiently strong for their goods and services and whether cost pressures persist thus cutting profit margins. The IMF found that business investment is about demand growth and cost pressure. Martin Sandhu, a columnist with the Financial Times, rightly pointed out that the US has made a very strong commitment to high demand and tolerance for higher inflation through fiscal and monetary policies. He wrote, "as a result, it bucks the trend in the Conference Board's productivity forecast of 1.0% over the coming years".

Excess Savings:

If one were to add up all the pieces that the government has spent on relief since the start of the pandemic, you get about $5 trillion in federal support, almost 25% of the N-GDP. As a result of the enormous influx of federal dollars, Americans are sitting on a huge hoard of unspent money. Before the pandemic, consumers were saving about 7.5% of their disposable income. During 2020, the savings rate soared to about 16.5%--the difference translated into $1.5 trillion in excess savings (and counting). I don't know what people will do with this new treasure. It is a $64,000 question. Will it be hoarded, saved or spent? I wish I knew, because herein lies the future investment landscape. Yet, I see three possible scenarios and each one of them is about inflation.

If only a third or less of the excess savings is spent, there will be a good chance that the current increase in the inflation rate would turn out to be a blip. The Fed would be happy, and it would not change its monetary plan. I give this scenario a 25% chance. I think that there is a far bigger chance, perhaps 50%, that only a third of the excess savings will be hoarded or invested. We shall likely end up with a robust cyclical upward movement in the inflation rate. If this is the case, the Fed will likely be nervous, change its monetary tune and adopt a much earlier tapering program than expected. There is also a real outside probability, perhaps as high as 25%, that consumers could believe that everything is "good and dandy" and spend the entire treasure. Such an outcome would likely create an inflation spike that could amplify inflationary expectation and spark a long-term trajectory of structural inflation. All hell would break loose at the Fed-- a new regime would emerge.

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The Conclusion:
If there is indeed less slack in the labour market than we think and if there is a lot more investment in productivity enhancement ideas and higher inflationary expectations, the reflation and reopening names that are ready and able to rapidly adopt technology advancements will be the winners. They will be ones who will profit from higher inflation because they will be the ones with pricing power. JPMorgan's Marko Kolanovic says, "the reflation trade to resume with a vengeance".

The Canadian Dollar:

The exchange value of the Canadian dollar was 80.07 US cents at the closing on Friday. It has been the best-performing major currency so far this year. Luckily, I got this one right. I'm comfortable with an 83 to 85 US cents target range for the second half of 2021.

Coincidently, the Loonie is trading at Palos' estimated purchasing power parity rate (PPPR) which is 80 US cents. While the PPP possesses the property of pulling currency prices toward its rate, prices often trade below or above the PPPR. Exogenous factors like changes in terms of trade, monetary policy and foreign inflow of capital can price currencies differently from their fundamental values, forcing currencies to trade far away from their perceived fair value or equilibrium rate. Unfortunately, it is very hard to forecast where exchange values are heading because the aforementioned forces that drive prices are unquantifiable. The forex market responds to narratives and usually acts as a shock absorber. Additionally, when it comes to pinpoint currency values, everything is relative.

Nonetheless, it just so happens that the Canadian dollar might be in a sweet spot-- that Canada is in one of those rare moments when the three main factors that usually determine the performance of the Loonie are in sync. It could trend higher, perhaps to 85 US cents, even though Canada is not terribly competitive when the Loonie trades above its PPPR.

Firstly, the Canadian terms of trade have significantly improved as a result of the rapid and robust increase in commodity prices like energy, lumber, agricultural products, industrial metals and minerals. For example, at the end of last December, on average the commodity prices were up 15% whilst the commodities which are particularly important to the Canadian economy were up by significantly more. For the comparable period, the exchange value of the Canadian dollar is up less than 2%.

Presently, the grim situation in India could for a time be a drag on the trajectory of the Canadian dollar. Consumption of diesel and gasoline which is expected to temporarily fall 20% until the coronavirus situation improves. India represents 5.4% of world oil demand, so a 20% fall equates to about 1% drop. Oil analysts believe

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that the decline will not amount to much. The interlude should be relatively easy to absorb, in spite of bigger than-expected flows of unsanctioned Iranian crude, because other economies are growing rapidly. The Citi team led by Edward Morse, a leading expert on the oil market, said that the current pause in the rise of oil price is not a function of deteriorating fundamentals. It is related to financial flows rather than change in supply versus demand bearishness. Citi still expects quarterly declines in total oil inventories through 2021 and possibly into 2022. That spells higher prices into the $70 range for Brent oil, bringing better terms of trade for Canada.

Secondly, the monetary stance of the Bank of Canada has meaningfully diverged from that of the Fed. Interest rate differentials have widened at the front-end and narrowed at the back-end of the yield curve in favour of Canada. The Bank of Canada (BOC) has allowed this to happen because inflationary pressures have been mounting, the housing market is red-hot and the economic recovery appears to be ahead of schedule. A few weeks ago, Deputy Governor Toni Gavelle announced that the central bank was winding down emergency liquidity programs, including programs to buy provincial and corporate bonds it deployed to grease the money and capital markets when the coronavirus struck last year. On Wednesday last, Tiff Macklem, governor of the BOC officially broke it to the market that he's slowing down the pace of the bank's bond purchases. In a nutshell, the BOC is cutting its bond-purchase target to $3 billion a week from a minimum of $4 billion and made it clear that a rate hike may be warranted sooner than originally expected--the second half of 2022 is now a probability. Given that the Loonie is not internationally important and a very marginal reserve currency, the BOC can afford to take more liberty to do what it thinks than the ECB or the Fed. It has no real risk of offending emerging economies or force the ECB and the Fed to catch up. In the words of Louis Vachon, CEO of the National Bank of Canada, the hawkish tone of Tiff Macklem is about being prudent and giving the BOC optionality in terms of policy. As a matter of fact, the Canadian yield curve has steepened to some 30bps (ten's minus two's), strongly suggesting that bond traders are expecting a lot more aggressiveness from the Canadian monetary authorities with swaps trading giving a 50% chance of a rate hike by next March.

Thirdly, Canada has not been in a better position than now to abundantly attract foreign capital. For the first time in years, the relative attractiveness of Canada as a destination for investments has not been better than now. The government introduced a $100 billion growth plan over three years without any increase in the personal income tax, capital gains tax and corporate tax rate. Neither was reference made to a wealth tax. By contrast, the US administration is determined to raise taxes on personal income, capital gains and corporate profit. Interestingly, it's happening when a strong cyclical reflation is apparent, the indirect beneficial effect of Biden's infrastructure package on Canada's economy could be huge and Washington is viewing Ottawa as a strategic partner in the development of minerals deemed critical for national defense. The Canadian stock market, adjusted for foreign exchange, is very cheap when compared to the S&P 500--the ratio is only 3.7x. History shows that this ratio could be considerably higher especially when cyclical reflation dominates the headlines.

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(An English message follows)

Le Département de science économique et la Faculté des sciences sociales de l'Université d'Ottawa vous convient à la Série de conférences Marleau sur la politique économique et monétaire. Joignez-vous à notre prochain webinaire avec la professeure Emi Nakamura (Université de Californie, Berkeley).

Date : Vendredi 30 avril 2021

Heure : 15 h – 16 h 30, heure d'été de l'Est (19 h – 20 h 30 UTC)
Où : En ligne sur ZOOM
Titre : *The Slope of the Phillips Curve: Evidence from U.S. States*

Résumé

Nous estimons la pente de la courbe de Phillips avec des données transversales des États américains en utilisant des indices de prix nouvellement construits pour les biens non échangeables depuis 1978. Nos estimations indiquent que la courbe de Phillips est très plate et qu'elle l'était également au début des années 1980. Nous n'estimons qu'un modeste déclin de la pente de la courbe de Phillips depuis les années 1980. Nous utilisons un modèle multi-régions permettant d'inférer la pente de la courbe de Phillips agrégée à partir de nos estimations régionales. L'application de nos estimations à l'analyse de la dynamique récente du chômage ne produit pratiquement aucune désinflation ou réinflation manquante au cours des derniers cycles économiques. Nos résultats impliquent que la forte baisse de l'inflation de base au début des années 1980 était principalement due à des anticipations changeantes concernant la politique monétaire à long terme, plutôt qu'à une courbe de Phillips pentue, et que la plus grande stabilité de l'inflation depuis les années 1990 est principalement due à un ancrage plus solide des anticipations inflationnistes à long terme.

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Inscription

La participation est gratuite. Il est nécessaire de s'inscrire pour obtenir le lien ZOOM. Une confirmation d'inscription sera envoyée par CITEwebi2@uOttawa.ca.

Inscrivez-vous aujourd'hui !
(l'événement se déroulera en anglais)
Nous avons hâte de vous accueillir!

The Department of Economics and the Faculty of Social Sciences of the University of Ottawa invite you to the Marleau Lecture Series on Economic and Monetary Policy. Please join our next webinar with Professor Emi Nakamura (University of California, Berkeley)

Date: Friday, April 30, 2021

Time: 3 p.m. – 4:30 p.m., Eastern DST (7 p.m. – 8:30 p.m. UTC)
Location: Online on ZOOM
Title: The Slope of the Phillips Curve: Evidence from U.S. States

Abstract

We estimate the slope of the Phillips curve in the cross section of U.S. states using newly constructed state-level price indexes for non-tradeable goods back to 1978. Our estimates indicate that the Phillips curve is very flat and was very flat even during the early 1980s. We estimate only a modest decline in the slope of the Phillips curve since the 1980s. We use a multi-region model to infer the slope of the aggregate Phillips curve from our regional estimates. Applying our estimates to recent unemployment dynamics yields essentially no missing disinflation or missing reinflation over the past few business cycles. Our results imply that the sharp drop in core inflation in the early 1980s was mostly due to shifting expectations about long-run monetary policy as opposed to a steep Phillips curve, and the greater stability of inflation since the 1990s is mostly due to long-run inflationary expectations becoming more firmly anchored.

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Registration

Attendance is free. Registration is required to obtain a ZOOM link. You will receive confirmation of your registration from CITEwebi2@uOttawa.ca.

Register today!

We look forward to welcoming you to our virtual event!

Acknowledgement

The Marleau Lecture Series on Economic and Monetary Policy was established in 2019 through the generous contribution of Mr. Hubert Marleau (Palos Management). Please visit our website to learn more about the series.

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