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Weekly Commentary

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By Hubert Marleau

The Fog Is Lifting: Growth Will Pick Up and Inflation Will Roll Over This Winter

Submitted October 31, 2021

A Snapshot of the Market for the Week Ended October 29, 2021:

In the quarter ended September, the R-GDP rose at an annual rate of 2.0%, while the GDP-deflator rose 5.7%. Except for the inflation rate, which is still out of whack, the pace of the real economy has essentially returned to normality. Investors should take note that the personal savings rate was 7.5% in September and this was where it was before the pandemic hit us. While these numbers reflect less than the forecasters were expecting, the performance would have been much better in both cases had the economy not been hampered by supply-chain bottlenecks and a resurgence of the pandemic. Inflation upset growth. The sharp slowdown in consumer spending to an annual rate of 1.6% reflected weakness in expenditures on long-lasting durable goods, the availability of which was limited by supply issues. Spending on durables fell more than 25%. The headline print was short of consensus, but it was significantly above the Atlanta Fed's NowCasting estimate of 0.2%.

Personally, I like analyzing what has occurred broadly in the economy with a longer perspective than three months. Year-over-year comparisons eliminate kinks which are often related to seasonality, irregularities and statistical errors. The U.S. GDP expressed in nominal terms is up 9.6% from last year. Employment growth accounted for 4.9% of the increase, productivity 0.2% and inflation about 4.7%. Viewed differently, the broadly defined money supply (M2) was up 12.6%, while its velocity posted a 3.0% decline. The money supply did not result solely from the issuance of productive bank loans, but from quantitative easing and reduced government deposits at the Fed.

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With growth in several key industrial sectors near or above potential, roughly half of the monetary stimulus generated the surge in the inflation rate. Now that the cat is out of the bag, traders alarmed the market that the Fed will have to conform with the realities of the current stage of the economy and perhaps imitate the precautionary tightening actions of their peers around the world, making interest rates chaotic. In the span of a few days, the front end of the yield curve is now pricing preemptive rate hikes as a virtual melee of central banks from the UK to New Zealand, and Canada to Australia said they could as early as this coming spring. In this connection, Goldman Sachs brought forward its forecast for Fed liftoff to July, followed by a second hike in November 2022 and two other hikes per year after that. Thus expecting a policy mistake to become a tail risk for market speculators is a reasonable assumption. In quantitative terms, it means that core PCE will stick above 3% and core CPI above 4.0% when the taper ends, presumably next June.

While I'm absolutely certain that the ECB and the Fed will soon taper their bond-buying program, I am very skeptical that they will succumb to the temptations to raise their policy rates because all of the foreign monetary moves were sparked by non-domestic factors. These two big central banks are unlikely to hike rates as much as the market expects. They are not "trigger happy''. Preemptive rate hikes to manage risk is not consistent with past behaviour. What exists is a coordinated attempt to tighten at the margins.

Additionally, none of the early respondents bear heavy world-wide responsibilities. Powell and Lagarde must keep an eye on global growth and its unevenness because the dollar and the euro are the foremost reserve currencies. The fragility of the economic system raises the stakes for these two institutions. Rebecca Wang at Nomura in a note to her clients wrote: "It would be difficult for the major central banks to plead mea culpa that the aim is to achieve a maximum employment goal and admit that the current high rate of inflation is not transitory because it would be a powerful signal for their counterparts to also consider changing course." In fact, the long part of the yield is not convinced that inflation will run amok. There have been inflows from long-duration bond-buyers. In any case, she made it clear when she said: "Our analysis certainly does not support that the conditions of our forward guidance are satisfied at the time of liftoff as expected by markets, nor any time soon thereafter". The message is indeed clear that the big central banks will do what they think they should do and give the markets "carte blanche" to interpret what is going on as the traders see fit. It's true that signals from the financial markets are hard to decipher. But one thing is certain, the central banks are of the opinion that the one who is making a mistake is the bond market. Bloomberg's Roberto Perli noted that none of the bigger moves in bond yields happened when the Fed was about to raise rates.

The spectre of tighter central banking is overdone: The bliss of easy money isn't about to be snatched away. The yield curve remains positively sloped. The Fed's policy rate would have to be hiked four times in bouts of 25bps to meet the so-called neutral rate, which I estimate to be around 1.25%, significantly lower than the

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2.5% which the Fed reckons. The Bank Credit Analysis hypothesizes that it could even be higher. That's theoretical. The market is effectively discounting a policy of only 0.50%-0.75% for late 2022. Moreover, it would be illogical to let this happen until the winding down of the central bank's current monthly purchases of $120 billion of securities is completed, which will likely be explained at Wednesday's FOMC meeting.

Although the macro narrative is centered around the conjecture that growth peaked over the summer and that the inflation rate is cresting, a recession in the conventional and strict sense of two quarters of negative GDP growth is not a probability: it's almost impossible. The ending of lockdowns, the reduction in Corona virus caseloads, and amassing of personal savings means that shoppers are well-positioned and incentivized to open their wallets this holiday. Moreover, an historically enormous amount of business capital is being allocated to information processing, industrial and transportation equipment along with intellectual property products like software and R&D. In the September quarter, businesses spent $2.5 trillion (saar), 13.0% more than a year ago. Given that the corporate sector, as many surveys show, eagerly wants to raise the prospective returns on its. invested capital, corporations are incorporating new technologies and other efficiencies. In this connection, the prospect for productivity growth will act as an inflation shock absorber, which should partially offset the rising cost of employment. At this time, worrying about productivity is contrarian. Economists and strategists are predicting a technology-led boom in coming years: Yardeni says odds are 65% that the current decade plays out like the Roaring '20s, not the 1970s, as companies innovate in response to the chronic labour shortage.

Given recent economic prints like new orders, job claims and sentiment surveys like one conducted by the Conference Board, chances are good that the economy will experience slightly above-par growth and get back to its pre-Covid trend with less supply constraints. Interestingly, the Baltic Dry Index, which is a strong leading indicator of the intersect between supply and demand, is still somewhat high by historical standards; but it's down 2020 points to 3630, registering a whooping decline of 36% in less than three weeks. It means that the story that one cannot buy what cannot be produced might become less problematic as the demand for hard goods wanes in favour of services. The bottom line is that at the moment, things are looking much better. IHS Markit projects output to expand at a 5.2% annual rate in the year's final three months and the initial estimate of the Atlanta Fed's GDPNow model is 6.6%. As a matter of fact, high frequency consumer activity numbers such as flights, restaurant dining and hotel stays have turned higher through mid-September into October. Personally, I'm backing JPM's Camporeale's view that the R-GDP will grow around 4.0% in 2022 and that inflation will be between 2% and 2.5%.

It's not that all the problems, hurting the economy are about to go away. The bond and commodity markets are signaling possible troubles, spelling rough waters for stocks in the near term. The yield curve has

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flattened, inflation expectations have stabilized and so have commodity prices: a situation, which could once again turn into another buying opportunity. There are anecdotals here, there and everywhere that the ketchup bottle could suddenly unplug. Deliveries are quicker today than they were a few months ago. Given the reduced number of Covid-19 caseloads, the view that the cyclical equity recovery is still on should persist. Thus the contrasting inflationary-productivity boom, which has characterized the pandemic economy, will continue but with less intensity. While earnings stayed in the spotlight throughout the week, the improving outlook for higher growth and less inflation has helped new money to flow into equities. The S&P 500 was up 60 points or 1.3% to end the week at 4605. The S&P 500 notched a respectable 6.9% for October, leaving a seasonally weak September and entering a usually strong November season. Since 1950, November has been one of the best months of the year.

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