PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

Formulating a View on the Fed's Monetary Stance

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On Wednesday, the minutes of the Federal Reserve's December policy meeting revealed that the monetary authorities had turned out to be more hawkish than the market generally anticipated. They telegraphed that they could not only raise the policy rate earlier, but at a quicker pace than the official plan and revealed that they had also started to discuss how to reduce the Fed's massive $8.8 trillion holding of government bonds. Abandoning any pretence of patience and leaving gradualism behind, the Fed spooked traders, sending the S&P 500 and the tech-heavy Nasdaq down 1.9% and 3.3% respectively, having seemingly started the new year on a strong footing. There were signs that the Omicron Covid-19 variant was less severe, labour conditions were improving and supply-chain bottlenecks easing. Speculators were betting that business conditions would not derail economic growth and/or cause more inflation than was already expected.

Firstly, the Mfg-ISM supply manager surveys hinted that maybe inflation had turned. The survey showed that what the manufacturers must pay to buy inputs had dropped remarkably, even though the numbers showed that the economy was still in a strong expansion mode. The "price paid" index fell from 82.4 to 68.4, for the biggest one-month decline in more than a decade, suggesting that supply constraints had significantly improved. Meanwhile, activity in the U.S. service sector expanded at a slower rate in December amid a deceleration in demand and production, the Service-ISM gauge having fallen to 62 from a record 69.1 in November. The rate growth is still strong but the pullback should ease pricing pressures in this sector as wait time for supplier deliveries improve.

Secondly, people are getting back to work at a brisk pace. The ADP's December employment report, which measures the change in employees on private companies' payrolls, said that 875,000 jobs were added last month, while the Household Employment Survey showed a gain of 651,000. Although the Non-Farm Payroll showed that the U.S. only added 199,000 in December, missing consensus estimates of 422,000, the strength in the labour market was detectable in the reduction in the unemployment rate, which fell 30 basis points to

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3.9%. At this point, the unemployment rate is only 40 basis points above where the Fed expects it to be in Q4 of 2022. We can now say with assurance that the economy is operating beyond full employment because a large portion of the participation shortfall is voluntary. The lower participation rate is mainly due to the fact that many people over 55 years of age no longer wish to work. This rare phenomenon, perhaps pandemic related, has brought about a magnitude of job openings, an elevated quit-job rate and rising average hourly earnings. Surveys conducted by various research groups found that

workers are quitting their jobs for higher wages, more flexibility, better opportunities elsewhere or to run a gig out of their home.

The Beveridge curve, which illustrates the relationship between job openings and unemployment, shows a big outward shift from the last recession and the rebound, suggesting a sizable disconnect between employers and potential employees. While the curve is slowly converging toward the pre-pandemic Beveridge curve, it is still off the chart.

The Fed confirmed that fighting inflation was more important than protecting growth because the economy is strong enough to stand on its own two feet. This was sensible, especially because the minutes of the December FOMC meeting had taken place before the Omicron coronavirus variant cases really took hold. The inflationary content of the Misery Index (inflation rate-6.8% y/y plus unemployment rate-3.9%) is extremely high at 63.6%. The Palos Monetary Policy Index, which calculates the interrelationship between price stability and full employment, is negative suggesting that the Fed has no other choice than to tighten its monetary stance: the risk of negligence would be too drastic.

Many pundits are now wondering at what level of a market selloff the Fed would be willing to tolerate before changing course. As long as the brunt of a drawdown is confined to the tech high flyers, they will remain steadfast. So far so good: severe pressure is essentially concentrated in the non-profitable speculative sector. I know enough about how the monetary authorities think to appreciate that they will not keep the so-called “Fed Put” in place to protect the price of these highly risky assets. Why should they when fundamentals were not respected while they were going up? Smashing market perception is precisely the way to get the job well done.

In this regard, I do not expect the Fed’s calculus to change for the time being, even if the inflation rate were to subside. Indeed at the end of the day on Wednesday, traders in interest-rate futures were pricing in an 82% chance that the Fed would raise its policy rate by 25 bps at the March meeting. Unsurprisingly, blue-chip corporate issuers rushed in, in an all-out sprint into the primary bond market, raising over $60 billion in a

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week. To make room for this frenzied deluge, investors offloaded Treasuries, which made matters worse for government notes but at least prevented indigestion in the corporate bond market.

From hereon, the future performance of the U.S. dollar and bond markets will determine whether the Fed will stick with its confirmed hawkishness. On December 31, 2021 the DXY was 95.53, the yield on ten-year notes was 1.49%, the neutral rate was 1.25%, the 10/2 yield spread was 77 bps, the five-year inflation expectation was 3.01% and an ounce of gold was trading for
$1828. At the close on Friday, these crucial market variables had changed so much that the tail risk, represented by the skew index, dropped to 140 from 155 a week earlier. For example, the

DXY ran up to 96.20, ten-year bonds rose to 1.77%, the neutral rate nudged to 1.50%, the 10/2 yield spread widened to 90 bps and the five-year inflation expectation dropped to 2.8%.

In this connection, it appears that the market has confidence that the Fed will be able to navigate interest rates in a way to contain inflation without crimping growth. As a matter of fact, it seems natural that most of the movement in the fixed income market was in the rise of real rates. Thus the Fed's pivot was probably more tactical than strategic. In the week ended January 7, 2022 the S&P 500 decreased 84 points or 1.8 % to close at 4682—2.4% % lower than its all-time high. Interestingly, Bloomberg noted that Dennis DeBusschere, who was voted the No. 1 U.S. portfolio strategist in last year's Institutional Investor survey, sees the S&P rising to 5040 by year-end. I suspect that this bullish bet is related to the forecast that the aggregate earnings of companies in the S&P 500 will reach 5.0% in 2022. That's 3.25% more than a 10-year bond would yield. History shows that's enough to compensate for the risk of holding stocks. Jacob Sonenshine, a writer for the Barron's, wrote: "Since 1960, when the gap between stocks' and bonds' expected yields has been between 2 and 3 percentage points, the S&P 500 has seen an average gain of 11.8% for the subsequent 12 months, according to data from Truist."

So it's not about whether investors should own stocks: they should. Technically, government bond yields have reached a resistance level. Should the stock market fall a bit more without a corresponding rise in long-term bond yields, a quick bounce-back would likely occur. It's not so much the level of yields that matters as much as it is the rapidity of ragged rise. In the Barron's Market Lab, I saw that insiders were buying more than selling stocks. That's a bullish sign.

A number of strategists have noted that the Fed may think surreptitiously that it would be a better idea to reduce the size of the balance sheet than raise the cost of money, preferring to reduce liquidity as opposed to increasing the cost of capital. Given the much lower interest rates in the rest of the developed world,

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raising the target rate too soon, too much and too fast could bring about undesirable effects in the foreign exchange market.

I think this idea has merit on two counts. Andrew Lees of Macro Strategy Partnership made an astute comment: "During the GFC, Bernanke said that USD600bn of QE was the equivalent of 75bps of rate move. Given the relative scale of M2 money supply today compared with back then, the USD 1.44trn annual QE would be roughly the same size, so the tapering by the end of March would theoretically be equivalent to a 75 bps rate hike." This means that it would only take two rate hikes to bring the target rate to the neutral point.

Moreover, there is a high probability that if nothing is done to reduce liquidity in the system, there could be too much of it for a market economy to handle. As I have mentioned on several occasions, there are factors at play here which could offset the liquidity drag of an accelerated

tapering process and the needed increase in treasury issues to rebuild governmental deposits at the Fed. It is very likely that commercial banks will use their excess reserves at the Fed to make commercial and household loans as government repayments fade; financial institutions will draw down $1.9 trillion of reverse repo as short rates rise and consumers make use of their excess savings.

Conclusion: I have been avoiding making new buys in the technology sector for a while now, but I have not sold any of my prime positions in such stocks as Amazon, Google, Microsoft, Cisco, Intel, Facebook and Apple, In spite of the negativity of rates, regulations and redistributions. I continue to be excited about the commodity sectors(copper and oil particularly) and financials (banks and insurers); but I've also started to scale down my purchases in these sectors. I agree with JPMorgan's economists predicting that global inflation will slow to a still-heady 3.5% this quarter from 5.9% in Q4 of 2021 and that we may get a downside Inflation surprise. It may very well happen. The dollar value of the world money supply has been softening. Andrew Lees of the excellent research firm called The Macro Strategic Partnership, calculates that the world money supply is up only 4.38 y/y, and up an annualized 2.51% over the past three months and 2.63% over the past six months. Of course the velocity of money could rise, but it's not very likely. Rising food and energy prices are claiming an increasing part of people's disposable income. In this regard, I intend to trade up in quality toward defensive growth such as healthcare, staples, utilities and corporate bonds.

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