PALOS

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Weekly Commentary

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Macro View

By Hubert Marleau

Six Turning Points Will Change the Times

Submitted February 14, 2022

The exhausting speculation about what the Fed is going to do next is the "soup du jour". It's affecting risk sentiment on a daily basis and is what the press is constantly printing in the financial pages. The zeitgeist fluctuates between hiking interest rates forcefully into a slowdown; hiking lightly into a boom; or moderately into a soft landing.

Most investors say they are cautious, fearing that they are facing a bear-case scenario. Yet neither stagflation nor an inflationary bust is in the cards. Interestingly, the SPX Skew Index is rather mushy, statistically manifesting no tail-risk anxiety that either scenario is likely. Traders have monetized protection hedges and feel that the market has sold off enough not to warrant them rolling their positions. The Fed may indeed have a huge task on its hands and needs to tread carefully. It will likely act cautiously and therefore avoid applying the brakes too hard or too fast because the objective is indeed to bring a soft landing. There is no way that they will hike interest rates 17 times in a row like they did in the 2004-2006 cycle. It's unnecessary.

First, the Fed is already tightening, even though the monetary authorities have not actually raised their policy rate or started a tapering process. Second, the forthcoming tightening cycle may not be all that bad because the economy has good fundamentals: productivity and private savings. Third, rate hikes can do nothing to resolve supply-chain problems. They can only take some steam out of the demand side of the economy, which has already begun. The Atlanta Fed's NowCasting model is predicting that R-GDP will increase by only 0.7% in Q1. Four, the federal government has closed the spending floodgates to battle the effects of the Coronavirus. It ran a budget surplus of $119 billion in January, compared with a deficit of $163 billion in the same month of last year. For the fiscal year to date, the deficit was $259 billion compared to $736 billion last year. Thus the removal of the bond-purchase program may not be as U.N. prudent and consequential as traders argue. On the contrary, bond investors are pricing in a relatively sanguine economic outlook.

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In this regard, the financial markets could withstand gradual and predictable hikes. Deutsche Bank has a shadow policy rate - a model that maps the signals from the yield curve into Fed funds' equivalent rate - that has risen 85 bps. This movement suggests yields have been partially adjusted to the upcoming monetary stance. The upshot is that both the Fed and the market have already kick-started the process. Furthermore, the rise in oil prices has raised the global energy bills to 9.0% of world GDP from 4.50% a year ago: that is effectively equivalent to a 50 bps rate increase. By the end of the day on Wednesday, the market was thinking in 25 bps increments until the neutral rate is attained.

A Snapshot of the Week:

In the first three days of the week, the S&P 500 rose 86 points and the DXY was stable. So were inflationary expectations, credit spreads and the yield curve. On Thursday, however, everything changed, particularly perceptions. The BLS reported that the consumer price index was up 7.5% last month compared with January 2021. On a monthly basis, the CPI increased 0.6%, steeper than predicted by most economists, driven by food, electricity and shelter costs. The financial markets did not like the inflation numbers. They kicked and screamed. U.S. stock prices fell distressingly hard, reversing some of the gains that had been made earlier in the week. Meanwhile, yields on 10-year Treasury notes ticked up 10 bps, touching 2.05%, and the 2-year to 1.62%, significantly flattening the yield curve and surprisingly leaving the DXY around 95.50–suggesting an overreaction. It goes without saying that these numbers were discomfiting, providing fodder for those guys who were looking for a 50 bps rate hike in March. Fearing that sticky inflation was already present, St. Louis Fed President James Bullard told Bloomberg News that he was open to a 50-basis point hike in March and wanted to see 100 basis points by July. That would take the policy rate to the 1.00%-1.25% range, pretty close to where the neutral rate is, where price stability coexists with full employment, between 1.50-1.75%. The 2's-10s curve has flattened to 43 bps: not recession-prone, but enough to reduce the potential profitability of bank lending, and therefore monetary growth. The money markets are implying a possible 50 bps intra-meeting hike as soon as now, and a further total of 125 bps in the rest of 2022. I find this difficult to accept, even though the financial conditions are loose enough to take it on the chin. An emergency increase of 50 bps would signal panic and cement criticism that the Fed is indeed far behind the curve. Bullard is not alone on that committee, however. I don't think he even has a vote. It may be a political football.

Nevertheless, should the Fed opt for these larger and faster increases, it would probably stay put in the seasonal half of the year and then directly reduce liquidity by leaning more on reducing the balance sheet than flattening the yield curve further. This would make good sense. I cannot believe that they would abruptly cause a recession in the middle of a midterm congressional election. In the current environment, lower-income households are seeing very large wage gains, and are actually the only cohort of workers who are

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getting real income growth. These relative gains are very much in tune with the Fed's economic new objective and philosophy. Acknowledging that hiking rates is of no help to low-income consumers, would it not be better to reign in monetary accommodation through a defined tapering process? This idea has not gone unanswered, Kansas City President Esther George having stated that reducing the central bank's balance sheet could allow for fewer rate increases.

On Friday, the market calmed down in the morning, thinking that it had overreacted to Thursday's print on inflation. Unfortunately, it did not last. Every sector, except energy, took the Washington-London announcement that Russia was about to invade Ukraine very badly. The market took a severe beating, while oil prices rose to new highs. The global energy bill now accounts for almost 10% of the world nominal GDP. At some point, too high a cost for energy could lead to an inflationary bust. We are not there yet, but closing in. Should the confrontation worsen over the coming weeks, oil could trade up to $125 a barrel. However, if progress toward a peaceful resolution is achieved, the price of oil could tumble to $85. The situation partially explains the backwardisation of oil futures. The 12-month future oil price is currently $82.80, $11.13 lower than the spot price of $93.93. It should be noted that such an occurrence is infrequent, either because of a sudden rise in demand, a potential reduction in supply chain, or an actual disaster.

In the week ended February 11, the S&P 500 decreased 82 points or 1.8%%, to 4419, putting an end to a two-week rally.

Six Turning Points:

<u>The Pandemic Is Over:</u>

Sweden has officially declared the Covid-19 pandemic over and done with. Pressure is mounting on politicians to end capacity limits in restaurants, vaccine mandates and masking requirements. England, Australia, Alberta, New York, Spain and many others are scrapping pandemic restrictions, while the push-back against pandemic emergency orders and overreach is global. Political pressure is mounting and relentless. The balance of recent surveys clearly suggests that the desire to return to normalcy has overtaken alarms about the Coronavirus itself. People are tired of the inconveniences, which have stretched far too long. Fully 70% of Americans agree with the statement that it's time we accept that Covid is here to stay, and that we just need to get on with our lives. Health officials and epidemiologists are working around the clock to find ways to dial back restrictions and implement unobstructive measures so we can live freely with the virus.

<u>Demographics are Different:</u>

The population is aging, individualizing, sharing and slowing. That means more savings and less growth.

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Productivity Has Broken Out:

The pandemic has spurred productivity-enhancement investments. There is a major composition shift on the supply-side of the economy in the form of automation, gigs, digitalization, logistics and ordering, which is allowing more output with fewer hours of work. Data released last week by the BLS made it official that productivity had turned the corner. Labour productivity grew at a brisk 6.6% annualized rate in the December quarter of 2021, the fastest in 20 years. Firms and workers are incentivized to be more creative and efficient. The wish to work from home has brought about the spread of flexible-work apps, allowing flexible hours, eliminating distances, distributing more information, improving the quality and quantity of matches, reducing bureaucracy, and creating more opportunity in the labour market. In the past, when prices dropped, supply needed to come down to reach equilibrium. Today, digitalization has abruptly changed this equation. In a digital economy, businesses react as much to changes in costs as changes of prices. In other words, lower costs lead to more supply, as with chips, data storage and bandwidth. Research conducted by the Deutsche Bank suggests that productivity could trot as fast and as high as 3.5% over the coming years. I suspect that the monetary officials are conservative in that they probably only expect it to run roughly around 2.0%. It still means that 4.5% wage growth could be consistent with price inflation rising slightly above 2.0%. Even Tiff Macklem, Governor of the Bank of Canada, also got into an upbeat act. He's optimistic about the outlook for Canadian productivity.

Monetary Policy Is Normalizing:

The new road to travel for Central Banks is to normalize their monetary stance. The world's most influential central banks (FRB, ECB, BOJ, BOE and BOC) are taking actions to regain control of the inflation narrative and contain further damage to their policy credibility. This hawkish policy pivot is here to stay. Central banks are on a mission to move monetary conditions to a neutral level: a rate estimated to be roughly 1.50%. This is low by historical standards, because the financial markets, the economy and monetary conditions are considerably more sensitive to real rates than in the past. The debt load and the convexity of low interest rates explain this weird phenomenon.

Inflation Rate has Peaked:

I'm not denying that inflation is hot at the moment. The current inflation rate is the highest since 1982. Ironically, it seems plausible that we're seeing the inflation stain on the economy might get washed away, returning inflation closer to its usual average. There is evidence that exertion in the supply chains has not been due to too much demand, but rather a sharp change in its composition, which has had the effect of taxing ports and logistics. In this connection, inflation will soon dip as low as 4.0% later in the year. Leading economic indicators like wholesale inventories and the Baltic Dry Index are suggesting that pricing is abating because bottlenecks in the supply chain are easing. Moller-Maersk, the world's largest shipper, suggested

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the global supply problems had peaked, and bottlenecks would be alleviated in Q2. Additionally, Foxcom, which buys upwards of $55 billion of semiconductors every year, expects significant improvement in sourcing chips in Q1 and an overall improvement in their supply chain by summer. Inflation is therefore expected to clock 2.5% in 2023 and 2024, and fall to 2.0% in the following year.

There are some encouraging signs under the hood that recent upward pressure from goods shortages are fading. Prices for core goods slipped in January for the first time since Covid started. Shoppers will likely stop hoarding. They may have already started. The inventory-to-sale ratio at US retailers shows the number of months of inventory on hand is rising. Stockpiling food and household goods will taper off as governments permanently see fit to relax their pandemic restrictions.

Sales at bulk retailers were 27% higher in dollars and 18% in volume during the fourth quarter of 2021, compared with the same quarter of 2019. That comes up to an annual rate of about 9% per year, after more than 20 years of steady and slow growth of 2.0% in real terms. What does that tell you? The New York Fed's Underlying Inflation Gauge, which captures sustained movements in inflation from information contained in a broad set of price, real activity and financial data, is currently estimating that basic inflation is up only 0.1% from the previous month and 4.6% year-over-year, significantly less than the CPI. In fact, the 3-month CPI annualized increase, while still elevated, has been slowing down since October.

<u>Alliance of Autocracies In the Making:</u>
Short of a formal bond, China and Russia have created an agreement to quash geopolitical tensions, counter economic sanctions and minimize diplomatic pressures, in order to attract other autocracies (Turkey, Hungry, Belarus, Iran and Venezuela) into their sphere, thereby increasing their international influence in the Arctic, Central Asia, the Middle East and South America. For the first time since the Berlin Wall was torn down, the world's democracies are facing a growing challenge that could turn into a major confrontation with autocratic countries. The Chinese/Russian Concord creates the potential for many more geopolitical conflicts, like the ones in the Ukraine, Kazakhstan and Taiwan. It is indeed very troublesome, because autocracy is on the rise all over the world, according to the latest edition of the Democracy index, which The Economist publishes every year. This annual survey, which rates the state of democracy across 167 countries on the basis of five measures - electoral process and pluralism, the functioning of government, political participation, democratic political culture and civil liberties - finds that more than a third of the world population lives under authoritarian rule while just 6.4% enjoy a full democracy.

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Conclusion:
The US stock market is about as cheap as it was before the pandemic hit. The selloff in growth stocks has brought back valuations close to historical norms. On Friday, the S&P 500 was trading at 19.5 times projected 2022 earnings, slightly above the five-year average of 18.9. (Take note that long-term bond yields were trading above 2.00% during the period under review.)

Barring a geopolitical catastrophic event, a gigantic market correction, in stock or bond markets, of the type that could push the economy into a recession, is essentially out of the question. It appears that the economy will continue in an inflationary, expansionary quadrant - so-called “growthflation” - for a while longer. But, given the aforementioned six big macro turning points, I suspect that a new pattern of returns from commodities to equities will eventually emerge, perhaps sooner than anticipated by the Street. In time economic data will likely show that the economy is transitioning to a different quadrant, which may resemble the disinflationary one that prevailed in 2014-15. Put simply, my best guess is that GDP growth will decelerate to about 2.5%, by 2023 but stabilize thereafter; meanwhile real 10-treasury yields should rise to 1.00% and find an equilibrium. In connection, the time may soon be ripe to take a position in dividend-paying stocks. I don't believe banks will compete. They have little incentive to raise the interest rate they pay on deposits. Flush with cash and excess reserves, they don’t need more deposits.

P.S. 1 The economy has four quadrants:

Disinflationary Expansion: Low inflation, low unemployment and growth.
Delaflationary Contraction: Low inflation, high unemployment and no growth.
Inflationary Expansion: High inflation, low unemployment and growth.
Inflationary Contraction: High inflation, high unemployment and no growth.

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You are invited to a Zoom webinar.

Date Time: Feb 18, 2022 02:30 PM Montreal
Topic: The Rising Cost of Climate Change: Evidence from the Bond Market (Conférence en anglais seulement/Conference in English only)

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Description: Social discount rates (SDRs) are crucial for evaluating the costs of climate change. We show that the fundamental anchor for market-based SDRs is the equilibrium or steady-state real interest rate. Empirical interest rate models that allow for shifts in this equilibrium real rate find that it has declined notably since the 1990s, and this decline implies that the entire term structure of SDRs has shifted lower as well. Accounting for this new normal of persistently lower interest rates substantially boosts estimates of the social cost of carbon and supports a climate policy with stronger carbon mitigation strategies. To read the paper : https://bit.ly/3rGknF9

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