PALOS

Weekly Commentary

Issue No. 13 | MARCH 28, 2022

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Macro View

By Hubert Marleau

The Soft-Landing Scenario

Submitted March 27, 2022

The Weekly Snapshot of the Market:

Last week data socket was a smattering of secondary economic prints that rarely move the needle. Instead, the drama of the week was dominated by war headlines, Fedspeaks, and the oil market creating fast and furious changes. Consequently, it has been hard to retrofit a narrative to the price volatility. Nonetheless, it is remarkable that the S&P 500 was up 80 points or 1.8% to finish at 4543, despite an horrendous increase in bond yields and a significant flattening of the yield curve. International capital-flow data are showing concerns among global investors about the security of investments in China, given its diplomatic friendship with much-sanctioned Russia. The Institute of International Finance (IIF), an association of the world's biggest financial institutions, reported on Thursday a surge in outflows of money from China. There is suspicion that this money has been earmarked for the North American and European capital markets. Equity funds raked in $93 billion over Q1 in a weak market. Furthermore, buyback authorizations are on track to 2021's record $1.2 trillion. Goldman Sachs expects gross buyback to reach $1 trillion this year, up from $870 billion in 2020.

As to Ukraine, Russia might be recalibrating its military strategy. Putin appears to have done a sudden pivot, telegraphing that he's fixated on Donbass, the easternmost region of Ukraine that borders on Russia. In a public communique, the Russian military said it was now focusing its efforts on taking full control of that region - a sign that perhaps the Kremlin may be backing away from taking large swathes of the country, lessening its former ambitious objective. The fighting has been hard with little gains.

The stock market has a mind of its own. It tends to interpret policies, events, and economic prints in terms of theoretical probabilities. As a result, market conclusions can sometimes look very weird and outside the box. Right now, the media pundits are falsely comparing the recent surge in inflation to what happened in the late 1970s and early 1980s. But, markets believe the experience of post-WW11 is a better comparison. In the

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meantime, the Federal Reserve's latest hawkish pivot has been welcomed with open arms by equity traders, who were being far more fearful before the hiking cycle started than they are now; until Russia threw a monkey wrench in the marketplace. So far, however, global economic activity has held up fairly well since the start of the war in Ukraine, showing welcome resiliency. The S&P Global/CIPS composite PMI only edged down slightly from an eight-month high of 59.9 in February to 59.7 in March versus a consensus of 57.8.

Scott Minerd, Guggenheim's global chief investment officer, believes that a more appropriate corollary from history is the 1946-1948 inflationary period, which averaged an annual rate of around 10%. The post-World War 11 inflationary episode was subjected to serious supply shortages, surging demand for consumer goods, and benefited from very high levels of personal savings. History shows that price increases slowed in 1948 and actually declined in 1949. Why? Here is a precis of his take:

Put simply, the dynamics between market economies and the financial markets never changes. Price movements are the prime force behind rising and falling demand and of supply, while the level of interest rate is an extra ingredient that helps the process. Meanwhile, monetary policy is what central banks use to get a desired equilibrium in a smoother and faster way than it would otherwise achieve. In accordance with conventional economic theory, the inflation episode of the late 1940s ended when the actions of the Fed allowed the invisible hand of the market to transition the forces of supply and demand from wartime to peacetime. Indeed, supply and demand ultimately came back in balance as pent-up demand subsided and supply came on board as profit margins boosted investments to raise production. During this adjustment period, the Fed pitched in by curbing bank credit growth and to a standstill. This normalization of monetary policy connection, led only to a very brief and mild recession because the excess savings generated during the War had acted as an economic cushion and liquidity booster. The latter prevented the stock market from falling into a protracted bear market. Instead, it initially stabilized and quickly resumed its upward trend in 1949.

It looks as if a similar pattern of normalization is unfolding. The current tightening cycle began in earnest in June 2021 as a reflection of the QE tapering, the expiration of temporary credit and liquidity facilities and the anticipation of the impending policy rate. In the 8-months ended February 2022, the money supply decelerated to an annual rate of 9.25% from annual rate of 30% during the onset of the pandemic. In the past three months, it decelerated significantly to 2.5%, a rate that was experienced from 2009 to 2019. A combination of rate hikes, elevated oil prices, replenishment of government deposits and balance sheet runoffs is bound to keep the annual pace of the money supply near 2.5% over the coming years.

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While the surge in gasoline prices will keep inflation close to 8.0% in March, medium-term inflationary expectations are well anchored. The bond market inflation expectation curve is calling for a rate of inflation of about 6.0% next year, but it is also projecting that it should fall to 2.2% by 2024. According to Capital Economics, which took into account factors like energy, reopening, shortages and cyclical effects, it thinks that inflation will fall sharply in the second half of 2022 and end up a snick above 2.0% in the early part of 2023. Similarly, Macro Strategy Partnership also shares the opinion that through demand destruction a collapse in inflation is pending.

The Global Energy Complex:

I should add that the path of oil prices will also play a role in whether we shall get a soft-landing or a hard one. Monetary policy is a blunt instrument, but oil is capable of surgical precision. With reason, oil is going to be expensive for a while longer, but the rise in its price will stop and may even fall. Ed Morse, head of the commodities team at Citi, is of that opinion. He projects that crude oil prices will fall to $85 in Q3/2022, $70 in Q4/2022, $65 in Q1/2023 and end around $55 in Q4/2023. Morse has made many correct contrarian calls in the past, therefore his projections could turn out to be right. As reported in the FT, he rested his case on 4 planks:

Current high demand is evidence of a recovery, not secular strength in the economy; the demand surge is a return to normal after a deep recession rather than a precursor of sustained demand; the hydrocarbon-intensity of the global economy is declining in a straight line; and rising demand is concentrated in jet fuel and petrochemical feedstocks.

The war in Ukraine is unlikely to disrupt supply as much as the markets expect. There are still buyers for Russian oil, which is selling at a $30 discount. Ships are loading oil, and there is enough tanker filling capacity for Russian oil to find a way to market one way or another. FT’s Ed Luce made the point that more than half of the world’s population did not join the UN resolution condemning Putin's war on Ukraine.

In the meantime, U.S. shale fields are going to produce more than the market expects. Private equity sponsors are pouring big money into the sector, and want the high cash flow that shale is currently generating. The North American drill rig count is accelerating.

Producers around the world are responding to higher prices with production. Canada, Guyana, Brazil, Argentina and Venezuela are signaling increased output.

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Morse's opinion may gain some respect from oil traders from hereon as the International Energy Association (IEA) issued a 10-Point Plan to cut oil Use that would save 2.7m bpd within the next
4 months relative to current levels in the advanced economies. The measures range from reducing speed limits on highways to car sharing. The report made a variety of suggestions to put oil demand into a structural decline in the medium term.

Moreover, Germany is on the front line of the economic war with Russia and is therefore exposed to a perilous liability. Olaf Schulz, the German chancellor, is rushing to fix the situation. He is accepting US gas imports and plans to cut imports of Russian gas to zero within two years, stop buying Russian coal altogether by early summer, and halve oil imports from Russia within months.

The Bond Market Believes the Soft-Landing Scenario:

The bond market has bought into this narrative as it is betting that Powell will succeed in a soft landing. Randall Forsyth of the Barron's reminded his audience that, in 1994, the Fed was able to pull one of these off. It did so by decisively tightening monetary policy with a 25 basis-point increase, followed by a series of sharper-than-expected hikes of 50 basis points, culminating in a 75 basis-point move. In a nutshell, Powell's plan resembles the one that the Fed adopted just after WW11. By such means, the Fed should be able to follow through with a soft landing, followed by a 1950's productivity-style economy. The February data on business equipment investment encourages this idea: an 8% annual rate of increase is projected for Q1.

Thus the anticipated rate hikes will likely reach the tipping point -the neutral rate- sooner rather than later. In other words, the "Fed Put" is a Federal Funds Rate of 2.00%, which is only 162bps from here. Soft landings happen when the Fed moves its policy rate in a gradual and predictable manner to mimic a neutral rate, which in turn keeps the economy on an even keel. The expected performance of the money supply is far more likely to push inflation down than anything else. Look at it on a worldwide basis. High food and energy prices have changed the terms of trade dramatically and have invariably transferred money from one part of the global economy to another without output improvement, at a time when the % increase in the dollar value of the World Money Supply (WMS) is up 5.0% y/y but has only risen at an annual rate of 2.1% in the past 3 months.

Does this mean that a recession is imminent? The short answer is no. While it is true that inverted curves have foreshadowed recessions on several occasions, they invert on average 18 months prior to recessions. (Incidentally, the 2s10s curve has not yet inverted and the really important inversion, which is the yield difference between the 10-year note and 3-month bills, is a positive 185 bps.) While these observations are comforting, what matters even more is how the curve flattens and why it inverts. The 2-year note is driven by market expectations of where

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the policy rate is heading, while the 10-year bond is a function of long-term growth expectations. For example, if the yield curve is narrowing because yields on 2-year notes are rising, while those on 10-year bonds are also rising, as they have recently done, then it is not a cause to be alarmed. According to the BofA, the Fed hiking cycle and balance sheet drain are now priced in. “There is a limit to how much more can realistically be priced into the front end of the curve, given that traders are already braced for a half-point rate hike at the May meeting.” Despite the monetary authorities’ tough talk, the Fed would not want to be blamed for creating financial instability by delivering anything bigger than what is expected at this stage.

One Last Point:

While I strongly suspect, along with Larry Fink, CEO of BlackRock, that the magnitude of Russia’s actions will play out for decades to come and mark a turning point in the world order of geopolitics, along with international trade and capital markets, it may turn macroeconomic trends to the West’s favour. The decoupling from the Russia/China axis will beget a premium of safety and surety, but it will bring economics back home; reunite former allies in a tight knit; decrease dependencies; and rearrange the natural resource and manufacturing footprints. It will particularly benefit countries like Mexico, Canada, Brazil, the U.S. and even the E.U. and Southeast Asia. This should result in massive amounts of business investment, infrastructure spending, and more on-shore industrial output. One may think that de-globalization will be neither a cheap or easy way to protect one’s economy, but the resulting productivity should make it a worthwhile endeavour.

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