To subscribe to our Newsletters www.palos.ca/register

PALOS

Weekly Commentary

Issue **No. 15** | **APRIL 11, 2022**

CONTENTS

The Weekly Snapshot of the Market 1
On Monetary policy 2
On Inflation 3
Disclaimer & Contacts 6

Macro View

By Hubert Marleau

It's About the Interplay Between Monetary Policy

Submitted April 9, 2022

The Weekly Snapshot of the Market:

Blue chip equities rose on Thursday and Friday, yet they registered their first weekly loss in a month. The selloff was basically attributed to a cacophony of over-transparent banter by talking heads at the Fed about the continued prospects of tighter financial conditions. When the Fed speaks loud, concerns understandably flare up. As soon as these 12 regional Fed Presidents and the bigwigs at the main office finished speaking, the markets reacted as if the world had just changed. The S&P 500 fell 57 points or 1.3% to 4489.

We are about to enter the Q1 earnings season and that is far more likely to determine investor behaviour: reported results will come in better than estimates, as they usually do. However, they will definitely not be close to the Q4's earnings-per-share gain of 32.1%. S&P 500 revenue is expected to increase around 11.0 % year-over-year, but rising commodity costs, shifting consumer spending and higher wage rates are going to cut profit margins. FactSet Research Systems Inc. show that brokers' estimates of profits dropped by 0.7% q/q. Thus, the market should anticipate a y/y increase of 8.5% for the S&P 500 earnings-per-share. Interestingly, insiders are buying.

Outside the inflation surge, the stock market's main metric is back to where it was in February 2020, before the pandemic struck. Presently, the P/E for the S&P 500 is 19.5x compared to 19.3x back then. At that time, the yield curve - 10s minus 3s - was inverted, the policy rate was above the neutral rate, and 10-year real rates were -20bps. Today, that part of the yield curve is steep, the policy rate is way below the neutral rate and 10-year real rates are also -20bps. This may explain why the stock market is not reacting to bombastic calls that a recession is imminent. We see this phenomenon also in the junk bond market. Yields on riskiest bonds have surely risen, but investors aren't asking much of a yield premium that normally precedes a looming recession.

Macro View cont.

By Hubert Marleau

From my standpoint, the broad benchmark appears to be stuck between 4800 and 4300 until we see clear signs of a deceleration in inflation. Joachim Klement, a strategist at Liberum Capital in London, has made the point that the stock market is behaving much like it did during the Iraq War, in a sideways pattern.

On Monetary policy:

Through the use of various monetary tools, the Fed hopes that it will be able to remove just enough heat from the economy to orchestrate a soft landing. The big question is what will happen first, falling inflation or a recession. Consumer and corporate balance sheets are flush with cash and employment is rising - factors that should themselves prevent a recession. What is more likely to happen is that consumers will hold on to their cash but spend their disposable income like they did before the pandemic hit.

The stock market is wishing for employment growth to slow down and/or inflationary factors to dissipate so that hawkish messages like the one that Fed Governor Lael Brainard delivered on Tuesday will stop. She signaled that she was on board with a series of 50-point moves in the policy rate and a rapid reduction of the Fed's $9.0 trillion balance sheet as soon as next month, pruning at the monthly rate of $95 billion. In other words, she wants the Fed to reach an even keel monetary stance as quickly as possible.

Behind this objective is the notion that normalizing the Fed's oversize balance sheet would make it less likely to raise the target rate beyond the neutral rate - estimates of a neutral policy rate ranging from 2.25 % to 2.5%. Indeed, the tightening in the market from QE to QT has already raised the shadow rate by 250 bps. Based on this notion, Solomon Tadesse and Albert Edwards, both with SocGen, have put together a compelling argument that a rapid balance sheet runoff may put the peak of the Fed Funds rate at much lower than the so-called official neutral rate. SocGen has it as low as 1.00%.

In this connection, a zero-real rate is a conceivable outcome, but not much beyond. The strong performance of the dollar agrees with this conjecture. The DXY Dollar Index is up 8% from a year ago. For seven years, this index has been trading consistently between 90.0 and 100.0. It's now 99.50.

Put simply, government bond yields should mirror inflation expectations. That's it, that's all. As I mentioned earlier, it will all depend on how inflation and employment turns out over the next few months, otherwise the Fed will keep on tightening until something breaks. The only place where I see this could happen is with commodities, but I elaborated enough on that subject last week. Luckily, commodity prices are either stabilizing or falling.

Macro View cont.

By Hubert Marleau

In the meantime, I'm confident that a big part of the forthcoming QT is already reflected in bond prices. Bond speculators expect that the Fed will stop tightening next year once the neutral level is obtained, when inflation and growth pricing will be in an agreeable balance. Firstly, the bond market is reflecting inflation of 5.5% over the next 12-months, 3.1% in the following year, 2.8% thereafter, and 2.2% in 4 years' time. Meanwhile, the real yield curve - inflation expectations stripped out - has not inverted, keeping its upward slope. It must invert to get a recession: it always has. In fact, the bond market, being an aggregation of expectations of traders, speculators and investors, is still quite accurate at pricing the future path of inflation and growth.

On Inflation:

A recent Gallup poll found that inflation is top on the list of concerns, just as it is for the Federal Reserve. While Chairman Jerome Powell has pledged to use tools to bring inflation down without killing the economy. Allan S. Blinder, a former Vice Chairman of the Federal Reserve, wrote in the WSJ that the Fed will need to be good and lucky. History shows that the Fed has managed to do it several times, if you are not too fussy about the definition of "soft." Indeed, trying to cut 3.0 percentage points off the core PCE inflation rate, which is currently running at an annual rate of 5.4% without a recession hit, some luck will be needed. Fortunately, he might get lucky. This may be the reason why expected inflation doesn't appear to have gotten out of hand. In 4 years time, the inflation rate is expected to run around 2.3% on an annual basis.

Once-in-a-generation inflation shocks, which result from exogenous factors (such as the pandemic and the Russian war), tend to pass fairly swiftly unless they are supported with a persistent, massive global increase in the money supply. That is clearly not happening. In terms of a U.S. dollar value, the year-over-year increase in the world money supply is 4.7% and has decelerated to minus 1.0% in the past three months, suggesting that there is perhaps a growing shortage of dollars outside the U.S., according to London-based Macro Partnership. In other words, there may not be enough juice to sustain persistent inflation.

Prices that have big booms also have big busts. The global economy was given a huge whack by the pandemic. This created a bullwhip effect on both the spending and production curves and in turn produced a major inflation spike. The effect obscures the real demand. Consequently the cycle should change. Logistics companies are already losing freight and warehouses are filling up with inventories, suggesting that the supply-chain kinks are loosening. The Baltic Dry Index and the Shanghai Containerized Freight Index are down 25% and 15% respectively from their January peaks. In such circumstances businesses usually try to sell what they have on hand in their expensive back rooms at discounted prices to avoid the rising interest cost of

Macro View cont.

By Hubert Marleau

holding on to them. This means the prices of durable goods, which have been turbocharged by demand stoked by fiscal stimulus while stymied by supply-chain problems, should head back to the zero-trend-line that prevailed before the pandemic. During the pandemic, durable and non-durable goods accounted for 30 % of aggregate consumer spending and two percentage points of the 5.4% rise in core PCE in the last twelve months. Consumers are therefore buying lesser quantities, switching to cheaper store brands and postponing purchases of big-ticket items. Indeed, should prices for services, which accounted for 3.4% of this, continue along their current trend and remain around 70% of total consumer spending, overall core inflation would fall to 2.4%, just as the bond market predicts.

Meanwhile, the narrative in the commodity market seems to be changing. Commodity prices have come off their highs. For example, crude oil prices are more than 20 % down from their momentarily high of $130 a barrel, a decline which qualifies as a bear market by conventional definition. Preliminary data points show that there is some demand destruction and stabilization of inventories at a time when oil production is rising and many members of the International Energy Agency (EIA) are releasing their stockpiles. As a rule, commodity prices move more often than not for non-monetary reasons. This is why even mainstream monetarists, like myself, separate volatile commodity prices from the equation. Nevertheless, they do play on sentiment. Less pressure coming from the commodity side of inflation usually reduces inflationary expectations.

The irony is that the Fed officials are taking inflation seriously and dialing up the rhetoric just as its visible manifestations are starting to show up in various corners of the economy, except the labour market. Many pundits believe that the threshold from good-tight to bad-tight has been crossed, creating an unhealthy possibility of a wage rate spiral. Really! What is so bad about offering job-protection plans, better-in-office benefits, increased job-security, larger compensation packages and job-training programs? It is true, however, that the demand/supply balance in the labour market is out of whack. The total number of employees and of job openings, a proxy for demand, is overwhelmingly above the labour force - an excess of 5.3 million at present. But new applications for unemployment benefits fell last week to 166,000 - a 54-year low. According to Goldman Sachs, we have the tightest job market since WW11. This explains why wages are climbing fast at an annual rate of 5.0%. However, given the huge amount of money being allocated to productivity enhancements, of administrative programs to process immigration faster, and of workers reentering the job market, I do anticipate some easing.

In this regard, history might be on my side. Between 1960 and 2019, wages rose by an annual average of 4.1%, while productivity gains averaged 1.0%. The inflationary effect was 3.1%. Interestingly, this is not much different from what is presently going on. Over the last few years, productivity has been rising at an annual

Macro View cont.

By Hubert Marleau

rate of 2.0%+. This new trend in the value of what workers produce per hour is very achievable, given the large investments taking place in remote-working technologies, digitization and domestic manufacturing.

The Citigroup’s inflation surprise index is elevated by historical standards. It may be cold comfort, but it's rolling over. It’s off 30 points from a peak of 80.0 that was registered only a few months ago. If my conclusion, derived from the aforementioned observations, proves correct, the index could fall another 30 points, bringing it to a threshold level that would support a lower inflation reading than generally anticipated. Bryn Torkelson of Matisse Capital says: “99% of individual investors think rates are higher and a lot of that is already priced into the markets.” The FT reported that Nancy Lazar, a top-ranked economist at Cornerstone Macro, thinks the biggest surprise will be that core inflation, which excludes food and energy costs, could be down to 2% by the end of 2022 as economic growth slows to 1%. The Atlanta Fed’s GDPNow model estimate for real GDP for Q1 is 1.1%, and a broad consensus is forming an opinion that the economy will trend between 1.0% and 1.5% over the next few years.

Follow us on LinkedIn:

Weekly Commentary

Issue **No. 15** | **APRIL 11, 2022**

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., "Palos"). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos' written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. "S&P" is a registered trademark of Standard and Poor's Financial Services LLC. "TSX" is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market value weighted index engineered to measure publicly issued noninvestment grade USD fixed rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca