PALOS

Weekly Commentary

Issue No. 17 | APRIL 25, 2022

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Macro View

By Hubert Marleau

The Mighty Dollar to The Rescue

Submitted April 25, 2022

The Weekly Snapshot of the Market:

The markets felt tentative and vacant as traders eyed a sparse docket of data-less economic prints. However, Fed Speaks filled the void, unrelentingly telegraphing the same hawkish message of the past five months that the monetary stance is heading expeditiously toward a neutral rate, estimated to be around 2.50%. Jerome Powell, Chairman of the Federal Reserve, along with his flock of regional governors, had hawkish words every passing day, culminating with an address that talked down inflation at an IMF-hosted panel show, along with a trial balloon that a 75 bps rate hike was on the table. As a result, U.S. stocks took their worst losses in weeks; the S&P 500 fell 122 points or 2.8%, to end at 4271.

Should those aforementioned announcements turn into real actions, the dynamics would further increase the cost of borrowing the greenback, reduce its availability, raise its foreign exchange value, and in turn erode the forces that have underpinned the powerful rise in inflation. In fact, the DXY is already up 11% year-over-year, suggesting that there is a lack of greenbacks to finance international commerce and investments, as a growing proportion of local currencies is needed to buy food and energy. The dollar value of world money supply is now down an annualised 4.0% over the past 3 months, and oil consumption is tumbling everywhere, particularly in China. Chinese demand for gasoline, diesel and aviation fuel may slide 20% in April from a year earlier, says Bloomberg. Meanwhile, through an opaque market of obscure origin, crude oil exports from Russia to European ports are, ironically, higher in April than they were in March. There is still supply around, which may explain why crude oil is selling at a huge discount in the futures market.

The strength of the dollar should not be ignored. It's definitely disinflationary, because imported prices indirectly account for an important part of the various inflation indices. This is in part what the Fed has ordered: that is to break the economy on durable and non-durable items that are usually financed by banks.

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Moreover, the action of the dollar could move the stockpile of cash away from the carry trade, due to the increasing cost of hedging, to other endeavours. Here is something that I picked up in the WSJ. Joseph C. Sternberg pointed out that there is a huge mismatch between the accumulation of assets in one currency and liabilities in other currencies. “Within the banking system, the past 15 years have seen a 60% increase in offshore claims denominated in dollars. These are credit arrangements in which neither the lending bank nor the borrower is American, and their value has increased to $11.1 trillion in the third quarter of 2021 from $6.1 trillion in mid-2017, according to the Bank of International Settlements (BIS). Add to this another $2.9 trillion in dollar-denominated credit extended by US-based banks to foreign borrowers, and you’ve got an enormous pile of debt that is more expensive for borrowers to pay in terms of their local currency as the dollar rises.” In other words, an extraordinary amount of money is needlessly being deployed to arbitrage the international money markets into a financial equilibrium at a time when growth and inflation differences among countries are unusually large. The hedging costs are so high that it may be better for banks to find an alternative.

Thus, a partial unwinding of this mechanical process could bring about a reallocation of capital to more productive outlets like supply-side potentials and partially offset the upcoming quantitative tightening that the Fed intends to install. Farfetched, but perhaps not. There is enough money in the system to carry a Marshall Plan to finance a de-globalization program, a reorganization of international trade, an on-shoring of manufacturing facilities, reconstruction of Ukraine and a catalogue of capital expenditures on national security, defense, technology enhancements and infrastructure.

While the anticipated move toward a tighter monetary stance has already curbed consumption that uses resources intensively, foreign capital is flowing into the US bond markets and fixed capital formation. It appears that this phenomenon is accelerating. In this connection, the Fed may not have to go much above the neutral rate if it raises rates fast and high enough now to prevent the need to increase them to astronomical heights. History is clear on this one: there have been precipitous rate increases in the past without causing a recession. Ed Hyman, the perennially top-rated economist who heads Evercore ISI, identified a prominent case. In 1994 when the Fed doubled the funds rate, to 6% from 3%, in short order.

U.S. rates only need to be higher than in other international markets to move labour and capital from one sector to another to attenuate inflation. In fact, shifting resources away from unproductive spending on goods to new investments in new capacity, does not work well when interest rates are sky-high. Confronted with an immediate need to accommodate this required structural shift, the Fed will not tighten to the point of losing control. The remedy is to reallocate capital to more productive potential. Interestingly, foreign

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investors are ditching record amounts of renminbi-denominated debt and Chinese equities in favour of US bonds, the yields of which are soaring. The dynamics have reversed.

In this connection, the World Bank lowered its estimate for global growth in 2022 to 3.2% and the IMF cut it to 3.6% amid the Corona virus lockdown in China and the Russian invasion of Ukraine. Both the real bond yields and stock market metrics are back to where they were just before the pandemic hit the economy in February 2020. US inflation-adjusted bond yields were on the verge of turning positive for the first time since March 2020, rising more than 100 bps in the previous six weeks. Meanwhile, P/E multiples are almost identical at 19.3X as is inflation-adjusted ERP at 5.20%. Believe it or not, monetary conditions were significantly tighter back then than they are today: the yield curve was inverted and the policy was higher than the neutral rate. Presently, the yield curve is positive, the policy rate is considerably lower than the neutral rate, and the consensus for medium-term growth expectations is itself positive, leaving little to worry about.

Robert Armstrong, a FT commentator, summarizes the Bloomberg's aggregate of economic forecasts in the following manner:
1) Real growth will remain above 2%
2) Core inflation will continue to to slow
3) Unemployment will stay near 3.5%
4) Housing demand will tick down a little
5) S&P 500 earnings per share will grow modestly
6) Interest rates will rise about 200 bps in the next year
7) There's a one-in-four chance of a recession

The ClearBridge Recession Risk Dashboard, a group of 12 recession-sensitive indicators, is flashing green in spite of the slowdown that occurred in Q1. So are we getting an "immaculate disinflation''? Maybe. Ian Shepherdson of Pantheon Macroeconomics is behind this scenario, arguing that healthy household and corporate balance sheets can keep growth firm while inflation moderates. In a note to clients, he wrote:

"In short, then, it's very hard to see why the private sector would feel compelled by a fed funds rate of 2% or so by the end of this year to cut back spending to the point where the economy might tip into recession. That's not to say the whole economy will roar back ahead; we expect a steep drop in housing market activity over the next few months…but housing aside, we see a few reasons to expect private sector spending to weaken, and plenty of reasons to expect solid growth, notably the potential for catch-up spending on services as Covid fear recedes. We just don't buy the idea that the Fed faces a binary choice between letting inflation

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rip or triggering a recession. Markets love black-and-white stories, but this time we think it will be more useful to think in shades of grey."

Looks as if the average investors have prepared themselves for slower growth and higher cost of financing. Macro Strategy Partnership reported to its subscribers, that US margin debt fell by USD 36 bn or 4.3% in March, and down 12.4% over the past 3 months to $800 billion. It peaked at $936 billion last October.

Meanwhile, assuming that bond yields are about to top-out, as derivatives seem to \suggest, the breakdown of the negative correlation between stocks and bonds that prevailed in past regimes, should keep the S&P 500 in what appears to be an established range - 4200 to 4800. The Skew Index, a gauge of possible tail risk, has receded. This should help to put a floor under stocks. Current price action is essentially a consolidation related to the initial removal of highly accommodative monetary policy and to a re-adjustment of values vis-a-vis prospective economic conditions - growth and inflation. Media sentiment and positioning is too bearish. So I'm calling time on rate hike bets beyond neutral, and think that the rise in real yields has gone far enough. And that is a good thing because it reflects that the economy is not as weak as some claim. Negative real yields are associated with weak growth and poor confidence. Jim Paulsen, chief investment strategist at The Leuthold Group, thinks that positive real yield reflects a restoration of normality and common sense. This makes sense because credit spreads appear to be well anchored, suggesting that the economy is chugging along: leading indicators are still rising.

I have a constructive attitude on equities. Stocks tend to go higher so long as forward estimates are rising. So far so good. Corporate America has navigated well through this difficult environment, showing respectable profit increases. Earnings reports too, have generally been better than expected, beating expectations by 8.6%, according to Credit Suisse.

Jim Paulsen, showed that based on historical data since 1945 that when annual inflation exceeds 8% and begins to moderate it pays to buy equities. As shown in last week's Commentary, the pace of month-to-month inflation has decelerated. Stripping out volatile fuel and food, so-called core prices climbed 6.5%, but slowed down on a monthly basis, rising only 0.3% in March, 0.5% in February, and 0.6% in January, registering the smallest gain in six months. If this deceleration in the rate of inflation were to continue, and if indeed the longer-term inflation expectations were to remain anchored around 2.75% as the derivative market claims, 10-year Treasury yield could stick around 3.00%.

He cooled the aforementioned notion, suggesting that this 3.00% was a key tipping point. Through the pen of Randall W, Forsyth, a writer for Barron's, he said: "Since 1950, when this yield has been below 3%, stocks

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have done fine. But they've fared worse when it was higher (and still worse when it topped 4.00%). When the yield was under 3%, equities' annualised monthly returns averaged 21.9%, versus 10.0% when yields were higher. In addition, volatility was lower (13.5% versus 14.6%), while monthly losses were less frequent (occurring 27.6% of the time, versus 38.2%)." The bottom line is that one can still make money when yields on 10-year Treasuries cross the 3% level, and more if one is audacious enough to trade the dips and the rallies caused by volatility.

According to the WSJ, institutional investors have $3.0 trillion of excess cash in their portfolios. There is a lot of capacity to buy the dips that this 3.00% could bring. And take note that insiders have bought stocks through the piece and corporate buybacks are in vogue. The Morningstar median price versus estimate for all stocks they have rating on is starting to look cheap.

The above points fit in well with the latest Big Money poll conducted by the Barron's. "A third of the poll respondents say they're bullish, 22% are bearish and 45% are neutral. The optimists expect the S&P 500 will trade around 4800 by the end of this year and around 5000 by June 30, 2023 whereas the bears are forecasting 4125 for both dates - that is about where we are now. Almost 60% of the respondents believe that equities are the most attractive asset class, especially stocks that are in energy, technology and healthcare that operate in North America. Poll respondents forecast 2022 growth in real GDP of about 3%, on average, and 2% in 2023. Inflation won't disappear overnight. The U.S. consumer price index is expected to come in around 5.5% this year, moderating to 4% in 2023. Only 25% of them believe that the U.S. Dollar Index (DXY) will weaken in the next 12 months and just about everybody expects the dollar to remain the world's reserve currency in the next 5 years, 10 years and 15 years."

P.S. Please note that there will be no macroeconomic commentary for the next two weeks.

Follow us on LinkedIn:

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(An English message follows)

Bonjour Hubert Marleau,

Le Département de science économique et la Faculté des sciences sociales de l'Université d'Ottawa vous convient le jeudi 28 avril 2022 au **diner-conférence Marleau** qui aura pour thème : **« Le changement climatique et la macroéconomie »**.

Cette conférence explorera les conséquences possibles de l'échec de la mise en oeuvre de politiques climatiques efficaces en temps opportun et les implications de cet échec pour d'autres aspects de la politique monétaire et fiscale.

Inscrivez-vous aujourd'hui!

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La conférence Marleau sera donnée par le **professeur James H. Stock**, vice-recteur chargé du climat et de la durabilité à l'Université de Harvard et membre du Conseil des conseillers économiques du président Obama en 2013-2014.

Nous aurons également le plaisir de compter sur la participation de **Mark Carney,** envoyé spécial des Nations unies pour l'action climatique et les finances, et conseiller financier du Premier ministre britannique Boris Johnson pour la conférence COP26 à Glasgow.

- **Date :** Jeudi 28 avril 2022
- **Heure** 11h45 – 14h30 HNE
- **Où :** Pavillon Faculté des sciences sociales, Pièce 4007, 120 Université Privée, Ottawa, ON, K1N 6N5
- **Titre :** « Le changement climatique et la macroéconomie»

La participation est gratuite et sur invitation uniquement. Deux choix de repas vous sont offerts. La capacité est limitée, inscrivez-vous dès aujourd'hui pour réserver votre place.

L'événement se déroulera en anglais.

Inscrivez-vous aujourd'hui!

Nous avons hâte de vous accueillir!

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Catherine Deri Armstrong

Directrice du Département de science économique, Université d'Ottawa.

Remerciements: La Série de conférences Marleau sur la politique économique et monétaire a été créée en 2019 grâce à un généreux don de **M. Hubert Marleau** (Palos Management). Veuillez **consulter notre site web** pour en savoir plus sur la série.

Hello Hubert Marleau,

The Department of Economics and the Faculty of Social Sciences of the University of Ottawa invite you on Friday, April 28th, 2022, to the **Marleau Signature Lunch Lecture** on **"Climate Change and the Macroeconomy".**

This lecture explores the possible consequences of failing to enact efficient climate policies in a timely way and the implications of that failure for other aspects of monetary and fiscal policy.

Register today!

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The **Marleau Signature Lecture** will be delivered by **Professor James H. Stock**, Vice Provost for Climate and Sustainability, Harvard University and Member of President Obama's Council of Economic Advisers in 2013-2014.

We will also have the pleasure to welcome the participation of **Mark Carney,** UN Special Envoy for Climate Action and Finance, and Finance Adviser to UK Prime Minister Boris Johnson for the COP26 conference in Glasgow.

- **Date:** Thursday, April 28th, 2022
- **Time:** 11:45 a.m.- 2:30 p.m. EST (5 p.m. – 7:30 p.m. UTC)
- **Location:** Faculty of Social Sciences Building, Room 4007, 120 University Private, Ottawa, ON, K1N 6N5

Participation is free and on invitation only. Capacity is limited, register today to save your seat.

Register today!

We look forward to welcoming you to our event!

Catherine Deri Armstrong

Chair of the Department of Economics, University of Ottawa.

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Acknowledgement: The Marleau Lecture Series on Economic and Monetary Policy was established in 2019 through the generous contribution of **Mr. Hubert Marleau** (Palos Management). Please visit our website to learn more about the series.

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