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Weekly Commentary

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By Hubert Marleau

Accentuate the Positive: Inflation Is Turning

Submitted May 28, 2022

A happy economy is one which has a sustainably low level of misery. The misery index, which is the addition of the inflation rate (8.3%) and unemployment rate (3.6%), currently stands at 11.9%, 4.9 points above the level and composition that the general public would consider desirable, 2% for inflation and 5.0% for the unemployment rate being optimal. There is theoretical validity and empirical evidence that, in order to have and keep this ratio in a happy medium, economic growth, expressed in real terms, must run at a 2% annual rate. While not inflexible, in order to achieve this objective in a sustainable manner, two important things must be always kept in sync. Firstly, the Fed's policy rate (1.00%) must be close to what is an acceptable neutral rate, which is estimated to be the yield on 5-year-treasuries (2.75%). Secondly, the yield curve, which is the difference between 10-year and 2-year Treasuries, must always be moderately positive: 50 bps is a number that can withstand strong headwinds.

Currently, the relationship among the aforementioned forces is completely out of whack, partly because of the shock effect of the pandemic in China, the rise in the cost of living, and the war in Ukraine. External shocks have dissociated between the normal relationship of these two factors that, together, usually put the economy in some sort of acceptable and happy equilibrium. It's the job of the Fed to bring that equilibrium back to where it belongs. In this connection, inflation must return as fast as possible to the 2%-3% range, re-allowing the policy rate and the yield curve to govern and steer the economy appropriately, as they normally do.

The first big question is whether the re-establishment of these two key variables to where they ought to be will require a hard landing, or whether a soft one will be sufficient. Presently, we know that economic growth is slowing down and that inflation and employment rates have peaked. The Fed has also indicated that it intends subsequently to increase the target rate by 50 bps at least two more times, followed by three 0.25% increases. The Fed Chair, Jay Powell, was crystal clear about this last week. He said that the Fed would

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implement those rate hikes until there is evidence that inflation is returning to the 2%-3% range, without showing any concerns about the labour market. His comfort is based on the recognition that there are currently a lot of job openings (11.5m postings), nearly double the number of unemployed workers. This is a conviction that is shared equally by the sell-side and buy-side of the market. Full-stop. This explains why the S&P has brushed aside a bear market definition numerous times in the past few weeks. Thus, the bond market and its derivatives fully anticipate that the Fed's intention of raising interest rates will hold.

The second big question is whether the Fed's policy will be able to keep growth in the money supply at bay. The U.S. money aggregates are still elevated on a year-over-year basis, but decelerating fast and broadly. Once quantitative tightening starts in June, it is likely that monetary deflation will continue.

Nonetheless, tough talk from monetary officials, economists and market strategists has already turned their harsh views into a self-fulfilling prophecy. Suffice to say that deafening the recessionary chorus has been impossible. Strangely, it's helping the Fed to do its job - without the burden of work. So far, it has not done much other than barking. As a matter of fact, the market has done almost all of the tightening, through the widening of the Baa credit spreads, the steep fall in stock prices, the strength of the dollar and the rise in bond yields, showing faith in the Fed's inflation-fighting credibility.

Yet, the money supply, which is up 8.0% from a year ago, has decelerated to an annual rate of 5.4% and 1.3% in the 6 months and 3 months ending on April 22, respectively. Actually, the money supply decreased in April, the largest monthly decline on record in 60 years. According to the MacroStrategic Partnership, a proxy for U.S. money supply is now down to a 3-month annualized 0.32% over the past 3 months ending in May. That's an early win for the Fed. On a global basis, the USD value of world money supply is only 1.1% higher than it was a year ago. In the past three months, it has fallen to a negative annual pace of 9.3%.

Should this new monetary pattern last for a while longer, it is probable that the Fed's attempted coup could bring inflation under control successfully, perhaps with an inventory recession. Numerous polls are finding out that many Americans are dining out less, have cut back on driving, cancelled subscriptions, and postponed vacation plans. Stagnant spending and softening plans for future spending should help to correct the price shocks which stemmed from the failure of suppliers to meet the rapid changes in demand. The goods-to-service switching and the diverting of dollars to more expensive food and energy is probably creating an inventory overhang. The reverse should put supply and demand back into alignment. Real inventory levels for durables and apparel are now well above trends. If the demand is not there to absorb the inventory build-up, the latter will have to be discounted. Citigroup's economic surprise gauge, which measures the magnitude to which reports either beat or miss forecasts, hit the lowest since September 2021: minus 41.2.

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It is important to acknowledge, however, that the capacity and desire to spend is not the same. Given the elevated prices of essentials, the remains of the ubiquitous excess savings which were amassed during the pandemic might not be deployed, but used as a cushion. Fortunately, the labour market could prevent a major fall-out in overall output from occurring. That labour market is tight, not because employment is high, but because vacancies are excessive. Reducing vacancies will likely prove to be easier than inducing layoffs as job-jumping recedes.

The prognosis, therefore, is for a synchronized slowdown, spelling a “moderate and passing stagflation” in the second half of 2022. It will not be a long-lasting episode because the near-term credit outlook remains strong, especially if Russian oil were to find new markets and if China were to end its zero-Covid strategy.

Firstly, there are growing signs that the Western coalition against Russia is fraying as the food and energy crisis deepens, and sanctions may have reached their limits. In a morning note from Macro Strategy Partnerships, Andrew Lees wrote that Veteran US statesman Henry Kissinger urged the West to stop trying to inflict a crushing defeat on Russian forces in Ukraine, warning that it would have disastrous consequences for the long-term stability of Europe. Kessinger said: “I hope the Ukrainians will match the heroism they have shown with wisdom and the country must be a neutral buffer state rather than the frontier of Europe. It would be fatal for the West to get swept up in the mood of the moment and forget the proper place of Russia in the European balance of power.” Germany and Italy told companies they could open rouble accounts to keep buying Russian gas following discussion with the EU. The Peak Oil website reported that Russian oil producers are starting to book an increasing number of tankers, suggesting that more oil is coming to the market. Saudi Arabia’s assessment of the energy market is that actually oil supply right now is relatively in balance.

Secondly, the People’s Bank of China is urging banks to boost loans, calling on them to accelerate the delivery of approved loans to small businesses, green projects, technology innovation, energy supply and infrastructure, hoping that these measures will offset the lingering Covid restrictions on growth. I suspect that the Chinese government officials will soon bring clarity on an exit strategy from the current Covid-19 policy.

The 1-year forward-forward of break-even yields, a bond proxy for inflation expectation, has fallen to 2.9%, down from 3.6% at its high, suggesting that inflation momentum has passed its worst. The PCE price index increased only 0.2% in April, the lowest monthly increase since February 2021. This is particularly interesting, given that inflation is the most lagging indicator of them all. History shows that it takes many inflation spikes

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like those in the 60s, 70s and 80s to entrench inflation expectations beyond the 10% level. In other words, what we have today is completely different from what we had when the last inflationary boom occurred.

In this regard, it should be easier for the Fed to reset short-term inflation now than during the 1970s and 1980s, when long-term inflation expectations needed to be tamed from scratch. We are already seeing some disagreement among the Fed policymakers. Raphael Bostic, the Atlanta Fed President, hinted that the Fed might pause interest rate hikes later in the year. Even St-Louis Fed President Bullard, a hawk, admitted that interest rates could come down next year, once the current cycle ends. They are aware that a big part of this inflation has been fueled by the supply-side of the economy.

What is going on is a re-adjustment process to get us back toward pre-pandemic conditions. The reality is that the printing and redistribution of money is over, and so are lockdowns. What we are witnessing is a shift in spending patterns at all levels - consumer, corporate and government with different sectors taking the lead away from those who profited enormously during the pandemic. Past losers became new winners and past winners new losers. This market correction is not traditional. It has been eerily orderly, with corporate revenues and financial conditions inconsistent with recession. Balance sheets are in good shape with very healthy cash holdings. The return to normalcy is also showing up in the demographics. The fertility rate is rising and immigration is on the rebound. We should focus on what we see and know, because the market needs a macro reason to turn.

We might be getting one. Just listen to the banks or listen to Jamie Dimon, JPMorgan chief executive and Brian Moynihan, chief executive of Bank of America. One says: “credit looks really good and they never saw it this good.” and the other says: “Recession risk? I’m not hearing it.”

In any case, it is conceivable that the monetary authorities would come to the defense against the prospect of a serious recession especially if job numbers start to change. According to job data updated by Revelio, new job postings have started to fall broadly. Labour demand is cooling, having hit a brick wall, with the likes of Amazon, Salesforce Inc. Meta Platforms Inc., Facebook, Walmart, Snap Inc. Target and Netflix are all giving negative guidance on employment. A collapse in inflationary wage rates is not in the cards, but labour tightness has peaked. Claims for unemployment insurance are slowly rising.

Consequently, we hold large positions in sectors that did well soon after WW11, because the current economic situation resembles the one that then prevailed. The Fed will face a marked slowdown in the second half of 2022. In this connection, it will end the rate hike cycle ahead of schedule, and perhaps proceed with rate cuts and possibly halt the QT process some time in 2023.

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I am showing fearless optimism, but I'm still hedging my bets as the market is pricing 80% odds on a recession being on our doorstep. I know from experience that entrenched inflation or a structural recession are possibilities, albeit remote. We have positions in sectors of the economy which are income- and price-inelastic, and also in other sectors which are quite the opposite, being both, income- and price-elastic. In other words, we are keeping our relative position intact, but buying the dips and selling the rips at margin.

Brian Coleman, a former Goldman Sachs trader, made an astute comment worthy of consideration: “It might be that what we are seeing is not, or not only, a bubble deflating but a shift in market paradigms, with generation of low interest rates, globalisation, growth and relatively free markets coming to an end. The end of the coronavirus pandemic, with all its economic peculiarities, muddies the picture further. In all, history may be a poor guide to what happens next.”

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