PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

It's About Engineering Lower Inflation

Submitted June 24, 2022

S&P's forward P/E multiples have fallen 33% in the last six months. Thirty percent is the median for every recession since WW11. Given the absence of an absolute recession, it makes current stock prices look particularly cheap. For now, recession is less than a 50% probability: it's simply not a reality.

The S&P 500 index may notch its worst first-half performance in decades, yet individual investors have still purchased a net $24 billion worth of U.S. stocks over the past month, in line with the average of the past few years, according to flow-tracker VandsTrack. The broad benchmark registered its first huge weekly gain in months, rising 237 points or 6.5% to 3911. Interestingly, the current bear market, which peaked in early January, is old by recent standards. Rick Derrick, chief market strategist at LPL Financial, wrote: "At about six months old, it is already older than six other bear markets going back nearly 40 years, with only the 2000-2002 tech bubble and 2008-2009 financial crisis bears lasting longer. This means the bear market may be closer to a bottom than many expect. The average bear market since 1950 has taken about 11 months to mark its low, but six out of the last eight bear markets ended within six months…If a full-blown crisis and severe recession, such as in 2000-02 and 2008-09, can be avoided, this bear market may bottom soon."

I do acknowledge that there is a spate of investment banks who have raised the odds of a forthcoming recession. Goldman Sachs has doubled the odds of a recession to 30%; Nomura says an eventual recession is more likely than not; for CitiGroup it's head or tail; and Deutsche Bank claims that a recession will indeed come, but only in the second half of 2023. Meanwhile, the Fed's officials now see 1.7 % growth this year and next, compared to their March projections that showed growth rising by 2.8% this year and 2.2% in 2023. There are still millions of unfilled job openings, and the cash hoards of households are astonishingly large. The Fed's thesis has merits.

Macro View cont.

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Two weeks ago, the monetary authorities decided to buck what they had telegraphed over the past few months in order not to lose credibility, demonstrating their seriousness to crush inflation even if it were to hurt growth. Powell said: “Failure isn’t an option. We have to restore price stability.” Consequently, the target rate may rise to 3.00% by year's end, showing that they are prepared to countenance a higher unemployment rate and lower growth than they were previously willing to accept. The Fed lost the early rounds, but does not want to lose the bout. Indeed, they left their inflation forecasts little changed with those made last March, projecting core prices, which exclude volatile food and energy prices, increasing 4.3% this year, up from 4.1%, but seeking an average annual inflation of 2.0% over the long run.

The Fed knows that the path to victory will depend on whether it has the fortitude to do what it takes to win the fight. But that path has first to go through the expectation channel. It is hard to see how the economic forces of supply and demand are going to play out, because they are simply unique to our moment. Yet deflationary pressures are finally in play. The combined effect of unprecedented amounts of wealth destruction, dollar strength and monetary deflation has lowered commodity prices, including energy and agricultural products, increased precautionary spending, reduced saving patterns, curtailed housing activity, eased supply shortages and left goods on the shelves. We’ve been on this track for sometime.

1) Over the past three months the money supply has fallen an annualized 0.84%.
2) The DXY is 14% higher than it was a year ago.
3) The sell-off has resulted in a dramatic $15.5 trillion write-down in balance sheet values: 60% of 2019 N-GDP, the most ever.

In this connection, bond traders have lowered their own inflation expectations. The one-year inflation outlook ending June 2023 is 4.7%; but falls precipitously to 2.6% in the following year and to 2.1% in the third.

One should bear in mind that market economists and strategists have an affinity for the macabre, printing breathless expressions in the media coverage regarding the proximity of the next recession. Statistically, it makes more sense that the aforementioned deflationary forces are far more likely to hit the inflation numbers than the low-growth ones. It usually does because inflation is significantly more elastic than growth. The real economy has several man-made economic stabilizers to protect growth. Indeed, research from the San Francisco Fed found that demand was driving about one-third of the current jump in inflation, while issues tied to supply, or some ambiguous mix of supply-and-demand factors were driving about two-thirds. The NYT added: “That means that returning demand to more normal levels should ease inflation, even if supply in key markets remains roiled.” The US’s PMI, which collates executives’ views on topics from order volume to commodity prices, showed input costs were rising at their slowest pace in five months.

Macro View cont.

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In this connection, I've decided to go with the idea that the sooner the Fed's monetary policy and natural economic forces can bring down inflation expectations to the 2.0%-3.0% range, the sooner the S&P 500 will retrace the 1000 points it lost since January. JPMorgan's Marko Kalanovic, more or less, stands behind that view. Oppenheimer CIO John Stoltzfus is even more bullish, sticking to his January forecast that the S&P 500 will end the year at 5330 - a whopping 40% increase from where it currently stands.

In fact, a lot of the fear has been front-loaded. Sometimes bad news turns to good news when the bad does the job of rectifying what is really bad: the inflation scare. Runaway inflation is running down: the hot commodity rally has cooled off: raw materials are retreating toward pre-war levels; and even DRAM prices are falling like a rock. Rogers' agricultural index is 10% off its high.

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