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Weekly Commentary

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By Hubert Marleau

Don't Panic Over the Recession

Submitted July 31, 2022

The never-ending deluge of headlines taunting the developed economies with rising cost of living and recession fears belies favourable development on the inflation front. Relying solely on reading real-time stock market data to make predictions about where equity prices are heading is not a very good idea. Day-traders tend to hear what they want to hear and algos trade headlines. They tend to trade quickly around key words interpreting economic prints and off the cuff remarks without nuance. That is why price action in the immediate aftermath of prints and remarks is merely a reaction, making it notoriously unreliable in providing advice. Consequently, it is much better to watch what the bond speculators are up to because it is they who are the macro experts. In this connection, the current bond market is teaching the world that the so-called "war on inflation" is abating and that the prospects for inflation itself are improving.

For now, bond traders are still putting a larger weight on inflation concerns than on rising unemployment, implying that one more big rate hike is coming. And that it is. What they see is very high inflation, but clearly falling, and very low unemployment, but clearly rising. Exactly when the Fed will back off is impossible to know, but one can presume that it will actually pivot when the sudden fall in the annual expansion in the money supply of the last six months starts to have its full deflationary effect on the economy. Indeed, it may have already begun: the U.S. economy shrank for a second quarter in a row - a common definition of recession - as businesses trimmed their inventories; the housing activity declined under rising interest rates; the trade deficit widened from the strength of the dollar; and inflation took the steam out of personal income.

Moreover, the household survey shows the economy losing an average of 116,000 jobs over the past 3 months with the price-trajectory of several offending commodities pointing to relief. The Bloomberg Commodity Spot Index, which features futures and the CRB, which only tracks commercial transactions, have significantly fallen over the past two and half months. Energy and agriculture prices have tumbled. As a

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matter of fact, wheat prices have returned to pre-Ukraine levels, down 50% from the peaks hit following the Russian invasion of Russia

Thus, the bond market is already predicting that the Fed may trim rates as early as next year, inflation expectations having dramatically decreased over the past 6 weeks. For example, derivatives, which are the by-product of the U.S. yield curve, indicate that inflation over the next twelve months will be 3.6% followed by much deceleration in the ensuing years with yearly increase of 2.7% in 2024 and 2.4% in 2025. The UofM survey showed improvement in inflation expectation falling to 2.8% for the next 5 years, a level not seen since July 2021. That could be a good thing because it could resolve the mismatch in the supply-demand of the labour market, rendering millions of unfilled job openings superfluous and closing the gap between openings and hires without actually having to forfeit too many jobs, if any. A normalization of the labour market is exactly what the Fed wants companies to do: reduce or freeze hiring. There has been no mass firing other than Amazon, just talk about eliminating new job openings and reducing the rate of hiring.

Perhaps miraculously, there is a very good chance that hot inflation data is behind us, and that this could happen without incurring a devastating recession. The existence of an inverted 10s/2s combined with a normal 10-year/3-month and an orderly pace on monetary growth, suggests a soft landing as supply-chain issues iron themselves out. The firewall between a continuing growing economy and a veritable recession is the cash hoard of consumers, the strength of corporate balance sheets, and the strong capital position of banks. The WSJ reported that companies are whittling down the unusual cash buffers they have built during the pandemic, putting capital to work through acquisitions, buybacks, and, in some cases, extra inventory to weather supply-chain backlogs.

Yet a prolonged slowdown in economic growth should be expected because the bulk of the inflation is non-cyclical related to the physical capacity restrictions and deteriorating demographics. Thankfully, productivity increases are on the come. While near-term economic reaction to the Fed's aggressive monetary stance will soon push inflation down precipitously, the 30-year/5-year spread, which is a "good as it gets" indicator of the inflation risk term premium, suggests that a higher plateau and secular increase in inflation has occurred. This means that, in the longer future, the inflation rate will likely be at the higher end of the Fed's 1% to 3% target range. I think the stock market knows this perfectly, as well as central banks.

As a result the S&P 500 rebounded from a tough first half of the year, rising 9.1% in July, its biggest monthly gain since November 2020. Although easing expectations for interest rate rises and upbeat earnings from the technology and energy sectors lifted spirits, I do not expect new highs. On the other hand, I don't think

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another S&P 500 market meltdown is in the cards. By year end, a 5% market return to 4350 is a very good bet, almost 10% less than the all-time high of 4800.

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