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Weekly Commentary

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Macro View

By Hubert Marleau

The Upward March To Normal

Submitted September 24, 2022

As expected, the U.S. monetary authorities delivered their third straight supersized interest rate increase, raising the cost of money by 0.75% to 3.125% in a further effort to reduce the Fed's balance sheet. What surprised the market however, was their forward guidance, which projected that the policy rate could rise another 125 bps this year and end around 4.675% in early 2023. The bottom line is the prospect that interest rates will now go and stay higher than previously anticipated, guaranteeing that the dollar will remain strong, the yield will remain inverted and the policy rate will hold out above the so-called neutral rate. Consequently, the pace of U.S. money supply will surely decline further and farther and by extension reduce the dollar value of the world supply of money.

According to MacroStrategy Partnership, the world money supply is down USD7.6trn from its high, retracing 29.4% of its entire rally from the March low to March 2022 high. Meanwhile, both the Federal Reserve Board and Federal Reserve Bank presidents have come out with new economic projections. On inflation, the Fed’s favored measure, the core personal-consumption expenditures deflator, which excludes food and energy prices, was up 4.6% in the 12 months ended July but only 4.5% by year end, and to 3.2%, 2.3% and 2.1% by 2023, 2024 and 2025 respectively. Powell emphasized that he wanted to see positive real interest rates - that are above the expected rate of inflation. They already are across the entire yield curve. Consequently, the Fed has adopted an asymmetric monetary stance, emphasizing inflation over employment and growth: a policy which has already made its mark on the economy. The Conference Board’s Leading Economic Indicator fell 0.3% m/m in August, the 6th such consecutive decline, while the GDPNow model is tracking only 0.3% growth for this September quarter. The Fed’s medium forecast for economic growth is now a mere 0.2% this year and a meagre 1.0% in 2023, with rumors of a looming recession here, there and everywhere along with rising unemployment. Fortunately, low labour participation rates and lots of job openings should prevent the unemployment rate from rising above 4.7% for this cycle.

Macro View cont.

By Hubert Marleau

In this connection and given the helping hand of the greenback, Fed may pull off a mild inflationary bust. The strength of the dollar will not be ignored forever. Otherwise something will break. Think of this, the S&P 500 is down 20% while the DXY is up 20% over the past 12-months. The reduction in world dollar liquidity is becoming a financial and economic threat not only to emerging economies but to the highly developed ones. Indeed, on Thursday, Japan took unilateral action to intervene in the forex market. The IMF and the World Bank have expressed concerns that central banks might be excessive in their actions to raise interest rates. This is bound to lead to coordinated intervention among developed countries as they did before in 1985 and 2000.

Meanwhile, I have lowered this year's target for the S&P 500 to 3650 because the market capitulated this week as retail market sentiment panic. Positioning in speculative futures is crowded on the short side. The primary reason is the fear of rising inflation. In such circumstances, pullbacks are something we have seen many times before. In the past 42 years, there have been 9 declines of 20% or more. But, once the monetary surgery was over, the market bounced to new highs because we ended up with a more normal, healthier and less inflationary economy. That may be why the Insider Transactions Ratio is bullish.

Yes, equities usually produce generous returns in similar aftermaths. As such, I'm targeting 4350 for the S&P 500 by the end of 2023 because by then there will be substantially more proof that inflation has cooled. Based on the experience of 1928-2021, periods of falling inflation have generated lasting average returns of 14.7%. The bond market is convinced. In the words of FT's Robert Armstrong: "The whole move up in long term bond yields this year is explained by real yields (that is, higher yields on inflation-protected Treasuries), not by higher inflation expectations, which are down. So the simplest interpretation of what has been going on is the faith in the Fed is deepening. People increasingly believe the central bank is going to be tough, and the toughness is going to work." Incidentally, the bullion market agrees. Gold price, which is billed as a hedge against inflation, is off 15% from the high registered last April even though the economy is in an inflationary boom. The first one in 4 decades.

In closing, it should be noted that history shows that equities also offer pretty good inflation protection. For the comparable period, the average returns under rising inflation was 5.5%. Companies have a tendency to react quickly to inflation pressures by cutting input costs. Costco, FedEx and many others have done so this week.

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