To subscribe to our Newsletters www.palos.ca/register

PALOS

Weekly Commentary

Issue **No. 30** | **OCTOBER 11, 2022**

CONTENTS

Keep Calm and Carry On: It Looks Like a "Soft Landing" 1
Disclaimer & Contacts 4

Macro View

By Hubert Marleau

Keep Calm and Carry On: It Looks Like a "Soft Landing"

Submitted October 8, 2022

Last week, I wrote that central banks were no longer in a position to ignore the liquidity drawdowns caused by "the relentless increase in the forex value of the U.S. dollar, the sharp run-off in bank reserve balances, the furious rise in interest rates and the rapid reduction of their balance sheets." Many countries are now getting into the action in some form or another. In recent days, the Bank of Japan sold dollars, the Bank of England bought bonds and the People's Bank of China relaxed their monetary stance.

On Tuesday, the Reserve Bank of Australia (RBA) raised rates by 25bpts to 2.60%, below market expectations, stating that it is appropriate to slow the pace of increase, while the Reserve Bank of India intervened to arrest the rupee's depreciation. The United Nations Conference on Trade and Development (UNCTAD) warned that central banks risk putting the global economy into recession if they keep raising interest rates.

Stateside, a dovish pivot may not be imminent, but a movement towards a less restrictive stance or less aggressive rate path may be in the cards. The U.S. monetary authorities are becoming concerned about the dollar's nefarious appreciation on key U.S. geopolitical allies. There is fear in the air that a capital flight could freeze credit and that imported inflation could destabilize the monetary system.

Rumors now abound that an international arrangement to engineer a reliquification of the dollar will be a main topic in mid-October when all the central banks meet for the IMF conference in Washington. According to MacroStrategy Partnership, the dollar value of the world money supply excluding the US is down USD8.0trn from its March 31st high, giving up 40% of the entire runup from its March 2020 low. No wonder hedging

Macro View cont.

By Hubert Marleau

costs for swapping foreign currencies have soured! U.S. monetary policy gets filtered out to the world because it's a global dollar system.

I don't know if we are going to get a formal accord or a surreptitious agreement. A chorus of bankers is increasingly name-checking the 1985 Plaza Accord, the 1987 Louvre Accord and the 2002 Shanghai Agreement. What is crucial is that there will likely be an intent or an effort to arrest the appreciation of the dollar.

Beating inflation requires a coordinated global response. Fearing collateral damage, Richmond’s Fed Chair, warned the market that the Fed may go along with one of the aforementioned ideas. This would mean that the Fed may modify its planned rate hikes, especially if hard data points and anecdotal indications continue to give nascent signs of cooling inflation and employment. It has been done before. In late 2015, with no official announcement, the Fed had promised 4 quarter-point hikes in 2016. It did not happen. It raised its target rate only once.

Hawkish cacophony from a variety of Fedspeaks has a lot more to do with posturing to keep expectations in check than anything else. Investors submit too easily to their official position. There’s often more truth in their thinly veiled comments or better hints in what they avoid saying. It's impossible for the monetary authorities to be unaware of the dollar risk. Over the past week, they had two wake-up calls: one in London and another in Tokyo. The Fed knows that continuing to hike policy rates aggressively will break something. Unprecedented levels of interest rate volatility must stop to avoid hidden landmines.

The Fed May Get an Opening:

The NY Fed’s Global Supply Chain Pressure Index (GSCPI) decreased broadly in September, making a fifth month of easing and falling close to historical levels. Unsurprisingly, the September ISM manufacturing index slowed to 50.9 registering the lowest reading since May 2020, and showing that prices paid by manufacturers for components fell to 51.7, the weakest since June 2020 and down from a 12-month average of 73.7, while the employment sub-index contracted to 48.7, suggesting that jobs were rolling over. US job openings notched one of the largest monthly declines on record in August. Openings were 10.053 million, a full million below consensus: an unambiguous indication that labour market friction is cooling as the ratio of job openings to those counted as unemployed is falling. A few more months like the one we just had would restore the old relationship of 1-to-1 between vacancies and unemployment, which could short circuit a wage-spiral without too many people losing their jobs. According to economic orthodoxy, inflationary episodes don’t originate

Macro View cont.

By Hubert Marleau

within the labour market. They are usually associated with highly expansionary fiscal policies combined with furious growth in the money supply.

The September job report showed that hiring was resilient. Nevertheless, a gradual cooling pattern in the labour market is taking hold. Employment grew 263,000, a marked deceleration from the previous 8 months' average of 440,000 while wage gains lost momentum, declining to a yearly increase of 5.0%, the lowest since last December. About half of the CEOs in America are not expected to add to their workforce from hereon. Companies, including Walmart and Amazon, are pulling back on hiring, while others like Google have frozen hiring altogether. Meanwhile, few companies like FedEx, Snap Inc or Facebook are cutting jobs.

Maybe Powell is right that the path to higher interest rates might be absorbed by the huge overhang of job openings rather than by the actual losses of jobs. A veritable Lazarus moment for the left-for-dead "soft landing" story is therefore still alive. A careful historical analysis suggests that the Fed had a much more encouraging record than the media says. In fact, it managed to get reduced inflation without causing a deep recession in 6 out of 11 cases. It failed when its policy was overwhelmed by events out of its control.

Nevertheless, pulling it off is no small feat. The best way to monitor how successfully the Fed will strike a delicate balance between inflation and employment is with the Misery Index, which is the addition of the inflation to the unemployment rate. Currently, the index stands at 11.8% with an inflationary content of 70%. A gradual movement to 7.5% with an inflation content of 40% would be ideal - no stagnation, no stagflation. The index is moving in that direction. If inflation is falling as fast as many surveys allege, the Fed may soon get a break. While I recognize that it will raise the target rate into restrictive territory and hold it there for a while, it will not likely be more than 25 bps above the neutral rate, which is 4.00%. The latest dot plot telegraphed a 125bps increase over this year's remaining meetings. However, Jerome Powell was keen to emphasize that many Fed members are calling for 100bps, a number that would collaborate with 5-year Treasury notes: 0.75% in November and 0.25% in December.

Although the S&P 500 took a big beating last Friday, it managed a weekly rise of 54 points or 1.5%, suggesting that investors have not abandoned the belief that the Fed will amend its monetary stance down the line. Given that the market is deeply oversold, guidance on the dollar, inflation and liquidity issues could bring about a long awaited technical rally. The technical analysts at JPMorgan, TheoTrade and Cantor Fitzerald have determined, through the use of quants and fundamental analysis, that the S&P 500 has turned tactically bullish and could finish the year nearly as high as 4200.

Incidentally, the Bank of America is long-term bullish on Canada.

Weekly Commentary

Issue **No. 30** | **OCTOBER 11, 2022**

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., "Palos"). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos' written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. "S&P" is a registered trademark of Standard and Poor's Financial Services LLC. "TSX" is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market value weighted index engineered to measure publicly issued noninvestment grade USD fixed rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca