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Weekly Commentary

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By Hubert Marleau

Is Canada Foreshadowing a Backlash Against Aggressive Monetary Policy: YES

Submitted October 29, 2022

Last week, Nick Timiraos, known on Wall Street as the Fed Whisperer, wrote in the WSJ that the Fed's rate-setters will raise the policy rate another 0.75% on November 2, but will likely tame future hikes. Well, Tiff Macklem, Governor of the Bank of Canada seems to have beaten Jerome Powell, Chairman of the Federal Reserve to the punch on this one.

Normally, I wouldn't waste too much ink on discussing what's up with Canadian monetary policy. Canada is not a significant player like the U.S., the Eurozone, the U.K and Japan. Yet it appears to be a front runner in this case. In the current rate-hike cycle, it took the lead, being the first one to raise the cost of money, combining quantitative tightening with huge interest rate hikes and being the most hawkish among the G-7 central banks. That was until now.

On Wednesday last, the Bank of Canada was again the first major central bank in the western hemisphere to admit that the end of this cycle was approaching. It raised the target rate by 0.50 percentage points to 3.75% rather than the widely expected 4.00%, and said that the end of the tightening campaign was not over, but near. The policy rate is now equal to the neutral rate; the yield curve is inverted where it counts: and the decline in the money supply is accelerating, as is the furious shedding of household wealth. Consequently, the Bank's governing body is probably convinced that past, present and anticipated actions are about to have the desired effect on the pace of inflation and economic growth. It has already cut its forecast for growth to 0.9% next year from 1.8%. Thus many economists are now predicting one more rate increase of 0.25% in December, leaving Canadians with a terminal rate of 4.00%.

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By Hubert Marleau

Meanwhile Christine Lagarde, the ECB's chief, delivered another 75bps rate hike on Thursday, doubling the policy rate in the process. But she simultaneously dropped the hawkish rhetoric used in September, moving from intended rate hikes to possible ones. I have a hard time figuring out where the Eurozone's neutral rate is. Europe is complex and convoluted. My best guess is 2.50%. That's 1.00% above the new policy rate, it shouldn't underscore the fact that Europe will have a very rough winter. All the European prints suggest awful sentiment and decelerating economic activity. Meanwhile, Hawuhika Kuroda, Governor of the Bank of Japan, said: "The Bank does not have any plans to raise interest rates or head for an exit from ultra-low interest rates anytime soon, despite forecasts for higher inflation.

When the latter is taken in conjunction with the Bank of Canada's giving notice of abdicating from an aggressive monetary stance, I have the suspicion that Jerome Powell may utter a slower pace of hikes, starting in December. In other words, the Fed will likely parley similar comments on November 2 when the FOMC meets, even though the U.S. economy expanded at a 2.6% annual rate in the September quarter, ending a streak of back-to-back contractions. The third-quarter figures were skewed by advantageous trade dynamics, as consumers shifted their spending away from durable goods toward services under supportive terms of trade, as the U.S. exported record amounts of high-price fossil fuels. This was accompanied by favourable productivity initiatives as firms invested in business equipment and software to replace labour. These three items camouflaged considerably slower consumer spending and a significantly weaker real estate market. Without those two former line-items, the economy would have contracted to an annual rate of 1.2%. Viewed in another way, final sales of private domestic purchases-a measure of underlying demand that excludes the effects of swings in trade, inventory levels and government spending-grew at an annual rate of just 0,1%.

Meanwhile, the headline price index print in the GDP report was 4.1%, far less than consensus and down from 9% in Q2. More of the same can be expected going forward. The Conference Board's leading economic index and the forward swap market confirmed that the Fed was having its desired effect on the economy. The index fell 0.4% month-over-month in September, after a 0.3% drop in August. Should it go along with the expected 0.75% rate increase on Wednesday, the yield curve would be inverted across the full term and the policy rate would only be 25 bps lower than the neutral rate. In this connection, the narrative could shift from the bearish inflation shock of the past 10 months to bullish inflation reversal. The thinking of both the bond and forex markets and the forex reflects this anticipated pivot.

Despite the wipeout in big tech stocks, with exceptions made for Apple and Shopify, the sunnier earnings season than expected, and hints that central banks are in the process of tilting their monetary stance towards moderation, made the bears look stupid. The S&P 500 ended the week at 3901 registering a gain of 148 points or 3.9%. Although the index is approaching a line of resistance, there are nonetheless reasons to believe that

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investors will manage it. Institutional investors are loaded with record amounts of cash and may decide to deploy it. The October bull run was associated with a steady decline in the skew index, a tail risk measure, which fell from 125 to 113 over the past month. Skew values generally range from 100 to 150, where the higher the rating, the higher the perceived chance of a severely damaging recession. Accordingly, the idea of a soft landing in growth combined with a hard fall in inflation idea is holding up. Incidentally, insiders are still buying their company stocks a lot more than they usually do.

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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