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Weekly Commentary

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Macro View

By Hubert Marleau

Moderating Inflation plus Purple Mud rock the Markets

Submitted November 12, 2022

In October, the Consumer Price Index (CPI) rose 7.7% from a year ago, far better than expected. While the yearly increase is making the headlines, both investors and central banks are starting to give more weight to timely measures to see if the data confirms whether inflation has indeed peaked, and if the trend has turned.

It has on both counts. First, in the three months ended October, 2022, the 3-month annualized rate was 3.8%, within the 1985-2020 range. Second, the Bureau of Labor Statistics (BLS) reported the 4th successive slowdown in the CPI from a high of 9.1% in June. The N.Y. Fed's Underlying Inflation Gauge (UGI) "full data set" measure for October is currently 4.2%, a 0.4 percentage point decrease from last month with an estimated trend of 4.9%. The latter was 5.2% in September. David Rosenberg, under the headline "Deflation Thumbprints All Over the CPI Data" wrote: "If not for the big increases in shelter (0.8%), energy (1.8%) and food (0.6%), the CPI would have declined outright by 0.1%, the first dip back to deflation on this measure since May 2020."

Moreover, there are other downbeat signals suggesting that the global economy is under deflationary pressures. Bulging inventories and cautious consumers are hitting Chinese-made goods. In the 12-months ended October, producer prices fell 1.3% and consumer prices rose 2.1%.

On Thursday, stocks were up 6%, the Greenback was down 2% and 10-year US yields fell 32 bps. What really happened was the realization that the days of accelerating price increases are behind us and that inflation has not only peaked but could sharply reverse. The swap market for U.S. treasuries instantly predicted that, by next November, the year-over-year increase in consumer prices would be only 2.5%. Traders no longer

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believe that the Fed will take the termination rate to 5%. Bloomberg's John Authers called that shift quite breathtaking.

With the help of Russian troops pulling out of Kherson and the lifting of many Covid restrictions in China, the week turned into a perfect bullish storm. Goldman's financial conditions index eased by over 50bps, a monumental drop that was among the largest on record for a single day. By Friday the S&P 500 stood at 3992, for a weekly gain of 5.9%. For the first time in a long time the NYSE registered more highs than lows and the Skew index fell to 111 suggesting that tail fears may have disappeared. Note that if FTX, a crypto exchange, had not fallen from grace, the broad market might have done even better. At this time, I don't see any bearish economic catalysts between now and the December job and inflation reports. The next FOMC comes after those two crucial prints. Strategists at Citi Bank said that based on history, the equity market has tended to rally for the following 60 days.

From hereon the Fed is likely to pay a lot more attention to the aforementioned forward-looking indicators and assess whether the monetary stance is over tightening into a downturn. The market is realizing that the Fed's focus is about to change, increasing the odds that the economy could glide into a soft landing. The Atlanta Fed GDPNow model estimate for real GDP growth in the fourth quarter of 2022 is 4.0%. The WSJ found that of the previous 11 battles the Fed has fought against inflation, only three produced "hard landings".

There is more to this endgame. The greenback could become a very significant factor as many foreign central banks are caught up in the dollar-based credit cycle. According to MacroStrategy Partnership's Julian Garran, what could prompt the Fed to moderate its monetary course is a final blowout of the dollar resulting from either a severe deterioration of China's property market and/or a devastating European energy crisis. Over the past six months, the U.S. money supply suffered a sharp reversal, declining at an annualized rate of 2.5% due mainly to base monetary contraction. It is therefore conceivable that the monetary authorities may have to rethink their quantitative tightening (QT) program and/or planned rate hikes.

The banks are obviously seeing the workings of this endgame. The scarcity of dollars in the forex markets, the ferocious fall in the dollar value of the world money supply, the precipitous decline in Chinese inflation, and the probable decline in government's largesse, are pushing the banks to tighten their lending standards as many more borrowers are falling behind on payments, according to the Fed's Senior Loan Officer Opinion Survey (SLOOS). They have essentially stopped their lending activity with borrowers thought to be too risky, in order to beef up their balance sheet, leaving that business with the so-called "shadow banking" system of hedge funds.

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I'm not sure how the latter will play out, given that the U.S. may end up with a split government colored in purple mud. There may be little point in speculating on the outcome. Yet, the probabilities favour a Republican majority in the House and a very remote possibility in the Senate. At the time of writing, the bets are giving the Democrats Arizona and the Republicans Nevada. Thus, if the Libertarian votes were drawn to Herschel Walker, the Republican challenger in Georgia - especially if he distances himself from Trump, the biggest loser of this election - the GOP could win the Senate with a Libertarian nudge. Should the Republicans take the House and/or the Senate, President Biden will have to deal with the reality that his progressive agenda would be dead in the water for at least 2 years.

In this regard, only compromises can be expected in return for an extension of the expiring tax provisions of the 2017 tax reform. What is certain is that the red-blue congressional blood will bring about a major fight over America's debt limit, fiscal largesse and tech regulations. On balance, fiscal drags are less inflationary.

The bottom line is that the administration might be forced to reduce spending in return for a debt deal or less regulation because crossing the aisle is unthinkable. Gridlock, which represents more continuity than change, seems to be what's in store. This might be positive for markets - bonds and stocks both - because it usually brings stability, making it difficult to get legislation through. History is clear on this one. A Democratic President with a Republican or split Congress has brought above-average returns for investors. However, over the long term, the cultural and legal differences between blocs of states will likely calcify, leading to a national divorce, with red states like Florida being against the elites and blue states like California being for them. Interesting times! Pretty much the same is occurring in Canada, but in a milder fashion.

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Disclaimer:

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