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Weekly Commentary

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Macro View

By Hubert Marleau

What Next? Money, Savings, Growth, Inflation and Policy

Submitted December 2, 2022

On What I Rest My Case for Lower Inflation:

As you know, I've been of the view for several months that peak inflation is behind us and that the trend has turned. I use money supply data as a guide to forecast whether monetary policy will eventually break the back of inflation. According to monetary theory, popularized by Milton Friedman, a contraction in the money supply should reduce inflation.

Growth in the M2 measure, which consists of currency, transaction bank balance and retail savings accounts, has collapsed to a negative annual rate of 2.6% in the 7 months ended October/2022, generating only a 1.3% increase from the level of a year ago. M2 expansion peaked around 27% in February 2021. By any record, we've had a stunning reversal.

Andrew Lees, the chief economist at Macro Strategy Partnership, showed in his November Monthly News Review that base monetary expansion had slowed heavily, leaving little room for the private sector to compensate for the shortfall. Banks will likely tighten their lending standards. Their tangible equity is much lower than reported book equity, if consideration were given to marking loans and securities to market, draws on FDIC and losses related to holdings of U.S. Treasuries, mortgage-backed securities and municipal bonds.

Christopher Whalen, the Chairman Whalen of Global Advisers, has put all of those considerations together and calculated they may represent a capital deficiency. US banks have already started to address this potential problem. The FDIC said that US banks had set aside $14.6 billion for bad loans in Q3, up 31.5% q/q.

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Perhaps for different reasons, but interestingly several Canadian banks have significantly increased their own loan loss provisions even though the economy is still expanding.

There are other big reasons why I believe low or no monetary growth is in store. The Fed is shrinking its balance sheet by $95 billion a month and will raise the policy rate by another 50 bps in 10 days.

Moreover, the dollars that were pumped into the economy by the pandemic stimulus are likely to remain in bank and money market accounts because business confidence and consumer sentiment feel incrementally bad about economic prospects.

I would be astonished if the Americans were willing to run down the personal savings rate any lower than 2.3% - the point where it stood in October. Hiring is slowing, layoffs are rising and job openings are falling.

There is also the “wealth effect on steroids.” In 10 months, a whopping $22 trillion was lost in equities, bonds, cryptocurrencies and real estate. That amounts to a $700 billion reduction in consumption expenditures, according to the Bank of America, representing 60% of the remaining amount of the so-called “cash buffer” held by the household sector. Unfortunately, the bulk (70%) of this $1.2 trillion cash buffer is concentrated within the merely rich and the ultra rich. Indeed, it is questionable whether those excess savings will ever be spent. Economics 101 is clear on this one thing that the richer one is the lower his marginal propensity to consume. And there is the fact that much of the money saved has been absorbed into long term savings or used to pay down debt and is therefore no longer available as extra spending money. That is the thinking of the Levy Center, a highly reputable research organization.

Based on these observations, I see nominal GDP expansion slowing sharply next year to 4% from 9.1% recently.

Guessing Fed Future Moves:

The fault lines between Fed officials are deepening as they grapple with disagreements over whether too much or too little has been done. This will become obvious after the December 15 FOMC meeting. A Fed pause will occur if the rate of inflation declines aggressively, or the economy falls off the track. Cognizant that higher rates and lower money supply growth impact output and/or inflation differently and with variable delay, trying to find the cause and the timing of an inflection point is tricky.

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We are indeed entering a difficult phase because we simply do not know what will be the cause of the prospective pause. Presently, economic data is signalling that the deflationary effect of the inverted yield curve, quantitative tightening and fall in the money supply, is hitting inflation here, there and everywhere much more than growth. Commodity prices, housing costs, retail margins and the pricing of durable goods, have plummeted. Meanwhile, for all the chatter about a recession, one hasn't arrived yet. R-GDP for the third quarter came at 2.9% and the Atlanta Fed Model is projecting an annual growth factor of 2.8% for Q4.

More Good News on the Pace of Inflation this Week:

The Citibank G4 Inflation Surprise Index is now 50.0, 60% less than it was at the end of last year.

In the past year, the trade service component of the Producer Price Index explains why the gross margins of retailers and wholesalers have exploded. The data shows that the gap between price paid versus price sold widened. However, the factors that created this pricing power appear to have peaked. Since last August some mean-reversion has occurred as the inventory-to-sales ratios for a large variety of products have risen.

It looks as if a glut is developing for memory chips that are largely used in personal computers and smartphones. A DRAM (4Gb 512m X8) currently priced around $1.50 is down more than 50% from a year ago. While high end chips used in automobiles, specialized applications and sophisticated equipment are not yet in a glut, they could very well be in 2023 because government restrictions on China will effectively raise domestic supply.

The Case-Shiller Home Index was down 1.5% m/m in October, having declined for three straight months while pending home sales fell 4.6% m/m - the 5th straight decline.

The Dutch November harmonized CPI slowed to 11.2% from 16.8%. It was down 4% m/m, with the 3-month negative annualized rate of 0.1%. Meanwhile, the annual rate of inflation in the eurozone fell to 10.0% in November from 10.6% in the previous month, the first such decline since mid-2021; and the Australian CPI slowed to an annual rate of 6.9% in October from 7.3%, way below expectations of 7.6%.

The labour market is slowly loosening up. The JOLTS job openings for September were revised down heavily, with October data now 1.551 million below the March high. Meanwhile the employment component of the ISM manufacturing index also declined, consistent with the slowing pace of payroll growth. The 263K increase in the November nonfarm payrolls, which was considerably above the 200K consensus, gives the Fed juice to

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raise interest rates. However, consideration must be given to the household survey. It showed employment falling by 138K, dropping by a total of 456K in the past 2 months.

The PCE price index came in 0.2% higher in October, lower than estimates of 0.3%, and taking it from 6.3% to 6.0% y/y. More decreases are expected because the ISM price index took a large drop in November, confirming that supply issues are improving, a good omen that further decreases in the PCE index are forthcoming.

The Fed Speaks Loud:

New York Fed John Willams said: “I expect inflation, as measured by the core personal consumption expenditures index, to slow from its current level of 5.1% to between 3% and 3.5% next year as a result of cooling global demand and few supply chain disruptions.”

Richmond Fed President Thomas Barkin said: “I’m supportive of a slower path, but one that would be probably longer and potentially higher.”

St Louis Fed President James Bullard said: “The policy rate has not yet reached a level that could be considered sufficiently restrictive.” saying that 4.88% is what is needed to put meaningful downward pressure on inflation.

A report by the Cleveland Fed said: “Based on 7 commonly followed monetary rules, the Fed Funds target is already too high.” It should be at 3.52% compared with the 4.38% expected on December 15.

Federal Reserve Chair Jerome Powell said: “The time for moderating the pace of rate increase may come as soon as the December meeting.” He added: “We wouldn't try to crash the economy and then clean up afterwards.” Put simply, the Fed may not want to overtighten because it does not want to be forced into cutting the policy rate.

Wall Street Dodged the Job Bullet:

The market has been groping for bottom for 6 months and the probabilities are weighing toward a positive settlement. From hereon the Fed will give increasing attention to its other mandate of keeping employment as high as possible, conditions permitting. Meanwhile, we’ve entered the best time of the year for stocks. December usually finishes with positive returns - about 75% of the time since 1950. Plus the latter half of the

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4-year election cycle is normally good for the stock market. The S&P 500 was up 46 points or 1.1% this week, closing at 4072.

P.S. Over the past few months Palos' exposure to gold stocks has risen and it's larger than it usually is. We bought gold for potential returns, nor for insurance.

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