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# Macro View

*By Hubert Marleau*

## The State of the Economy is Disinflationary not Deflationary

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We live in an age of information overload where little attention is paid to nuances, definitions and precision. What really counts is not so much what is said but how it's said, if one wants to capture the situation accurately. As a rule, commentators have made hardly any distinction between deflation and disinflation, confusing investors as to whether the path of the market and its components are moving in the correct direction. Deflation is defined as a process of falling price levels, which is usually associated with a severe contraction in economic activity and/or a fallout in liquidity. Meanwhile, disinflation means a slowing rate of inflation, which is associated with increasing productivity or cyclical slowdowns. The former is devastating, while the latter is normal. It is basically a cyclical or technological process of equilibration where the forces of supply and demand are rebalanced. And that is the situation we are in.

A few weeks ago, I wrote that there was a 75% probability that we would end up in 2023 with either a "soft landing" or "immaculate disinflation," and a 25% chance of a deflationary outcome. So far, I have no reasons to change my mind. There have not been any major developments to negate or adjust my outlook. Inflation is falling fast and business activity is weakening, but not collapsing. December retail sales fell 1.1% m/m, having already fallen 1% in November while industrial production was down 0.7% m/m. On January 18, the Atlanta Fed GDPNow model estimate for real GDP growth in Q4 of 2022 was reduced to 3.5% from 4.1%. After the recent release of the aforementioned economic prints, the nowcasts of 4th-quarter real growth for gross personal consumption expenditures, gross private domestic investment and government spending, decreased from 3.5%, 6.8% and 1.0% respectively to 2.6%, 6.6% and 0.8%. Yet, amid massive tech layoffs, the labour market is showing resilience. Indeed, many of those layoffs are finding their way into the service and manufacturing sectors, which are seeking experienced digital workers. And there are millions upon millions of openings. Perhaps remarkably, the jobless claims remain low. Only 190,000 people filed for unemployment

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benefits last week. New research from the Federal Reserve of Chicago examined the recent behaviour of the Phillips curve - a measure of the inverse relationship between inflation and unemployment - and found that the curve has steepened, meaning that a decline in inflation is leading to a smaller increase in unemployment. In other words, the sacrifice ratio is substantially lower than it used to be. In this connection, we are either going to get a slowdown to 1.0% or a modest decline of 1.0% in Q1/2023: precisely “Immaculate Disinflation” or a “Soft Landing.” Put simply, it's my view that an extended contraction isn't necessary to corral inflation. Credit spreads are too narrow, the dollar too weak and balance sheets too strong to suggest that we are confronted with a liquidity crisis.

Indeed, markets were handed a lot of favourable news on inflation. Firstly, The December CPI slowed to 6.5% y/y, down 0.1% m/m with the 6-month annualized rate at 1.89%, compared with 11.1% in the first half of the year. Secondly, producer prices fell 0.5% in December, depressed by a 6.3% drop in energy prices and a1.0% fall in food prices. In fact, the 6.2% 12-month increase was the softest since March of 2021 and way better than the consensus expected. Thirdly, the Canadian CPI rose 6.3% y/y in December, down from 6.8% in November and a high of 8.1% in June. It was down 0.6% m/m with the 3- and 6-month annualized rate 0.79% and 0.1% respectively, down from 12.68% in the first half of the year.

Incidentally, The Wall Street Journal’s latest quarterly survey reported that, on average, the business and academic economists put the probability of a mild and short recession at 61% and expect consumer inflation to fall to 3.1% by the end of this year. At a global strategy conference a few days ago, Goldman Sachs queried hundreds of clients on the most pressing macro issues facing the U.S., finding that 57% expected a downturn in 2023. On the same day, the BofA released the January Global Fund Manager survey, which showed that 68% of the respondents expected a soft recession in the next 12 months. Despite all of that, however, it won't stop Federal Reserve officials from favouring more interest rate hikes, albeit at a much lower pace. Expect a quarter percentage point increase on February 1. The futures are giving that a 96% chance.

Contrary to the prevailing view, however, I believe it may be the last one for this cycle. Why? I have 3 big reasons.

Productivity:
Over the past 18 months, businesses have allocated an abnormally large amount of money to measures which optimize their production lines with robotics; to back-office efficiencies, by cutting white collar redundancies; and to marketing operations through digital transformation. A back-of-the envelope calculation, based on employment and GDP increases for Q4, gives me an estimated annualized productivity increase of 1.5% to 2.0%.

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Rent Charges and Wage Rates:
In order to get the 2% to 3% target that the Fed is seeking, rent and wage pressures must ease. The stats show that this is happening. The rent inflation - a core component of shelter inflation, which is arguably the most important part of “sticky” service inflation, is actually far lower if measured correctly. If the BLS were to look at the “New-Tenant Repeat Rent” index, which tracks market indices such as Zillow and Apartment List more closely than the “All-Tenant Repeat Rent Index” it would readily see that CPI inflation is falling much faster than reported. The December CPI y/y increase would be closer to 6.0%, compared to the reported 6.5%. This brings me into the “core-core” ex-housing series. It's the new thing in inflation tracking because it is driven by all-important labour costs. In December, average hourly earnings rose by just 0.3%, putting the y/y increase at 4.6% and the last 3 months at 4.1%. If my productivity measure is correct, the unity labour cost would be within the 2.0% to 3.0% target range.

The Monetary Stance:
Metrically, monetary policy is where it ought to be. There is absolutely no reason to go beyond a policy rate of 4.75%. The yield curve is already inverted, and has been that way for a long time; plus the policy rate is above the so-called neutral rate and inflation expectations, at a time when the money supply has hardly budged in a year. The big money banks were littered with disinflation rhetoric during their earnings call. Secretary of Treasury Janet Yellen and Fed Chair Jerome Powell are not going to allow disinflationary conditions from becoming a horrendous recession. In fact two senior Fed officials (Brainard and Williams), both recognised members of the triumvirate, acknowledged that progress on inflation will raise questions over the extent to which the Fed needs to cool off the labour market to further the fight.

**The Stock Market Outlook May Surprise to the Upside:**

Ed Yardeni of Yardeni Research, a top of the line strategist, believes that we are in a young bull market. The S&P 500 is up 11.0% from the October low of 3577. It's the fourth attempt by the bulls to keep the rally above the 200-day moving average. This time it might succeed, because inflation has rolled over, the soft landing scenario is present, and earnings are holding up at a time when the Fed tightening is fast approaching its apex.I'm sticking with my forecasts of 4200 by year-end, because I expect S&P 500 EPS earnings to grow by 5% to 8% above the 2020 level of $230. According to Refinitiv, S&P 500 companies have so far reported earnings 3.7% above expectations compared with a long-term average of 4.1%. It’s lower, but much better than the general belief that earnings would tumble: 63% of reported earnings were above analyst expectations The equity risk premium is perhaps somewhat low at 3.00% (earnings yield of 6.40%, less 10-

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year treasury yield of 3.40%). But, when it's adjusted for what the bond market's price inflation expectation will be a year from now (1.90%) it looks pretty good at 4.50%.

**The Debt Gridlock is Investment Risk:**

The Federal Government has hit its $31.4 trillion debt ceiling. If that ceiling is not increased, its cash balance of $400 billion will be exhausted by the end of May, in spite of the introduction of extraordinary measures like stopping contributions to the Federal pension fund. The Republicans and the Democrats are on a collision course over it, even though they are both at fault. The debt, which now accounts for about 150% of N-GDP, is the product of decades of tax cuts and increased government spending. Over the years, it has been a routine matter to raise the cap to avoid default. Since 1960, the ceiling has increased no less than 78 times. This time however, it could be different, because something has to be done before it gets too late. The newly empowered House of Republicans has vowed that it will not raise the borrowing limit again unless President Biden agrees to steep cuts in federal spending. Meanwhile, Biden has said he will not negotiate conditions for a debt-limit increase, arguing that lawmakers should lift the cap with no strings attached to cover spending that the previous Congress authorized. It's a James Dean chicken game. Thus, I can't dismiss the real possibility of a default. Should the full faith and credit standing of the U.S. government be lost, the default would send shock waves throughout the world economy. The US debt and dollar are the global benchmarks for interest rates and currency exchanges and the bedrock of the world-wide financial system. I do not subscribe to this threat. Both chambers of Congress operate with very thin majorities. Therefore, Washington is likely to come up with a compromise. Someone is bound to come up with an idea that would impose specific solutions to control debt already on the books making them palatable to a majority of Republicans and Democrats. Democrat Senator Joe Manchin said he wants to seek a deal with the Republicans, and there is talk of the creation of a special commission to examine the situation.

There are two other intractable headwind risks: the Greenback and Geopolitics. They are, however, for another day.

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