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Macro View

By Hubert Marleau

What’s Going On?

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The Anticipated Slowdown is Here:

In the final 3 months of the year, the economy expanded more briskly than expected. The N-GDP grew at the annual rate of 6.4% in Q4, registering a year-over-year increase of 7.3%. In real terms, it was up 2.9% during the last quarter of 2022, but only 1.0% y/y because the US economy was in a recession in the first half of the year.

Household employment rose at an annual rate of 0.5% and inflation at 3.5%, leaving 2.4% for productivity. The latter, however, rose 2.0% in Q3. I use a proxy, which excludes hours’ work, to calculate productivity - R-GDP/Household employment. It's not accurate but good enough to see trends. The best quote on the matter came from Jay Bryson, chief economist at Wells Fargo: “2020 was the pandemic, 2021 was the bounce back, and 2022 was the transition year.” 2023 is the slowdown in economic growth.

Overall the numbers were not indicative of a recession or a slowdown, but one could nitpick on inventory accumulation and the trade deficit to argue that the growth risk is skewed to the downside. In the past 3 months businesses have raised their inventory levels by $130 billion in real terms not because of lack of buying but because the supply chain was functioning properly.

Nonetheless, there were signs of strain in sectors sensitive to borrowing costs. Spending on durable goods, housing and business capital formation made no contribution to growth in Q4, falling to 31% of R-GDP. The money supply is lower than it was a year ago, and its velocity should soon fall because the banks’ loan-to-deposit ratio is decreasing. Thus the anticipated slowdown has likely begun. The excess savings that Americans accumulated during the pandemic are still about but locked-up in long-term investments, forcing them to spend what they make. The personal savings rate was only 2.9% for the quarter compared to the

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pre-pandemic level of 7.5%, suggesting that less should be expected from consumers from hereon. Indeed, the personal savings rate climbed to 3.4% in December.

The alarm is therefore loud that the economy is in some sort of a contraction. The conference Board's Leading Economic Index, which has a solid record of predicting slowdowns, showed a larger than expected 1% drop in November, marking the 10th straight decline since it peaked in February.

The Fed is getting what it wanted when it inaugurated its tightening monetary stance - lower inflation - and it will soon know for sure that the threat has passed. Core inflation is falling. It's my view that the Fed will follow the lead of the Bank of Canada (BoC), similarly raising its policy rate by 25bps to 4.58% and inferring that it will pause for a while to measure the cumulative impact of previous increases and even a full stop if inflation data were to support such a decision. The Canadian CPI annualized in the second half of 2022 at 0.26% compared with 12.7% in H1, respectively it's 1.8% compared to 11.1% in the U.S. The Bureau of Economic Analysis (BEA) reported on Friday that the Federal Reserve's favoured inflation gauge, the core personal expenditure price index, rose 0.2% m/m in December, bringing the y/y increase to 4.4% and the 3-month annual rate to 2.8%, down sharply from the 5.1% increase as recently as the 3 months to August of last year. This is long before the full effect of the Fed's tightening in the second half of 2022 has worked through into the inflation numbers.

In the same way as the rapid increase in the money supply back in early 2021 was forecasting a surge in inflation because productivity was falling apart, now the opposite is happening. Indeed it may not be stupid to assume that inflation will continue to drop like a shoe throughout the rest of the year. We have reason to believe inflation is poised to collapse commensurate with the sharp decline in the money supply and that some growth will be saved by the grace of the current rise in productivity. In fact, the 3-year surge of applications to start new businesses is indicative of an explosion in entrepreneurial activity, an economic dynamism that usually promises innovation, jobs and particularly productivity advancement. My surrogate indicator of productivity tells me that it looks as if we're getting it. The economic effect of current monetary conditions will likely reduce inflation more than growth but hurt corporate revenues more than profit margins.

At this point in time, the economy has the ability to bend without breaking. Market liquidity is abundant, corporate balance sheets are strong, and the labour market seems to be holding up. Yes, big technology companies are letting people go, but it's not a very large share of total jobs. It's mainly the result of how the pandemic upended the economy. Generally, firms are withdrawing job adverts rather than sacking workers.

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Many of the lost jobs stemming from the technology sector are ending up with small businesses or taken up by start-ups.

Meanwhile, consumer confidence across the OECD has risen, reducing the probability of a full-blown global recession. According to forecasters, who respond to real-time data, it's likelihood is now 30% versus the 50% that they maintained through the second half of 2022. In this respect, the best guide is the U.S. dollar and the energy bill. Since its peak in October, the DXY, a trade-weighted value of the greenback, has fallen 8% and the fossil fuel bill as a share of world GDP is 6.5% compared to 12% last September. That is why both recession and inflation fears have ebbed, encouraging the soft landing crowd. In the US, consumer sentiment posted a sizable gain in January, according to the University of Michigan, maintaining a modest upward trend in place since it hit a low last June. In the week ended on Friday, the S&P 500 shot up to 4071, registering a weekly gain of 2.5% and an increase of 13.6% from the October bottom.

I approach technical indicators with apprehension, despite their outstanding historical record. Many seasoned investors swear by them. The S&P 500 is on the verge of achieving a "golden cross", a very positive sign especially when confirmed by a positive advance-decline line. The former is a momentum indicator, occurring when the S&P 500's 50-day moving average crosses its 200-day moving average. This will happen if the benchmark stays above 4020 until Friday, February 3. The latter is a measure of market breadth, which shows whether the S&P 500 index's gains are powered by a broad range of stocks. On Thursday the advance-decline hit 2.2, its highest level in a year. According to Dow Jones market Data, the S&P 500 has seen 52 golden crosses since 1930. In that time, stocks were trading higher 1 year later 71% of the time. The Barron's pointed out that there were 3 notable exceptions. In 2019 before the pandemic, in 1999 ahead of the dot-com bubble burst and in 1986 preceding the "Black Monday '' crash.

Grey Swans in our Midst:

Rona Forrohar, a columnist at the FT, wrote a thoughtful and insightful letter in May 2021, in which she argued that there were many known risks, unlike unpredictable ones called "black swans," hidden in plain sight that we can see coming in advance. Deborah Pretty of Pentland Analytics dubbed them as "grey swans,". Their timing is unpredictable but the events are not. I've come to the realization that climate change, supply chain disruption, inflation, demographic shifts, financial instability, inequality and populism were predictable before they actually happened. Add in digital connectivity and one has what complexity theorists would refer to as an infinite problem rather than a series of finite issues.

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These types of risks can have investment implications over time, which investors must deal with to minimize their effects on the performance and volatility of their investment returns. Given that such risks usually take a rather long time to fully express themselves, they require step changes in thinking about managing serious underlying problems. If one waits too long until all the data shows, it's going to be too late because deep changes in the way to invest will become necessary without warning.

Last week, I wrote about the U.S. debt ceiling risk. I did not dismiss the possible nefarious outcome of this risk, but I concluded that, perhaps only at the 11th hour, the issue would get resolved. This week let's discuss the risk to the U.S. dollar.

The Dollar Order is Fading Away:

A desire by central banks to hold dollar assets as reserves and a move away from the dollar by foreign investors could reduce in the future. The US owes foreigners a net $18 trillion or 73% of the US GDP, far more than the cautionary 50%, and its current account deficit is close to 5% of GDP., 2 thresholds that have often foretold past currency crises because both are taught to be an unsafe level. This time it could be deep and long enough to threaten the US dollar’s status as the world’s most trusted currency because the geopolitical background is different than it used to be. The dollar share of Foreign Exchange Reserves is currently 59%, the lowest since 1995.

This is what Ray Dalio says: “We are now going to have the major powers and their allies form economic, currency and military blocs.” He’s not to be trifled with. His thesis is based on the assumption that globalization is waning as nationalism replaces democracy, state capitalism replaces free markets, regionalism replaces internationalism, and conflict replaces cooperation. In this connection, many countries have openly flouted, or are about to, the international dollar-denominated economic system.

This change is afoot because China and Russia, among many others, have taken up the task. As China's military and economic power nears parity with the U.S. many other countries may decide to buck the U.S. dollar standard and opt instead for hard or digital currencies backed with gold and/or strategic materials. Brazil and Argentina have manifested intentions to form a South American currency that would rival the dollar, while South-east Asia’s largest economies are settling many payments to one another directly, and India has launched a rupee-settlement mechanism. China, meanwhile, is soliciting countries to make use of the Shanghai Petroleum and Natural Gas Exchange for Renminbi settlement of oil and gas trades.

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De-dollarization is not the only challenge. Central bank digital currency (CBDC) is another. According to the IMF, more than half of the world's central banks are exploring or developing digital currencies through pilots or research, the idea being to digitally interlink themselves, essentially to recreate the network of correspondent banks that the US dollar system runs on. A CBDC-based network would enable central banks to serve as foreign exchange dealers to intermediate currency flows between domestic banking systems without referencing the dollar or touching the western banking system.

There are further changes afoot. China, Russia and Saudi Arabia, who have record current account surpluses, are not recycling them into Treasuries. Instead, they are not only loading up with gold and strategic commodities or making big geopolitical investments, but are also financing countries in need like Pakistan, Egypt and Turkey.

This leads me into Zoltan Pozsar's far-ranging view that the final curtain is closing on the informal Bretton Woods II system, which means the end of world domination of the mighty dollar. Zoltan is a Credit Suisse geopolitical thinker, who asserts that stochastic inflation is here and will eventually bring about the end of the current regime and the dawn of a new one that he calls Bretton Woods III. Bretton Woods I was established in 1944 as a fixed exchange system. It was dismantled in 1971 when President Nixon suspended the convertibility of the dollar into gold, effectively introducing the current floating exchange system based on the dollar called Bretton Woods II. In his judgement, the sanctioning of Russia highlighted how countries could not always rely on access to their dollar reserves. That faith has been shattered. If people cannot buy stuff with money they own, then the situation becomes a major problem. The FT wrote: "The third Bretton Woods era is defined by 3 main pillars: The Chinese renminbi is going to play a far bigger role; gold is going to play a far bigger role in foreign currency reserves: and countries are going to stockpile reserves in essential natural resources."

Here is Zoltan's latest dispatch: "For two generations of investors, geopolitics did not matter. This time is different: It's time to start pricing the secular end of 'lowflation.' When you look at the yield curve and think about the five-year section and then the forward five-year section, by the time the forward five-year' section starts, President XI may have accomplished his next three-to-five-year goal of paying for China's oil and gas imports exclusively in renminbi and may have advanced commodity encumbrance by developing downstream petrochemical industries in the Middle East 'region' of Belt and Road and also the rollout of 'BRICS coin.' I don't think five-year forward, five-year rates are pricing the future correctly."

It is of course possible that the bond market is blind to Zoltan's risk, but preemptively penning macro history of the dollar for next 5 years is dependent on many "ifs and buts". Indeed, the end of the domination of the

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mighty dollar and the demise of the U.S. bond market are hard calls to swallow. I'm not ready to fully embrace either Zoltan or Dalio’s idea that the end of the world as I know it is coming to an end, but I accept the notion that the greenback is not going to be what it once was. Nonetheless, change will occur very slowly. History shows that periods of technological innovation combined with R&D spending at levels we are in today, tend to push the dollar higher.

Moreover, Stephen Jen, a former economist at the IMF and Morgan Stanley, baptizes “The Dollar Smile Theory” as an equilibrator of the world economy. The greenback tends to rise when the U.S. economy is motoring ahead of its peers, falls during growth downturns, and re-rises when a hard recession hits. Keep that in mind, because his thesis can blur the outlook. If $6.5 trillion trade against other currencies occurs everyday and everywhere surely there must already be some bets placed in the very long-end of the futures market against the dollar.

When all is said and done, even though I usually don’t hold gold except around my wrist, I’m discounting these risks with positions in gold, copper stocks and strategic metal, being more hedged in these than I’ve been in years.

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