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Weekly Commentary

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Macro View

By Hubert Marleau

It's All about Inflation:

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Higher-for-Longer Inflation Remains the Biggest Tail Risk:

According to a closely-watched Bank of American survey of fund managers, the biggest tail risk by far remains "higher-for-longer" inflation (40%) followed by "worsening geopolitics" at 17%. The probabilities of a "deep global recession" (16%), "persistently hawkish central banks" (15%) and "systemic credit event" (8%) were much less. The Pew Research Center stressed that the economy is the public's top policy priority. Americans want their government to stabilize growth and reduce inflation. Inflation has become such an important public issue that even the President of the U.S. is compelled to comment on CPI reports, as he did on Valentine's Day. This sensitivity keeps investors guessing whether policies will ever be able to bring back inflation to an acceptable level, in a timely fashion.

The January Reports on Consumer, Producer and and Import prices:

On Tuesday, bullish players who insist that underlying economic and monetary trends will lead inflation consistently toward the Fed's 2% to 3% target range were dealt a "queen of spades" by the January CPI report. It was hotter than expected, up 6.4% year-over-year versus 6.2% expected, and up 0.5% month-over-month. It did not take long for several Fed officials to inform the market that the central bank will need to keep raising rates to a terminal rate as high as 5.5% and keep them higher-for-longer. However, the most critical issue is not necessarily the absolute level of inflation, but rather its direction and whether it is embedded in labour, product and financial markets. Although the pace of easing showed signs of levelling off, U.S. inflation moderated in January to 6.5% from a year ago, marking the 7th straight month of cooling.

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Unfortunately, the data is difficult to parse. The Consumer Price Index included updated category weightings and methodological changes, which biased it to the upside. It could have been interpreted more negatively, if it had not been for the steep 0.7% rise in the price for shelter, by far the largest contributor, - accounting for almost half of the overall monthly gain of 0.5%. The shelter print is backward-looking and destined to fall in the months ahead as inferred by the Zillow's asking-rent numbers. Moreover, the headline was boosted by a 2.4% jump in gasoline prices and a 6.7% leap in piped natural gas utility prices, reflecting the surge in spot wholesale prices in December, which has since more than reversed, and a 0.5% increase in food prices. Food inflation is now slowing, however, lagging the drop in global food commodity prices. That leaves us with the Fed's favourite core measure, services ex-energy, food and housing - the supercore - which rose only 0.36%, pushing the 3m/3m annualized rate down to 4.5% from 5.3% in December. This may be the most important data point for the Fed because it refers to prices that rise when workers get paid for their toil. So when you put it all together, disinflationary trends remain intact. The NY Fed's Underlying Inflation Gauge (UIG), an index that captures sustained movements in inflation from information in a broad set of price, real activity and financial data, for January is currently estimated at 5.1%, a 0.3% point decrease from the previous month.

The January report on wholesale prices added concerns, even though the index slowed to 6% y/y from 6.5% in December. The producer price index, a measure of what raw goods and trade services fetch on the open market, rose 0.7%, but economists had been looking for an increase of 0.4%. What was not picked up by the market was the continued slowdown in the Core Producer Price Index. Ian Shepherdson of Pantheon Macroeconomics made the astute observation: "January was very warm and un-snowy compared to normal and weather effects like that do not persist. It does not follow that there is permanent strength."

Prices for U.S. imports decreased 0.2%in January as expected, posting their seventh straight monthly decline, after declining 0.1% in December. Over the past year, import prices increased only 0.8%.

High Inflation Will End:

The quantity theory of money argues that the money supply transmits its changes to financial and material asset prices, which are linked to economic growth and inflation. In March 2020, the Fed embarked on a large-scale purchase of assets to finance huge government deficits and on an aggressive policy of reducing interest rates. These measures brought about a massive increase in the money supply, which rose by 40% in the 24 months ended March 2022. Sure enough, inflation surged to a record high 9.1% y/y in June 2022, but thankfully, the Fed reversed its monetary stance sharply at the end of 2021. The money supply peaked in

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March 2022, declining in the past 9 months to an annualised rate of 3.2%. This steep historical contraction was accompanied with the fastest and largest increase in the policy rate. John Greenwood and Steve Hanke wrote in the WSJ: "Based on 2022's fourth-quarter data, the excess money balances have already declined to only 11.8% greater than normal." Given that the Fed is not likely to get off its high horse yet, the aforementioned slight bump could dissipate entirely by mid-2023. Accordingly, we could be out of the inflation bewilderment by June.

Economic Growth Is Resilient:

So far so good. January's payroll data and retail sales were robust and there are even signs of life in manufacturing and housing data. Retail sales rose 3% m/m in January compared to a slimmer expectation of 1.8%. There are several factors behind the rebound, after slipping 1.1% in December. The durability of the job market, the end of the pandemic, large social Security checks and a warm winter were behind the stalwart economic prints. It may feel like a recession in the more-affluent sector of the economy; but it isn't that way with the lower-income workers. Their wages have risen and jobs are aplenty.

A No-Landing Scenario Is Probable:

The long running hard-vs-soft-landing economic debate now includes a no-landing prospect, reducing the probability of a hard and soft landing. The case for" no landing" is now very compelling and it has found its way into mainstream media. An "Immaculate disinflation" would be ideal and it's now considered by several strategists to be a real possibility. The Atlanta Fed's GDP NowCasting model estimate for R-GDP in Q1 is 2.5% with a GDP inflation-deflator that may not be any higher than 3.5%.

Monetary Policy:

Surely, the Fed is aware that there is a connection between money and inflation. Nevertheless, it is unlikely to ease off contractionary policies until there is proof that the fall in the money supply will take us out of the inflation maze, as monetary theory suggests. By June of this year, the monetary policy will need to adjust to this reality. When it is all said and done, the Fed can no longer be accused of being behind the curve on price pressures, having restored its inflation-flighting credibility, says David Wessel of the Brookings Institute.

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However, investors need to also realize that we've just come off a 5000 year low for interest rates according to Bank of America's CEO. The Fed wants a more normal interest rate environment than we've had for the past 20 years, meaning that it may want the policy rate to fluctuate more around the new 4.00% neutral rate than the previous 2.00%, implying a more consistent 6.0%-to-8% average annual rate of change in the erratic and capricious behaviour of the money supply. Supply-side developments, energy transition, shifting geopolitical issues, tight labour market and de-globalization necessitate a higher neutral rate.

History shows that the US economy can perform quite well with a 4.00% policy rate that oscillates 2.00% above or below it. Jared Dillan, author of The 10th Man, says the US is as accident-prone as perma-bears tend to suppose. The Fed will concede at some point, as it once did at the Jackson Hole Symposium of 2019, that there has been an upward acceptable shift to 3.0% inflation. It's just something we're all going to have to live with. I dont think it's a big deal. Inflation expectations have already crossed the Rubicon, hovering around 3.00%. The world has changed dramatically in a very short span. A Minneapolis Fed model of options-derived probabilities suggests the odds of elevated inflation are sharply down and it seems to have normalized around 3.00%.

Interestingly, Bank of Canada governor Tiff Macklem, the un-official world leader on monetary policy, is sticking with the plan to pause interest rate increases, despite evidence that the Canadian business activity could end up being stronger than he expects. In a prepared testimony for the House finance committee on Feb16, he said: "We are still a long way from our inflation target, but recent developments have reinforced our confidence that inflation is coming down." The Fed may again take the BoC's cue. The notion that the U.S. policymakers will be willing to return briefly to 50bps hikes is absurd. There is no case to be made that recent and forthcoming data will prolong the hiking cycle to higher rates. The fact is the Fed has moved fast as inflation pressure eased. Why not wait for a while and see rather than setting itself up for a collision that it also must avoid.

Implication for Stocks:

The market took it on the chin due to the hope that a clear signal that the fight against inflation had been won was chartered. Investors realized that the macro-focused thinking heads were reducing recession odds, but they could not ignore the rise in inflation expectations and bond yields. They shrugged off interest rate risks, attributing them to repricing, and classified them as normal. In other words, interest rates are up not because the monetary stance is tighter. They are up for the right reason: the economy is holding up. The big question here is whether inflation came tamed without a landing. It's increasingly possible. It is rational to

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conclude that the Fed's monetary stance will eat where the fat is. Currently, inflation accounts for about 85% of the increases in N-GDP. Moreover, the inflation content of the misery index, which stands at 9.8%, is 65%. (The misery index is the addition of the inflation and unemployment rates.)

The succession of strong economic data without incurring higher inflation rates is interpreted as being bullish by many individuals. So what's not to like about a scenario where work can be found in a growing economy and the cost of living is backing off.? Retail trades were running hot in the past few weeks, pouring %1.5 billion per day. 20% of the market volumes came from retail orders. They may be right. The Producer Price Index showed that retail and wholesale margins jumped in January, increasing 0.8% m/m.

Yer, the market mood is currently and generally dizzy. Many also fear that inflation numbers may not cooperate with my aforementioned thesis. An inflationary no-landing scenario may only be a long way to a hard landing because the Fed may not have any incentive to halt. Its mission is unaccomplished. Some say that the greenback is the omen and it's back up. But caution is warranted in this lonely indicator. The FX market is as much an inflation adjuster as it is for interest rate differentials.

Ostensibly, there's a mathematical limit on stocks' apathy. Real rates are a factor in valuing equities. The gap between earning yields and real rates has decreased 30 bps to 4.66% since the end of January. In the meantime, The S&P 500 registered a weekly loss of 11 points or 0.3% to 4079 compared to 4077 on January 31 of 2023, suggesting that the market is confused because the cycle is performing awkwardly. Talking-heads have been predicting a recession for two years. Where is it? Certainly not the numbers. Waiting for a disaster to happen will get you nowhere. I say stay put, look for cheap plays if the market were to cool off some more. BofA's Michael Harnett warned his readers that what we have are violent narrative flips.

The Trick to Permanently Fix Inflation: Productivity

The McKinsey Global Institute released a brand new research on productivity a few days ago. If for any given reason the economy were able return productivity growth to levels recorded since 1948 as opposed to the subpar 1.4% rate registered during the 2005-2019 era, it would add $$10 trillion in real terms to cumulative business activity between now and 2030. Looking to the future, the additional output would help the US confront looming challenges including workforce shortages, public debt, inequality plus the cost of welfare and energy transition. Most importantly, inflation would be kept at bay without much interference from the central banks.

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There are signs that the recent burst of inflation, the pandemic effect on the workplace, the shortage of workers on the labour market, ramification of de-globalisation, the move to on-shoring plus the modernistic behaviour of the Gen Z and Millennials is leading huge sectors of the economy to finally adopt digital, robotic and customise services. In the 6 months ended December 2022, a measurable increase in productivity has occurred and the prospects are excellent for Q1. Investors should take note that positive real rates, and that is what we now have, is conducive to productivity enhancement investments. The last time we had a surge in productivity, real rates were positive.

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