To subscribe to our Newsletters www.palos.ca/register

PALOS

Weekly Commentary

Issue No. 8 | FEBRUARY 27, 2023

CONTENTS

The Fed and Inflation are Still the Big Story on Wall Street 1
Monetary Policy 4
Disclaimer & Contacts 6

Macro View

By Hubert Marleau

The Fed and Inflation are Still the Big Story on Wall Street

Submitted February 24, 2023

Investors were kept busy all week with a docket of economic prints, especially the BEA January report of inflation, even though it came out late in the week. The idea that the core personal consumption expenditure (PCE) price index would reveal just how sticky inflation really is, spooked the markets into believing that the Fed is nowhere near done. Historically, the 30-year Treasury yield (4.00%) trades on average roughly 3.00% above PCE inflation - This +3.00% spread is true specifically when the prospects for higher inflation are shared unanimously, and monetary policy seems oblivious to a prospective decrease in employment.

As a rule, academic working papers don't exercise any influence on market behaviour. But Nick Timiros of the WSJ, known as the Fed’s whisperer, spoke of a January 2023 study by the Federal Reserve Bank of Cleveland that did just that, disturbing the market and contributing to the return of interest rate volatility. The working paper suggested that post-Covid inflation dynamics demand higher interest rates for longer, and even a possibly deep recession, including a more than doubling of the unemployment rate to 7.0% to bring inflation to the 2.0% target rate by the end of 2025. The story has support. The Fed’s preferred inflation metric was released by the BEA on Friday. PCE month-over-month was forecast to have increased by 0.5% in January from 0.1% in the prior month and up by 5.0% y/y, in line with the December reading. Meanwhile, core PCE was expected to rise by 0.4% m/m versus an increase of 0.3% in December and 4.5% y/y, down from 4.4% in December. The consensus was far off. They actually increase 0.6% m/m to a yearly rate of 5.4% and 4.7% respectively, slightly higher than in December (5.3% and 4.6%)

Walmart gave a neat resume of the prevailing mood. “There is a lot of trepidation and uncertainty with the economic outlook. Balance sheets are continuing to get thinner, saving rate is roughly half of what it was at a pre-pandemic level and we’ve not been in a situation like this where the Fed is raising the cost of money at

Macro View cont.

By Hubert Marleau

the rate it has. So, that makes us cautious on the economic outlook because we simply don't know what we don't know."

Within 4 weeks, inflation expectations shot up. It is now expected to run as fast as 3.2% in 12 months from now, versus 2.1% at the start of February; while 5-year real rates ramped 52 bps to 1.72%, a crude measure of expected growth for the next 5 years. Given this apparent inflationary boom, the stock market took it badly, declining from 4180 on February 2 to 3970 on February 24, down 5.0%, showing the degree to which the market is hostage to inflation and the Fed.

Extreme bearish sentiment usually brings new buying impetus however. The State Street Investor Confidence Index increased by 1.1 points to 77.5, which explains why earnings yields (6.27%) have not risen as much as bond yields (3.94%) have - 31 bps versus 54 bps. In fact, the PMIs for January pointed out that input cost inflation was the second-weakest in more than 2 years (which, incidentally, augurs well for maintenance of profit margins). Indeed, the S&P 500's distance from its 50-day moving average, suggests that stocks may have moved sharply from being overbought - but unfortunately only to neutral. Better, but no cigars. However, there are no traffic lights that signal when traders are about to press on the gas pedal. Thus the fear of missing out on buying opportunities is always present when pessimism is rampant.

The point is that investors should not be fooled by the January raft of unpleasant inflation numbers, nor fall for claims that the economy is not answering to the Fed's monetary stance. It's unbelievable the degree to which the media, and even policy-makers, have extrapolated the January data on payrolls, real sales and manufacturing output into headline stories that the economy is rebounding at an accelerating pace. The Atlanta Fed's GDP NowCasting model, which has incorporated these unreliable and noisy January economic prints, estimates the R-GDP in Q1 will be 2.7%.

Looking under the hood, one would see that the underlying trends are intact, suggesting that the January inflation is merely a short term setback. It's not that we shall witness a complete reversal in February - mean reversion takes time but it will happen. First, home-base surveys suggest that the January payrolls were a fluke. Job openings have peaked, layoffs are rising rapidly, and hiring intentions are trending down. Second, people have chosen to run down their pandemic savings: excess savings are down 60%. Third, the temporary effect of favourably lower energy bills is probably over. Fourth, the strength of consumer spending was caused by a one time hefty 8.7% cost of living adjustment in Social Security benefits, which gave recipients their biggest raise in more than four decades.

Macro View cont.

By Hubert Marleau

Because of factors acting together at the same time, they are bound to put a damper on consumer spending, which accounts for 70% of the N-GDP. As a matter of fact, the weekly Redbook chainstore sales survey - a measure of the big picture in retailing and an excellent tracker of core retail sales, which excludes auto, gas and food - has reported steadily slowing same-store sales growth for over a year. As I suggested last week, the seasonal adjustment process may have thrown a misleading curveball. The cat is now out of the bag. Actually, retailers had $121 billion less sales in January than they did in December - a 16% drop. A similar quirk occurred with the job report. A San Francisco Fed model, that adjusts jobs reported for weather effects, found that the nation would have added around 390,000 jobs in January, instead of the 517,000 reported by the Labour Department.

I don't expect a recession. But I believe it will be close. GDP in both Q3 and Q4 was boosted by net exports and inventories and Q1 by a flood of social security payments which are not going to recur. On the contrary, an inventory correction plus an import surge are coming, which could bring about a flat R-GDP growth in Q2 and Q3 - a soft landing (45% chance) - or slow growth to a crawl -no landing (25% chance). Thankfully, we shall be saved from an official recession by those guys who are the most hated by the general populace - corporations. According to Goldman Sachs, we are in a capex supercycle. In the 4Q of 2022, the S&P 500 grew business capital formation (20% of GDP) 17% year-over-year. This phenomenon will likely continue, perhaps at a lower pace, because inflation and labour shortages are forcing corporations to enhance productivity. And, guess what, business firms have a lot of cash left from the pandemic give-aways. According to Pantheon Macroeconomics, companies. have a cash buffer of $400 billion. That is 1.7% of N-GDP. And they may well spend it because their balance sheets are strong and debt maturities are pushed out, blunting the immediate impact of higher capital cost and of lower profit margins. As opposed to reducing investments, companies are also cutting dramatically share buybacks and limiting dividend increases.

Thus it would be incorrect to believe that the disinflationary narrative is finished. The flash US PMIs may have suggested that January's hot economic data was not merely a reflection of temperate weather conditions and seasonal adjustment quirks, but it showed nevertheless that the improved supply situation has taken supply-price pressures out of the manufacturing sector, underscoring how the driving force on inflation has now shifted to wages.

In this connection, nominal wage growth has sharply increased since the middle of last year. Average hourly earnings for private-sector nonfarm workers rose 4.4% in the 12 months through January, down from 5.6% last March and less than the 6.4% rise in consumer prices in the year through January. As a matter of fact, in Liberty Street Economics, the New York Fed wrote that the surge in wage growth experienced by the U.S. economy over the past 2 years was showing tentative signs of moderation. In this post, its economists took

Macro View cont.

By Hubert Marleau

a close look at the underlying data by estimating a model designed to isolate the persistent component - or trend - of wage growth. The central finding is that this trend peaked in early 2022, having experienced an earlier rise and subsequent moderation that were broad-based across multiple sectors.

Meanwhile, existing home sales in January fell short of expectations, declining to an annual rate of 4.0 million, registering a 12th monthly decline and dropping 37%. Overall the secondary market is indeed soft. The median price for an existing home was $359,000, roughly 13% below the record highs of last July, under rising inventories and still low affordability. Mortgage purchase applications are at their lowest level since 1995, down 4.3% y/y as sales orders are cancelled. Bad news for real estate brokers, but good news if you're counting on pipeline shelter disinflation to manifest itself in CPI series in the coming months. The Zillow rent index supports that outcome.

In Canada, where weighting adjustments, social security payments and seasonal anomalies were not as pronounced as they were in the US, the economic prints on inflation were probably more reliable. And that goes for both headline and core inflation. Headline CPI rose 5.9% y/y, below expectations of 6.1% and 6.3% in December while core CPI rose 5.0% versus a consensus of 5.5% and a previous print of 5.4%.

Monetary Policy:

The January FOMC minutes signal no material change in the Fed's approach: that means more rate hikes, but soft ones in March and May, in spite of the fact that inflation was red hot in January. My prediction is based on the thesis that much of the apparent strength in the economy of the past 4 months can be explained by weighting adjustments, lower energy cost, the runoff of excess savings and warmer-than-usual weather. I recognize that the monetary authorities are focused on core services ex-housing and therefore on the likely path of wage growth. The latter will be determined by productivity growth, which is rising, and employment growth, which is slowing. In this regard, the Fed will have done enough because the full effect of its actions will have worked through by the end of May. On this one thing, the minutes were unclouded. What the Fed wants to see is that inflation is clearly on a path to 3%. In other words, as we move forward the policymakers will become more interested in the direction of inflation than the level. Why? They know that hikes beyond May would only serve to increase the risk of a recession, which won't be needed to bring inflation back to target. Incidentally, it would be myopic for the Fed's policy-making not to follow broad global trends: a number of central banks (Canada, Japan, China, Australia, France and South Korea) have already adopted a less hawkish plan. Put simply, central banks are not entirely unified about the outlook. In less than a month, 10-year treasury yields (3.94%) are 253, 485, 295 and 56 bps higher than comparable Euro, Japanese, Chinese

Macro View cont.

By Hubert Marleau

and Canadian bonds respectively. As a result the DXY, a measure of the value of the dollar relative to a basket of trade partners' currencies, is up remarkably: 4.5% to 105.25.That is definitely disinflationary because it is forcing a renewed deceleration of the world money supply.

The contraction of the U.S. money supply, which is expected to continue because of the banks tightening their lending standard, will sour the lagging indicators like wages, employment and inflation on which the Fed depends to conduct its monetary stance. The credit cycle has turned because the turnover of money will additionally slow down. The Fed's Senior Loan Officer Survey for Q1 showed looming contractions in the supply of credit across all forms of business and household loans. Money tends to change hands less when the loan-to-deposit ratio falls.

A study by economists at the Bank of International Settlements (BIS), showed that there is a statistically significant correlation across a range of countries between money supply and nominal GDP and that information content of the money supply can be a helpful guide for forecasters and policymakers. Acknowledging that inflation is about 4 times more sensitive than real growth, the ongoing contraction in the monetary aggregates has, so far, impacted mainly inflation as it should have. In the fullness of time, the normal range of growth fluctuates between -2% and +2%, whereas inflation is between -2% and +10%. Assuming, therefore, that an appropriate pace for the money supply is 6%, the current 2.0% decline in the money supply should reduce real growth close to 0.0% over the next 2 quarters and inflation near 2.5% in 12 months time.

Weekly Commentary

Issue **No. 8** | **FEBRUARY 27, 2023**

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., "Palos"). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos' written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. "S&P" is a registered trademark of The McGraw-Hill Companies, Inc. "TSX" is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market value weighted index engineered to measure publicly issued noninvestment grade USD fixed rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM. Palos Funds are not available for non-Canadian residents.

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