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Weekly Commentary

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Macro View

By Hubert Marleau

Disinflation Is Still On

Submitted March 3, 2023

Good news has been bad for both stock and bond markets. Good news has added upward pressure on inflation expectations, forcing the Fed to react aggressively, which ricocheted into higher interest rates. Consequently, consumer confidence has erratically trended lower through the piece. The Conference Board's monthly consumer confidence index, which reflects changes in the labour market and inflation, fell for consecutive months in February, with the index measuring future economic conditions falling sharply. In the last two months, yield on 10-year Treasuries rose 60 bps to 3.94%, inflation expectation surged from 1.63% one year out to 3.50% and 5-year real rates increased 30 bps to 1.54%. As a result, the futures market has priced in a 25% chance of a half-point hike in the policy rate on March 22, something no one thought possible just a month ago. Several Fed officials tried to quell those worries, but investors did not respond. The S&P 500 touched 3950 last week, close to the 3900 red thin line. The levels surrounding 3900 include the internal trend line that defined the 2022 bear trend. The 50-day, 100-day, and 200-day moving averages also rest in that same area.

Yet, bearish sentiment may have ended. The Skew index, a measure of the perceived tail risk of the distribution of S&P 500 returns over a 30-day horizon, has fallen steadily since mid-February. It is true that stock prices immediately suffer from higher interest rates. However, equities have innate inflation-hedging characteristics that can compensate for inflation. They resembled real assets. WisdomTree produced a series of charts, showing that S&P 500 dividend growth has consistently outpaced inflation except during the Great Financial Crisis by an average of 3.68% in the 1957-2002 period. Professor Siegal in the sixth edition of Stocks for the Long Run argued that it is much better to compare forward earnings yields (6.31%) with real bond yields - 10-year inflation-indexed bonds (1.55%). The difference comes up to 4.76%, above the 4.00% long-term average.

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Tom Lee, Fundstrat's head of research, believes that the S&P 500 is ready for a strong 8 weeks and could run up to 4250. His optimism is based on the neglected fundamentals that suggest that valuations are not demanding. First, ex-FAANG, the P/E (2024) is 14.8X and sectors like Energy and Financials are trading at 10x and 11X respectively. Second, the 4.00% yield on 10-year treasury bonds is an implied P/E multiple of 25X. Thus, it would not take much to turned the table around if Fed were to manifest support for babe steps, bond traders were to take a breather and the falling VIX let up.

As far as I know there are only 5 laws in economics: the Marshal's law, which guarantees that prices are determined by supply and demand. Say's law, which postulates that supply creates its own demand. Keynes' law, which states that demand creates supply when capacity is low without inflation. And the other two are the Smith's laws of self-interest and of competition. Incorporating these precepts into macroeconomic terms, a plausible thesis can be constructed to explain why inflation went through the roof. On the supply side, the economy worked at full employment and industrial output was hemmed in by various constraints with limited possibility to increase in productivity. On the demand side, spending was bankrolled by excessive amounts of savings and monies. This is exactly what happened - demand outstrip quantitative supply. Consequently, the y/y change in the PCE price index, a comprehensive metric of inflation, rose from a low of 1.5% in January 2021 to a high of 7.0% in June of 2022.

The big question now is whether the conditions that prevailed until then, which brought inflation to unacceptable levels, will remain in play in the foreseeable future. I don't think so. An inflection occurred during the April-June of 2022. The variables, which caused brutal inflation, have changed. The January PCE price index rose 5.4% y/y, 1.6 percentage points lower than it was last June. Moreover the Atlanta Fed's NowCasting Model is now projecting an annual rate of increase in Q1-GDP of 2.3%, down from 2.9%. The housing market is frozen and ISM numbers show that the manufacturing sector is still contracting. I believe that the process toward lower inflation and moderate growth will continue for 4 basic reasons.

The Labour Shortage Is Easing:

In March of 2021 there were 1,457,698 fewer people of age available to work than in December 2019, and 4,679,000 less people willing to push the plough. The reduction in the supply of workers forced businesses to pay up, swelling wage rates with no apparent increase in productivity. The situation reversed in April of 2021, slowly in the beginning, but accelerating as 2022 progressed. Since April 2021, 3,212,721 people joined the cohort of potential workers while the labour force rose 5,807,000. Wage rates slowed as supply rose. In fact, senior executives across a host of public companies gave optimistic updates on the labour market, suggesting

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that hiring conditions had dramatically improved. This is happening because demand for workers is slowing. ZipRecruiter and Recruit Holdings Co, two large online recruiting companies, have data that show job postings are falling while job seekers are rising. Meanwhile, Goldman Sachs economists, analyzing private-sector data, estimate the official mismatch between the 11 million job openings and the 5.7 million unemployed people might not be that large. Indeed, there has been a noticeable decline in unfilled jobs. The employment component of the ISM index fell 1.5 points to 49.1, which makes me confident that private payroll growth softened significantly in February. As a matter of fact, preliminary numbers show that the Wage Phillips Curve - the relationship between labour compensation and unemployment is normalizing and returning to pre-pandemic levels.

Productivity Is Rising:

During the 2 years ended Q2/2022, productivity decreased on average 0.9% per quarter while wage rates were rising, resulting in significantly higher labour input cost. Unit Labour Cost gushed upward to an average rate of 8.7%. Productivity, however, took a turn for the better last June, accelerating to an estimated 1.8%% per quarter, thereby reducing the change in unit labour cost for the comparable period to an average rate of 1.9%. Labour shortages and input costs that plagued 2020 and 2021 forced corporations to spend a lot of money on digitalization, methods and robotics to enhance efficiencies. Anecdotal reports abound that huge sectors like professional services, construction and restaurants, which have hitherto shunned technology, are starting to embrace it. Bank of America noted in a recent study that the adoption rate of new technology like ChatGPT is unprecedented, putting the economy on the verge of another iphone moment and predicting that its economic impact would be $15.7 trillion by 2030. Daily visits to ChatGPT is 40.0 million, same as Microsoft Bing's web traffic.

Excess Savings are Diminishing:

The stock of excess personal savings peaked in the early Fall of 2021 at $2.0 trillion, a lot of that excess has been absorbed into higher levels of nominal GDP. This excess felt 65% to $700 billion in January and will soon be totally exhausted. As a matter of fact, if it would have been for the huge, one time, $1.1 trillion increase in social security payments, the American people would not have saved any of their disposable income in January. Recent reports are indicating that confidence sentiment has reached a level where consumers usually start to retrench their spending habits in order to replenish precautionary cash reserves. Department

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stores like Macy's, Nordstrom and Kohl's, plus big box-retailers like Best Buy, Walmart and Costco are all telling the same story: consumers have turned frugal on discretionary spending. Nordstrom is exiting Canada.

The Money Supply Is Declining:

The U.S. money supply just experienced its largest y/y decline on record in January - minus 1.1% - due the Fed's most aggressive monetary policy campaign in decades. Normally, the money supply runs at an annual rate of 8.0%, suggesting that it ought to be around $19.6 trillion. That is still $1.6 trillion or 8.1% too high. Given that we still have quantitative tightening, an inverted curve, prospective increases in the policy rate, a government that is running out of cash balances, and rising bank lending standards, another yearly decrease in the money supply is a likely outcome. Incidentally, the world money supply valued in US dollars is also down 1.1% from a year ago.

The Conclusion:

I'm not of the opinion that PCE inflation will end the year at the 2.0% target. However, I do believe that things are in place to bring inflation progressively to a desirable pace by the end of 2023. Indeed, protectionism, de-globalization, and demographics may force the central banks to accept a new inflation target to prevent recessionary conditions. A 3% inflation target would be a welcome event. In this regard, a Fed funds rate of 5.00% would be adequate, but it would have to stay at that level well into 2024.

P.S. I'm leaving for 4 weeks, cruising the Caribbean Sea and crossing the Atlantic to Lisbon. Should I decide to write, the commentaries will be short and sweet.

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