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Weekly Commentary

Issue **No. 10** | **APRIL 10, 2023**

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Macro View

By Hubert Marleau

The Economy Is Cooling Down Without Falling Down:

Submitted April 7th, 2023

Based on the observation that labour shortages were easing, productivity was rising, and excess savings were diminishing, I argued last month that the path to lower inflation was on course. Yet the Fed officials were still shouting that they would continue to tighten the screws more than they already had, and longer than originally forecast. Markets are questioning if such actions would become necessary. The forex, bond and stock markets said no way. Since my last letter, dated March 3, the DXY fell 3.71 points to 101.96, the 10-year Treasury yield decreased 76 bps to 3.30%, crude prices rose $14 to $80.50 and credit spreads hardly budged - an indication of financial stability. When all is said and done, the S&P 500 rose 209 points to 4105. The latter might go even higher if it were to cross 4200. Up until now, traders have not been willing to push stocks out of its 3800 to 4200 range for months.

Where stocks go from here boils down to whether the economy is still on track to price stability. I think it is. I recognize, however, as I have often argued in previous commentaries, that regulation, government deficit spending, energy conversions, de-globalization, ageing demographics and slowing population growth could eventually bring about a secular inflationary trend, if prospective increases in productivity failed to materialize. Thankfully, the cyclical forces are clearly strongly disinflationary. As a matter of fact, there isn't much evidence to support a bearish posture in the direction of inflation over the intermediate term.

Monetary policy operates with a lag, and the full effect of the substantial increase in the policy rate and material decrease in the money supply have yet to be fully felt. In the 3 months ended March 2023, the money supply decreased at an annualized rate of 5.1% and was 2.4% lower than it was a year ago. According to a chart produced by Macro Strategy Partnership which tracks M2 money supply against N-GDP and under the assumption that the velocity money will keep on falling in line with its average over recent decades, the intercept could happen as soon as June of this year, setting a dangerous situation for the Fed. There are numerous reports stating that banks are taking a precautionary view to lending while borrowers are

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demanding less money and the government is running out of it. In fact, the Federal Reserve reported that US lending actually contracted in the last 2 weeks of March, the most dating back to 1973. The $105 billion pullback in commercial and industrial loans was not only large but broad.

In other words, the financial system is clearing. People have become less willing to draw down their remaining excess pandemic savings to support consumption. Moreover, the Treasury General Account (TGA) fell to $140.3 billion last week. The TGA is what the Federal government holds at the Fed to pay bills. The balance is getting low, which means that the government will need to rely on issuing debt to pay for expenditures. Given that the Fed is a net seller of bonds, the government will need to rely on outside sources - domestic and foreign - to finance its spending deficits. This will tend to decrease the money supply even more.

The situation should raise alarm bells at the Fed. Put simply, it makes me wonder if the economy can afford a 5% target rate. Interestingly, the Atlanta Fed's GDP Now model is forecasting that U.S. real gross domestic product expanded at a 1.5% annual rate in Q1, down from an earlier estimate of 3.5%. Meanwhile, the New York Fed's Yield Curve Model, as a leading indicator, is suggesting that the probability of a mild recession in the next twelve months is as high as 50%.

It should be noted that the surprise Opec cut in oil production caught the market off-guard. Perhaps Opec foresaw the weaker economic prints, concluding that the U.S. economy was in for a rougher time. The release of the March ISM numbers, the February job openings and the April non-farm payrolls confirmed that business activity is cooling off, further easing inflationary pressure. The oil cut, which amounted to 1.66 million barrels per day, and pushed the oil price above $80 per barrel, was a tactical move to protect it from falling in the event that the widely forecast recession was to mature into a reality. Usually, higher oil prices are stagflationary. However, this particular decision may not be, according to the bond market, whose policy-sensitive, 2-year bond yield fell 9 bps. This apparent indifference is related to the central prediction that the economy is softening. Thus the increase in the energy bill as a percentage of N-GDP is making the aforementioned forecasts more believable. In the week ended April 7, all the economic prints supported the idea of softer demand.

The ISM Manufacturing Index:
The headline index fell 1.4 points to 46.3, the lowest level since May 2009, excluding the Covid hit, because of hefty falls in new order and employment, resulting in a slump to a new low.

The Job Openings and Labour Turnover Survey:

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US job openings dropped sharply in February, falling to 9.932 million, the lowest in 2 years. The ratio of open jobs to unemployed people - a data point closely watched by the Fed - fell to 1.67 from a high of 2.0. Moreover, job postings are not as conspicuous as they were over the last couple of months. Workers are holding on to their jobs and employers are less eager to hire. Indeed, I suspect that the labour market will return employment smoothly to pre-pandemic conditions by early summer. The Challenger March Report job layoffs rose to 89,703, the highest since October 2020.

The ADP Employment Report:
US private sector employers added 145,000 jobs in March, well below expectations and the second-slowest pace of hiring in 2 years. Employers are pulling back, while pay growth, after a 3-month plateau, is inching down.

The ISM Non-Manufacturing Index:
This index plunged to 51.2 from 55.1, significantly below the 54.5 consensus: a slump which is a clean break from the broadly flat trend since the summer, capturing some of the initial hit to activity and sentiment stemming from the bank failures.

Initial Jobless Claims:
The Labor Department made considerable revisions to jobless claims, revealing that the level of job losses was much higher than previously believed and the trend was clearly upward.

The Global Supply Chain Pressure Index (GSCPI):
Global supply chain pressures decreased again in March, falling from .28 to -1.08, below the index's historical average. Recent movements suggest that global supply chain conditions have largely normalized.

The Employment Situation:
US employment growth slowed in March. The economy added 236,000 jobs: a step down from February but far below the 472,000 recorded in January. Meanwhile, average hourly earnings rose 0.3%, turning the annualized rate in Q1 to 3.8% - the smallest increase since Q4 of 2019. Meanwhile the U.S. labour-force participation rate hit its highest level since February 2020, just under 55, back to pre-Covid peak and the unemployment rate reached a historical low of 3.5%.

The aforementioned prints should help the doves' position to pause sooner rather than later. They are getting what they want. Good prices are well-behaved, and the odor in the labour market is recessionary in the face of stubborn service-sector inflation. Indeed, the prices paid index by the manufacturing sector has slipped

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back below the 50-demarcation line and the labour market is not as tight as it once was. Lower hoarding of workers, higher jobless claims, higher layoffs, and a diminishing quit rate are four reliable indicators, confirming that the tightness in the labour market has finally pivoted. Soon the BLS will report near-zero increases in non-farm payrolls. I expect a 150K increase in April, then just 50K in May followed by a run of outright declines over the summer months. Investors should remember the 'Sahm Rule'. It says that a sustained half-point increase in the unemployment rate from the low, being 3.5%, invariably spells disinflationary conditions. This is a prospect that should prevent wage rates from rising unreasonably.

These yellow warning signs will not be permanently ignored by the Fed. On the contrary, it will capitulate to the wisdom of the bond crowd. Presently, the swap market is predicting that the inflation rate will rise at the annual rate of 3.0% in one year's time and 2.2% in two years. The Fed has done enough tightening. Its policy rate is 150 bps above the neutral rate, and the yield curve is inverted. Moreover, the Fed has resumed its quantitative tightening posture at its past pace and banks have started paying back the liquidity excess support they received during the turmoil. There is no need for the Fed to go beyond what it already has. The only reason I see to raise the policy rate another 25 bps on May 3 is because the next monthly jobs number will come out later on Friday, May 5.

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Issue **No. 10** | **APRIL 7, 2023**

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