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

# PALOS

## Weekly Commentary

Issue **No. 13** | **MAY 1, 2023**

## CONTENTS

The Immaculate Scenario is Still in Play: 1

Disclaimer & Contacts 5

# Macro View

*By Hubert Marleau*

# The Immaculate Scenario is Still in Play:

Submitted April 28th, 2023

No matter how hard traders try to keep up with the news, absorbing and interpreting economic prints as they roll in, speculators never seem to know for sure what is going on or what lies ahead. Indeed, the economic picture always looks different each time new data comes out with the word "uncertainty" appearing in almost every missive published in the major financial papers. Economic scenarios vary constantly from no-landing to soft-landing to hard-landing, and price outlooks from inflation to disinflation to deflation. This happens because it is known that forecasting is a probability process prone to upsets, which can cause traders and speculators to overestimate the information that the latest prints gave. It's called recency bias, making forecasts subject to noise and inaccuracy.

In this connection, the stock market has struggled to understand the full picture on which it depends for direction. There is a lot of confusion because of the huge disparity between hard data, which point to expansion and to soft measures, which look recessionary. Unsurprisingly, stocks and bonds have telegraphed different messages to investors lately, which may be hard to reconcile. The equity market seems hunky-dory, as implied by the sober reading of the VIX - a fear measure - suggesting a very mild recession and greeting disinflation. Meanwhile, the MOVE - the analog for the Treasury market - is predicting a deeper recession and undesirable deflation. It may indeed be hard to come up with a view, but one needs to pick one. So which is it? I'm banking on the former. Why?

Economics is a soft science, which means Monetary, Keysenian and Rational Expectation theories are essentially imperfect and therefore often demoted or even jettisoned. That should be avoided. Unless one has a direct link to the Almighty, we don't have any alternative but to use whatever predictive power they may have. They are not axioms but nevertheless reliable and comprehensive enough to help mortals like me to make sense about why certain things happen and judgements about things to come.

# Macro View cont.

*By Hubert Marleau*

First, the official March M2 money supply is 4.1% lower than a year ago and down to a 3-month annualized rate of 9.7%. A contracting money supply, with the aid of tighter bank lending standards, should bring about lower levels of expansion or an outright decline, especially when the economy is running full blast. The amount of money floating around in the system is a critical factor. The less money is around, the less there is for banks to lend, and for companies and consumers to spend, helping to cool the economy and push prices down.

Second, the Phillips Curve, a derivative of the Keynesian idea, which argues that there is a relationship between the labour market and inflation, and was thrown in the wastepaper basket, is making a comeback. If the supply for labour exceeds the demand for it, especially when productivity is rising, the pace of wage rates will tend to fall. The biggest cost for industry is labour. When the going gets tougher, firms act in the usual way, by firing employees. The lesson of previous cycles is that the labour market looks fine until it suddenly doesn't blink, and you'll miss the turn.

Hence these two simple relationships: money on the demand side and labour on the supply side. This explains why the rational expectation theory, which is hidden in the swap market, shows that inflation will be as low as 2.1% in one year's time. As a matter of fact, the feedback loop from inflation expectations to the economy is real, pointing to reduced demand and higher allocation of savings to money market funds. The Conference Board's current condition index rose a bit, while confidence and expectations dipped, signaling weaker consumption, but not a disaster. That's the short-term outlook. And guess what? The same swap market predicts a similar long-term outlook, suggesting that in 5 years from now, inflation will also run a tiny bit more than 2.0%. What's going on?

In order to achieve maximum potential output without accelerating inflation, one must first know what the economy's potential growth rate is and the desired level of savings vis-a-vis quantitative supply. What brings these two forces in unison is the level of real natural rate of inflation, which is a function of savings and investment. The trend rate of U.S. economic growth is around 2.50% - 0.75% from labour growth and 1.75% from productivity growth. The anticipated fall in labour growth will likely pressure the monopsonists to revert to productivity improvements to keep their dominance in setting wages. And that occurs in a society dominated by monopsonies where the labour market stops expanding.

In this connection, the Fed's policy rate must be more than 2.50% when desired savings are higher than planned investments, but less when the opposite rules. Household savings are the main determining factor.

# Macro View cont.

*By Hubert Marleau*

According to Jackson Hole Economics, lower investment returns, precautionary motives and demographics are the critical factors that induce people to raise their savings. If, therefore, total savings were to rise relative to total investment, demand would struggle to keep pace with the potential rate of trend growth. In Q1/2023 household savings represented 20.7% of total private investments compared to 16.3% in Q4/2022. There is a trend here. Personal savings as a percentage of disposable personal income has increased uninterruptedly from 3.0% in September of 2022 to 5.1% in March 2023.

Moreover, the inverted yield curve may have lost some of its predictive power. There is ample evidence that the yield curve has been skewed intentionally by the Fed, which has borrowed trillions of dollars from money market funds and banks, keeping those trillions from flooding the financial markets. Thus it is probable this inversion is not the result of the normal functioning of the financial markets, but more of a fabrication of the Fed than pessimism about the future. Put simply, short-term Treasury rates have been skewed higher on purpose. If those monies were in the hands of the people, rates would be forced down. We got a glimpse of this in the past few weeks: retail investors are snapping up new Treasury bills at a record pace.

Meanwhile, the S&P 500 rose 35 points or 0.6% because the earnings season did not prove as disastrous as many pundits had predicted. On the contrary, many companies reported strong earnings. The market might have done even better if federal funds futures had not repriced the chance of another rate of another hike to almost 100%, when fears of a dangerous fallout from the messy banking situation, and the aggravating dilemma connected to the debt-ceiling issue, are still unsolved - all too much for the market to ignore. Moreover, not enough Fed officials acknowledge that wages may not be the only sole factor responsible for driving inflation nor a 1970s-style wage-price spiral.

Last week, we got more empirical evidence that since the Fed's rate hikes, which began to bite since the summer of 2022, are cooling the economy. The March PCE rose only 0.1% m/m, registering a 4.2% year-over-over-year increase compared to 5.1% in February. What looked much better was core services-ex housing - an influencer of wage rate. The employment-cost index advanced 4.8% last quarter from a year earlier, an easing from the 5.1% gain at the end of last year. Meanwhile, the annual rate of increase in R-GDP came at 1.1% in Q1, dragged down by a huge decrease in inventory-building.

Given that real rates are positive, the yield curve inverted and the policy rate is above the neutral rate, lower growth and inflation rates are guaranteed. However, business activity will not fall apart because there is

# Macro View cont.

*By Hubert Marleau*

sufficient fuel left in the economy to take it forward. Based on pre-pandemic trend rates and levels of stock to N-GDP, there is still roughly $750 billion of excess savings in the household sectors and about $2.2 trillion of extra money supply, while some relief is coming from a lower energy share of N-GDP. The NY Fed revealed on April 26 that the market for both high-yield and investment-grade sectors of the corporate bond market is healthy, functioning close to historical norms. Credit spreads are narrow. In fact, evidence of serious economic pain is scant, even though there is a crunch going in the broader banking sector.

As a matter of fact, Spencer Hill of Goldman Sachs argued that consumer spending may plateau at a high level instead of falling back to its pre-pandemic trend. He rests this on the observation that since 2019 real wage levels for the bottom 50% of earners, where the marginal propensity to consume is high, has increased 6.2%. As a matter of fact, economic growth in Q1 was not as weak as headlines suggested. Excluding inventories, real final sales rose at the annualized rate of 3.4%, led by a solid 3.7% increase in real consumer spending.

The bottom line is that there is no recession imminent, and none on the horizon. However, a lower projectile is in front of us. “The effect of warm weather in January and one-off

cost-of-living adjustments to benefits payments will fade” said Ian Shepherdson of Pantheon Macroeconomics.

In this regard, I think it plausible that the economy will glide into an “Immaculate Scenario” where the Fed curbs inflation without a recession. The Atlanta Fed’s initial estimate of second quarter GDP is 1.7%. The recession will have to wait.

# Weekly Commentary

Issue **No. 13** | **MAY 1, 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