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

PALOS

Weekly Commentary

Issue No. 14 | MAY 8, 2023

CONTENTS

The Fed Is Done with Tightening: 1

Disclaimer & Contacts 5

Macro View

By Hubert Marleau

The Fed Is Done With Tightening:

Submitted May 6th, 2023

The Fed Is Done With Tightening:

Federal Reserve officials raised interest rates by a quarter-point last Wednesday to a range of 5% to 5.25%. It was the 10th straight increase, capping the fastest series of rate increases since the 1980s and reaching a level not seen since 2007. Investors did not like the action, thinking that it was superfluous, unnecessary, and bold. The S&P 500 fell 3 points registering a weekly decrease of0.7%.

Yet there was a meaningful shift in the Fed's assessment. Wednesday's language softened some more. Within three months, the language went from "Ongoing increases in the target range will be appropriate" to "Some additional policy firming may be appropriate" to "We're closer, or maybe even there".

Concerns about the banking contagion, the debt-ceiling issue and recession risks plus some consideration for falling inflation were the headline reasons behind the apparent shift. There is also another less talked-about reason for the change. Several key Fed officials believe that grim productivity, ageing population, de-globalization and changing societal habits will keep the neutral rate low. I'm putting it at 3.00%, which is higher than the Fed's long run estimate of 2.25%. In this connection, the policy rate is now 2.125% above the level that it ought to be for neutrality. Should this spread be maintained over the coming months as Powell suggests, the money supply is bound to fall some more, forcing inflation and economic growth down a few more notches.

My take is that over the next 6 months economic growth will be positive but near zero. The Atlanta Fed just raised the second quarter GDP growth to 2.7% from 1.8% on May1 because the April job report was unexpectedly strong in a cooling economy. Thus, it follows the impact of the monetary stance and financial conditions has and will fall mainly on inflation, where the fat exists. According to research produced by the NY Fed, both inflation persistent and global supply chain pressure is consistently falling.

Macro View cont.

By Hubert Marleau

Perhaps surprisingly to some observers, the short end of the yield curve is predicting that in one year's time, the year-over-year inflation will be below the Fed's target at 1.9%. I'm not as optimistic as that, but I would venture a year-over-year increase in the CPI of 3.1% by September/2023 and 2.2% by March/2024.

This is what is needed to turn the monetary policy around. Indeed, history shows that when payroll growth dissolves and inflation closes in on the target, things can happen very fast. On Thursday last, swap contracts were giving 95% odds that the FOMC will pause all rate hikes at the next meeting in Mid-June and 55% chances that it will cut the policy rate as soon as late July.

As the economic data heads south, the Fed will have no problem abandoning its current view that the policy rate must stay higher than the neutral rate. The job is done.

Weekly Commentary

Issue **No. 14** | **MAY 8, 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