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Weekly Commentary

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Macro View

By Hubert Marleau

Don't Worry, Be Happy:

Submitted May 13th, 2023

It wasn't a bumper week for economic prints as the earnings season drew to a close. But we did get the Fed's Survey of Senior Loan Officers and the BLS' inflation report. Neither was an event of consequence on the financial markets, where stock indices and bond prices had a lifeless week, until Friday when the debt ceiling deadlock was taken seriously. The S&P 500 nudged lower to 4124 closing above the first line of defense (4100) according to market technicians. I recognize that the media does not speak of the possibility of an imminent rally. Yet, systematic trend-following funds have been raising their equity exposure lately ahead of discretionary investors, who are heavily underweight the market. According to Deutsche Bank's Parag Thatte, equity exposure is at its lowest level in a year and at only the ninth percentile historically. I think investors are waiting for an official Fed pause. That will be announced in June. Stocks have done well during a Fed pause. Jonathan Golub, chief U.S. equity strategist at Credit Suisse, noted in the Barron's: "The S&P 500 has returned 16.9% on average in the 12 months following the last interest-hike of a cycle, while losing 1% on average in the year after the first rate cut."

According to the Federal Reserve, banks continued to tighten their lending practices in the first quarter, amid tumbling demand for loans, particularly within commercial real estate. 46% of respondents said that they had reduced the availability of credit for the widely watched commercial and industrial (C&I) loans. This survey is the best-but-rarest leading indicator. For a monetarist, like myself, the survey is a very important forward-looking tool because it helps me to determine future movements and velocity in the money supply. I'm getting vibes that a credit squeeze may have begun. A majority of banks said that they expect to tighten terms for the remainder of 2023 across all loan categories due to, on the one hand, lower credit quality of their loan portfolios, borrower's collateral values and risk tolerance and, on the other hand, increasing concerns about funding costs, liquidity, and deposit outflows. The NFIB small business survey echoed the Fed findings. The headline index of small business sentiment and activity dipped to89.0 from 90.1, a 10-year low, led by declines in expectations for the broad economy.

According to the BLS, the CPI rose 0.4% in April, registering a year-over-year increase of 4.9% and a 3-month annualized rate of 3.6%: a hefty increment, thanks to higher gasoline prices and shelter costs. Perhaps the report was uninspiring to some observers because it showed that inflation remains stubbornly elevated. However, the rate had dropped for 10 straight months suggesting that inflation's inevitable march downwards is ongoing. Moreover, energy and shelter

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prices are now reversing. Interestingly, the supercore inflation - the change in services prices excluding energy and housing costs - which is closely linked with wages, rose just 0.11% from a month earlier, marking the slimmest monthly gain since last July. Moreover, the NY Fed's Underlying Inflation Gauge (UGI) - a measure that captures sustainable movements in inflation.

from information contained in a broad set of price, real activity, and financial data - has an April inflation estimate of 4.0%, down 0.3% from March.

The CPI swaps market is also forecasting a significant drop in inflation, with the year-over-year rate of change falling to 3.25% by the end of 2023. The New York's Survey of Consumer Expectations showed that it anticipates inflation one year from now at 4.4%, down from 4.7 % in March, and higher unemployment with greater probability of job losses and a harder time to find new work. Meanwhile, the Atlanta Fed's latest Business Inflation Expectations survey revealed that business inflation expectations for the coming year is 2.9%. That is without any decrease in profit margins.

Cooling From a High Level:

Consumers are goggling at all of this, lowering their inflation and employment expectations as monetary data moves in the direction of disinflation, ebbing growth, and normalization. US producer prices, a reliable leading indicator of changes in the CPI, rose only 0.2% in April for a y/y increase of 2.3%, less than expected. The 3-month annualized rate is -2.0%. Yes, negative. Meanwhile jobless claims exceeded estimates, spiking to 264K, and registering a cycle high on route to 300K by mid-June, adding evidence that the tight market is weakening.

Over the past 10 months, from July 2022 through April, the CPI has annualized at 3.41%. It is still too high. Be patient because the BLS will be the forebearer of good news. Last year's May and June inflation figures, which annualized at 13.5%, will drop out of the annual measure, bringing the change in the CPI closer to the 2% target; and by mid-July, the Fed might realize the 5.25% policy rate is a bit too high to justify. The swap market is even predicting that in one year's time, the headline inflation will be 1.8% - below target.

The Debt Ceiling Imbroglio:
The big risk is the debt ceiling impasse, which will surely intensify over the coming weeks. In the U.S. it is a constitutional reality that Congress has a say in federal spending and debt decisions. The White House is willing to discuss spending cuts as long as they are not tied to the debt ceiling, while Congress wants the opposite. Macro Strategy Partnership

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noted that 18 former chairs and vice chairs of the Treasury Borrowing Advisory Committee had warned Treasury Secretary Yellen that “Any delay in making an interest or principal payment by the Treasury would be an event of seismic proportions, not only for the financial markets but for the real economy.” Despite this, the market has so far ignored the potential threat.

The Republican senators, coalescing with the House Republicans, are opposed to raising the debt ceiling without spending cuts and structural budget reforms. It is now clear, however, that a negotiated deal is a must. The Republicans have a good case. The April budget numbers show an urgent need for spending cuts. The April budget surplus - the best month for the federal fiscal year - fell by $274 billion, 73% from April 2022. The deficit for the first 7 months of this fiscal year is already $938 billion, 236% higher than in 2022. The big culprit is spending, which is up 12% or $440 billion, while revenue fell 10% because receipts from capital gains were bad. Currently total debt ($31.4trn) is 117% of N-GDP. Many believe that 120% should be the upper limit.

It's nerve wracking, but we’ve seen this playbook before. The two sides will almost certainly find a way to avoid catastrophe. There will be a deal by the 11th hour for three reasons:

First, several aides have recognized the need for an agreement on government spending.

Second, invoking the 14th Amendment to raise debt raises the legality of the move. While the validity of U.S. debt authorized by law shall not be questioned, increasing the debt above the limit without congressional approval would create legal ambiguities about the status of new unauthorized debt.

Third, the consequences of default are unacceptable because the U.S. debt is the base of the global financial system. Such an occurrence would undermine US global leadership, reduce national security and boost China's effort to displace the dollar as the world’s reserve currency. I hate to think what the market and people’s reaction would be.

In the end this is a rancor over future spending and revenue policy and not about how the Treasury should manage the debt. I agree with David P. Vandivier’s article in Barron's. He wrote: “The budget process already has rules by which a

divided government can debate the merits of each of their respective positions, and if the parties can’t get to an agreement, the threat of a government shutdown remains in order to force a resolution.”

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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