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PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

The Restoration of Price Stability:

The foundation of sustained economic and financial soundness is entirely dependent on the restoration of price stability. This is why Fed Chair Jerome Powell is keeping the consecutive interest hikes on the table. Moreover, many influential economists are warning that the hardest part of reining inflation to 2.0% lies ahead. The Bank of International Settlement (BIS) wrote in its latest annual report that the last mile to price stability may be the most challenging. That was echoed by the gathering of the top policymakers of the 4 most powerful central banks in Sinatra, Portugal last week. What is even more interesting was their admission that they do not understand why the economy is not responding to rising interest rates in an usual manner. Accordingly, they have publicly broadcast that they don't have confidence in their own forecasts. Thus, if these global monetary authorities cannot make up their mind as to what's coming, we, as investors, have no other choice but to make up our minds. In my judgement, I believe that the current cycle of inflation will be arrested by two main forces.

The first disinflation phase lasted 12 months, which resulted from global supply chains righting themselves after pandemic-caused disruptions plus the rectification of food and energy distortions caused by the Ukrainian war. As a result, the May CPI index has plunged to 4.1% y/y from its 9.1% peak registered last June. Likewise, headline PCE inflation fell to 3.8% from 4.3% in April.

We have come a long way to arrest inflation, but now we have not conquered the last mile. It's on the come. The next disinflation phase will likely happen over the next 6 to 12 months. It should come about from the deflationary effect of the past and the future fall in the monetary aggregates. This could bring price pressures down to target. On Wednesday, the Fed reported that the money supply in May fell 4.0%% year-over-year. This contraction has lasted for 6 months, an unprecedented stretch, that should last for many more months. There is a decent chance for PCE inflation to fall to 3.0% in June, at which point it will have fallen by 2.0% in just two months. This rate of decline won't be sustained, yet the year-over-year rate could be as low as 2.5% by December and with further declines in H1 next year.
Why?
The Fed will continue to trim its inventory of bonds as bank deposits should decline as excess savings get eaten up by consumer spending, the Federal government replenishes its bank balances and stricter lending standards are implemented by banks. Assuming that the money supply were to fall at the $100 billion per month, as it has over the

Macro View cont.

By Hubert Marleau

past 10 months, it would be about where it ought to be if it had not been for the pandemic. That is $19.5 trillion versus 20.8

trillion at the end of May. This means that the money supply could start to grow at an annual rate of 6% - a pace that would be in sync with an economy that has the potential to grow at 2.0% per annum, to keep inflation at 2.0% level, and supply enough liquidity to keep the financial system sound.

The economy has not tanked, despite the rapid-fire increase in the policy rate and the fast decline in the amount of money circulating, giving credibility to the notion that a path to 2% inflation does not require a recession. Indeed, further easing of inflation is already in the cards and business activity is doing better than critics fear to admit. Remarkably, the swap market keeps on demonstrating that inflation expectation is well anchored around 2.25% and the Atlanta Fed NowCasting model's estimated real growth for Q2 is 2.2%, following a 2.0% increase in Q1. The barrage of favorable data is putting the recession narrative on ice. The Citi Bank's macro surprise index is perched at 53.9, a 2 year high. In fact, the tightening transmission is hurting inflation and not real growth. The most predicted recession in history is being refuted.

In this connection, I still envisage an "immaculate disinflation". Confidence in this scenario has built-up, as it appears to be playing out, gradually. The healthy non-stress conditions of the banking system, the huge increase in household wealth and, particularly, the unusual resilient behavior of the labour market has prevented the economy from faltering. The point here is that workers are not losing their jobs but working fewer hours. On the one hand, employers are responding to tight money by cutting hours rather than firing workers and on the other hand workers are opting to work less because of a shift in work-life priorities. The introduction of digital, robotics and new methods has increased the need to hire experienced workers. That's different from the past. The shortage of labour is making good and experienced workers hard to find. So, businesses do not want to let them go. What is going on is cause for cautious optimism. In the week ended June 30, the S&P 500 rose to 4450, registering a 2.5% gain.

P.S. The Canadian Consumer Price Index rose 3.4% in May from a year ago, a huge drop from the 4.4% recorded in April. If it had not been for the massive 29.9% increase in the mortgage interest cost index, the year-over-year increase would have been only 2.5%. That tells me that from here on the Bank of Canada would be an abettor of inflation if it were to increase its policy rate in July.

Huber Marleau's 'Macro View'

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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