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Weekly Commentary

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Macro View

By Hubert Marleau

The Storming of the Bastille Day or The Dog Days of Summer

Year over year, consumer inflation fell to 3.0% in June, a remarkable year-long fall of 600 bps versus a 500 bps increase in the Fed's policy rate, with further declines in view. The New York Fed's June monthly Survey of Consumer Expectations showed that respondents had predicted that inflation would continue to decline for the next 12 months. Moreover, the net share of small-business owners who had raised average selling prices over the past 3 months fell to 25% in June from 65% last March, while core inflation, which excludes food and energy, was also notable, rising 4.8% - way below expectations, even though shelter prices have not yet shown any signs of easing, and rising as much as 0.5% m/m in June. However, private data suggests that upward pressure is subdued. The price increase for new leases has fallen faster than average rent, which will contribute to reduce core inflation in the future. Another precursor of consumer inflation is the producer price index. The BLS hailed more evidence that inflation moderation is no head fake this time. Wholesale prices, a reliable forerunner of consumer prices, rose just 0.1% in June and likewise year-over-year.

All told, the U.S. is about to pull off a soft landing - an immaculate disinflation. The Atlanta Fed's NowCasting model is estimating real growth of 2.3% for Q2, while NY Fed's Underlying Inflation Gauge "price only" measure for June is currently estimated at 2.5%.

However, the respondents to the NY Fed Survey were less optimistic about the long run. They expect inflation to resume its upward trend late next year and remain sticky at 3%, a full percentage point higher than the lows from August of last year. What is particularly interesting is that the swap market, which reflects the sentiment of the bond traders, who are supposed to be the smartest guys in the financial market, is partially in concert with their forecasts. The bond market dwarfs the stock market, which is another reason it's the main subject of conversation among seasoned investors.

Bond futures are predicting that inflation in one year's time will fall to a 1.4% low, but coil up to 2.6% a year later. This is new, and it may have to do with the aggregate belief that the probability of losing jobs is much lower today than originally taught in the past. Perhaps the economists at Goldman Sachs (GS) get the drift. Back in winter, they surprised

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many market strategists with their bullish outlook for growth. This time around, they have another surprise, suggesting that the risk of a second coming of inflation is real because a re-acceleration of growth above the economy's potential makes it a meaningful probability. They may be right again. Financial conditions have eased substantially in the past few weeks, says the MainFed's Financial Condition Index, including similar indices produced by Goldman Sachs, Bloomberg, the St. Louis Fed, the Chicago Fed and the Kansas City Fed. Goldman Sachs has now put its odds on a downturn within the next 12 months at only 25%. As a matter of fact, the University of Michigan's consumer sentiment index surged to 72.6 from 64.4 in May, considerably above the consensual expectation of 65.5.

WOW, WHAT IS GOING ON?

Perhaps the real neutral rate - the interest rate that balances savings with investment, from which the economy hums along at its potential, with full employment and inflation at 2% - is much higher than the 1.00% the NY Fed pins it at. In my judgement the real natural rate is 1.88%, which is expressed by the 5-year Treasury Inflation Protected Securities (TIPS). Estimates of the real natural rate of interest are imprecise and subject to changes, which is why I prefer an estimate that moves around. It's an acceptable explanation of why the most anticipated recession has not yet come. Put simply, it may have climbed sharply.

Interestingly, Vanguard offered empirical evidence and rational explanations why the natural rate may be higher than generally perceived. Four economists at Vanguard in a white paper to the SSRN, demonstrated mathematically that 2% is a better guesstimate. Moreover, Roger Aliaga-Diaz, head of Vanguard's portfolio construction, offered 4 good reasons why: the massive global fiscal impulse, the colossal issuance of government debt, the enormous global savings glut, and the new demands on developed-market governments. On the last point, think military budgets, green investments, energy independence, industrial policy, and onshoring. And we are in the midst of serious demographic and technological changes.

This brings me to Bloomberg's John Authers recently questioning the feasibility of the current 2% inflation target. He correctly pointed out that labour charges have taken over profit margins and non-labour costs as the major driver of inflation. It may indeed be normal for this stage of the cycle, but it's a once-in-a-lifetime occurrence that labour is finally capturing a bigger piece of the economic pie. David Kelly, of JPMorgan, describes wage rises as a bad excuse for more monetary tightening, as rising shelter prices, supply chain pressures and inflation expectations have all moderated. Higher standards of living are clearly what workers want. Indeed, the world is better off if people's wages rise faster than inflation. Plus, many forget that labour increases the supply of goods and services as much as it increases demand for them, particularly when overall growth of hours worked is not increasing as fast as aggregate growth. This is presently happening, and it's raising productivity.

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Pushing up the cost of money to politically intolerable levels is a serious side constraint. Thus the Fed may be forced to eventually accept an inflation target of 3% rather than 2.0%. Otherwise, it would keep on trucking until the unemployment rate reaches 4.25% or more. A higher inflation target is therefore an appealing idea that makes sense.

Meanwhile, the Fed is so locked into another unnecessary rate increase that it is poised unfortunately to raise rates because its old-school think is unable to adjust. What is needed is more workers to cure the labour shortage, and more shelter to cure the shortage of homes. I fail to see how higher rates can make this happen. Are the U.S.central bankers stupid? Surely they know better. This week's expected hike is likely to take place in a conciliatory and dovish manner because they know it's a mistake, but in this connection it will likely be the last hike for this cycle. Futures markets on Wednesday were pricing in a more than 90% chance that rates would go up by another 0.25 percentage points at this week's FOMC meeting, but would pause briefly thereafter and ease 125 bps over the subsequent 12 months. The Citigroup economic surprise index stood at 70.6 a few days ago, considerably above the 50-point threshold, which usually brings economic disappointments and falling long-dated treasury yields. It fell to 65.7 on Thursday.

Treasury yields and slopes are trending sideways indicating that the bond market does not believe that the Fed prefers the "Storming of the Bastille'' to the "Dog Days of Summer."

Meanwhile, Ed Yardeni, chief strategist at Yardeni Research, thinks that Wall Street may be too negative on earnings, with analysts expecting the biggest quarterly decline in S&P 500 earnings per share (9.0%) in 3 years. Indeed there's near-term risk to earnings thanks to tighter margins. However, there are also reasons to be optimistic. It might be easy to clear the lower-than-usual bar, given the positive macroeconomic backdrop; and a 7% increase in the N-GDP could provide good revenue and earnings support. Moreover, the federal budget deficit is larger, the trade deficit smaller, and personal savings lesser - 3 positive factors for higher corporate profit.

The current 17.9 times forward 12-months P/E ratio is a bit below the 5-year average of 18.6 and above the 10-year average of 17.5. Given the narrow corridor for stock market returns, investors will therefore need to pick their spots. In this respect, I would use Morgan Stanley's "Rule of 40" - whether the combination of revenue growth and operating margins exceed 40% -as a screen for picking winners. According to it, the large-cap public stocks that have surpassed this rule at least 10 times since 1999 have driven 56% and 112% outperformance vis-a-vis Nasdaq and the S&P 500 since 2018. It's still a mega-cap market, but its breadth is broadening. Indeed, according to technicians at Evercore, the remaining bears will come out of the woodwork if the S&P 500 crosses 4560, the last red line of resistance. I'm keeping my year-end forecast for the S&P 500 at 4850 because we are in a soft landing scenario. But, from a contrarian point of view, I expect a small immediate correction to 4275, where the 50-day moving average stands. I would buy into the prospective dip.

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On Friday the S&P touched 4505, for a weekly gain of 106 points or 2.4%.

P.S. I’ve changed my mind on the future path of oil prices. They may have bottomed around $70 per barrel, after suffering a long and painful decline since March 2022. China is reflating with monetary and fiscal stimuli and projected production is now lower and anticipated demand.

Huber Marleau's 'Macro View'

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