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Weekly Commentary

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Macro View

By Hubert Marleau

Yogi Berra said: "It's tough to make predictions, especially about the future."

At the moment, the U.S. economy is in a sweet spot. In the 3 months ended June 2023, the Atlanta Fed's NowCasting model predicts that business activity rose at an annual rate of 2.4%, and that in the last 12 months consumer prices were up 2.97%. The latter is within the Fed's 1% to 3% control range. Lower personal savings, reduced trade deficits and higher government spending deficits are the main macro sources behind the strength of the economy and the normalization of the supply chain combined with a weaker Chinese economy and tightening monetary conditions at home, were the main reasons behind falling inflation.

There is little doubt among economists that the pace of inflation and growth will slowdown over the coming quarters. On the one hand, the labour market is resilient, consumer confidence has risen, and many firms have aggressive plans for the future: while on the other hand, household savings are finding their way to corporations, affluent earners, construction activity and repayment of debt, thereby reducing the amounts flowing to conspicuous consumption of discretionary services and items, where inflation remains concentrated. Credit scores are falling as charge-offs in credit card debt have risen. Moreover, the Atlanta Fed's Wage Tracker, which measures the premium for switching jobs, is back to normal and the downshift in the Zillow numbers, which follow the pricing of new leases, is bound to arrest soaring rents.

It is nonetheless true that every economic expansion ends at some point, which is why the probability of a recession is roughly 15% all the time in any given year. Right now, a recession does not look imminent. Economic news has been very positive. The Citigroup Economic Surprise Index, which gives heads-ups on how the economy is faring against expectations, stands at 74.8 - its highest level in 2 years. In this connection, economists are backing away from their calls for an impending recession. The Wall Street Journal's survey of 69 business and academic economists showed them cutting the consensus probability of a downturn over the next 12 months to 54% from 61%. In a poll of 143 CEOs conducted by Fortune-Deloitte, only 38% said they had a pessimistic outlook for the global economy for the next 12 months, down from 76% last October. In a separate poll, JPMorgan showed only 45% of midsize business leaders expected a recession before year-end, down from 65% six months ago.

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Meanwhile, the Federal Reserve Bank of New York has a gauge, named Outlook-at-Risk, for growth, unemployment and inflation, that is getting a lot of attention. The July print was released on Wednesday, indicating that downside risks for GDP growth had declined noticeably, with the estimated conditional probability of average growth over the next 4 quarters falling below -1%
standing at approximately 14%.

The economists at Goldman Sachs are even bolder and often correct on their conjectures. They just trimmed the estimated chance of a U.S. recession over the next 12 months to 20% from 25% last week and 35% from March of 2023. They said: “The main reason for our cut is that the recent data have reinforced our confidence that bringing inflation down to an acceptable level will not require more than one more rate hike.” Traders are assigning a 99.8% probability that the central bank will increase interest rates by 25 basis points on Wednesday. The move is expected to be dovish because it will likely signal a wait-and-see approach for the following meetings.

From my perspective, I have a constructive view on the so-called “immaculate disinflation.” Nevertheless, I expect the pace of the economy to decelerate to 1.25% per quarter over the next 18 months, commensurate with slower real disposable personal income growth and lackluster performance of the money supply. In this connection, over the past 30 days investors’ sentiment has gradually tipped from ridicule to recognition, turning a narrow bull market into a broad one. The weekly AAII survey of retail investors is now positive, indicating that more of them feel bullish than bearish by a relatively wide margin. Last Friday’s University of Michigan consumer sentiment survey gave us a taste of this. And it is indeed remarkable. Corporate buybacks, algorithms, professional traders, momentum players and discretionary speculators are all in the melee. Their enthusiasm is convincing the remaining bears to jump into the fray, pulling the S&P 500 across the 4560, where the red line of resistance once stood. This apparently unshakable propensity to melt up has a lot to do with the growing probability that we are going to have a disinflationary soft landing, rather than a deflationary recession. This immaculate transmission is about fewer hours’ work and unjammed bottlenecks; and as simple as it may sound, these two ongoing events are raising productivity and lowering unit labour cost, the latter being the root cause of core inflation. The second-round effect on the remaining inflationary fat will come with the delayed aftermath of the 2022-23 application of tightening monetary policy. Moving inflation from 3% to 2% should be easier and faster than from 9.1% to 3.0%, rendering further rate hikes beyond July unnecessary.

Indeed, this macroeconomic backdrop is changing Wall Street’s consensus outlook for earnings. Regional manufacturing surveys illustrate that prices paid for material input are dipping, while prices received for goods sold are rising. In accordance with the observations, the earnings season is off to a good start. The majority of those who have already reported their second quarter earnings are beating expectations. For example, the analysts at Credit Suisse increased their estimate for 2024 EPS for the S&P 500 from $220.00 to $237.00. I’m banking on

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$250.00 because government budget deficits are rising, the trade deficit is declining, and personal savings are falling. What is forgotten neglectfully is that under rising earnings and declining inflation, investors do not have to demand a lot of extra return in exchange for locking away money for long durations. From an historical perspective, the bond risk term premium (what fixed-income investors want as insurance to cover bond price volatility) is negative at 0.75%,

and the equity risk premium (what risk investors want as insurance to cover stock price volatility) is low at 1.70%.

This unusual phenomenon has to do with the belief that the Fed will get inflation back to the 2% target, suggesting indirectly that 10-year Treasury yields will return to 3.00% or less. This enthusiasm is probably well founded, but a lot of it is already priced in, and possibly the market may be ahead of itself. However, it comes with a caveat that the market may not be overbought. Tom Lee, head of research at Fundstrat, commented in Market Watch that although the S&P 500 is trading at more than 12% above the moving average, it does not mean that it is. Since 1970, he showed that in 8 of the 12 instances when this benchmark was that much above that trend line it still managed to move up more than 20%. Consequently, a shallow immediate correction to 4300, where the 50-day moving average currently stands, should be expected.

I still believe that the S&P 500 will see 4850 before year-end, and would therefore buy on the prospective dip. It closed at 4536 on Friday, registering a weekly gain of 31 points, up 0.7%.

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