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

PALOS

CONTENTS

Weekly Commentary

Issue **No. 29**| **AUGUST 28, 2023**

Macro View

By Hubert Marleau

The Brave New World of Jackson Hole

The media has a tendency to treat everything like a horse race, even the framework under which the Fed makes monetary policy.The reality is that when it comes to the travails of the Fed, it labours like a turtle. Indeed, the monetary authorities don't know the future, let alone what is going on now. That is why they rarely change their modus operandi. Despite pressure from the media, Powell did not make any aggressive statements at Jackson Hole in order to avoid any chaotic shock. Instead, he delivered a prepared “something for everyone” speech designed not to rock the boat, dismissive of raising the inflation target above 2.0% or of sharing any view as to what the neutral rate of interest might be. Bottom line is that the Fed will proceed carefully, hold the policy rate constant and await further data. According to the CME FedWatch Tool, which tracks moves in futures, traders put the odds of the Fed holding steady at the September 19-20 meeting at 83%, a 4% point increase from before Powell’s speech, suggesting that they neither expect a controversial job report nor bad personal spending numbers this week, and believe him when he said that the Fed will not hike at the next meeting and proceed carefully in the future. The S&P 500 closed at 4406, up 36 points or 0.8%.

Nonetheless, it has become blindingly obvious that the world is changing rapidly. I’ve identified 8 anatomical issues, which are dramatically shifting the way industry operates and market functions, but are currently excluded from economic models used as compass dials to navigate the economy.

The Environment - availability of freshwater, clean air, green space, critical resources. Climate Change - explosion in the deployment of renewable energy, rising energy efficiency

Geopolitical Confrontation - warfare, rearmament, cyber security, underwater sea cable, drones, satellites

Demographics - ageing society, low birth rates, slow population growth, rising income and wealth inequality.

The Political Economy - state intervention, onshoring of supply chains, protection of strategic industries.

The Political Landscape - market concentration (duopoly and monopoly) political divide, abusive fake news.

Indebtedness - high debt levels, government deficit spending, affordability of housing.

Macro View cont.

By Hubert Marleau

De-dollarisation - third world and emerging economies' wish for another reserve currency

The dynamism of these structural changes is world-wide and pervasively in the ecosystem, causing deep uncertainties about how the Fed should deal with this new reality. That is why the theme of this Jackson Hole summit was "Structural Shifts in the Global Economy."

I have not read any academic research papers presented at the conference. Nonetheless, I'm certain that ideas and suggestions abound that over-reliance on demand management is unrealistic, and that the supply side of the economy has become more important than the demand side. In this regard, a new framework may become necessary in the future, but for now what is urgent is whether a new reference point is desirable. That is the so-called neutral rate (R-Star*). Given that the fate of monetary policy is inextricably bound up with this concept, the time has come to mull over the future of this one issue.

Why is this so important?

There are several ways to look at this. The classic scholarly definition of the neutral rate of interest is the real (net of inflation) interest rate that supports the economy at full employment/maximum output, while keeping inflation constant. In other words, it is where an economic equilibrium exists, which happens when the demand for savings and investments is symmetrical - in tune with each other. In practical terms, it's when the Fed's policy rate neither stimulates nor restricts growth and inflation. Every quarter, Fed officials project where rates will settle over the long run, which is in effect their estimate of the nominal neutral. Last June, they had a nominal estimate of 2.5%. After subtracting the Fed's 2% target, the real neutral rate (R-Star*) is 0.5% compared to 2.25% in 2012 when the 2% target was formalised.

It's the view of many, including me, that the R-Star debate will take centre stage, once all the research presented at Jackson Hole is absorbed. Thus I foresee a December or March upward re-evaluation of the Fed's forecast for the long-run interest rate under the "Summary of Economic Projections," combined with a cut in the policy rate and without any adjustment in its 2% inflation target. Yes, a decrease! The only reason why Powell left in the possibility of raising rates is to prevent the market from quickly thinking that a cut is imminent or that the Fed is on a "stop-go" policy. Justin Lahart astutely wrote in the WSJ: " It won't be necessary for inflation to come all the way down to the Fed's 2% target, but instead, as Powell reiterated Friday, for it to be more clearly headed in that direction."

At first glance, this may seem odd. Not really. The current rule dictates that the policy rate has to be higher than the actual inflation when reported inflation is above the 2.0% target, especially when actual growth is running faster than 1.75%. Currently. inflation is above the 2% target by about 1.0% and so is growth by a similar amount. This has been going on for more than a year and even more acutely in the last 6 months. Put simply, inflation has fallen because the money supply has been declining, while growth has risen because productivity has been increasing with the rise of technological change - digitalisation, robotics, artificial intelligence and cloud storage.

Macro View cont.

By Hubert Marleau

Thus the stagflation scenario has been blown out of the water by a new productivity era that has suddenly begun with a bang. A technological boom has emerged as companies across all industries are transitioning aggressively to accelerated computing, digitalisation, robotics, cloud storage and generative artificial intelligence. Productivity is amicable to growth but inimical to cost-push inflation. Thus inflationary readings may not blip up as some analysts are forecasting, but it explains why real rates have risen as much as they have and caused most of the increase in bond yields. A lot of empirical evidence shows that low inflation can coexist with strong economic growth under a higher neutral rate. Presently, the true market-sensitive real neutral rate, which is the product of the 5-year Treasury yield (4.25%) less expected inflation for the next 5 years (2.25%), is 2.00%, 150 bps higher than where the Fed has it.

All told, the productivity hypothesis tells us that we are in for a higher interest regime than the one experienced since 2008, not because inflation expectation is out of hand, but because growth prospects are higher. Jim Grant, a veteran observer of interest rates, argued in a recent note to his followers, reproduced in the Financial Times that there have been 5 long-term shifts in rates since the mid-19th century. “From the Civil War to 1900, rates were in steady decline. They rose in the two decades through 1920, spurred first by gold discoveries that effectively printed money, and later by the inflation produced by the First World War. From there, rates declined until 1946. Then, we’ve had two postwar regimes: rising rates through to 1981, and falling rates ever since.” The point is that we may be at the start of another generational-like interval that has lasted between 25 and 40 years. Take note, however, that a generational increase in interest rates does not prevent cyclical decreases. The policy rate is 1.13% above the nominal neutral rate. The cyclicall decrease in interest rates that I envisage will not bring them down to the low levels that prevailed from 2008 to 2020.articular on structural shifts in the global economy - matters of concern for investors.

Huber Marleau's 'Macro View'

Issue **No. 29**| **AUGUST 28, 2023**

Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

4711 Yonge St, 10th Floor
Toronto, Ontario M2N 6K8

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca