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Weekly Commentary

Issue **No. 31** | **SEPTEMBER 11, 2023**

Macro View

By Hubert Marleau

The Real Enemy is Oil Geopolitics

The docket of economic prints was sparse last week. Nonetheless, the stock market took a hit as the ongoing strength of the dollar, combined with higher crude prices created a risk-negative sentiment. The S&P 500 fell 1.3 % to close at 4457 on Friday, back to its 50-day moving average. It may prove to be a good moment to pick stocks, unless the oil market were to upset the apple cart: oil can be a wrecking ball.

However, the rising price of dollar and of crude oil will further persuade the Fed to wait and see their effect on future economic prints. For instance and purpose, we are almost in a 2% world. The economy is moving back to the slow environment that preceded the pandemic, namely 2% for growth, 2% for inflation expectations, and 2% for y/y employment increase.

At this point, it looks as if the Fed will pull off the so-called soft landing that we predicted last year. Core PCED inflation is dropping closer to 2%, demand for labour is falling near its supply, and consumer spending is cooling. Goldman Sachs, in a note to clients, cut their subjective 12-month recession odds to 15% because the drag from monetary tightening will continue to diminish, vanishing entirely by early 2024. Indeed, top monetary officials, even the more hawkish ones, are signaling strongly that interest rates will stay on hold at the next meeting in September, opening the door to the possibility that they may revise down their interest rate projections.

Crude Oil is a Geopolitical Wrecking Ball:

Unfortunately, the likelihood of an unprecedented occurrence in which a yield-curve inversion brings down inflation without a recession could be in jeopardy. The popular opinion that higher oil prices will lead immediately to higher inflation is correct, but only until energy bills as a % of N-GDP become too high: currently 3.25%, up from 2.60% a few months ago. If it were to go beyond 3.75%, it could become deflationary. So far it's OK. US gasoline prices are averaging a little over $3.80 a gallon, far below the 2022 peak of $5.00. Nonetheless, it could happen.

Macro View cont.

By Hubert Marleau

Crude oil is now trading above $87/bbl, up more than $20 since the start of June, as production and discipline among all producers weighed down on inventories. Yet the oil market is still in a backwardation mode, signaling that the fundamentals will continue to be very tight and in turn suggesting higher spot prices are likely. The production and discipline among all producers have weighed down on inventories.

Surprisingly, Russia and Saudi Arabia unexpectedly decided to extend their production curbs, 300K and 1 million apiece - to the end of the year, forcing forecasters to raise their average price for domestic oil to $90 in the December quarter of 2023 and $110 in 2024. Should these predictions prevail, the energy bill as a % of N-GDP would breach the 3.75% threshold. The question is why would Russia and Saudi Arabia take such a risk, without strong reactions from Washington, when there is a presidential election in their midst? Put simply, it's about geopolitics and how countries deal with each other.

First, Saudi Arabia has plenty of money. Yet it needs a lot more. Mohammed bin Salman (MBS) is a reformer and a modernist and wants to build futuristic cities, while keeping social expenditures high to pacify the populace. In this regard, the Kingdom is pursuing a price-over-volume strategy. MBS brought to bloom bilateral ties with Beijing, who in turn brokered an ostensible truce between Riyadh and Tehran, thereby concentrating his effort on modernizing and reforming his country.

Second, Russia needs money to finance the war in Ukraine.

Third, U.S.officials have held their fire. The White House wants to normalize formal relations between Israel and Saudi Arabia and find an ally, perhaps in Saudi Arabia to draft a diplomatic solution to end the war in Ukraine. Why would they upset such discussions when they know that Putin and Mohammed bin Salman are likely to reverse their decision in December? It's not worth bitching about and obstructing what is going on in the geopolitical arena when one thinks how much a win on these 2 fronts would mean to Biden's re-election effort.

The Long-Term Outlook for Canada:
Part1- Population and Capital Shortage

Macro View cont.

By Hubert Marleau

Canada will soon have a Federal election. Presently, it looks as if the Conservative Party under the leadership of Pierre Poilievre will form the next government with a plurality of votes and majority of elected representatives. People who know me know what my political bent is. I will not reveal publicly whom I favour, but over the next few weeks I shall try my best to tell my readership what I sincerely believe Canadians need to be conscious about when it comes to the long-term outlook for Canada.

There is growing evidence that this country is no longer a productive, growing economy like it once was, when it was driven by exploitation of natural resources in the West, and by industrial productivity in the East. Except for a few industries that are insulated by federal regulations like transportation, banking, and ailing companies protected by provincial legislation, our economy is basically a branch-subsidiary of the USA. Unfortunately, subsidiaries spend little on innovation, research and development and major plants. Moreover, while endowed with an abundance of natural resources, especially fossil energy, agricultural, fresh water and minerals, their development is bogged down by overzealous dissenters, forcing these commodities to be exported only in raw form, making our Canadian terms of trade subject to the whims of international commodity prices. We just don't add value.

Thus Canada has been unable to generate significant productivity gains in its manufacturing and service industries and incapable of adding value in its natural resource sector, making it impossible to grow on its own. In this connection, its economic fortunes are still totally dependent on immigration and foreign capital. The Canadian population is too small and is wasting too much of its savings on residential construction, government deficits and foreign properties to boost productivity. The latter must stop and the former must grow, otherwise Canada is toast.

In future letters, I will make policy suggestions that a new government, of whichever colour, should implement to increase the value of our natural resources in the West and the productivity of industry in the East. What is needed is lower corporate taxes, higher depreciation rates, the eradication of interprovincial trade regulations, more gas pipelines, less onerous zoning restrictions, removal of trade barriers, more skilled immigrants, higher R&D initiatives, more risk-capital for innovations, the elimination of government deficits by spending less on welfare, and more exports, including trade deals. There is an urgent need to act because the consequences of inaction are enormous. According to researchers at HEC Montreal’s Centre for Productivity and Prosperity, if nothing is done about the causes of our plight, Canadian industry will not be able to compete globally. Should I elaborate?

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