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PALOS

Macro View

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CONTENTS

By Hubert Marleau

The Fall in Bond Yields

Bond and Gold prices rallied impressively at the beginning of last week. Yields on 10-year Treasury notes fell as low as 4.50% from a recent high of 4.87%, while gold's price rose $52 to $1886 in part due to a flight to safety by international investors seeking haven after Hamas' attack on Israel and also by speculators rushing to cover their short positions, foreseeing lower inflation prints and declining consumer demand for anything that requires financing.

That said, the big rally in bond prices resulted mainly from Fed officials who talked down future interest rate hikes, hinting at stable interest rates and focusing on the length of time they will remain at current levels. I think they gave the wrong message on September 20th unintentionally that rates were projected to rise some more. But they made amends:

Lorie Logan, President of the Dallas Fed proposed that if long term rates remained near current levels, there might be less need to raise the policy rate. Phillip Jefferson, Vice Chair of the Fed's board, concurred with Logan's viewpoint, saying that he was committed to consider higher bond yields while assessing future policy decisions for they will surely aid the central bank in achieving its 2% inflation target.

Raphael Bostic, President of the Atlanta Fed, said: "I actually don't think we need to increase rates anymore because the central bank has done enough." He added that the current policy was sufficiently restrictive, and that "a lot" of the impact of the Fed's hikes was yet to come.

Neel Kashkari, President of the Minneapolis Fed, said: "It is possible that the recent rise in treasury yields may not need to raise rates as much as otherwise. It's certainly possible that higher long-term yields may do some of the work for us in terms of bringing inflation back down."

Mary Daly, President of the San Francisco Fed, said: "5% is not going to be the new neutral rate. There is no evidence that it will be the new neutral - that's still the policy rate trying to fight back inflation. I completely could imagine that we go from 2.5% to anywhere between 2.5 and 3 as the nominal rate."

Macro View cont.

By Hubert Marleau

Susan Collins, President of the Boston Fed, said: “Officials are taking a more patient approach to monetary policy now that rates are at or near their peak”.

Governor Christopher Waller said: “The financial markets are tightening up and they’re going to do some of the work for us. We are just keeping a very close eye on that. We will see how those higher rates feed into what we do on policy in the coming months”.

Finally, Patrick Harker, President of the Philadelphia Fed said that he believed the central bank did not need to raise rates again. He added: “Absent a stark turn in what I see and hear from contacts, both in one-on-one conversations and in forums, I believe that we are at the point where we can hold rates where they are”.

Then all of a sudden, a moderately disappointing inflation report upset the apple cart. Just when many thought it was safe, the bond market took it on the chin on Thursday, 10-year bond yields rising to 4.70% because traders disliked the September CPI report. It did meet expectations, rising 3.7% y/y instead of 3.6%. The path to 2% core inflation may be tortuous, but it’s still very visible. Stripping out food and energy costs, consumer prices rose 4.1% y/y in September compared to 4.4% in the prior month as the spectre of high inflation recedes. Without the cost of shelter, which is admittedly sticky but will soon fall, inflation is on target at 2.0%. Meanwhile, Rogers’ Agricultural Index, a worldwide gauge of food prices, has fallen recently to 1295.0 from 1425.0. Meanwhile, the price of crude ran up only because a Middle East fear premium set in and not strong demand; rent inflation on new leases was down 3.2% in September and 1.2% in August. CPI’s shelter costs have not yet embraced these numbers, but they soon shall. According to the NY Fed’s Underlying Inflation Gauge (UGI) - a measure that captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data - inflation declined 0.1% in September to 2.9%, inside the officially permissible range of 1% to 3%.

The Rise of Stock Prices

October often marks the start of a seasonal bounce for stocks and it did so despite the fog of war in the Middle East. Based on the belief that crises in the Middle East are usually of short duration with little impact on oil prices, traders turned bullish because the S&P 500 was near its 200-day moving average of 4200. Using that level as ground zero to run up the benchmark to 4377, they registered a 3-day gain of 68 points or 1.6%, buying the “soft landing scenario,”as there is a lot of momentum in the economy: jobs are plentiful, savings are high, wage gains are exceeding inflation and retired baby boomers are spending their ample savings - also believing that Q3 earnings would be better than generally expected. The NY Fed’s Weekly Economic Index (WEI), which has been

Macro View cont.

By Hubert Marleau

on an uptrend since last April, was revised up again to 2.14 due to a rise in retail sales and railroad traffic, combined with a decline in unemployment insurance claims.

Thus, companies in the S&P 500 are projected to post a very small 0.3% year-over-year drop in third-quarter earnings - the smallest decline in 4 quarters.

Note however, that a majority of such companies usually beat expectations, which may insulate individual stocks from the wholesale effect of geopolitical events. Accordingly, many analysts are betting that we could see the first earnings growth in a year, with estimates for the 4th quarter painting a 10.8% increase from a year earlier. The Bank of America is of the opinion that the benchmark will avoid a big drop for as long as yields on 10-year Treasury stay below 5.00% and continue to stay above the key support level of 4200. In the end, the S&P 500 was unable to hold on to its early gains as equity traders drove it to 4328 for a meagre weekly gain of 9 points.

Meanwhile, there are concerns, stemming from a series of geopolitical risks - gold price jumped to 1945 so did the tail risk index to 144 on Friday -that will make it a hard-won battle for the S&P 500 to reach our year-end target of 4650. Given that dividend-yielding stocks are earning between 5.00% and 7.00% without consideration for potential growth (which I clock at 2.00% per year), they are alluring when one acknowledges that in the fullness of time stocks, in aggregate, gave a market return of about 9.0%. Indeed, the difference is not much, considering the relative certainty of dividends, which incidentally covers the risk premium handsomely.

Huber Marleau's 'Macro View'

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