PALOS

Macro View

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By Hubert Marleau

The Fed Barks More Than It Bites:

A sparse docket of economic data prints has left the market at the mercy of Fedspeak. It appears that a suite of top Federal Reserve officials would err on the side of over-tightening monetary policy, rather than not do enough to bring inflation down to their 2% target. Fighting inflation remains for now their economic priority. Generally, the majority of the Fed speakers jawboned to cool market expectations for rate cuts.

Minneapolis Fed's President Neel Kashkari said: "Undertightenning will not get us back to 2% in a reasonable time." He's worried that the resilience of the economy may lead to an uptick in inflation forcing it to settle somewhere north of 2%."

Dallas Fed President Lorie Logan said: "For me, inflation is too high. The core question is whether financial conditions that we are seeing today are sufficiently restrictive to return inflation to 2% in both a timely and sustainable way." In her judgement, inflation is trending to 3% rather than 2%. She continues to expect that the Fed will need to increase the federal funds rate further.

Fed Governor Christopher Waller called the run in yields an "earthquake," describing Q3 GDP as a blowout that warrants a very close eye when we think about policy going forward."

Fed Governor Michelle Bowman said: "I took the recent GDP number as evidence the economy has not only remained strong but has gained speed and will require a higher Fed policy rate."

Philadelphia Fed President Patrick Harker argued that policy rate decisions could go either way, depending on what the data will tell us. He does not expect any rate cuts in the near future, ascribing it to the position where they need to remain higher for longer.

Atlanta Fed President Raphael Bostic said: "The monetary authorities are going to get to 2% inflation because they will keep the policy restrictive until that happens, or until they are sure that it's going to happen."

Richmond Fed Chief Thomas Barkin said: "I believe there's a slowdown coming and we're going to need one, because I think that's what it's going to take to convince price-setters the days of pricing power are over."

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Kathleen O'Neil Paese, the interim president of the St. Louis Fed suggested that "policymakers should be ready to continue hiking if progress on inflation slows."

Traders did not seem to care much about what these guys had to say, until Federal Reserve Chair Jerome Powell called the shots on Thursday, snapping an eight-day winning streak for stocks. Powell wrapped up the week saying that the central bank will continue to move carefully, but said that it won't hesitate to tighten policy further if appropriate, addressing the risk of being misled by a few good months of data and accepting the risk of overtightening. The pushback created uncertainty, bringing about another outsize move in stock prices and bond yields.

Given that there was little on the calendar to build on from last week's momentum, traders stayed on the alert for indications from Fed speakers that could favour a full stop to further rate hikes or upset the apple cart. The rally in the stock markets showed fatigue, being prone to succumbing to macroecomic headlines, which have nothing to do with complex mathematical simulations that economists use to forecast, like falling oil prices and a rising unemployment rate.

The Oil Run May Be Over Amid Three-Month Lows:

Rapidly falling oil prices are a clear sign that a global cyclical slowdown is at play. In the 8 weeks ended November 10, the international price for a barrel of oil has fallen $15 to $81.25. Moreover, the steep drop in the forward curve backwardation added to the bearish tone, but signalled a near bottom. Global demand has slumped, especially in China. The global energy bill as a percentage of world GDP is presently only 2.71%, compared to a September high of 3.28%. While there are pundits who blame the steadily ratched up production of U.S. oil, this thesis does not hold much water. More importantly, demand for petroleum-driven lubricant, which is used to grease industrial activity, is falling everywhere, from Europe to the US to China to India. Like copper, lubricants closely mirror global business activity.

The Trajectory of Job Growth is Slowing Down:

October's unemployment rate rose to 3.9% from a low of 3.4% in April. More significantly, it has risen 50 bps in the last 6 months, possibly marking a turning point for the economy. By this stage in 2001, 2007, and 2020, the US economy was entering a recession. Over the past 6 months, one million people joined the workforce of which only 19% found work, swelling the unemployed by 849,000. Claudia Sahm has devised a rule that stipulates that when the 3-month moving average of the national unemployment rate rises 0.50 percentage points or more, relative to its low during the previous 12 months, the economy is in a recession. Of course, the rule is not a law of nature, but its empirical regularities have worked since the 1970s. The current value is 0.33 percentage points.

Conclusion: A Tug of War

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These two aforementioned macro observations illustrate that the balance of risk is heading toward much slower growth. We are in the early innings of the fourth quarter of 2023. Nonetheless, the Atlanta Fed's NowCasting model is predicting much slower growth than the 4.9% annual rate registered in Q3 clocking 2.1% in Q4.. This is hardly a harbinger of an imminent recession. Some of the extraordinary surplus people accumulated during the pandemic is still about, perhaps as much as $500 billion, and is not likely to be depleted before the end of October, according to San Francisco Fed researchers Hamza Abdelrahman and Luiz Oliveria. Private economists at JPMorgan and UBS Group, believe that excess savings are even higher: around $1.0 trillion. Moreover, productivity is still holding up.

Nonetheless, policymakers cannot shrug off the ongoing slowdown as easily as they have. The Fed's policy playbook needs a revision that supports the idea that it's finished for this cycle and starts to broadcast that the right course of action is to signal a few interest-cuts in 2024. With both the labour market and inflation heading down into 2024 softer than they were going into 2023, two top officials are preaching a calibration of the monetary policy to reflect the changing environment. They probably acknowledge that the policy rate is 100 bps above the market neutral rate (4.50%) and 200 bps above the academic-neutral rate (3.50%). Governor Lisa Cook even opined that a decomposition of the recent rise in long-term bond yields suggests it was not driven by expectations of further interest rate hikes. Austan Goolsbee corroborated this, noting that Americans may have witnessed what may be remembered in the history books as the fastest-dropping inflation rate in the last century, and that without a recession. Indeed, we might not be head-faked this time around.

Thus, if many speculators took some profits last week as the S&P 500 approached its 50-day moving average, it is perhaps fitting to believe that last week's epic rallies in the bond markets probably ended the stock market correction, bringing it back on track to end the year around 4600. Indeed this is probable, for on Friday the benchmark closed at 4418, rising above its key 4400 mark, and crossing its 100-day moving average: a bullish development.

First, there is an historical tendency for stocks to do quite well when the Fed is over and done with recalibrating the economy between inflation and employment through interest rate movements. David Rosenthal made the astute observation in the Financial Post that if the Fed were to stay put in December, it would be tantamount to a 5-month pause. He said: "History shows that once the Fed goes that long without hiking after a tightening cycle, the cycle is over. The next move will be a cut, with the lag from the last hike to the first cut being 10 months on average. That puts the first cut as early as May, or June, which is where the futures market is now leaning." Second, earnings have been generally strong. With 439 of the S&P 500 companies finished reporting, revenues have exceeded consensus estimates by 0.8% and earnings by 7.1%. Indeed, so far, third-quarter profits from the S&P 500 are shaping up to produce a y/y increase of 3.7%. However, Q4 estimates have softened because executives have telegraphed cautious messages, suggesting that most of the expected increase in profits will stem from cost-cutting measures and not from an acceleration in revenues. Surveys and research by the Bank of America show that corporations are trying to protect their margins to safeguard profits and pointing that earning troubles are due to idiosyncratic problems like Merck and Pfizer.

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What is key here is that the earnings recession is over. Lately earnings have lagged GDP growth for five straight quarters, which is a rare phenomenon because they usually outdistance the pace of the economy by about 1.5% per year. They have done so since 1950, according to Savita Subramanian. This dislocation seems related to 2 factors which increase costs faster than revenues: a consumer spending shift to services against goods and a rise in reshoring, creating demand for jobs, a reallocation of labour needs and dislocation costs: a process that initially raises inflation, but should start to produce positive results.

P.S. 1 Moody's Investors Service changed its outlook on the U.S.'s credit rating to negative from stable (citing the federal deficit and political polarisation as the key drivers) but affirmed that it still enjoys a Aaa classification.

P.S. 2 The October's headline CPI due on Tuesday is expected to rise 0.1% m/m, while rising by 3.3% y/y, down from 3.7% in September.

Huber Marleau's Macro View

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