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The Palos Perspective

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Three Big Things Say "Immaculate Disinflation" is Not a Fairy Tale

American exceptionalism may have faded, but not when it comes to the economy. The U.S. economy is still a "shining city on a hill." Inflation is decelerating fast, productivity is surging and jobs are plentiful. There's just nothing in any economic prints since the start of the year signalling that the economy is in danger of falling off a cliff. As a matter of fact, Americans, as suggested by various consumer surveys of confidence and sentiment, are finally shaking off the "vibecession" that has characterised the mood of the nation over the last 2 years. This improvement is bound to continue because incoming data is arriving ahead of expectations as illustrated by the Citi Economic Surprise indices.

The Employment Situation:

This week's key labour market data showed that the jobs are plentiful and are being filled. Vacancies rose above 9 million in December for the first time since September, exceeding expectations by a considerable margin. Indeed, the pace of job creation is not only holding up, but still growing, ADP having reported that the private sector added 107,000 jobs in January alone. Meanwhile, the BLS noted that Non-Farm payroll (NFP) increased by 353,000, leaving the unemployment rate at 3.7%. The economy added an average of 289,000 jobs over the past 3 months - the fastest pace of job creation since Q1/2023.

The Inflation Situation:

The rate of inflation is unmistakably declining. The progression on the PCE deflator clearly shows it is definitely in the rear view mirror, with the 12-month annualised rate at 2.63%, the 9-month at 2.15%, the 6-month at 2.02% and the 3-month at only 0.4%. Interestingly, the Employment Cost Index (ECI) rose by a relatively weak 0.9% for the 3-month period ending December 2024 and 4.3% from a year earlier - the mildest in the last 10 quarters. Workers are not switching jobs for higher pay like they did in the last 2 years: the quit rate is stuck at 2.2%. Sticky-churn usually brings cooler wage growth. Moreover, the Truflation index dropped to 1.3 y/y on Thursday. These measures are bolstering the prospects that the inflation deceleration will continue. Indeed, the economy is within striking distance of hitting the Fed's 2% inflation target. Average hourly earnings jumped 0.6% in

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December from a month earlier, putting them up 4.5% from the year before. It seems like a lot, but given that productivity gains are running at better than 3.0% per year, the inflationary impact is negligible.

The Productivity Situation:

Productivity rose at an annual rate of 3.2% in Q4/2023, 4.7% in Q3 and 3.6% in Q2 and counting. Erik Brynjolfsson, senior fellow at the Institute for Human-Centered AI and a leading authority on measuring the productivity contribution of information technology productivity who studied under the guidance of Robert Solow is betting that the outlook for productivity gains in the 2020s is significantly higher than the 1.4% that the Congressional Budget Office is projecting. He argues that it could be twice that and closer to 3.0%. Meanwhile, the Atlanta Fed's NowCasting model has a 4.2% GDP growth estimate for Q1/2024, having considered more than the anticipated 1.2% gain in total employment and, in turn, suggesting that the economy is in the midst of a productivity boom.

The Monetary Stance is Conservative not Hawkish:

With a poker face, Chairman Powell pushed back against the market's expectation of sooner-rather-than-later rate cuts, dashing hopes for an interest rate cut on March 20. Fed officials believe that they can afford to wait on cutting rates because the economy is strong, the stock market is trading at all time highs and the potential inflationary consequences of a major geopolitical shock is huge. Moreover, there is the running idea that the Fed may decide to lessen its quantitative tightening program before introducing a cycle of rate cuts. This has some merits because drawdown in the reserve repo, the rise in money market volatility and the increased usage of the discount window would be better served with liquidity to avoid a credit squeeze. The New York Community Bancorp, for example, posted an unanticipated loss, cutting its dividend and boosting its provision for loan loss 10 times more than expected.

No matter how one looks at it, however, the Fed is conclusively too restrictive. Bond market breakeven rates of inflation across all maturities (2.35%) are about 300 bps below the policy rate (5.38%) The bottom line is that the prudent policy stance is to return to a neutral setting, the economy having moved in a better balance between inflation and employment because productivity has allowed it. Thus the Fed will eventually ease policy. It did indeed signal that rate cuts are on the way and was reluctant to definitively rule out a cut at the next FOMC meeting. The market-implied probability of a March interest rate cut is still 35%.

The Stock Market:

Given that the market's vulnerability to geopolitical shocks, a worsening of conditions in Taiwan, the Middle East or the Ukraine could create some upside inflation risk and, in turn, stall the October-January rally in the immediate future. Nonetheless, I'm still maintaining the view that the S&P 500 will nudge toward 5400 in 2024 and further along to 5900 in 2025.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.27	0.55%
Palos Equity Income Fund - RRSP	PAL101	$6.77	0.45%
Palos WP Growth Fund - RRSP	PAL213	$8.91	-6.33%
Palos-Mitchell Alpha Fund [3]	PAL300	$10.14	-0.71%
S&P TSX Composite (Total Return with dividends reinvested)			0.24%
S&P 500 (Total Return with dividends reinvested)			3.97%
S&P TSX Venture (Total Return with dividends reinvested)			-0.85%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.10%
Canadian Government 10-Year			3.43%
Crude Oil Spot			US $73.31
Gold Spot			US $2,034.50
US Gov't10-Year/Moody BAA Corp. Spread			157 bps
USD/CAD Exchange Rate Spot			US $0.7412

[1] *Period ending February 6th, 2023. Data extracted from Bloomberg*
[2] *Fund is priced annually*
[3] *Fund is priced weekly on Tuesdays*

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