PALOS

The Palos Perspective

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A Macro Market View by Hubert Marleau

Inflation Flirtation or Long Boom? Long Boom:

Bond traders have marked down drastically monetary policy easing by the Federal Reserve, setting the odds of a first move in June below 50%, while swap contracts are projecting fewer rate cuts than 65 basis points because economic prints are strong, beating expectations. It appears that the rolling recession in the industrial sector and in retail sales have turned into rolling recoveries.

First, the March ISM Manufacturing Index jumped to 50.3, registering the first expansion in 16 months, while the ISM Service Index was a tab weaker at 51.4. Anything above 50 reveals expansion. It should be noted that its components were especially strong, with new orders at 51.4 for manufacturing and 54.4 for services, and production for manufacturing at 54.6 and services at 57.4.

Second, personal spending remains strong, rising 0.8% m/m in February, 0.4% after accounting for inflation. The latest data on Job Openings and Labor Turnover hardly changed in February: job openings ticked up along with the quick rate, while rate of hires and laid-offs remained stable. Accordingly, ADP private payrolls gained 184,000 during March, while non-farm payrolls increased 303,000 - more than expected in both cases.

Given these economic prints, the Atlanta Fed's GDP Now model estimate for real GDP growth has risen to an annual rate of 2.8% from 2.1% a few weeks ago. Unsurprisingly, inflation worries have re-emerged in the press, pushing the notion that progress toward the Fed's 2% inflation target appears to be too slow. The headlines have led the public into believing inflation expectations have risen.

Given the power of the media, the economic narrative has shifted in favour of the Fed's thinking that there is no rush to cut interest rates, suggesting that any, - if indeed any -anticipated cuts are reserved at best for the last 2 months of 2024. A veritable procession of Fed officials carefully emphasised that rate cuts were not guaranteed.

Thus the rally stalled. It finally happened as bear-operators borrowed the "Inflation Flirtation" idea to justify their bearish actions in the market. By the time the week was over, the S&P 500 was down 50 points, registering a loss of 1.0%. It could have been much worse, if it had not been for the realisation that the blowout jobs will support consumer spending and keep free corporate cash flow growth robust. After-tax corporate profits rose to a record $2.8 trillion (saar) during Q4-2023, which

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combined with another record $2.5 trillion (saar) in tax-reported depreciation generated yet another record $5.3 trillion (saar) in free corporate cash flow. Of that last amount,

corporations paid $1.9 trillion (saar) in dividends and invested $$3.8 trillion (saar) in non-residential private fixed capital. They borrowed $600 billion.

In this connection, I bought a few tech stocks that fell sharply and re-loaded my portfolio with underperforming defensive stocks in the consumer staples, healthcare and utility sectors. Why?

Media has come up with this inflation scare because of a steep and rapid rise in the price of gold, which has registered a $200 increase to $2300 since the beginning of March. Interestingly, Bitcoin, a rival to the legacy of gold being an inflation hedge, has not followed suit. Indeed, the correlation between digital gold and true gold has faded to zero over the past month. Moreover, gold rose while Treasuries sold off, and the greenback overpowered challengers. Crazy! The whole thing is an unusual phenomenon, which I think has happened because gold has benefited from a surge in consumer demand from India and China, and is in official demand among autocratic central banks. And there is the escalation of tension in the Middle East to contend with.

In fact, there has been no meaningful increase in inflation expectations in either the swap market or in surveys conducted by reputable organisations. Currently, derivatives are predicting that inflation will hover around 2.45% over the next 5 years - the same as it was 4 weeks ago. This is worthy of consideration, because economic data is not fabricated by economists, but generated by the actions of people at large. I have far more confidence in the tell-tales of the financial markets than that of central bankers and economists.

Meanwhile, actual inflation may have ticked mildly up in the U.S., but it's falling everywhere else in the world. As a matter of fact, the March ISM's measure of prices paid by service providers, where the bulk of inflation has stemmed, was a welcome reprieve, for it undershot expectations at 53.3, printing a 4-year low. In addition, average hourly wages were up 0.3% m/m, meeting expectations, and registering a 4.1% y/y increase, 0.2% less than in February. This is not that much, taking into consideration that productivity per worker is running at an annual rate of 2.0% or more and, in turn, shouldn't raise excessive inflation concerns. The NY Fed determined the multivariate core inflation trend was still falling, decreasing to 2.9% in February with a 68-percentile probability band of 2.4% to 3.3%.

In my judgement, this flirtation with inflation should not be regarded as a nightmare scenario, for bond yields and copper prices are higher than they were a few weeks ago because the economy is strong, stemming from superior productivity gains and immigration increases. I agree that price stability hasn't been entirely restored, but inflation is by some measures back at the Fed's 2% target. For example, Truflation, a dynamic index that updates prices from numerous sources daily, is up only 1.8% y/y.

What the economy is experiencing is not a classic cyclical upturn, but a productivity and entrepreneurial boom in electrification, life sciences, nearshoring and technology (data-centre and

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artificial intelligence), like the one we enjoyed in the late 1990s. At that time, the Fed's policy rate stayed above 5% for an extended period of time because the economy was roaring, like today. Productivity pitches curve balls - you don't see them coming. I think this is hidden in credit spreads: yield spreads of BAA corporate bonds over 10-year Treasuries are only 1.50%, way below the historical average of 3.00%.

The thing is that the equilibrium interest rate, which is the rate at which the Fed can consider borrowing costs to be neutral, is neither inflating or deflating demand in the economy. Higher productivity growth, an increasing supply of workers and strong physical investments, on which model-based estimates of the neutral rate are based, have lifted it to 3.00% from a long-time view of 2.5%. Given the optimistic perspective of productivity, the encouraging stepped-up prospect of immigration, and the fragile state of the U.S. government's audit, I peg the neutral rate at 4.25%. In this regard, I don't think the policy rate can go any lower than the 4.25% to 4.50% range for this cycle, even if inflation were to fall to say 2.25% that the 3-year swaps are predicting.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.66	7.78%
Palos Equity Income Fund - RRSP	PAL101	$7.18	6.92%
Palos WP Growth Fund - RRSP	PAL213	$10.75	13.38%
Palos-Mitchell Alpha Fund [3]	PAL300	$10.91	7.20%
S&P TSX Composite (Total Return with dividends reinvested)			7.67%
S&P 500 (Total Return with dividends reinvested)			9.66%
S&P TSX Venture (Total Return with dividends reinvested)			6.69%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.36%
Canadian Government 10-Year			3.56%
Crude Oil Spot			US $85.23
Gold Spot			US $2,343.50
US Gov't10-Year/Moody BAA Corp. Spread			146 bps
USD/CAD Exchange Rate Spot			US $0.7369

[1] *Period ending April 9th, 2024. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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