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A Macro Market View by Hubert Marleau

Navigating Disinflation: Market Implications

As a rule, the Fed and the economy are asymmetric to exogenous geopolitical shocks, unless they lead abruptly to a steep rise in energy costs, bullion prices, and/or foreign exchange value. At time of writing, the aforementioned markets have initially reacted calmly to the Israel raid on Isfahan, a city in Iran. Gold, oil and the dollar were all down at the opening on Friday because no one, including Iran and Israel, seems willing to take this incident any further. In short, it's likely a pause. I shall therefore review the week in my usual way, resting my views on what is going on in the financial markets in relation to what is happening in the economy.

The US Economy Refuses to Land:

The Atlanta Fed GDP NowCasting Model is predicting that Q1's real GDP grew 2.9% (saar) from 2.1%, 3 weeks ago. This upward revision was brought about by a large estimated 2.5% increase in productivity, which, in turn, resulted in another large 3.4 % rise in real consumer spending. This kind of growth is expected to continue, NYFed Staff Nowcast for Q2/2024 being 2.7%.

This productivity boom is ongoing: worker-employer matching has improved as the labour market tightened, while business fixed capital formation has not reverted, and R&D investments and private innovations have been relentlessly strong. Consequently, US manufacturing capacity is growing at the fastest rate since 2008, says Ethan Wu, a financial reporter for the Financial Times.

In the words of Ed Yardeni: "That's neither a hard nor a soft landing. The US economy is flying." As a matter of fact, the WSJ's April survey of forecasters showed they had ratcheted up their expectations for economic growth by as much as 2.4% in each of the first 3 quarters of this year and significantly reduced odds of having a recession in the next 12 months from 63% last December to 29% now.

On March 20, however, the market underwent a change of perception from an ideal world of strong growth, normalising inflation and falling rates to strong growth, stubborn inflation and flat rates, dashing all hopes of a first rate cut in June and rolling it back to the end of 2024. Combined with rising bond yields destroying equity risk premiums and escalating geopolitical tensions, the S&P 500 has fallen since the end of March by as much as 5%, when it touched a record high of 5254. The benchmark booked its longest skid in 6 months with more than 70% of its companies in corrections mode. The 2024 rally caught a severe cold from too much inflationary rain.

Maybe the deleveraging process is over. Maybe the disappointment over sticky inflation is ending. And maybe the technical numbers are just getting better. Tom Lee, a reputable market

analyst, who has an uncanny way of right often, thinks that the technicals are good enough to keep his fundamental case that stocks are heading high. The VIX is relatively subdued, the VIX futures structure is bullishly uninverted, the put-to-call ratio is a tradeable low, and breadth indicators are too low. The bottom line is that the accelerated declines in the S&P 500 have reached a point where a rebound is now likely.

The Disinflation Trend will Continue:

As has been the case throughout this cycle, swings in inflation have been frequent and have on many occasions provoked flip-flopping stories and abruptly changed market sentiment. I have not given up on the disinflation narrative. Why? If there were fears US inflation were about to get out of control, one would see weakness in the dollar, not strength. The DXY, a measure of value of the US dollar relative to a basket of foreign currencies, touched a near record high on Thursday 106.25, registering a 5.0% increase since the end of December. This forex move is equivalent to a 25 to 50 bps increase in the policy rate, which officially stands at 5.38%. In other words, the monetary conditions have tightened without any effort or action on the part of the Fed, in a manageable manner. Statements by their officials are enough to get them what they want. On Thursday, the 2-year Treasury note jumped to 4.99%, implying one cut in the federal funds rate in the next 12 months.

Perhaps inflation is indeed not falling as fast or as far as the authorities would like. Nevertheless, I am encouraged to see that the headline and core CPI inflation rates excluding shelter, were only 2.3% y/y and 2.1% in March. Shelter inflation is the dominant component of the CPI, which was up 5.7% y/y, and is the biggest stumbling block in taming inflation. This is what has made the Fed hesitant to cut rates.

Shelter has nonetheless been on a slow but steady moderating trend from a high of 8.3% a year ago and the problem appears to be concentrated in the Midwest and the Northeast. There are, however, encouraging signals from forward-looking metrics and coincident indicators, suggesting that shelter inflation is bound to fall in months to come. Investors should bear in mind that the official data capture paid leases, newly signed and existing ones. It's OK as a comprehensive gauge, but is not as timely as Zillow, which records what is going on with rents now. The Zillow multi-family rent index, which leads - unfortunately with a long lag - movements in the rent of primary residence components of the CPI, says that new market rents have increased at or below their pre-pandemic pace for 18 months in a row.

Actually, recent developments in US multi-family housing supports Zillow's observation. Multi-family starts and permits have come down as existing home sales have fallen and price reductions of

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active listing have risen. With new listings rising and sales dropping, owners' equivalent rent - the statistic that makes up CPI shelter cost - should bring lower inflation.

The Cleveland Fed expects Core PCE, the preferred inflation gauge of the Fed, to moderate to a yearly increase of 2.6% in April. This would be the slowest pace since March 2021. Interestingly, there are other measures that are bullish on inflation. Truflation, a dynamic index that updates prices from numerous sources daily, is up only 2.1 y/y. Adobe's Digital Price Index, a measure that tracks online prices, is almost 6% less than a year ago. In this connection, the swap market for bonds is predicting that inflation in one year's time will not be any higher than 2.6%: a few days ago it stood at 4.0%. That is a dramatic change in perception. This can only be attributed to an out-of- the- blue feeling that either growth or inflation is about to fall out of bed.

P.S. Strategies at Bank of America led by Michael Harnett found that there is an unusual combination in this year's market that has happened only 5 times in the last 60 years, with tech stocks up 21%, commodities up 47% and dollar gains of 17%. These occurred in 1983 and 2021 when they were stimulus-induced booms. Both 1969 and 2016 were inflection points - 1969 was the beginning of stagflation and 2016 was the start of de-globalisation. Lastly, 1999 was the dot-com bubble. What do we have now? A boom, a bubble or an inflection? Email me to let me know which one you think it might be.

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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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