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The Palos Perspective

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A Macro Market View by Hubert Marleau

A 'Compte-Rendu' of Where the Economy Stands:

Growth Decelerated:

On Thursday last, the Commerce Department reported that the U.S. economy had grown at the annual rate of 1.6%, significantly less than the 2.5% consensus because, surprisingly, it had been dragged down by companies depleting their inventories and an outburst in imports. If it hadn't been for these 2 setbacks, real growth would have been 2.9%.

The economy has slowed down from the astronomical annual rate of increase of 4.9% in Q3/23 and 3.4% in Q4/23. But while it is clear the economy is not accelerating, this does not mean the big picture is windswept. The underlying data shows that economic activity is rock-solid.

Acknowledging that total hours worked in Q1 was up around the annual rate of 1.4% - employment was up 1.9% and average hours worked was down 0.5% - my estimated annual rate of increase in productivity is 1.5%. In this connection, there is little evidence that productivity is being challenged by a sour outlook. High-technology industries currently account for a disproportionate share of the surge in new business creations; and private investments in intellectual products in real terms has surged around 8.0% per year throughout 2021, 2022, 2013 and into 2024, rising 5.4% in Q1, and contributing 0.29 percentage point to the entire growth rate for the economy in Q1.

Indeed, conditions bode well for productivity going forward because a lot of attention is being paid to it by players like software publishers, scientific researchers, and developers of data processing and hosting to raise productivity levels for others. All the money that is being spent to compete in the AI arms race will surely pay off in productivity gains and profitability.

Productivity is a magical concept. It's that dark matter which can at times make a big difference as to whether the economy is heading north or south. Adhering to Say's law that supply creates its own demand, one might agree with me that the rise in the labour force, combined with the one in productivity led to another steep rise 5.9% (saar) in wages and and salaries for workers, furnishing consumers with the the spending power to buy goods and services, which incidentally also rose 5.9%.

Inflation Accelerated:

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Unfortunately, the productivity boom was unable to contain the inflationary pressure stemming from the persistent strength of consumer demand. The core personal consumption expenditures deflator (PCED). a number the Fed watches closely, accelerated at a greater-than-expected 3.7% (saar) in Q1/24 compared to 2.0% in Q4 and 2.0% in Q3 of last year. From the standpoint of inflation, this flare-up is the worst thing that could have happened to confidence for it challenged the deflationary story. Nonetheless, the disinflation trend remains intact. Core PCED inflation continued to moderate on a y/y basis to 2.9%; and on Friday morning, the Bureau of Economic Analysis (BEA) printed a 0.3% increase in the PCE price index, both core and headline, matching expectations, with the former registering a y/y gain of 2.8%.

The Financial Markets Took a Hit:

The combination of slower growth and hotter inflation was enough to send a stagflationary shudder through bond markets. In this connection, the yields on 2-year Treasuries touched 5.00% as traders pushed back on rate pricing to December. I don't want to give investors a false sense of security, but the stagflation fear is probably a “bridge too far.” It perhaps explains why it did not spook the U.S. dollar or gold. markets, which held their ground, suggesting that we should not worry too much about these two data points, which most economists had anticipated a month ago anyway. The thing is that neither the ongoing performance of employment nor productivity have collapsed, suggesting that there is no evidence a recession is in our midst. As a matter of fact, the initial estimate of Q2 GDP growth calculated by the Atlanta Fed is 3.9%. This number will come down. Yes, the pace of economic activity is bound to fall toward an annual rate of around 1.75%. Ultimately consumer spending will weaken now that the personal savings rate was only 3.2% in March - the lowest point in years - at a time when supply of the working-age population is shrinking.

In this regard, the deterioration in market and consumer sentiment witnessed in the month of April, which is related to the 50 bps rise in the 10-year Treasury yield to 4.70%, should stabilise. The Investor Intelligence Bull-Bear Ratio fell for the third week to 2.15 last week, after climbing to 4.43 three weeks ago. From a contrarian point of view, however, that number is bullish. It does not mean that there isn't any downside from here. There is, but it does not affect my previous belief that the S&P 500 could touch 5400 in 2024. By the end of the week, the S&P 500 was up 2.9% over the previous Friday, closing at 5100.

Ben Carlson, an astute observer of markets, demonstrated that historically the stock market has done just fine during rising interest rate cycles. He wrote: “From 1950 through the pre-pandemic era, the average annualised return when the 10 year yield jumped 1% or more, was just shy of 11%. That’s basically the long-term average performance for the U.S. stock market. It was only

down twice when this happened and the losses were minimal.” The latter happened when interest rates were considerably higher than now.

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P.S.1 Last week, I asked my readers if the economy was in a boom, bubble or inflection. ** I received almost 200 answers. Incredibly it was ⅓ for each.

**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	$8.47	5.39%
Palos Equity Income Fund - RRSP	PAL101	$7.03	4.69%
Palos WP Growth Fund - RRSP	PAL213	$10.75	13.37%
Palos-Mitchell Alpha Fund [3]	PAL300	$10.75	5.61%
S&P TSX Composite (Total Return with dividends reinvested)			5.99%
S&P 500 (Total Return with dividends reinvested)			6.76%
S&P TSX Venture (Total Return with dividends reinvested)			4.45%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.60%
Canadian Government 10-Year			3.76%
Crude Oil Spot			US $83.36
Gold Spot			US $2,327.70
US Gov't10-Year/Moody BAA Corp. Spread			147 bps
USD/CAD Exchange Rate Spot			US $0.7319

[1] *Period ending April 24th, 2024. Data extracted from Bloomberg*
[2] *Fund is priced annually*
[3] *Fund is priced weekly on Tuesdays*

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