PALOS

Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative: Week Ended December 6, 2018:

Last week, I emphasized that Fed policy, trade and oil were the key factors that are on the mind of the financial markets.

The Monetary Stance

Powell's comments on Wednesday last showed that the fed had acceded to financial-futures market expectations that, after a likely quarter-point hike at the December 18-19 FOMC meeting, the odds are no longer pointing to any upward movement in 2019. As a matter of fact, the bond and stock vigilantes want to put a stop to this madness now. The current midpoint is 2.125%. Assuming that the Fed will hike to 2.375% on December 19, the spread between the neutral and policy rates will have narrowed to 0.125%. That will be all folks. There is growing evidence that from surveys of consumers and polls of manufacturers covering the Fed's preferred price gauge, that price-inflation is getting pulled down. The NowInflationCasting model of the Cleveland Fed is predicting that the annual rate of the core PCE price index will only be 1.45% in the fourth quarter. It was running at the annual rate of 2.25% last March. It's amazing that many economists fail to take into account productivity when they look at increases in wage rates. If the Fed is as data dependent as it says it is, the monetary authorities will either qualify the widely anticipated hike with dovish comments or just pause for a short while and see the effect of how what has transpired.

Is it possible to know when the policy rate equals the neutral rate? YES. When the yield spread between five-year and two-year treasuries is zero, the yield on six months treasury bills is the neutral rate. This market related arithmetic says that the neutral rate is now 2.50%. One key estimate of the US neutral rate is produced by the "Laubach Williams Model". It shows that two more hikes will get the fed roughly in line with what Powell calls "the level that would be neutral for the economy" - that is, neither speeding up nor slowing down growth.

An inversion in the belly of the yield curve is not a predictor of an imminent recession but a market signal to the Fed to either stop or pause the rise in interest rates. The point is the wider the gap in maturities between an inversion, the more significant the recession-signal. This latest compression in the U.S. curve does not imply that the U.S. economy is unhealthy. It does do not pass the muster. Arguably, the best leading indicators for U.S. growth are the Manufacturing

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ISM and the Non- manufacturing ISM surveys. The new editions came out this week and they were strong. Additionally, retail sales are doing very well. The Cleveland Fed uses a far better metric than the aforementioned yield curve to gauge recession probabilities. It looks at the differential between the 3-month yield and 10-year yield to build its recession indicator. The gap may be narrower than it has been since 2007, but it implies only 20% chance of recession in the next year. Other gauges that I religiously follow, sense that there is only a 15% probability of a recession in the next six to nine months. The yield curve is revealing that the rate of growth and of inflation is rolling over to its accustomed two-plus-two regime. This is 2% for growth and 2% for inflation. The difference is that the bulk of the next growth phase will come more from productivity than employment.

The G-20 is About "He said Xi Said". Chaos Breeds Chaos

The G-20 negotiators put together a communique which finds a compromise between the diverging views of China, Europe and the U.S.. The U.S. succeeded in erasing "protectionism", China managed to strike out "unfair trade practices" and the E.U. kept the idea of "multilateralism" alive. What is noticeable is that the compromise text acknowledges that trade and investment are "important engines of growth, productivity, innovation, job-creation, and development." Yet, it added that "the system is currently falling short of its objectives and there is room for improvement. We therefore support the necessary reform of the World Trade Organization (WTO) to improve its function and we will review progress at our next summit." But what averted a potential breakdown that could have shaken the global markets was the China-U.S. agreement to a cease-fire in the ongoing trade war - a move in the right direction. The truce was designed to ease tensions, decrease the fear of a new cold war, and stave off an immediate disaster. It probably will. President Trump agreed to keep tariffs at 10% and not raise them to 25% on January 1, as previously planned. In return, President Xi vowed to increase imports of U.S. energy, agricultural products and industrial goods. But there is a catch: If they do not make some headway to bring about structural reforms in 90 days and just before China's annual national legislative session on March 5, U.S. duties will spike to 25%. The talks will be difficult because issues of Chinese economic policy are thorny. They include forced technology transfer, intellectual-property protection, non-tariff barriers, services, agriculture, cyber-intrusions and cyber-theft. It's never a good idea to count the proverbial chickens before they hatch, but the consensus is that the optics have improved. Indeed, this counts as a thawing in the relations as the stalemate is broken.

Anatole Kaletsky has good reasons why the U.S.-China trade war should be defused to avoid a potentially ugly situation in 2019. The two sides will endeavour to wrap up the talks in the nominated time frame.

1) It is a fact that the WTO's dispute settlement process is essential to rules-based global trade. But contrary to popular belief, the U.S. wins far more often than it loses. From 1995 to March 2017, the U.S. prevailed in 91% of cases that it brought against other countries, according to data from the Cato institute. In this connection, it looks to me as though the lurch in U.S. policy against WTO framework is the confrontational way Trump chose

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to persuade others to force Beijing to follow the rules of the multilateral system and be transparent. Many countries would like to join the U.S. in such an effort.

2) The American administration is realizing that President Xi has many policy tools to ensure that the Chinese economy does not suffer serious damage from U.S. tariffs. Policymakers in China have indicated that they will not allow any further economic weakening and could reverse their current austere posture to combat U.S. tariffs. In this connection, U.S. rhetoric has shifted from job security and growth to the objective of facing the challenge that China poses to the U.S. global hegemony.

3) The 2020 presidential election is approaching, and Trump needs a "BIG WIN". He probably wants to strike a deal with Xi as soon as possible. My gut tells me that it would be unpopular with U.S. voters to increased tariffs to 25%. The trade war is fake. I fail to understand how U.S. tariffs can bring about more jobs to America when the economy is operating at full capacity, suggesting that there is no way domestic production can substitute Chinese imports.

4) President Trump carries a "war-like big stick" and a "peaceful-white mouchoir". One should not neglect the pattern. His style is to escalate whatever with aggressive tweets to a point of warfare and retreat tactically later to claim victory. For example, he eased sanctions on Iran to reverse the rise in oil prices.

5) Sources familiar with what is going on have said that China has admitted it could meet 40% of the 142 U.S. trade demands and could negotiate an another 40%. It leaves them with 20% that are non-negotiable because militant sinophobes must denounce them if China is to challenge U.S. technological and military hegemony by 2050. Do you think for one second that Trump cares about what may happen after 2050?

6) China is getting more skilful and has a better understanding of the geopolitical playground. They are starting to understand why international companies are not in a rush to defend the multilateral trading system against Trump's rampages. The point is that Western CEOs have had enough of the way China treats them - the artificial barriers, the ownership restrictions, the intellectual property theft, and the repeated delays in opening up markets.

7) It is notable that China's rhetorical defence is increasingly anchored in its faith in the multilateral system. It condemns the law of the jungle and beggar-thy-neighbour policies and stresses that opening up its economy is in its own interest. This is how China rebukes publicly American protectionism.

8) The Chinese economy is in a transition and the phase of growth will likely stem from services and personal spending. In this regard, China would prefer to suck in foreign capital rather than rely on more debt and government stimulus. We shall know soon. On December 18, the 40th anniversary of the third plenary session of the 11th Central Committee of the Communist Party of China, which was the moment in 1978 Deng Xiaoping

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started opening up China's economy. Xi might use the venue to unveil commemorative reforms. There is some suspicion that China may give in. Treasury Secretary Mnuchin said China have agreed to eliminate tariffs on imported autos.

John Authers of Bloomberg said it well. "Trump and Xi needed a break, and both needed to show they'd won something." The truce will probably bring a trade agreement, but it will not resolve the upcoming tech war. The "Thucydides Trap" is not dead. The conflict between China and the U.S. is a long term one and beyond economics. While both parties want to avoid a full-blown trade war, it is known that there are deep and irreconcilable geopolitical differences. What lies ahead is complicated. We saw it on Tuesday. In one day, no one could figure out who said what, undermining the success of an "encounter of a third kind". All that was good turned bad because the apparent breakthrough was mired in confusion. On Tuesday, the "tariff men" make erratic and false claims that roil the global market, and nobody understood what the deal is. On Wednesday, the Chinese officials brooked their silence to declare that they accepted Trump's 90-day clock and confirmed that the two sides can reach an amicable agreement. On Thursday morning, China began to flesh out details of a trade truce with the U.S. and various Chinese agencies and the nation's supreme court unveiled tough punishments for infringing on intellectual property - a prominent complaint from the Trump administration.

The Global Energy Complex:

On December 6-7, the members of OPEC and allies are meeting in Vienna. We had a glimpse of what to expect on Monday when Saudi Arabia and Russia agreed to extend into 2019 their deal to manage the oil market, opening the door for an arrangement. We shall know on Saturday morning, if OPEC+, as it is now known, will come up with the widely anticipated production cut of 1.0 to 1.5 million barrels a day. OPEC's own forecast shows global inventories growing at a rate of 1.4 million barrels a day. Odds are OPEC+ will cut. Most analysts say that oil producers have little choice but to announce a substantial cut of about 1% of world oil output. Otherwise, oil prices could slide rapidly to $40 a barrel.

Yet, there are some concerns. Qatar surprised everyone this week with an announcement that it's leaving OPEC to focus on gas. It said that it had nothing to do with the Saudis. I wonder. Several OPEC members blame Saudi Arabia for the oil glut and believe that it is up to the Saudis to bear the brunt of the cuts. Nevertheless, it is not dramatic in itself because Qatar is a very small producer - 600k barrels a day. Additionally, Texas also needs higher oil prices and might force Trump to relax his grip on Saudi Arabia. Most shale drillers don't make much money at $50 a barrel. According to FactSet, when oil prices averaged about $50 a barrel last year, the oil group as a whole was barely in the black, with profits of about $1.7 or roughly 1.3% of revenue. That confirms my estimate that the marginal cost of production is around $50 a barrel and $57.50 is needed to make decent money.

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Interestingly, Morgan Stanley came out with a new forecast for 2019 and 2020, predicting that R-GDP growth will average around 2.0% for the next two years. It makes sense to me because the yield curve has been boxed in a flat zone since the beginning of July and the 4% annual pace of change in the money supply supports this view. While analysts have downgraded the 2019 earnings growth forecast, there is sufficient juice left in a two-plus-two economy to bring about a 9% increase in operating profits.

What is also significant is the unprecedented order that the Government of Alberta gave to oil producers to reduce output by 325,000 barrels a day from January until excess oil in storage is drawn down to 95,000 bpd. Interestingly, the 8.7% cut represents half of what Qatar produces.

Notley's government estimates that the measures will narrow the price discount between WCS and WTI by at least $4 a barrel and expects them to last three months as rail capacity comes online. From here on, intervention may become the new way because Notley said that her government will work in the future to match capacity with production. Earlier last month, WCS was selling for $ 13.50 a barrel. This morning it was capturing $33.00.

On U.S. Productivity:

A week ago, Richard Clarida, Vice Chairman of the Federal Reserve and the smartest guy in the room during the FOMC meeting, acknowledged that something was going on with productivity that could have serious implication for monetary policy. It should be noted that he was the first Fed official to say that the current policy rate is close to the neutral rate. The thing is that productivity is like a cure-all, it allows real economic activity to grow faster than the population can generate employment increases. And, it can do this without creating excessive inflation and by distributing its economic benefit between better wages for workers and better profits for businesses. As a regular reader of my weekly views on the U.S. economy, you are aware that I have been a been a promoter of the idea that U.S. productivity has turned the corner. Since the first quarter of 2016, productivity gains have accelerated. In the September quarter of 2018, productivity was up an estimated 1.7% compared to minus 0.3% in the first quarter of 2016.

The National Bureau of Economic Research released a working paper produced by Bryan Kelly (Yale School of Management), Dimitris Papanikolaou (Kellogg School of Management, Northwestern University), Amit Seru (Stanford Graduate School of Business), and Matt Taddy (Amazon) that "uses textual analysis of high-dimensional data from

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patent documents to create new indicators of technological innovation". It identifies patents based on textual similarity of a given patent and subsequent work: their measure of patent significance is predictive of future citations and correlates strongly with measures of market value and productivity. They identify breakthrough innovations as the most significant patents - those in the right tail of measure - to construct indices of technological change at the aggregate, sectoral, and firm level. These technology indices span two centuries (1840-2010) and cover innovation by private and public firms, as well as non-profit organizations and the U.S. government. These indices capture the evolution of technological waves over a long time-span and are strong predictors of productivity and market value at the aggregate, sectoral and firm level. I'VE BEEN READING ABOUT PRODUCTIVITY INTENSIVELY FOR YEARS AND THIS WORKING PAPER IS THE MOST CONVINCING I"VE EVER COME ACROSS.

The paper is 78 pages - full of big data, machine learning, algorithms, mathematics, equations, and references. It took me 12 hours to get through it. To produce a consistent measure of U.S. innovation, the four economists built a database of more than 9 million patents. But there is a simple message - a productivity surge is on the move. We know rationally that productivity determines growth and intuitively, that innovation brings productivity. While I recognize that innovation defies measurement because its intangible, the aforementioned study does a wonderful job with the use of an algorithm and data of showing the interconnection of innovation, productivity, and market value.

Put simply, they constructed an aggregate innovation index that uncovers three major technological waves. The index of breakthrough innovation peak in 1880-1888 period brought about huge advances in electricity, agriculture and transportation. The index also peaked in 1931-1938 and it was followed by a revolution in chemistry and energy. The third and largest wave of American innovation which took place in the 1995-2015 is drawing to a close. It may sound like a radical hypothesis, but productivity is now appearing in the numbers. The innovations of the past decade may have laid the groundwork across a broad frontier of industries and bring a rapid expansion in productivity. A one-standard deviation increase in their innovation index is associated with a 2.5% higher productivity over the next five years. And, guess what? It's where we are now. On Thursday, the BLS reported that U.S. productivity advanced at the annual rate of 2.3% in the third quarter of 2018.

What's Going in Canada?

The Bank of Canada kept interest rates on hold because the economy is just too weak to justify one and the economy is not as close to full capacity as previously believed by Governor Poloz. He admitted surreptitiously that he was wrong, and the economy was losing momentum. The Bank of Canada pegs the Canadian neutral rate between 2.5% and 3.5%. I think that the estimate is way too high and way too broad. Using the same methodology that I used to calculate the U.S. neutral rate, I get 2.0% to 2.25% for Canada. This tells me that interest spreads between Canada and the U.S. will remain negative for a long time and that the most one could expect is two hikes down the road. The current banks' overnight stayed at 1.75% and the Canadian dollar tumbled. In my judgement, the Bank of Canada will likely hold at

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1.75% for a good while. The Bank of Canada does have productivity to fall on to bail itself out of a messy economy unlike the Fed.

New Technical Perspectives as of December 6, 2018—Sevens Report

1) Based on the Dow Theory, the trend for the S&P 500 is bullish with key resistance at 2774 and key support at 2633—on Thursday morning the S&P 500 was 2659

2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $57.03 and key support at $46.31——on Thursday morning crude traded around $51.08

3) Based on a proprietary model, the trend for gold is neutral with key resistance at $1290 and key support at $1181——-on Thursday morning gold was selling for $1241

4) Based on a proprietary model, the trend for ten-year treasury yield is bullish with key resistance at 3.19% and key support at 2.85% ——on Thursday morning the yield was 2.87%

5) Based on a Palos Currency Model, the trend for the Canadian dollar is bearish with resistance at 76.20 us cents and key support at 74.88 US cents - on Thursday morning the loonie was trading for 75.54 US cents.

Disclaimer:

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