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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative of January 17, 2019

The Fed's Tightening Monetary Stance Is Over

Over the past four months, the Fed has flip-flop between being hawkish and dovish decimating market credibility in the Fed. Usually, investing is about figuring out the unintended consequences and unexpected possibilities of monetary policy because the expected is already price in. This is why I keep score of what the Fed is doing and its effect on the bond, foreign exchange and stocks markets.

Powell was hawkish in October, dovish in November, hawkish in December, and dovish in January. Powell's ambiguity is not over. The new position of the policy makers is that they will be patient and watch. That is wait and see before adjusting interest rates. It means that they could either raise, keep or lower the policy rates. Currently, I'm of the opinion that the once widely expected March rate hike is out of the question because all the Fed governors stand behind him. Yet, the Fed is still intent on cashing in maturing debt rather than reinvesting it to attain a "substantially smaller" balance sheet. It should be noted that the current pace of quantitative tightening will vaporize $150 billion of liquidity per quarter. That is de-facto tightening effect of one rate hike every four months. Whether the QT will remain intact will be dependent on three factors, barring the sideshow of trade wars and political theatrics. These are the inflation rate, the broad exchange value of the U.S. dollar, and the recession risk. The bottom line is the lower the inflation rate, the stronger the dollar and the higher the recession risk, the greater the likelihood that the Fed will adjust or pause QT. The best way to carry out this investigation is to see what happened to those three factors since the 21st of September when the S&P 500 peaked.

Firstly, inflation is not an immediate concern. The CPI slipped 0.1% in December, caused mainly by a drop in energy prices. On a year-ago basis, the headline and core CPI were up 1.9% and 2.2% respectively. Since Core CPI historically runs above the Fed's preferred core personal consumption expenditure deflator, inflation appears to be where it ought to be. There have not been any consumer price increases in three months. Moreover, increases in producer prices have also been tepid and import prices are now down on a year-over-year basis. The U.S. Department of Labor reported a few days ago that after adjusting for inflation, average hourly earnings rose a seasonally adjusted 1.1% in December from a year earlier. This happens to be less than the latest increase in yearly productivity. It means that, businesses are

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not suffering from any cost push. Interestingly, the Inflation Nowcasting model of the Cleveland Fed predicts that annual rate of inflation will be only 1.2% in Q/1. The lack of an acceleration in inflation supports the idea that the Fed should relax its QT stance.

Secondly, the DXY-Copper ratio is a simple real time index that historically has shown the trending direction of global growth. A strong dollar combined with weak copper prices usually indicates where the global economy is heading. For the period under review, the ratio has been steady so far. It was 35.5 times back then and 36.0 today suggesting that world growth may be slower - but not a disaster. The world economy should grow 3% in 2019. Thus, the slowdown may not look as sharp as expected in some quarters. However, world growth will be less synchronized. And, that will be enough to keep the Fed and other central banks on guard.

Thirdly, while the recession fear seems overblown, it has nevertheless risen in the past three months. The economy is relatively safe from having a slump; but the rising probability of a recession, which is caused more by tighter financial conditions than actual economic data points, supports the notion that the Fed should be careful on how it handles its QT stance from here on. Former Chair Janet Yellen acknowledged that the tightening cycle might be over and Ben Bernanke, another Fed chair, said that “economic expansions do not die of old age, they are murdered by policy mistakes.”

There is also a technical reason why the Fed may be compelled to back off from its QT stance.

Many investors have significantly exited inflation-linked Treasuries as bank reserves shrink due to balance sheet reduction. This is making it very hard for the Fed to control the effective fed funds rate. As a result, the Fed may have to stabilize reserves soon. Stable reserves will mean that the overall balance sheet will expanding again as currency in circulation rise.

There is also a political reason why the Fed will likely back off from its QT stance.

What surprises many members of the Barron’s round table is the fact that 3% wage growth and an unemployment rate below 4.0% is not the type of economic condition that would normally cause populist rhetoric. Then it must be the spread of globalization, income inequality, social discontent, and disruptive technological advances that have brought all this political uncertainty and political turmoil in the U.S., the U.K. and France. Saint Mungo of the FT says it well: “the funny thing is, it’s the post liberal order in the Western world that has given us peace for so long that so many populists today have forgotten the dangers of far left and right politics. A classic case of victim of its own success.” Historically speaking, there is a remarkable level of political volatility. James Hofmann of the Washington Post figures that only 3 of the 10 cycles from 1960 to 1978 brought such change. It was four of 10 from 1980 to 1998. The fact is that most Americans think the country is on the wrong track. The numbers on the right and the far left who believes the system is not working for them continue to rise. Both cohorts are sceptical of the establishment, elites and moderates. Trust in government and confidence in every institution is seemingly in long term decline either because people believe that

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change is happening too fast or coming too slowly. Those on the right blame globalization, immigration and political correctness for their problems, reverting to nativism, protection and isolation. Those on the left are angry about the failure to address accelerating climate change, income inequality and mass shootings, reacting against capitalism and embracing socialism.

Reputable political strategist Bruce Mehlman believes that “Trump is a symptom, not a cause, of dissatisfaction with the way the world is.” He adds in a new 35-slide PowerPoint deck that the world has become more “permissionless” because of the diminishing power of traditional gatekeepers, the information technology revolution and the broad dissatisfaction with the pace of change. The internet tools of the permissionless society are the weapons of choice for both the Too Fast and the Too Slow coalitions. One only must think about it. The Permissionless world has allowed lots of new solutions like Lyft, Uber, Airbnb and so on that people love, solving problems that weren’t solved. At the same time, it reflects a world where fewer people win and feel excluded. The division is reducing social trust. The General Social Survey shows that people only trust 31% of the people - an historical low. In 2019, there will be elections in countries that account for 36% of the planet’s population, from India, South Africa, Argentina, Canada, Afghanistan and Australia. That will tell us if the populist world trend will continue. Three things that come out - permissionless empowers the disrupters, a lot of legislating gets done when no one is tweeting, and social issues are inescapable when stakeholder engagement is broadening.

In this connection, the Federal Reserve, the Bank of England and the ECB will have a much greater inclination to emphasize their mandate to maintain employment over their mandate to control inflation. Maintenance of employment may be the only way to create overall political stability. If our thesis holds, the end-of-year stock market sell-off that was driven by a Fed-instigated QT of global liquidity could turn the other way. It would lessen the crowding-out issue and the global liquidity squeeze, especially if the expected Chinese decision to further ease monetary, fiscal and regulatory policies come true. On Tuesday, the Chinese government announced that it will pour hundreds of billions of dollars into its economy including tax cuts and support from monetary policy.

Consequently, the stock market will likely keep on being volatile but with a reversal of what we saw in 2018. Stocks could be weak early in 2019 but stronger in the year. This scenario suggests that investments should be in companies that operate in oligopoly, monopoly or duopoly conditions with sustainable businesses that can be bought with low EBITDA multiples and have net cash position. That is with more quick assets than debt. Allan Sinae, the veteran CEO of Decision Economics, believes that “the rebound in stocks will continue and the market bull-run is not over.”

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New Technical Perspectives as of January 17, 2019

1) Based on the Dow Theory, the trend for the S&P 500 turned bearish recently with key resistance at 2738 and key support at 2401 - on Thursday morning the S&P 500 was 2606

2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $57.04 and key support at $45.44 - on Thursday morning crude traded around $51.62

3) Based on a proprietary model, the trend for gold turned bullish recently with key resistance at $1337 and key support at $1223 - on Thursday morning gold was selling for $1294

4) Based on a proprietary model, the trend for ten-year treasury yield recently turned bearish with key resistance at 2.85 % and key support at 2.55% - on Thursday morning the yield was 2.73%

5) Based on a Palos Currency Model, the trend for the Canadian dollar recently turned neutral with resistance at 76.35 us cents and key support at 73.87 us cents - on Wednesday morning the Loonie was trading for 75.43 us cents, 2.57 us cents below its Purchasing Power parity Rate.

The Recession Risk as of January 17, 2019:

1) Analysts surveyed by Bloomberg in January see a median 25% chance of a slump in the next 12 months.
2) Moody's Analytics is predicting that there is a 17% chance of a recession in the next six months.
3) The WSJ January survey predicts that there is a 38% chance of a recession in the next 12 months.
4) The message from the latest survey of fund managers from BAML is that we are back to secular stagnation as a net 60% of survey respondents expect global GDP will slow but only 14% foresee an economic recession in 2019.
5) The probability of a rate hike this year declines to 12% yesterday in response to the Fed's Beige Book report.

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The Outlook for U.S. Economic Growth as of January 17, 2019:

1) Oxford Economics predicts real growth of 2.0% in Q/1.
2) The Bloomberg median projection for 2019 economic growth edged down to 2.5% following a 2.9% estimate in 2018, buoyed by a strong job market, rising wages and lingering effect of tax cuts.
3) Michael Ferori, chief economist at JPMorgan Chase, cut his first quarter growth forecast to a 2.0% annualized pace from 2.25%, citing the government shutdown.
4) The January WSJ survey predicts that growth will grow at the annual rate of 2.2% in Q/1, 2.2% in 2019 and 1.75 in 2020.
5) Moody's Analytics predicts that the U.S. economy grew at the annual rate of 2.7% in Q/4.
6) The Atlanta Fed predicts that the U.S. economy grew at the annual rate of 2.8% in Q/4.
7) The St-Louis Fed predicts that the economy grew at the annual rate 2.8% in Q/4.
8) The Cleveland Fed expects that the pace of economic growth to slow around 2.0% in 2019 and 2020.

The Outlook for Inflation:

1) The Cleveland Fed's Inflation NowCasting Model predicts that the PCE Deflator is expected to fall to an annual rate 1.3% in Q/1 of 2019 and the CPI to 1.2%.

2) Economists and markets expect a slowdown in inflation resulting mainly from lower oil prices. The U.S. CPI year-over-year increase is expected to fall from 1.9 % to 1.0% by July 2019.

3) Goldman Sachs predicts that the yield on ten-year Treasury note will end 2019 at 3.00%. This ties in neatly with a 4% increase in N-GDP—2% for growth plus 2% for inflation.

4) Goldman Sachs also expects that the U.S. dollar will weaken against most currencies as the Fed adopts less aggressive monetary stance—-good for commodities, materials, financial stocks and dividend paying equities.

Macro View cont.

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The Global Demand Outlook for Oil as of January 2019:

1) According to the January OPEC Monthly Report, OPEC significantly dialed back its crude oil production in December—- a 751,000 barrel-a -day decline was reported to average 31.58 million barrels a day.
2) Canadian crude oil prices are currently trading at the smallest discount to U.S. in a decade, thanks to Alberta's efforts to hold back output.
3) The EIA predicts that global oil demand should rise by 1.52 million barrels per day in 2019.
4) The IEA predicts that global oil demand should rise by 1.40 million barrels per day in 2019.
5) OPEC predicts that global oil demand should rise by 1.29 million barrels per day in 2019.

The Barron's 2019 Roundtable:

> "Despite worries about debt, interest rates and trade, Barron's 2019 Roundtable members seen a decent year ahead for stocks. Almost none of Barron's market seers is predicting a recession in 2019 and almost all expect the U.S. economy to keep growing. While stocks might stumble through the first half, Bloomberg's seers suggest that stocks will sprint through the second half of 2019 and into 2020."

1) Meryl Witmer of Eagle Capital Partners predicts that real growth will be 2.0%.
2) Mario Gabelli if Gamco Investors predicts that real growth will be 2.0%.
3) Henry Ellenbogen of T.Rowe Price predicts that real growth will be 2.0%.
4) Jeffrey Gundlach of Doubleline Capital predicts that the real growth will be 0.5%.
5) Scott Black of Delphi Management predicts that real growth will be 2.0%.
6) Abby Cohen of Goldman Sachs predicts that real growth will be 2.4%.
7) William Priest of Epoch Investment Partners predicts that real growth will be 1.5%.

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The chart below shows the historical probability of seeing positive returns in stocks by different time frame——courtesy of Wealth of Common Sense by Ben Carlson:

S&P 500: 1926-2018

Time Frame	Positive	Negative
Daily	54%	46%
Quarterly	69%	31%
1 Year	75%	25%
5 Years	88%	12%
10 Years	95%	5%
20 Years	100%	0%

It shows that the longer your time horizon, the better the chance of success.

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