PALOS

Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative of March 28, 2019

U.S. Monetary Policy: Is the Fed's Abruptly Changed Course an Overreaction?
No, the Fed Was Correct to Pause and To Admit That the Markets Were Right.

We have had enough green shoots in recent data points to suggest that the economy could climb out of the rut it fell into during the current quarter. The Federal Reserve has an adequate number of economic models and high frequency trackers to know that the recent weakness will likely not last and will prove to be temporary. Economists polled by Bloomberg, the WSJ and Macroeconomic Advisors expect GDP will grow at 1.1% annual rate in Q1 and bounce up to 2.7% in Q2. Indeed, high-frequency global tracking devices have firmed up, suggesting that the downside risk has receded somewhat and may be less severe than market pricing suggests. However, the future is never certain, and the expected bounce is more a probability than a sure thing. The monetary authorities know that too. While they do expect a "hockey stick" inflection later in the year which explains why they built in their forecast a rate hike in early 2020, they also know that America does not have tremendous momentum right now.

Because the monetary authorities have tendency to err on the side of caution since the financial crisis, they decided to buy some insurance. In other words, they are not willing to count on the "hockey stick" unless they give the system a reprieve. Therefore, the main reason for the dovish confirmation is that the Fed can ill-afford to purposely invert the yield curve--it would only take one rate hike to create a higher recession risk. Effectively, the Fed surreptitiously acknowledges that it should not have raised interest rates last time. Tim Duy, a leading expert on monetary policy, wrote in a Bloomberg article that " the December rate increase seemed more model-driven than reality-based." Now the Fed is trying to fix that hawkish error. The officials at the Fed cemented their "Patient Policy Stance" in their "no rate hike" forecast in 2019 and the central tendencies for the federal funds rate in 2012 and 2021 are both 50 bps lower. The bottom line is that the Fed no longer anticipates that containing inflation requires restrictive monetary policy. Demographics, productivity, technology, globalization and debt will keep inflation in check, even though unemployment is below its so-called natural rate.

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There are several other reasons that were given as to why the Fed made a U-turn.

1) The Fed would like to make sure that the economy revives sufficiently to raise the interest rate at least one more time in 2020 and, in turn, get a bit more rate-cutting firepower. It would give them 11 possible rate cuts in case their economic outlook is wrong.

2) Powell decided to take a risk-management approach, trying to balance the risks of being too loose and ignite unwanted inflation with the risks of being too tight and prematurely ending the expansion - it shows that he is willing to risk letting inflation perk up to avoid a minor recession. In practical terms, Powell is not going to raise rates until there is an actual and persistent spike of inflation rather than relying on some phony forecast based on the "Phillips Curve" theory that has lost credibility. For as long as annual wage rate increases less yearly productivity gains are less than 2.0%, there is little chance that core inflation could exceed the Fed's target.

3) The Fed is acknowledging that they misjudged what was going on in the later months of 2018, believing that the tax reform would do more than give a short-term consumer demand lift and the supply-side incentives like capital repatriation and deregulation would do more to raise business investments.

4) The Fed is aware that the administration is at a critical juncture in the trade talks and we do not know if there has been progress on the remaining sticking points and on details about enforcement. Until the Fed becomes sure that China and the US are no longer at odds on these items, it makes sense for the monetary authorities to stay put.

5) The Fed is not satisfied with the current rate of expansion and that puts the monetary authorities in a tough spot. They surely do not want things to decelerate from here. The White House budget assumes that the economy will grow at the average speed of 3.1% during the 2019- 2021 period. It's not realistic. The Consensus forecast for the period under review is 2.5%. Goldman Sachs (GS) thinks that the White House is out to lunch. GS has placed a bet at 2.2% and the Fed at 1.9%. The Fed will have to eat a lot of treasuries if we end-up with a two-plus-two economy and, obviously a lot more if the path of the economy were to fall even lower than the Fed's mid-term projections. In the first five months of this fiscal year, the budget shortfall rose 40% above last year to totalled $544.2 billion. The national debt load topped a record $22 trillion in February. The budget deficit as a share of N-GDP is expected to widen to 5.1% this calendar year, up from 3.8% a year ago. They might fear that the economy can't bear a rise in interest rates without the negative consequences of a higher cost of funding the growing budget deficit and debt repayment on the economy.

6) It is possible that the Fed could believe that they have done enough QT and rate hikes to eliminate the liquidity trap that has kept over-leveraged firms alive that have been incentivized into making poor investments. The

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point is that the vestiges of past crises linger on, making creative destruction not a viable option. What needs to be avoided is leverage and volatility and being forced into an ugly balance sheet reduction.

7) The Fed has come to realize that the slump in world trade for durable goods stems from the lack of global liquidity which was partially caused by the decrease in the U.S. monetary base.

The State of Yield Inversion:

It should be noted that the Fed has essentially eased policy as much as possible via lowering the anticipated path of rates. The next step is an actual rate cut if the yield curve inverts. On Friday last, the yield on a three-month Treasury bill rose above the yield on a 10-year Treasury note for the first time since 2007. The San Francisco Fed has found that every single downturn since 1950s was preceded by a period of yield inversion. I don't want to scare investors more than necessary. There are facts about yield curves that should be understood before taking rash investment decisions. Firstly, it is important to know that for a yield inversion to be meaningful it must last for at least three months--not a day. Secondly, history is clear that an inverted yield curve led to a recession within 12 to 24 months. However, the yield curve model needs to be cross referenced with other objective indicators and subjective uncertainty. A very large proportion of the yield curve inversion can be attributed to dynamics outside of the U.S. like Germany and Japan.

What all of this means is that the Fed has three months in front to make a second decision. If the US economy does not return to a safe equilibrium, be sure that the Fed will react with a rate cut. The issue is that as the growth is impaired by aggressive savings, the economy converges to the zero-sum game. In that kind of economy, income-redistribution questions set. Political uncertainty rises as politics heats up, creating market volatility. If the latter is happening as the curve is levelling too fast or inverting too quickly, the money guys will reduce interest rates to widen the yield curve and regain peaceful political life. In this regard, I monitor the VIX-to-3M-10Yratio. A bad-looking ratio invites aggressive monetary intervention. Bad is when the VIX is low (meaning high volatility) and the three-month-yields are higher than 10-year-yields. But, when the VIX is high (meaning low volatility) and the yield curve is inverted, the monetary policy mildly eases. And that is where we are - easing mildly. As a matter of fact, the latest numbers on policy uncertainty is very stable. The Moody's Analytics Policy Uncertainty Index is 128.9 and it has not budged in seven weeks. Indeed, the economic picture is not as dire as the media tells. As a matter of fact, there has not been any aversion to riskier corporate debt. The spread between investment grade and lower grade bonds remain narrow.

Imagine a lot of volatility and a narrowing curve---someone or something must give in and it's usually the central bank. This little analysis begs an answer to a simple question. What would happen to the stock markets if the expectations for the commencement of actual easing was via a rate cut. The market's probability of having a realistic easing off in late 2019 or early 2020 is about 75%. Thus, it is possible that we already have the widely anticipated bear trap in the quarter ended December 2018. If this turns out to be true, it would be because the growth and inflation

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paths will have converged in a two-plus-two pattern. In this connection, 10-year treasury yields should stabilize around 2.40% and a plain vanilla 25 bps rate cut would be enough. However, if the growth rate were to tumble down to zero, the Fed would not settle for a quarter rate cut but for a full 100 bps cut to get maximum impact because long term yields would go down deep into a lower yield range centring around 2.00%. Additionally, the Fed can react quickly at the push of a bottom. Every time credit markets dried up in the past, the Fed announced rate cuts during trading hours without any warnings.

This brings me to the question about how equities would ultimately respond as the Fed gets closer to a hypothetical rate cut. In last Sunday's Heisenberg Report, Heisenberg wondered if bad news is good news to the extent that dovish Fed would implicitly support "short volatility" and "carry" trades. BofAML studied what happen at all the first-rate cuts in Fed Funds since 1972 and found, unsurprisingly, that they came amidst a worsening labour market except for two - Black Monday and LTCM incidents. The good news is that the S&P 500 generally did ok over the 12 months preceding the cut, except when market stress and not economic conditions drove the rate cuts as in Black Monday and LTCM moments. Specifically, the index was up 5 times, down more than 5% twice and the other four times--neutral.

What really happened is a lot of volatility. It's as if volatility sniffs things out and tends to capture the increase in uncertainty as the actual change in monetary policy approaches. Increased volatility was experienced 9 out of 11 times - the two exceptions being again Black Monday and LTCM. Put simply, the market in the end does ok when it senses that a rate cut is coming - unfortunately the ride is rough and bumpy. It's certainly hard to digest because its counterintuitive - like saying that bad is good, black is white or red is green. This fearful historical asymmetry that favours higher volatility, but also mildly higher stock prices can be mitigated with long volatility positions. Allow me to say this one more time: "the S&P 500 does not often decline significantly in the twelve months before the Fed lowers rates. But volatility does capture the increase in uncertainty and tends to rise leading up to a rate cut."

Yardeni on Corporate Profits:

Given the ferocity of the rebound in equity prices year to date, there is clearly less gas in the tank. Given the Fed's dovish pivot, it is likely to inject heavy amounts of liquidity on a need be basis and be inclined to protect risky assets, thus making a contraction in P/E multiples unlikely. Consequently, the future performance of the stock market will increasingly be dependent on earnings prospects and the fear of missing out (FOMO).

As a matter of fact, a wave of massive inflows occurred in the week that ended on March 20 - $20.7 billion according to EPFR. Interestingly, S&P 500 net short positions are high by historical standards and NYSE margin debt has plunged to a two-year low. This means that there is firepower on the side-line. Therefore, we might have already had our main event in the stock market, especially if we end-up with a soft landing or a shallow and relatively uneventful recession. Indices of financial conditions and stress are not forecasting a harrowing bout of imbalances and forced deleveraging.

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Ed Yardeni and Joe Abbott wrote in the Barron's on March 22.

> "2018 was a great year for earnings, but a lousy year for the stock market, especially during Q4. This year is starting on a sour note for earnings, yet stock prices have rebounded nicely so far. While the fourth-quarter 2018 growth rate was still in the double digits, the typical earnings hook was anaemic. Furthermore, corporate managements' guidance about the 2019 outlook during their last conference calls was generally cautious. That triggered a sharp drop in earnings expectations for Q1 of 2019. The growth rate for that quarter plunged from 5.5% at the end of last year to -1.5% during the week of March 14. As a result, there has been lots of chatter about an earnings recession, particularly by bearishly inclined investment strategists who are warning about an imminent reversal of the post-Christmas stock market rally. While the Q1's growth rate for expected earnings is slightly negative, the second quarter consensus estimate remains slightly positive, and is showing signs of bottoming just north of zero. Here are the March 14 week consensus growth estimates: Q1 (-1.5%), Q2 (1.1%), Q3 (2.6%) and Q4 (9.4%). Barring any unforeseen calamities, it looks like the bears won't be getting two back-to-back negative quarters for the S&P 500 earnings growth."

Is the earning recession over already? They say yes.

Conclusion:

At a Hong Kong speaking engagement, former Chairwoman Janet Yellen stated that an inverted Treasury yield curve is not necessarily the harbinger of a recession, but the inversion does suggest the Fed might want to lower the federal funds rate target. One rate cut and instantaneously the inversion disappears. It's very possible because there is no inflation risk currently. The bond and foreign exchange markets agree with Janet. That is where the smart speculators trade. The weird shape of the yield curve is giving a 65% chance that the Fed will introduce a rate cut in 2019 and behaviour of the greenback against the euro, yuan, yen and the loonie tells that declining U.S. interest rates are more about the idea that the economy is flatlining to a lower pace that will fluctuate around 2.0% than heading into a contraction. Interestingly, estimates for Q1 growth are inching up.

Data Points that Matter for the Week ending March 28, 2019

- Canada:
  1) Wholesale sales rose 0.6% to $63.5 billion in January for a year-over-year increase of 1.8%.
  2) ADP Canada National Employment Report showed that payrolls increased by 36,200 in February, after rising 33,900 in January. Employment growth is healthy.

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3) STCA reported that the value of retail sales dropped 0.3% in January. It was the third decrease in a row. In the retail sales showed positive monthly increase only twice in 5 the last eight months. On a year-ago basis, e-commerce sales rose 12%, compared to 1.7% for total sales. E-commerce accounts for 3.4% of total retail sales.
4) Consumer price inflation accelerated ever so slightly on a year-over-year basis from 1.4% to 1.5%, following a 0.3% seasonally adjusted month-over-month increase.
5) Canada has just experienced a dramatic yield inversion.

- The United States:
  1) Bloomberg's economic expectation index declined to 47.5 in March. It was less than 20 in 2008. The peak was registered at 58.1 in the fall of 2018.
  2) The February Conference Board US Leading Index bounced back by 0.2% after two monthly consecutive drops.
  3) The federal government has incurred a cumulative budget deficit of $544.2 billion in fiscal 2019 compared with $391.0 billion last fiscal year.
  4) Existing-home sales bounced back strongly in February to 5.51 million (sa), making up most of the losses from previous year.
  5) The pace of economic activity slowed a bit in February. The Chicago Fed National Activity Index declines to -0.29 from -0,25 in January.
  6) Texas factory activity continue to rise in March (8.3), though more slowly than in February.
  7) Residential construction took another tumble in February, indicating that confidence in the housing market is still unsteady despite the recent fall in mortgage rates and the steep increase in the sales of existing homes. There were 1.162 (saar) starts in February.
  8) The FHFA Purchase-only House Price Index rose 5.6% in January from a year ago.
  9) The S&P CoreLogic Case-Shiller Home Price Index reported that the decelerating trend in home price was extended in January. The index is down 10.9% from the July peak of 2006.
  10) The Richmond Fed's regional manufacturing index was 10 in March in line with expectation.
  11) The Conference Board reported that its index of consumer confidence declines to 124.1 in March from 131.4 in February.
  12) The January trade deficit narrowed more than anticipated, falling by $8.8 billion to $51.1billion.
  13) The mortgage market posted a robust increase in activity, with the top line market index rising 8.9%.
  14) Initial jobless claims are down again totalling 211,000 this week, it has been doing so since the middle of January. News on sentiment have been mixed, but this leading indicator is suggesting strength in the labour market.
  15) Pending home sales index edged down 1% to 101.9 in February on a seasonally adjusted basis.

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- China:

  TS Lombard wrote in a research note to clients that Asian trading indices are pointing to further deterioration in Chinese exports.

- The Euro-Zone:

  In Germany, the manufacturing slump deepened, as the flash PMI for March came at 44.7 well below consensus (48) and missing the lowest estimate (46.5) by country mile. This was the worst reading in six years and the third consecutive month on contraction.

The Recession Risk as of March 28, 2019:

1) The NY FED' s yield curve model shows that the probability of a recession 12-months ahead is 25% - needs to be at 50% to trigger one.
2) Moody's Analytics is presently predicting that there is a 35 % chance of a recession in the next 12 months.
3) The March WSJ survey shows that the chance of having a recession in the next 12 months is 25%, last it was 24%
4) An index of CEO's compiled by the Business Roundtable declined for the fourth quarter in a row, falling 9.2 points to 95.2 - the long-term average is 82.4 and needs to be 50.0 to signal the onset of a recession.
5) Piper Jaffray thinks that the chance of a recession in the next 24 months is 48%.

The Economic Outlook for Q1 2019 as of March 28, 2019

1) The NowCast Model of the NY Fed is pointing at a 1.0% growth
2) The Goldman's Current Activity Indicator is running at an annual rate of 1.4%.
3) The NowCasting Model of the Atlanta Fed increased its view on growth from 0.4% to 1.6%.
4) The High Frequency Economic Model of Moody's Analytics increased growth expectation to 1.6% from 0.6%.
5) Oxford Economics' model is predicting a 1.0% growth factor for Q1.

The Outlook for Inflation in Q1 of 2019 as of March 28, 2019:

The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to increase at the annual rate 1.0 % and the CPI at 0.7%.

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Technical Perspectives as of March 28, 2019

1) Based on the Dow Theory, the trend for the S&P 500 is now neutral with key resistance at 2833 and key support at 2708 - on Thursday morning the S&P 500 was 2809
2) Based on a 7-AM proprietary model, the trend for crude oil is neutral with key resistance at $63.50 and key support at $54.47 - on Thursday morning crude traded around $58.66
3) Based on a 7-AM proprietary model, the trend for gold is neutral with key resistance at $1367 and key support at $1242 - on Thursday morning gold was selling for $1303
4) Based on a 7am proprietary model, the trend for ten-year treasury yield is lower with key resistance at 2.63% and key support at 2.20% - on Thursday morning the yield was 2.37%
5) Based on a Palos proprietary model Currency Model, the trend for the Canadian dollar is lower with resistance at 75.87 us cents and key support at 74.01 us cents - on Thursday morning the Loonie was trading for 74.46 us cents, The Purchasing Power Parity Rate is 76.05 us cents. Rising oil prices could help the Loonie; but the monetary and economic conditions dictate otherwise.
6) The Equity Risk Premium for the S&P 500 is 355 bps, the P/E multiple is 16.9x and the earning yield is 5.93% - 4.10% above inflation expectations.
7) The Rule of 20, which is the addition of the 12-month forward P/E multiple and 5-year inflation expectation, stands at 18.7 - market neutral
8) The Equity Risk Premium for the TSX 300 is 505 bps, the P/E multiple is 15.2x and the earning yield is 6.59% - 5.40% above inflation expectations. The TSX, foreign exchange adjusted, trades at 4.29 times the S&P 500 compared to 4.38x one month ago and 4.18x three months ago. The 5-year long term average is 5.73x.
9) The U.S. Palos Monetary Policy Index is 571 down from a recent high of 586 from last week. The index considers inflation, international trade, employment and growth. The current index suggests that the economy could take another rate hike. But the market is betting that there is a 75% chance of a rate cut in 2019. This is dysfunctional and rarely happens. The market usually wins the battle.
10) The Canadian Palos Monetary Policy Index is 100, down from 130 and heading lower supporting the a BoC decision to cut its target rate to 1.50%.
11) The St-Louis Fed Financial Stress Index continues to show steady amelioration. The touched -1.28 on March 28 compared to -0.62 on December 24. A bullish downtrend that has not relax since last December. The more negative the index, the less stress there is. Financial conditions are good and above average.

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