PALOS

Palos Weekly Commentary

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By Hubert Marleau

The Weekly Narrative of April 11, 2019

The U.S. Employment Situation: A "goldilocks" Job Report

A few months ago, markets believed the Fed had tipped the economy into a recession. The March job report suggests that the fuss was for nothing and February's soft job report is seen as an aberration. It must be a relief for Chairman Powell. Nonfarm payrolls grew by 195k, above consensus expectation. Given that the participation rate and the employment-to-population ratio fell, employment still has room to expand because more potential workers are on the side-lines. Moreover, private hours work, a good guide of the underlying strength of the economy, grew at the annual rate of 1.8% in Q1. It won't take much of an increase in productivity for R-GDP to cross the 2.0% level of growth. What's remarkable for investors and reassuring for the Fed, is that wages are not rising fast enough to push broad inflation higher. Average hourly earnings in the private sectors were up 3.2% from a year ago compared to 3.4% in February. Interestingly, real wages are up 1.7% and that is equal to the anticipated year-over-year productivity gains. Thus, it is conceivable that pay raises are approaching a ceiling. They normally are not better than productivity gains plus inflation; and that is maximum expectation because typically businesses do not pass on all productivity gains to workers--they keep some of it in the form of added earnings. Unless workers get a miracle, 3.5% annual wages will be as good as it gets--i.e. 1.5% for productivity and 2.0% for inflation - meaning flat earnings for the owners for this year. As a rule, businesses don't make more money out of inflation; they do out of productivity gains.

There is another big thing going on. Job creation is mainly taking place in the relatively stable service and government sectors. In the last eight months, 1.6 million jobs were added to the economy of which 86% were in the sectors. This pattern, which has existed for more than a decade has become the new characteristic of the economy and, in turn, changing the nature of recessions.

The Recession Watch: Where Is the Contraction?

Predicting recessions borders on the impossible. Yet, there is a surplus of soothsayer's warning that the yield curve and the long length of the recovery augurs that one is in front of us. The bearishness rests more on intuition than facts. Therefore the perma-pessimists push the recession forecast further out when the economic data shows strength.

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Its without question that the longer time tables offer better odds that a recession will eventually strike. At some point a recession will pop up. But the reality is that predicting recessions beyond a couple of months is little more than guessing. Downturns are wickedly complex. I know of no one who has been able to foretell with precision more than one contraction six to nine months in advance---"six months" is the amount of time needed to be timely with the market. A more reliable method is to analyse the economic, financial and monetary data points as published and estimate the risk in real time.

Financial history shows that markets react when they get assurance that the above indicators are decidedly pointed down. In this connection, I follow the market related newsreel on a daily basis that produces data on the business cycle. It is a difficult process. Thus, I keep in touch with several seriously constructed models that are updated daily. They are very good at estimating the current 1) recession risks, 2) prospects for the economy and 3) outlook on monetary policy. Together they have a low level of false signals. I detailed them every week at the bottom of these weekly commentaries. At this time, the risk of an immediate recession is low, the short-term economic outlook is positive and the Fed presently on hold. Indeed, there are no obvious signs that the U.S. economy has deteriorated to recession levels. The Atlanta Fed's and Moody's GDPNow models among many others predict 2.3% growth during Q1/2019, near the annual rate of the past 10 years.

Unfortunately, the market has a mind of its own and, in turn, there can be many temporary divergences between the real world and how market prices are acting.

I picked up a wonderful quote on CNBC from Ralph Wagner, a notable fund manager in NYC. He said: " there's an excited dog on a very long leach in NYC, darting randomly in every direction. The dog's owner is walking from Columbus Circle, through Central Park, to the Metropolitan Museum. At any one moment, there is no predicting which way the pooch will lurch. But you know he's heading northeast at an average speed of three miles per hour. What is astonishing is that almost all the dog watchers, big and small, seem to have their eye on the dog, and not the owner."
Put simply, a bull market has no expiration date. It zigzags north east to higher destination until the leach breaks---that is when the recession comes, and the real bear hits the market with an historical 21% drawdown. In other words, the high frequency models, while not failed proof, can be telling of when money managers ought to take some chips off the table.

The Independence of The Fed: Next to Attorney General, the Fed Chairman is the Most Powerful Person in Government. Their Political Independence Is Crucial for the Maintenance of Democracy.

Trump's nominee David Malpass who is a well-documented trade protectionist, sceptic of multilateralism and an anti-globalist, was unanimously selected as the new president of the powerful World Bank. It marks a major victory for President Trump. He prevailed because no countries wanted to pick another fight with a unilaterally-inclined and sovereignty-obsessed administration, despite his laid out narrower vision on the World Bank. One should expect more geopolitical tension with China over financing of the "Belt and Road Initiative" and less " Direct Infrastructure Lending"

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to participants - and that is exactly what Trump wishes. It's not that I think that Malpass will revolutionize the institution, but his anti-multilateral view will certainly ruffle feathers.

The Malpass appointment makes me wonder if Trump is going to get his way in reducing the independence of the Fed. Last Friday, we got a good idea about the difference in views between the Fed officials and Administration officials. On the one hand, Federal Reserve officials are pushing back against the notion that the central bank should cut interest rates now or very soon. The Fed is still on record to raise the target rate one more time and several policy makers have said in recent days that they see future rate increases as more likely than decreases. The Fed's view is that monetary policy is in the right place---rate hikes are on pause and QE-Lite will begin in October. On the other hand, the administration is calling for a rate cut now, a stop to the Fed's balance sheet runoff now and a resumption of quantitative easing now. Both Larry Kudlow, White House National Economic Council Director and President Trump do not agree with Chairman Jerome Powell and his colleagues. They are unhappy with the Fed. After the job report, the president tweeted: "Got that? If the Fed dropped rates and went back to QE, you would see a rocket ship." The November election is coming, and he wants the Fed to launch a full-on, pedal-to-the metal, easy monetary stance. President Trump is as much for MMT as AOC. The two are monetary interventionist. Yet, the Republicans have shown disdain for the supporters of the MMT.

The hypocrisy is startling according to the Heisenberg Report. In order to get his way, he decided to appoint Herman Cain, a former pizza man, who is accused of sexual misconduct and views on monetary issues are quackish, to the Fed's board. He has spent his time raising money for Trump's upcoming presidential campaign. Additionally, he has nominated Stephen Moore, the raving sycophant without a coherent ideology, and a promoter of falsehoods who spends his time as a partisan hack on talk shows and as a fact-fudged critic in op-eds.

If the Senate Republicans do not stand up to the President on this one, the market confidence in the U.S. central bank as the impartial rudder of its official mandate and monetary defender of the currency will be significantly eroded. The central bank must remain apolitical. Several foreign central banks have already reduced the U.S. dollar content of their official reserves. I trust that the smarter Republican senators, more intelligent business executives and the more responsible conservative "think tanks" will align themselves and stop the President from encroaching on central bank independence with malleable supporters and convince him to kill his self-destructive partisan plan by withdrawing their names. While I recognize that Moore and Cain would account for only two of twelve votes, it remains that market perception would be bad. Their effort to sway the Fed toward the wishes of the Administration would be public and witnessed in the transcripts. The Economic Expert Panel of the University of Chicago, the premier school of economics, vigorously rejects their nominations. A few days ago, Trump said: I guess I'm stuck with you."-- meaning Jerome Powell. Let's hope so. On that score independence looks good. The minutes of the last meeting of the FOMC reflected that the Fed has no intention to increase or decrease its policy rate in 2019.

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Secular Trends That Matter: To Become a Weekly Feature

I distrust money managers that incorporate business cycles into long term investment plans. I do not think that this kind of thinking serves long term investors well. The "business cycle" is a misleading way to think about long term growth. Identifying emerging secular trends is as important as understanding where the business cycle lies ---meaning that we should have an idea of where we are going and one about where we are. Assessment of secular trends should be made independent of business cycles. The big picture has little to do with business cycle details.

Last week, I mentioned that there will soon be more Millennials than the Baby Boomers and that Gen-Z will also overtake Gen-X. The previous week, I wrote on advent of the Modern Monetary Theory. There are many new emerging trends that will toss aside old ways, beliefs and habits If you have secular ideas, please email them to hmarleau@palos.ca.

The Changing Nature of Recessions

Australia:

Neil Irwin, a senior economics correspondent for the NYT, flew 16,000 miles down-under to find out why the Australian economy was remarkably resilient. As a matter of fact, one of the directors of Palos Management asked me why the Australian economy has gone 28 years without a recession. My answer was immigration. Mr. Irwin had a different take than mine. He basically attributed the economic miracle to the good fortune of being a major exporter of raw materials to China, to the application of smart economic policies and a collective rejection of complacency. He may be right that the Aussies had good luck, good policy and good prudence. I cannot help but to think that a lot more had to do with immigration. The current population of Australia is about 25.9 million souls of which a bit more than 30% are foreign-born. Since 1996 the population has grown by 6.8 million people---6.2 million are immigrants. Put simply, foreigners drove the population growth. Immigrants are hardworking and do the dirt and tough jobs like mining Iron and coal farming wheat and cattle, they don't take anything for granted and therefore are not complacent or reckless spenders, making it easier for the policymakers. Incidentally, immigration is what is saving Canada's butt. Twenty-one percent of Canadians are foreign born.

The Real yield Curve:

If the inflation expectation content of the yield curve were to be stripped out, the shape of the curve would neither be flat nor inverted. For example, the shape of the yield curve on Treasury Inflation Protected Securities (TIPS), which is nominal yields less inflation expectations over time, is upward sloping. The real yield gap between 10-year (.50%) and 1-year (.29%) would be 29 bps. If the term premium were to be added, the inflation protected yield curve would be even steeper - the gap would be widening to .70%. If this observation is meaningful, and I think it is, it would mean that the normal yield curve is flat and inverted not because economic growth is going to "rat shit" but because inflation is going nowhere. This may sound implausible because today's eight-year stretch of low rates seems long. But

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not really. When compared with prior periods of low rates, which lasted around 40 years. It doesn't look so long. Since 1870, we have had low rates (5.0% or less) 66% of the time. High rates (7.5% or higher) happened once in 150 years - in 1970-1992 for only 22 years representing 15% of the time.

Do We Have a Bull or a Bear Inversion?

Most investors know what inverted yield curves are and that they precede recessions. What is often neglected is the explanation as to why a yield curve is inverted. It should be noted that there is a big difference between a yield curve that inverts because short rates are rising and one that inverts because long rates are falling. The former occurs when the central bank rapidly tightens its monetary stance because inflationary pressures are rising while the latter occurs when the central bank suddenly eases its monetary stance because inflationary pressures are falling. The first example is called a bear inversion and the second is termed a bull inversion. What we just had was a bull inversion.

Another important and related factor is the real cost of money. There is a big fundamental difference between an inverted yield curve when the real cost of money is low and when it is high. An inverted curve is dangerous when front-end interest rates are considerably above core inflation. Presently, the three-month treasury yield is just 35 basis points above core inflation. According to data provided by Bloomberg, prior to every recession since 1960 the gap was more like 200 basis points. Investors should note that corporate yield curves of every investment grade are upward sloping and, in turn, support the idea that the shape of the government bond yield curve is bullish inverted. For example, the spread between 10-year (4.05%) and 3-month (2.90%) BBB corporate bonds is currently 115 basis points.

The Statistical Facts Behind Recessions:

Since 1850, the U.S. has had 34 recessions and the ones before WWII were very different than the ones that came afterwards.

1) Prior to WWII, there were 22 recessions compared to 11 during the post war period.
2) Prior to WWII, the U.S. experienced, on average, a recession happened once every two years compared to 5.3 years during the post war period.
3) Prior to WWII, the average contraction in economic activity was 22% compared to 2.2% since the end of WWII.
4) Prior to WWII, the average length of a recession was much longer than during the post-war era.

I trust that in some of my previous weekly commentaries were able to convince readers that the bulk of bear markets do not happen before a recession hits but during one. During the modern era, the frequency, magnitude and duration of recessions have been acutely different from those during the prior era, I will aim my observations from 1948 to 2018. Since 1948, there have been 11 recessions. The average GDP contraction was 2.2% and lasted for about 10 months. It also looks as if most recessions were associated priorly with fast growth rates and/or high inflation rates.

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As stated earlier in this text, the U.S. economy is huge complex and ridiculously difficult to predict far ahead. But I believe that gauging the economy in real-time, using high frequency models fed with a constant stream of economic, financial and monetary data points, along with a historical perspective, is the most reliable process.

The Outlook for the S&P 500 Over the Next 12 Months:

During Q1, the S&P 500 recorded an increase in value of 13.1%. According to FactSet, industry analysts in aggregate predict the S&P 500 will see a 7.5% increase in price in the twelve ending March 2020. That would put the S&P 500 at 3096.66.

Data Points that Matter released in Week ended April 11, 2019

- The United States:
  - The labour market posted a convincing rebound in March. Nonfarm payrolls increased by 196.000, besting expectations. Average hourly earnings were only up 3.2%, despite tightening conditions - remarkable.
  - The Fed reported that consumer credit grew $15.2 billion in February.
  - Household debt as a percentage of N-GDP has significantly declined in the past 10 years. It reached a high of 140% in 2017. Today, it close to 100%.
  - The California Purchasing Managers' Composite Index increased from 61.2 in Q1 to 63.3 in Q/2.
  - Factory orders fell 0.5% in February, the fourth decline in five months.
  - The February Job Openings Survey showed that there were 7.087 million job openings at the end of February. Although, there fewer job openings than in January, they were 8.5% higher than a year ago and larger than there were unemployed people.
  - Canada:
  - Hiring dropped off in March, falling 7,200. In the quarter ended March, employment grew 1.4% year-over-year.
  - Wage growth recovered a bit in March, registering a 2.3% annual increase.
  - Housing starts jumped 15.8% in March to a seasonally adjusted annualized rate of 192,527, a bit less than consensus expectations.
  - Moody's Economic Policy Uncertainty Index is 128.9 and has not change since the end of December.
  - The NFIB Small Business Optimism Index inched higher in March to 101.7 with hiring plans edging higher.
  - The March consumer price index won't cause the Fed to be less dovish, but bets on a rate cut may before year end might be overdone. The CPI increase 1.9% year-over-year from 1.5% in February. The monthly increase resulted from higher energy prices. The Core CPI was only up 0.1% in March for a year-over-year increase of 2.0%. Reminder, it was as high as 2.3% November last.
  - The top-line market index fell 5.6% in the week ending April 5 due to refinancing activity falling back to earth.

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- The Federal government has incurred a cumulative budget deficit of $691.2 in the first half of fiscal 2019, compared to $599.7 for the same period of last year. The Fed did not finance the budget deficit over the past 12 months.
- U.S. producers' prices posted a solid gain in March because of surging energy prices. Year-over year the PPI rose 2.2% and Core PPI increased 2.1%.
- The labour market is good shape, as jobless claims keep on plunging. U.S. initial claims for unemployment insurance benefits swooned to 196k last week - a record low.

- China:
  - China's foreign exchange reserves grew for the fifth straight month in March to a seven-month high of $3.099 trillion.
  - The Fulcrum nowcasts model shows that the growth of the Chinese economy which showed a miserable 4% in December has now rebounded to 5.7%. That is close to the government's 6.0-6.5 % target range for 2019. JPMorgan has upgraded growth projections from 6.2% to 6.4%.

- The Euro-Zone:
  - German industrial production rose in February by 0.7% m/m while the consensus predicted 0.5%.

- The World:
  - The Brookings-FT Tracking Index for the Global Economic Recovery (Tiger) which compares indicators of real activity, financial markets and investor confidence has slipped back significantly at the end of last year to its lowest level since 2016. While economic sentiment and real data are off the boil and have turned down in both advanced and emerging economies, the financial chaos of December quarter was the main culprit. According to Fulcrum nowcasts, the global economy has stabilized of late and should expand at the annual run rate of 3.1% in 2019. The same model was pointing to a growth rate of 2.6% a few weeks ago.
  - The I.M.F.'s latest economic forecasts cut the outlook for growth in 2019 to 3.3% from earlier estimates of 3.5% in January and 3.7% in October last. Interestingly, the IMF definition of a recession is 2.5%.

The Recession Watch as of April 11, 2019:

1) The NY FED' s yield curve model shows that the probability of a recession 12-months ahead is 27%.
2) The High Frequency Model of Moody's Analytics says that there is a 26 % chance of a recession in the next 6 months.
3) The March WSJ survey shows that the chance of having a recession in the next 12 months is 25%.

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The Economic Growth Estimates for Q1 2019 as of April 11, 2019

1) The NY Fed is now estimating a 1.3% GDP growth, up from 1.0%
2) The NowCasting Model of the Atlanta Fed increased its view on growth from 1.5% to 2. 3%.
3) The High Frequency Economic Model of Moody's Analytics increased its growth estimate to 2.0% from 1.1%.
4) A Canadian feeder of printed economic data points indicates an annual growth rate of 1.2%.

The Estimated Inflation for Q1 of 2019 as of April 11, 2019:

The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to increase at the annual rate 0.7% and the core deflator at 1.5%.

Fourteen Technical Perspectives as of April 11, 2019

1) Based on the Dow Theory, the trend for the S&P 500 is now neutral with key resistance at 2950 and key support at 2743 - on Thursday morning the S&P 500 was 2896
2) Based on a 7-AM proprietary model, the trend for crude oil is neutral with key resistance at $66.69 and key support at $58.51 - on Thursday morning crude traded around $63.83
3) Based on a 7-AM proprietary model, the trend for gold is bullish with key resistance at $1367 and key support at $1242 - on Thursday morning gold was selling for $1296
4) Based on a 7am proprietary model, the trend for ten-year treasury yield is bearish with key resistance at 2.63% and key support at 2.38% - on Thursday morning the yield was 2.49%
5) Based on a Palos proprietary model Currency Model, the trend for the Canadian dollar is stable with resistance at 76.24 us cents and key support at 74.25 us cents - on Thursday morning the Loonie was trading for 74.70 us cents, The Purchasing Power Parity Rate is 77.50 us cents.
6) The Equity Risk Premium for the S&P 500 is 330 bps, the P/E multiple is 17.4 and the earning yield is 5.76% - 3.83% 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 19.3 - market neutral
8) The Equity Risk Premium for the TSX 300 is 487 bps, the P/E multiple is 15.3x and the earning yield is 6.55% - 5.40% above inflation expectations. The TSE, foreign exchange adjusted, trades at 4.26 times the S&P 500 compared to 4.34x one month ago and 4.31x three months ago. The 5-year long term average is 5.71x.

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9) The U.S. Palos Monetary Policy Index, excluding the current account deficit, is 238. Currently, the index suggests that the U.S. economy could take one more rate hike.
10) The Canadian Palos Monetary Policy Index, excluding the current account deficit, is 35. The index is suggesting that the BoC should cut its target rate to 1.50%.
11) The St-Louis Fed Financial Stress Index continues to show steady amelioration. The index touched -1.26 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.
12) Copper/DXY ratio is 302, and the trend is flat. It's a sign that the world economic outlook is stabilizing. The ratio was 300 a month ago.
13) ERP/CNN ratio is 47, suggesting that the market is a bit rich. But the trend is positive. A high ratio means that the stock market is very cheap. For example, on December 24, 2018 the ratio was at an all-time high of 2090. One month ago, the ratio was 59.
14) VIX/CNN ratio is 19, also suggesting that the market is a bit rich. But the trend is positive. For example, the ratio was at an all-time high of 1800 on December 24, 2018. A high ratio means that the stock market is very cheap. One month ago, the ratio was 29.

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