PALOS

Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative of April 18, 2019

Monetary Policy and the Neutral Rate of Interest:

The Q1 earnings season started last Friday with JPMorgan, Wells Fargo and PNC Financial. They reported solid earnings. While the reports might seem comforting for investors because corporate profits are a reliable gauge of equity values, however analysts tracked by FactSet anticipate S&P 500 earnings per share for Q1, as a whole, to fall 4.2% from a year earlier. This estimate is based on the strength of the U.S. dollar, the rise in wages, the slowdown in economic growth and the cost of absorbing tariffs. While corporate profit is a reliable gauge of value and a gut check on whether business is good, the analyst's sentiment about corporate profits might not be enough to cut the enthusiasm of the stock market.

Furthermore, the latest edition of the BofAML "Rates and FX Sentiment Survey" which consults 66 funds managers across the Europe, Asia and U.S., suggests that it is time for more optimism. Few respondents think that the bond rally has further to go because they believe that the growth scare has been overdone and the central banks will be effective at warding off an economic contraction. Last week, I wrote that if the inflation content were to be stripped out of the yield curve it would neither be flat nor inverted. I argued that what we had was a bull inversion of the yield curve. I supported my thesis by the observation that real rates are low, the corporate yield curve is positive, and the term premiums are depressing yields of long duration. Now things are even better. The yield curve is no longer inverted, and the 10-year Treasury yield is safely above the yield of three-month bills. In other words, the yield curve being briefly inverted for only three weeks is hardly enough to bring about a recession. Consequently, the chance of having a recession is low and the probability that the economic expansion, albeit at the slower pace of 2.0%, will continue is high. Economists at Goldman Sachs just lowered the recession risk over the next four quarters to 10% from 25%. Meanwhile, the April WSJ survey of economists estimated that the economy grew 1.5% in Q1 and that it will grow 2.5% in Q2.

I suspect that other institutions will do likewise in the coming days. We may be skating over thin ice when it comes to Q1 earnings, but the Fed's monetary stance should protect the market from drowning.

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Why? The neutral rate (2.38%), which is the most important metric in monetary policy decision-making, is presently equal to the Fed's policy rate (2.38%) and it's an untouchable. On the contrary, the WSJ April economic survey predicts that the next rate-move for the Fed will be down. It means that the upcycle in Federal funds rate ended in December 2018 and the current target rate is neither stimulating nor restricting economic growth or inflation. In this connection, I'm clinging to the view that the U.S. economy will land softly in a two-plus-two pattern--i.e. 2% for inflation and 2% for growth. Federal Reserve officials see both the economy and monetary policy in a "good place". A few days ago, Fed Vice Chair, Richard Clarida, expressed an upbeat view on growth prospects with no sign of a recession in sight. He's probably right because bank credit is presently expanding at the moderate pace of 5.0% which is neither hot nor cold, suggesting that the Fed had indeed managed to find a policy rate that balances the supply and demand for money. The Chicago Fed President Charles Evans said: " I can see the funds rate being flat and unchanged into the fall of 2020 and for me, that's to help support the inflation outlook and make sure that it's sustainable at two or a little bit above."

Navigating the economy into a two-plus-two holding pattern is not going to be easy, given the President's relentless attacks on the Fed's even keel monetary stance.

But, given that the health of the economy, which comes down to the consumers' attitude and spending, is in a pretty good shape, it should help the monetary officials to remain steadfast. Interestingly, JPMorgan, the largest credit card issuer in the U.S., reported that spending on its credit cards jumped 9.8% to $172.5 billion in Q1, while the volume in its merchant business increased 12.7%. According to the Federal Reserve, consumer credit continues to grow at a steady pace building a solid start to the year. Moreover, it noted that surveys conducted by the Conference Board and the University of Michigan show that consumer confidence and sentiment are holding well, and economic conditions have improved. This was confirmed by the Conference Board Leading Indicators. The later rose 0.4% in March and all the index's components were in positive territory. On Thursday morning, retail sales confirmed the later point. Retail sales bounced back in March, exceeding optimistic expectations and surging 1.6%. Plus, the gains were widespread. Year-over-year, retail sales were up 3.6%.

The Outlook for the Canadian Dollar as of April 18, 2019

Since the end of December, the exchange value of the Canadian dollar has risen from 73.25 to 75 US cents. Technically, the short trend is currently neutral and stable with key resistance at 75.70 US cents and key support at 74.25 US cents. The Loonie is about 2.80 US cents below the estimated PPPR of 77.50 US cents.
The Loonie is an oil-sensitive currency and its exchange value will swing in near perfect correlation with the price of fossil fuels as long as the outlook for Canadian monetary policy looks the same as in the U.S. and Canada keeps on being a comparatively attractive place for foreign investments. In this respect, the Loonie may have found a new trading level with more upside than downside potential. That is if my view prevails that the Bank of Canada does not decrease its overnight rate for now, that capital inflows cover the trade deficit and oil prices stay where they are currently.

Macro View cont.

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a) The outlook for monetary policy in Canada

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. The Canadian Palos Monetary Policy Index, excluding the current account deficit, is 49 and the Bank of Canada Business Outlook Indicator shows that the economic conditions soured in Q1.The two indices are suggesting that the BoC could cut its target rate to 1.50%. However, the central bank will likely stay put for now. Yield-Curve Models, like the one the BNS relies on, show that the probability of having a recession in 2019 is only 17% and the current estimates for Q1 growth is around 1.2%. I think that Governor Poloz is banking on signals that Canada's oil industry is improving. Not only is the international price for oil higher but the spread between U.S. WTI crude and Canada Select has shrunk from $40 a barrel to $10, enough for the Alberta government to allow oil producers to raise output. Moreover, Poloz might be satisfied with its preferred measures of core inflation also edged higher in marger.

b) The relative attraction of Canadian investments

In the first two months of 2019, a considerable amount of foreign capital flowed into Canada—-about $44.1 billion. Many foreign and Canadian investors are attracted to Canada. The Equity Risk Premium for the TSX 300 is 481 bps compared to 318 bps for the S&P 500 and the TSX earning yield is 6.61%---5.44% above Canadian inflation expectation. Comparatively, the S&P 500 earning yield is 5.72%—377% above U.S. inflation expectation. Put simply, the TSX, adjusted foreign exchange, trades at 4.28 times the S&P 500 and significantly below the 5-year average of 5.7x.

c) The global oil complex:

Crude inventories are set to decline for the rest of year as Saudi Arabia and its oil partners curb output, while exports from Venezuela and Iran are squeezed by economic problems and political issues. Longview Economics opines that the balance between supply and demand will be reached by June of 2020. Consequently, International oil prices have rallied by about 35% since the end of December to $71 a barrel. During the period under review, U.S. oil prices also rose. On Thursday, WTI crude was trading at $63 a barrel. Recent information released by the Dallas Fed revealed that oil producers need $48 to profitably drill a new well. Since it costs about $10 per barrel to deliver this oil to the international markets, the equilibrium price is around $58. If the shale producers will take advantage of the excess profit, the North American oil benchmark will probably stabilize near $60. Based on a 7-AM proprietary model, the upcoming trend for crude oil will be neutral with key resistance at $64.47 and key support at $58.51.

The U.S. Outlook for Inflation as of April 18, 2019

Higher global energy prices provided a boost to various measures of U.S. inflation. Yet, three major underlying core inflation measurements reported last week continued to drift lower, a sign that inflationary pressures have eased. For example, import prices rose 0.6% in March to register a year-over-year increase of 0.0%. Excluding fuels, import prices are lower than they were last year by 0.8%. The recent upticks in overall headline prices should be transitory because oil prices should stabilize from hereon. As a matter of fact, the April consumer sentiment survey of the University of Michigan indicated that inflation expectations for the coming year have decline since October----from

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2.9% to 2.4%. Moreover, the NY Fed Underlying Inflation Gauge (UIG) has turned and is trending lower. The UIG in March was up 2.9% higher than last year. It was up 3.3% last November. The data points support the San Francisco Fed's view that cyclical core inflation is showing less momentum in this expansion than in previous ones. In the 1990-1994 period cyclical core inflation peaked at 4.25%, at 3.50% in 2005-2009, and at 2.50% in 2015-2018. Should this trend continue, as I expect, 2.00% core inflation may be the next low point.

The U.S. Outlook for Economic Growth as of April 18, 2019

- The consensus of forecasters is currently projecting a gain of 2.0% in Q1, with growth poised to accelerate to around a 3.0% pace in Q2.
- The NowCasting Model of the Atlanta Fed increased its view on Q1 growth from 1.5% to 2. 3%.
- The High Frequency Economic Model of Moody's Analytics estimate for growth in Q1 is 2.2%
- Continuum Economics upgraded its estimated growth for Q1 to 2.2%.

The Recession Risks as of April 18, 2019

- The St-Louis Fed Financial Stress Index is manifesting improving financial conditions. The bullish downtrend has been continuous and impressive.
- Goldman Sachs is suggesting that the recession risk is now only 10% compared to 25% a few weeks ago

The Outlook for the S&P 500 as of April 18, 2019:

So far, the April earning seasons has not been as bad as many expected. There are been several bullish surprises. Nevertheless, the outlook for U.S. stock market is mix. Tom Essay's Sevens Report shows that his technical view is that "the price action of the last few days largely validates that a lot of good news on trade, global growth and central banks is price in". Yet, we have a bullish "Head & Shoulder" meaning that if the market breaks the S&P 500 2940.91 high, Larry Fink of BlackRock believes that we could get a melt-up. That said, reliable market indicators are essentially neutral to mildly bullish.

- The ERP (3.18)/ CNN F&G (71) ratio is 44, steady but neutral
- The VIX (12.60)/CNN F&G (71 ratio is 18, declining, therefore a bit rich.
- The Rule of 20 which is the addition of the 12-month Forward P/E (17.4) plus the five-year inflation expectation (1.8%) is 19.2--that is below 20 and therefore mildly bullish.
- The S&P 500 (2900)/ Gold (1276) ratio is 2.3 times and rising--a usually good indication of sentiment. The ration is bullish, sensing that the market is going up because inflation and geopolitical fears are receding.
- The yield curve 10's (2.59%) minus 3's (2.43%) /VIX has significantly improved in the three weeks.
- Also, positive yield curve combines with declining gold prices often brings positive stock market returns.
- The April Empire State Manufacturing Survey indicated that business conditions are improving in NY state, the top-line index climbed 6 points to 10. The showing was best so far this year.

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The U.S. Recession Risk:

- The University of Michigan's preliminary report on consumer sentiment slip in April. The index was 96.9 compared to 98.4 in March. The perception of those who were surveyed was that economic conditions had improved.
- The NY FED's yield curve model shows that the probability of a recession 12-months ahead is 27%.
- The High Frequency Model of Moody's Analytics says that there is a 26 % chance of a recession in the next 6 months.
- The March WSJ survey shows that the chance of having a recession in the next 12 months is 25%.
- The Deutsche Bank Research believes that there is a 20% chance of a recession in the next 12 months.
- 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.

Technical Outlook for U.S. Ten-year Treasury Yield as of April 18, 2019

- 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%

The Technical Outlook for the S&P 500 as of April 18, 2019

- 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
- 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.
- The Rule of 20, which is the addition of the 12-month forward P/E multiple and 5-year inflation expectation, stands at 19.5 - market neutral
- ERP/CNN ratio is 47, suggesting that the market is a bit rich. But the trend is positive.
- 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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