CONTENTS

Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narratives of May 2, 2019

Say’s Law and Productivity Is the Big Story

Of all the data points that are printed in press, the GDP is far and away the most important one. Last Friday, the Bureau of Economic Analysis (BEA) gave us an advanced read on how well the U.S. economy fared in Q1. The U.S. economy expanded at a flashing 3.25% annualized pace. It dramatically exceeded expectations by a country mile. The best guess was 2.8%. The consensus was 2.3% and the range of forecasts was 1.1% to 2.8%.

The BEA explained what happened in the following terms: “The acceleration in real GDP in the first quarter reflected an upturn in the state and local government spending, accelerations in private inventory investment and in exports, and a smaller decreased in residential investment. These movements were partly offset by decelerations in personal consumption expenditures and non-residential fixed investment, and a downturn in federal government spending. Imports, which are a subtraction in the calculation of GDP, turned down.”

On the surface, it would appear the economy is not as strong as the eye-catching headline suggests. Excluding inventories, trade and household spending on durable goods, the economy grew at just a 1.0% annual rate. That is what occurred on the demand side of the economy but it’s not the full story. The BEA never gives more than a skin-deep analysis. In other words, it is up to market economists and investment strategists to look under the hood and try to figure it out what runs the economic engine.

An economy is a very complex system. The complexity stems from the fact that it has two faces--a production side and a spending side. In other words, workers with the aid of capital produce goods and services for wages and profits which in turn they sell to consumers and investors for a price. In a perfectly tuned market economy, demand clears what is supplied at an agreed price. This supply/demand equation brings forth the following question. What comes first the chicken (demand) or the egg (supply)? Based on write ups by columnists on what went on in the U.S., one would conclude that there is only one facet of the economy that counts--the chicken. That is the wrong way to see things. I invoke Say’s law--- supply creates its own demand. As a rule, when demand does not consume what is produced, it’s because the price is not right. And, this is what is happening, price levels are too high to clear the market.

Macro View cont.

By Hubert Marleau

In the March quarter of 2019, American workers generated at a seasonally adjusted annual rate $21.0627 trillion worth of goods and services for a 3.8 percent annualized rate of increase from Q4/2018. During this short period under review, employment accounted for only 0.1% of the gain, productivity for a whopping 2.8% and inflation for 0.9%. Unfortunately, aggregate spending increased at the seasonally adjusted annual rate of 3.3% - not enough to swallow all the output produced by the increasing efficiency of workers. Put simply, not all the workers' production was taken up by the buyers, creating the surplus of 0.6% between quantitative supply and quantitative demand. The 0.6% gap ended up on shelves and in warehouses - $128 billion on an annualized basis. This phenomenon is not new. The Commerce Department reported that changes in private inventories were also up in the third and fourth quarters of 2018–increasing $92.7 billion and $107.5 respectively. Goods come from variable sources. They are either imported from abroad or made in America. But industrial production has slipped, and imports have fallen. So, what is it? In my view, there is only one explanation, prices are not low enough to clear the market.

Taking into account that both the money supply (M2) and personal income are running at the annual rate of 4.0%, while producers are pushing the N-GDP at the annual rate of 5.0%, price levels will need to fall to attract buyers and/or consumers and will need to tap their financial resources to pay the demanded price. It will likely be a bit of both because 1) large productivity gains will tend to offset rising wage rates, decrease unit labour cost thus lowering prices and 2) elevated levels of personal savings suggest that the consumers have room to spend. I estimate, through a proxy that considers real output, employment and hours work, that productivity increased 2.0% form a year ago and that the amount of money that individuals saved is about 8% more than they did last year. In this regard, the University of Michigan Consumer Sentiment Survey shows that confidence has recovered from its swoon early in the year. The majority of Americans is saying that they are personally experiencing improvement in their finances. This renewed optimism led to a strong pick up in retail sales in March, rising 1.6% - the best month-over-month increase in a year and a half. Things are looking up because the quarter ended on a strong note. Income and wages are rising faster than inflation because productivity is rising, the Fed is on a wait-and-see monetary stance and the global outlook has improved. The ECB is launching a new program of monetary stimulus, Japan passed a new fiscal stimulus and China has enacted tax cuts. It's easy to punch holes, it makes for a flashy front-page story. But it is not the story.

The big story is PRODUCTIVITY. Productivity has been on a tear since the first quarter of 2017. Year-over-year gains in productivity went from minus 0.3% to plus 2.0% in the first quarter of 2019. Despite living proof, the majority of investment strategists and economists are either supply-side skeptics or ignorant of the trend. As a matter of fact, there are hardly any comments in the press about the productivity phenomenon. Yet, there are emerging signals that the supply side of the economy is becoming energized. Workers are increasingly using tools, machines and computer-run robots to efficiently produce goods and services. It's not the first time that I have brought this up on these pages. It's been my mantra for years on which I have based my optimism on the future. For years, serious amounts of capital have poured into information processing equipment, industrial equipment, software, and R&D. For example, in the first quarter of 2019, businesses invested $1.558 trillion in these efficiency-producing programs for a yearly increase of 7.1%.

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I see that a few are closing ranks. Macroeconomic Advisers, a modelling firm, has a higher year-over-year estimate for productivity gains than mine for the first quarter of 2019. They have an estimate of 2.3% versus my 2.0%. Between 2010 and 2017, productivity growth averaged just 1% per year. Renaissance Macro Research is of the view that the economy is in the “Goldilocks Scenario” of good growth and benign inflation - all because of productivity. In some ways, today’s economy feels like the late 1990s. The last time the economy experienced a supply-side acceleration was in the 1997-2000 period - growth was robust, unemployment was low, inflation was meagre, wages and profit were rising. Moreover, the Fed was able to avoid raising rates for much longer than originally expected and had enough leg room to trim rates when the global economy wavered in 1998. It’s not that I think that the potential growth is about to shift into high gear, running at the annual rate 3.0% or higher. But what I see is that productivity is replacing labour as the engine of growth. In connection, II revised my previous two-plus-two economic pattern to 2.2 percent for growth and 1.8 percent for inflation.

U.S. Monetary Policy as of May 2, 2019

As expected, the monetary authorities decided to keep their policy rate on hold at 2.38% and reiterate their “patient call” despite a positive economic assessment of higher growth, moderate price inflation and lower recession risk. They disregard the politically motivated demands of President Trump to cut benchmark interest rate by one full point and restore QE.

Moody’s High Frequency GDP Model is projecting a growth factor of 1.7% for Q2 while the Atlanta Fed’s Now-Casting Model has a lower but positive forecast of 1.3%.

All meaningful readings of inflation are below the Fed’s inflation target. March data showed headline inflation measured by the Personal Expenditure expenditures Deflator (PCED) was just 1.5% y/y. Besides the PCED, the Fed monitors the core rate, excluding food and energy; it slowed to a 14-month low of 1.6%. Interestingly, the Cleveland Fed’s Inflation Nowcasting model is calling for an annualized rate of increase in the Core PCED of 1.2% for Q2. It should be noted that productivity is doing better than I calculated. This morning the BLS officially reported that productivity increased at the annual rate of 3.6% in Q1 versus my 2.8% estimate. Year-over-year, productivity rose 2.4% versus my calculation of 2.0%. Productivity is offsetting wage inflation - unit labour cost is up only 0.1% from a year ago.

Goldman Sachs now believes that the chance of the U.S. encountering a recession within the next 12 months is only 10%. Moody’s Analytics is professing that the probability is 21%, down from 26% in April. Moreover, the yield curve (10-years minus 3-months) is now positively signalling that there are less recessionary pressures.

Finally, the Fed needed to show some independence by defying relentless political pressure while making sure that it does not disappoint dovish expectations. They sympathetically acquiesced, for technical reasons, by increasing the rate of interest paid on excess reserves to 2.35% from 2.34% - certainly enough to erode the credibility of the monetary officials.

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Considering where the neutral rate (2.38%) and the current flatness of the yield curve in addition to the statutory mandate of fostering full employment and price stability, the Fed did the only thing that could have been expected. However, Chairman Powell, said during the press conference that the central bank is still watching intently for a rebound in persistently sluggish inflation and argued that temporary factors might be holding down inflation. Without proof or evidence other than an arcane discussion of the elements that make up core inflation he suggested recent inflation weakness could prove fleeting as one-off factors dropped out of inflation calculation. Blaming low inflation on apparels is a bit too much.

As reported in the FT, he resisted questions aimed at eliciting a discussion as to the possibility of “insurance rate cuts” proposed by his confreres (Charles Evans, the Chicago Fed president, and Richard Clarida, the Fed’s vice-chair) may be considered. Conversely, the Federal Reserve Chair downplayed tepid inflation and did not want to prepare the market for a possible rate cut. The bottom line is that the Fed wants to leave the policy rate where it is--intact with no bias in either direction. The markets do not like the idea that subdued inflation might be the sole cause of “transient or idiosyncratic” factors. The push back against the suggestion that a rate cut was a real probability caused gold, copper, short bond and stock prices to fall and the dollar to advance.

Friday’s job report will be more important than how sensitive the markets are to turns of phrase. A middle of the road employment report would validate the Fed’s monetary stance of keeping rates here. The ADP non-farm employment for April supports the Fed’s decision as the correct posture. It appears that the job market is holding firm as business work hard to fill open positions. Job gains may overstate the economy’s strength; but they make the case that the economic expansion continues.

The Outlook for The Canadian Dollar - As of May 2, 2019

Yesterday, I lowered my estimated Purchasing Power Parity Rate (PPPR) of the Canadian dollar to 75.75 US cents. It’s presently settling in the foreign exchange market for 74.35 US cents. If it were not for the renewed upward trend in the price of exportable Canadian oil, the Loonie would be trading at an even larger discount to its PPPR. Last week, the Bank of Canada lowered its neutral range rate to 2.25% to 3.25%, citing additional information and improved modelling. The central bank may need to do more work on this one. How can it be that the Canadian neutral rate is the same as in the U.S. when the Canadian economy is doing so poorly compared to the U.S. The best annualized growth estimate for Q1 growth is 0.7% and the Bank of Canada has cut its estimate to a low 0.3%. The Canadian neutral rate is 1.50%--that is 75 bps below the U.S. neutral rate. It would seem that the Canadian monetary policy is significantly more influenced by what is the monetary policy in the U.S. than whatever power the White House may over the Fed. The forex market is not dumb, a neutral rate differential of 75 bps is enough to make traders aware that Governor Poloz will eventually need to address this anomaly with at least one rate cut. This market expectation is negatively influencing the Loonie and, in turn, keeping its value lower than it ought to be.

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