PALOS

Palos Weekly Commentary

Issue **No. 29** | **JULY 18** 2019

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Macro View

By Hubert Marleau

The New Monetary Gauge Is the DXY Because Trade Deficit Prone Countries Like the U.S. Believe That Economic Success Is "Every Nation for Itself Rather Than Cooperation".

Under normal circumstances, the blowout June Job report, the strong June retail announcement and the hot June CPI print would have been enough for the Fed to contemplate a rate hike. The Palos Monetary Index stands at 283, substantially above its neutral point of 100. Moreover, the inflation content of the Misery Index is also above its 25% neutral point at 31%. Import duties are filtering through in the inflation numbers in various ways. As a matter of fact, two non-voting regional Fed Chairs have disputed the necessity and merit of being more accommodating than the Fed already is. The goals of sustainable employment and price stability are being met. Their concern is that moving in Powell's indicated direction may result in a costly policy mistake.

Yet, the Fed Chairman Jerome Powell, speaking before the Senate Banking Committee, proclaimed that the economy is in a very good place and we can use several tools to keep it there. Thus, he cemented a 25-bps rate cut at the end of July. While there's rarely a risk-free choice in central banking, the Fed nevertheless has justified its view on two grounds. It now believes that the 1) neutral interest rate and the natural rate of employment is lower than originally thought and 2) overall financial conditions are supportive for growth on the premise that market expectations for an easier monetary policy will be met. On this last point, the St. Louis Financial Stress Index has been firmly moving lower for weeks.

In these connections, recession indices that calculate the chances of having an economic contraction in the next twelve months have considerably diminished. The yield curve has bullishly steepened, the newly calculated neutral rate calls for a minimum decrease of 50 bps in the policy rate by December and long-term bond yields have edged up. If the economy will maintain a two-plus-two pace—2% for inflation and 2% for growth—ten-year bond yields (2.10%) should trade between 2.40% and 3.00%. The 30 to 90 bps gap is the cost that foreigners are willing to pay for insurance against a recession. How long are they going to pay that price, if the perception turns negative on the dollar?

Macro View cont.

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While short-term interest rates are highly directed by monetary policy, long-term treasury yields are very sensitive to likely perceived exchange rates. Importantly, the Dollar Index (DXY) is down significantly from a year high of 98.21. This morning the dollar index was 96.72.

On the surface, it may look as if the independence of the Fed has not been shaken. However, the prospective monetary stance will be undermined by worsening business confidence linked to trade tensions which are disrupting worldwide supply-chains and, in turn, slowing worldwide manufacturing growth.
The best way to inoculate the U.S. economy from being shot in the back by tariff bullets is with the exchange rate. There is ample empirical evidence and theoretical validity that when monetary policy is easier than it ought to be, the bet for a weaker currency often wins.
And, the best way to undo the worldwide damage of realized or threatened tariffs and prevent the international slowdown from dragging down the U.S. is with easier money.

Given that the other major central banks are running short of monetary ammunition, it has put the Fed on the spot to underpin global growth. It would not be the first time that the Fed has shifted its monetary stance in response to economic changes in the outside world. In 2016, it scaled back plans to increase rates when the Yuan's abrupt decline shook the financial markets and in 1998 when it cut rates three times in rapid-fire succession as Russia's debt default rock the world.

It would not be a giant leap for the Treasury to initiate some active foreign exchange intervention. Competitive easing, trade wars and currency manipulation are inherently related. And, we already have extraordinary monetary policy. It does not take a lot of hard thinking to see that the application of an easy monetary stance, either by reducing rates or quantitative easing can indirectly target the currency. Negative interest rates in Japan and Europe are tantamount to monetary debauchery. There is little to wonder about why the U.S. dollar is so overvalued and why the above countries have gargantuan trade surpluses. If for any given reasons the U.S. were to succumb to some deflation, be assured that the U.S. administration would take the global currency war to a whole new level and weaponize the Federal Funds rates.

Macro View cont.

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The Economist has a Big Mac Index that may not be a precise gauge of currency misalignment but good enough to give a global various exchange rates vis-a-vis the U.S. dollar should be. For example, the U.S. dollar is generally overvalued---10% against the Loonie, 20% against the Euro, 29% against the pound and 35% against the yen. In a world where the dollar becomes the barometer in an age where currency wars dominate the headlines, the Fed has a lot of leeway. It can remain on an easier stance than it should and easier than any of its trading partners. The median estimate of currency strategists surveyed by Bloomberg is for it to fall to 95 by December. But few are considering that it could go below 90, if the U.S. were to officially abandon the strong-dollar policy. Such a shift would be a game-changer. As a matter of fact, there is more to it than that. There is an offshore dollar deficit which needs to be corrected and can only be done by printing more money. Many international investors are either avoiding the dollar or international borrowers can't find dollars to fund their needs. Last week's bond auction was a disaster. In mid-2014 the dollar index was around 80.

It could turn out to be a truly amusing development. The expectation for lower borrowing costs combined with a lower dollar could do wonders for risky inflation-type assets. And in that regard, core consumer prices shot up in June. The thinking is that if inflation is really accelerating, then perhaps many companies will be able to pass on price increases to consumers, reversing the present trend toward narrower profit margins—the cause of weaker earnings in Q2.

The same conditions were experienced in the 2012 to 2015 time period, when the S&P 500 did very well. It was known as the TINA (There Is No Alternative) market. The Fed was holding rates low giving no other choice than to buy equities. If one looks at all the initial rate cuts since 1954, they have tended to push the stock market up in the following year. Audrey Kaplan, the head of global equities at the Wells Fargo Investment Institute, observed that the S&P 500 gained about 14% on average the year after the Fed's first cut. The gains worked 13 times out of 16 instances. While these probabilities are good, it should be noted that rate cuts work well until they become insufficient to offset employment weakness and/or become too stimulating to contain inflationary pressure. This off course can bring about difficult consequences unless productivity fills the gap. Barring the possibility of more political polarity and/or geopolitical risk, the recent increase in efficiency will likely carry the day. Efficiency tends to lower inflation and raise productivity.

Macro View cont.

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Few recessions are the outcome of financial crisis. They have usually been associated with inventory cycles. Until recently, price signals did not travel quickly, and businesses track inventory manually. Today, price signals which move around the world in nanoseconds and enterprise software that use digital cash registers, bar codes and logistics, have perfected the just in-time supply chain. The data that are derived from these are fed into machine learning apparatus that customize and implement business processes. This practice of connecting manufacturing, transportation and retail is now ubiquitous, magically delivering inventory just as it's needed and finding patterns to squeeze out more efficiencies. Economic trackers are pretty sure that should a recession emerge it would likely stem from inventory adjustments attributable to the disrupted effect of tariffs.

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