PALOS

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Palos Weekly Commentary

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Macro View

By Hubert Marleau

Where the U.S. Monetary Policy Stands

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The rationale for the Fed's last round of rate cuts may not be what the officials had broadcast earlier. The official explanation was that it was an insurance policy to reduce the risk of bad outcomes. As a matter of fact, the Fed cut interest rates in 2018 without clear evidence that the business cycle had turned. On Monday, the truth came out. In a prepared text, Chairman Powell said that the central bank had cut interest rates in 2019 in part because officials concluded that the economy, the labour market and general inflation weren't as strong as anticipated when they lifted rates in 2018.

Given that the contraction risk did not materialize, the monetary authorities should reverse its policy rate with at least one upward adjustment. The S&P Global Ratings says that there is now a 30% chance that the U.S. economy will enter a recession in the next 12 months, scaling back the 35% recession risk it foresaw in August. Additionally, the economic outlook for 2020 has improved and we've seen some mild but rising inflationary pressure. The High Frequency Model of Macro Advisors is tracking a growth factor of 1.9% for Q4. Consumer sentiment fell a bit in November but not enough to jeopardize confidence that the economy will continue to roll on. The Palos Monetary Policy index has risen above the 100.0 threshold suggesting that the Fed should contemplate some tightening.

Yet, Chairman Powell argued on Monday that the Fed has now entered a "quiet period" ahead of the next interest rate decision because it wants to wait and see how the trade war along with other risks to growth and inflation shake out. I think that the less obvious but real reason not to reverse the federal funds rate is the growing realization that the neutral rate is a lot lower than estimated and the yield curve sits well for

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the current stage of the business cycle. The CME FedWatch Model is predicting that there is a 95% chance there will not be any more rate decreases this year. Based on our calculation, the neutral rate is 1.62%. That is exactly where the midpoint of the Federal Funds rate is. Meanwhile the curve is out of the danger zone that characterized most of 2019. Moreover, the performance of the U.S. dollar has also stabilized, suggesting that the foreign exchange market is satisfied with the Fed's monetary stance.

Investors should take note that there is a growing body of international market strategists and economists who believe that the trading activity of the DXY (a weighted basket of foreign currencies) which has been boxed in an unusual five year period of relatively low volatility could presage a new bearish cycle for the dollar. Cross border funds have started to flow to foreign entities reflecting that R-GDP growth deviation from potential is much larger in the rest of the world than in the U.S..

Acknowledgement of these circumstances combined with renewed hope of a favorable resolution of the trade dispute, has bullishly permeated the market, resulting in a mini melt-up. In this connection, I strongly suspect that the yield on ten-year notes will reach 2.00% by the Q1/2020 and that copper prices will head towards $2.85 a pound.

Looking at the 11 Sectors of the S&P 500 by the Numbers:

Name	Index Weight	10-Yr Annualized Total Return	Current Dividend Yield	P/E	P/B	P/S	Comment	Dependency
S&P 500 INFO TECH INDEX	22.8%	17.58%	1.3%	25.35	7.57	4.94	Growth	Future
S&P 500 HEALTH CARE IDX	14.1%	15.03%	1.7%	21.38	4.45	1.78	Growth	Age
S&P 500 FINANCIALS INDEX	13.1%	11.68%	2.0%	14.16	1.49	2.45	Neutral	Interest Rates
S&P 500 COMM SVC	10.4%	10.21%	1.3%	21.93	3.46	3.11	Growth	Innovation
S&P 500 CONS DISCRET IDX	9.8%	17.99%	1.3%	24.42	8.13	1.74	Growth	Inequality
S&P 500 INDUSTRIALS IDX	9.3%	14.06%	1.9%	19.40	5.04	1.85	Cyclical	Exports
S&P 500 CONS STAPLES IDX	7.2%	12.12%	2.8%	21.39	6.17	1.57	Defensive	Population
S&P 500 ENERGY INDEX	4.3%	2.75%	4.0%	18.09	1.53	1.10	Cyclical	Gas & Oil
S&P 500 UTILITIES INDEX	3.3%	12.76%	3.1%	20.67	2.24	2.68	Defensive	Bond Yields
S&P 500 REAL ESTATE IDX	3.0%	12.57%	3.1%	50.05	3.82	7.04	Defensive	Population
S&P 500 MATERIALS INDEX	2.7%	9.82%	2.1%	19.69	2.45	1.78	Cyclical	Global

Source: Bloomberg

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