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Palos Weekly Commentary

Issue No. 50 | DECEMBER 13 2018

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Macro View

By Hubert Marleau

The Weekly Narrative: Week Ended December 13, 2018:

What's Going in Canada?

The Bank of Canada decided to keep interest rates on hold last week because the state of the economy did not justify one. Governor Poloz was right to do so on three counts. In the quarter ended September 2018, the Canadian economy lost a great deal of momentum, was not operating at full capacity as previously believed and the energy sector was hit hard.

Growth in Q/3 slowed to an annual rate of 2.0% from 2.9% in Q/2. If one were to subtract inventories, the trade balance and government spending, the level of economic activity would have contracted at an annual rate of 0.6%. It is clear that the effects of rising interest rates and of sluggish equity markets are hurting the cyclical sectors that are sensitive to financial conditions. What is troublesome is the very poor performance of business investment, which retreated at an annual rate of 7.0%. Business spending on equipment and machinery decreased at a 10% annualized rate. This is very bad because productivity is going nowhere. According to my calculation, productivity increased only 0.4% in the last twelve months. It is hoped that the recently announced $16.0 billion package of tax breaks and investments for business will address the country's competitiveness. However, there are doubts whether this approach will produce the desired result because a big chunk of the tax incentives will be directed into clean energy investments to meet the commitments of the Paris Climate Agreement. Furthermore, U.S. tax reforms which slashed corporate taxes to 18.7% pose a big competitive challenge. It should be noted that the acceleration in depreciation allowance will reduce the effective tax rate on corporate profit to 13.8% . The new measures should help. They provide the cash flows needed to enhance productivity.

Encouragingly, Canada's job market showed surprising resiliency in November. Employment increased 94K, led mostly by full-time jobs that were broadly-based across industries. Economists were only expecting a gain of 10K. The biggest surprise was the increase in the labour force. It grew by 77K, driven by rising population and participation rates. Plus, actual hours worked were up 2.1% in November from a year ago and wages registered an annual gain of just 1.7%. These numbers prove that there is slack left in the economy.

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Lastly, the energy sector is getting a lift from Alberta Premier Notley's order to reduce oil production. The measures have significantly reduced the price differentials between Canadian and US oil prices. In defence of the energy sector, the Alberta government is distancing itself from the environment lobbyists. Premier Notley is cancelling planned increases in the Provincial carbon tax, supporting investments in refineries and upgrades and buying rail cars to move crude to markets. Additionally, there is a limit to how long Alberta will tolerate the lack of pipelines to carry its oil to east and west water ports. Something will eventually give - perhaps the Canadian equalization arrangement.

It seems probable that we are heading back to a "2 plus 2" economy with sufficient leftover capacity to keep the pace of the economy in a "Goldilocks scenario" for a few more years if the Bank of Canada has the smarts to keep its policy rate near neutral. The Bank of Canada pegs the Canadian neutral rate between 2.5% and 3.5%. I think that the estimate is way too high and way too broad. I understand that the neutral rate is not a fixed point. But, it's not a broad range either. I fail to understand why the Bank of Canada does not acquiesce to the idea that the neutral rate is a moving target which can be derived from the market stats, economic data and inflation. Poloz says that "he does not know when we will arrive at neutral until we get there". So the central bank is using a "wait and see" approach. This kind of attitude on the part of monetary authorities is what causes policy errors. This is the narrative that the market is listening to. No wonder the market is as volatile as it is. It's a dangerous game to play because it is easy to miss the train. I am fully aware that my estimate of the neutral rate is a bit elusive and not precise. Nevertheless, I prefer to have a floating estimate of where that point is at any given time rather than let it go by. In this connection, I carefully watch the five-year government bond yield less the two-year bond yield. When that spread is zero, the six months interest rate is the neutral rate. I also carefully calculate the differential between the annual increase in wage rates and productivity in order to get a feeling of whether inflationary pressures are intensifying or not. Lastly, I look at how household and business spending on interest sensitive items is doing. Household credit growth has softened to a 35-year low for a yearly increase of 3.5% in October. Surely, the Bank of Canada is aware of all of these data points and will be smart enough to keep the policy rate low enough to avoid a policy mistake.

Put simply, I look attentively and vigilantly at the aforementioned indicators to spot what the neutral rate could be. The spread between the neutral and policy rate can signal opportunities to either buy or sell securities. At this time, the neutral rate, according to my calculations, is 2.125% for a positive spread of 37.5 bps over the policy rate of 1.75%. Given that the Bank of Canada has put on hold further rate hikes, the stock market should recover at the expense of the Canadian dollar and long-term bonds. If the Canadian monetary authorities were to keep, as I expect, the overnight rate below 2.125%, the TSX might surprise the doomsayers.

It's hard to fight narratives, even false ones. The newsreels speak endlessly of the trade gap, tax gap, productive gap, budget deficits, growth gap, and the energy gap. In the end, the weak loonie and low interest rates will rectify the problems. Then new headlines will appear on the front page of newspapers and the narrative will change, providing the potential for large stock gains. As was shown in the last two weeks, the Canadian stock market is selling at an

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enormous discount. Incidentally, Black Rock noted this morning that Canadian stocks have a large value advantage over U.S. equities. Canada has not been this cheap in 30 years.

New Technical Perspectives as of December 13, 2018—Sevens Report

1) Based on the Dow Theory, the trend for the S&P 500 turned bearish with key resistance at 2790 and key support at 2581 - on Thursday morning the S&P 500 was 2654.

2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $57.03 and key support at $46.31 - on Thursday morning crude traded around $51.00.

3) Based on a proprietary model, the trend for gold turned bullish with key resistance at $1290 and key support at $1201 - on Thursday morning gold was selling for $1246.

4) Based on a proprietary model, the trend for ten-year treasury yield is bullish with key resistance at 3.08 % and key support at 2.73% - on Thursday morning the yield was 2.91%.

5) Based on a Palos Currency Model, the trend for the Canadian dollar is bearish with resistance at 76.24 us cents and key support at 74.51 us cents - on Thursday morning the loonie was trading for 74.78 us cents.

The Palos High Frequency Model in Real Time and U.S. Recession Risk and Growth Reports.

I. Moody's Analytics is predicting that there is a 15% chance of a recession in the next six months.
II. The WSJ is predicting that there is a 30% chance of a recession in the next 12 months.
III. Moody's Analytics is predicting that the economy will grow at the annual rate of 2.8% in Q/4.
IV. The Atlanta Fed is predicting that the economy will grow at the annual rate of 2.4% in Q/4.
V. The Cleveland Fed is predicting an annual rate of inflation of 1.5% for Q/4.
VI. The St-Louis Fed is predicting that the economy will grow at the annual rate 2.7% for Q/4.
VII. The WSJ is predicting that the economy will grow at the annual rate of 2.6% in Q/4.
VIII. The Marleau-Palos Model is predicting that the economy will grow at the annual rate of 2.3% in Q/4 and a 20% chance of a recession in the next nine months.

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N.B. The aforementioned forecasts and predictions will be revised on a weekly basis with new data points. The Marleau-Palos Model is comprised of financial, monetary and economic variables and are integrated into the model on a daily basis. It should be noted that there have been many market corrections since 1947. But there have never been any bear markets without a recession. And, bear markets do not lead recessions. They correlate with them. The 1987 bear market was a flash and a technical problem that was quickly fixed.

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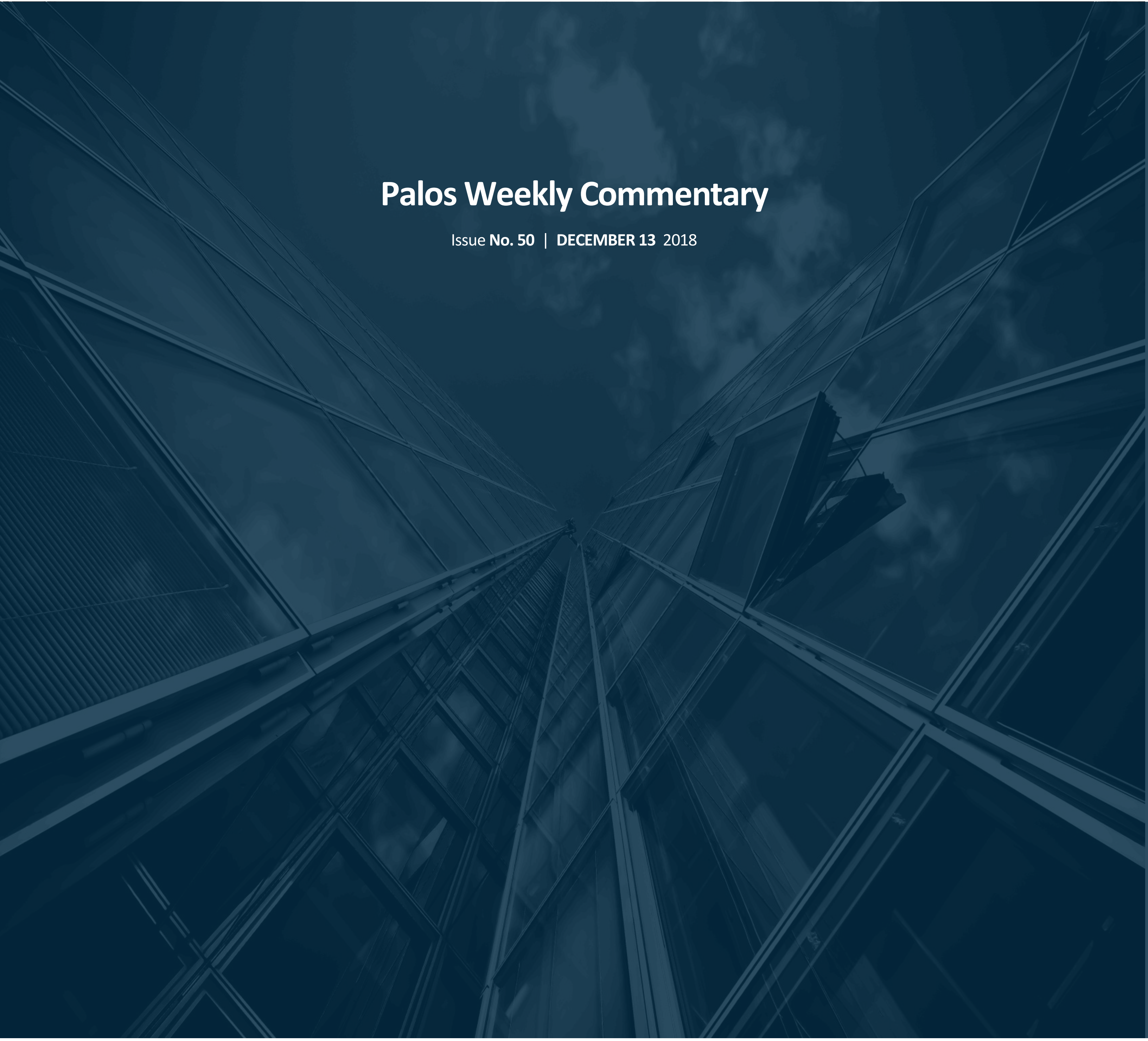

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