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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative: Week Ended December 20, 2018:

The Fed's Monetary Stance: A Mild Dovish Shift. Not Enough to Satisfy the Market. Yet, Enough to Expect a More Dovish Stance in 2019. Powell is Confident That the Economy Is Healthy, Betting That the Market Is Wrong.

All eyes were focused on the Fed this week. Bond traders were convinced with 66% assurance on Wednesday morning that the Fed was going to tighten policy in a dovish manner on December 19 because they were much less certain about whether the fast pace of the economy was sustainable. It explains why financial conditions have changed. Credit spreads are up, the equity risk premium is up, the U.S. dollar is up, and real rates are up. A good part of this change was caused by the algorithms of hedge funds. Hedge funds raised record amounts of money for new launches in 2018; but they are having a hard time turning the new bounty into profits. They sold stocks and/or shorted them in November and December, in a low volume environment, to send a message to the Fed that enough is enough. Hedge fund operators know very well that the Fed usually does not raise interest rates when financial conditions deteriorate quickly as they have in the past 30 days. At this point in time, the S&P 500 is down over the last three, six, and twelve months, a backdrop that has accompanied just 2 of 76 rate increases since 1980, Bloomberg's Lu Wang reported.

As bond traders expected, the FOMC decided to raise its policy rate to 2.375%. As a matter of fact, the Palos Monetary Index which takes into account price stability, the viability of the trade balance, economic growth, and employment suggests that the Fed had no other choice than to increase interest rates at least one more time. Consequently, the Fed's policy rate is now one notch below neutral meaning that the effect of this decision will neither speed nor hamper economic growth and will not materially change the course of inflation. The Fed thinks that the neutral rate is 2.80%.

Fed Chairman Jerome Powell cushioned the increase with signals that the monetary officials are willing to stop the tightening process, if the domestic evolution of financial, monetary and economic conditions warrants it. Furthermore, Powell is now unshackled and can, therefore, respond to unforeseen events, big meaningful data points, and market expectations at home and abroad. In other words, the Fed wants the market to believe that the monetary stance will be totally data dependant and that the monetary authorities will, therefore, either raise, pause, or even decrease rates from hereon. Unfortunately, the Fed moves slowly and takes one small steps at a time. The direction is changing but

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not fast enough to satisfy the drummers who want the Fed to come to a full stop. The algos went ballistic because they neither saw nor herd the word “pause”.

Investors should bear in mind that all previous FOMC meetings since December 2015 came with a cue that the Fed would continue to lift borrowing costs. The paring of previously anticipated rate increases for next year is significant. The Fed is aware that there is as much risk of over tightening as under tightening. In a world of low inflation, low neutral rate and slow recuperation from the financial crisis, small increases in interest rates can have a weighted effect on monetary policy and expectations. If the target rate is to stay where I think the neutral rate is at 2.625% or even higher at 2.875%, it would be about half its average from 1950 to 2007. More importantly, it would prevent the yield curve from inverting and permit the quantitative tightening program to do its job on its own, reducing the risk of conducting a two variable monetary stance at the same time.

It should be borne in mind that the profit return on invested capital has consistently been around 9.50% during the aforementioned period - 1950 to 2007. In Q/3 the annual rate of return on business investment was 9.57% - $2,250 billion of corporate profit over $23,500 billion of invested capital. Put simply, the current spread between the return on capital and the cost of money is large enough at roughly 7.00% to lure capital into corporate investment plans. It’s true that international credit and global trade is slowing. But it has been doing so in a moderate fashion. Yet, the markets have been behaving as though we are heading into a recession now. On the contrary, the Big Macro Indicators are suggesting that the economy is slowing toward a “2 plus 2” economy and not falling down. Yes, the yield curve has flattened but real fed fund rate is only 0.25%. It’s absurd to think that a recession is in our midst. History shows that real rates need to be at least 3.25% in order to get a recession. Recent economic data remains solid. Employers are hiring, and retail sales have been strong and so has industrial production. Weakness is concentrated in rate-sensitive items like housing, autos, and other durable goods. This is further proof that the federal funds rate is approaching neutral state.

According to the Global BlackRock Geopolitical Risk Indicators (BGRI) markets are behaving badly due to geopolitical uncertainties and according to Moody’s Analytics Policy Uncertainty Index markets are doing badly because of domestic political problems. These two indicators are telling me that stocks are selling at basement price levels. There are bargains in the stock market that represent huge unconventional opportunities. Markets ultimately reward investors who remain disciplined and have the courage to place bets when fear is in the air.

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New Economic Perspectives and Recession Risk as of Dec 20, 2018:

I. Moody's Analytics is predicting that there is a 15% chance of a recession in the next six months.
II. The Marleau-Palos Model predicts that there is a 20% chance of a recession in the next nine months.
III. The WSJ December survey predicts that there is a 30% chance of a recession in the next 12 months.
IV. A survey conducted by Reuters in December mark-up the probability of a U.S. recession in the next 24 months to 40% from 35% in November.
V. Moody's Analytics predicts that the economy will grow at the annual rate of 3.0% in Q/4—up from 2.8% last week.
VI. The Atlanta Fed predicts that the economy will grow at the annual rate of 3.0% in Q/4—up from 2.8% last week.
VII. The Cleveland Fed predicts that annual rate of inflation will be 1.5% in Q/4—same as last week.
VIII. The St-Louis Fed predicts that the economy will grow at the annual rate 2.7% for Q/4
IX. The WSJ December survey predicts that the economy will grow at the annual rate of 2.6% in Q/4
X. The Marleau-Palos Model predicts that the economy will grow at the annual rate of 2.5% in Q/4—up from 2.25% last week.

N.B. The aforementioned forecasts and predictions are revised on a weekly basis with new data points.

The Marleau-Palos Model is comprised of financial, monetary and economic data. The variables are updated at the closing of markets every day. It should be noted that there have been many market corrections since 1947, but few turned into bear markets. There has never been a bear market without a recession, except for the technical crash of 1987. Bear markets do not lead recessions. They correlate with them.

Macro View cont.

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