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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative of February 14, 2019

The Big Question Is Whether the Fed Will Stay Dovish If a Recession Is Avoided?
The Answer Is Yes.

There is concern that the Fed’s dovish turn is temporary and that the monetary authorities overreacted to last December’s market volatility or just simply succumbed to political pressure. The fear is that the Fed may not have enough room with the federal funds rate being as too low as it is and effectively too close to the effective lower bound of zero to combat a recession. I disagree with those who believe that it would be better to target inflation than to tolerate the risk of an inflation overshoot. Firstly, inflation is contained and going nowhere. Secondly, the recession risk is low. Thirdly, history shows that the Fed does not need even a quasi-recession to necessitate decreases in the federal funds rate. The Fed eased its monetary stance in 1966-66, 1984-86 and 1995-99, even though there was no recession in sight. This does not mean that a recession risk does not exist, after all it’s been a long expansion. However, recessions generally result from deleveraging due to surging inflation, long slowdown in employment growth and financial imbalances in the economy. None of the above factors are present currently.

A recent Heisenberg Report suggests that it is important to note that fear-based stories are not necessarily indicative of deep understanding or inside knowledge. Recessions are rare events and therefore one should be wary of people professing to know things that everyone else doesn’t. Additionally, there is no doubt that the Fed is in a better place than its European and Japanese counterparts. Interest rate differentials are wide and are favouring the U.S. by a significant margins---more than 300 bps for 2-year duration. John Authers, my favourite columnist at Bloomberg, pointed out that the gap in long term inflation expectations is the widest in four years. The difference is almost 1.0%. It means that it is much easier for the Fed to decrease interest rates than it is for the ECB. Yet, the ECB is renewing monetary stimulus. A deflation scarce has hit the euro zone—or at least disinflation. Moreover, the Bank of Japan is rethinking its monetary posture and the Bank of England plans for multiple interest rate rises is delayed and the Bank of Australia introduced the possibility of a rate cut and the Bank of China is trimming interest rates. In other words, the major central banks are now allies, all stepping back from previous plans for tighter monetary policy.

Macro View cont.

By Hubert Marleau

All monetary decisions are made on imperfect information. Nevertheless, enough economic and financial concerns rose for the Fed to make a U-turn. The bottom line is that many Fed officials like St. Louis' Fed James Bullard, Dallas Fed Robert Kaplan and Minneapolis Fed Kashkari are arguing that the current target rate (2.38%) is the terminal level for this cycle. The new chief economist at the IMF said, " the fact that the Fed decided to pause is going to be good for the economy." Aware that the cost of money in the domestic market and the price of money in the foreign exchange market are what calibrates the economy, they believed that the job is done and that incalculable intangibles like global growth worries, trade war and dysfunctional governments are now more crucial than domestic economic conditions. This is particularly important because the policy rate is finally the neutral rate, the yield curve is flat, and the cost of money is real.

A scatter plot between the employment-population ratio, " often considered by many Fed officials as the best measure of economic slack", and interest rates shows that the federal funds rate may be too high. It explains why the dollar has been very strong despite the Fed's dovish pivot, reflecting instead differences in broad cyclical trends between the U.S. and the rest of the world. Accordingly, a halt to the Fed's passive reduction of bond holdings is a now a probability. However, such a decision could send the 10-year Treasury yield down enough to create an unwanted inversion of the yields curve. In this connection, the federal funds rate might need to be lowered. Interestingly, a recent survey by the Arbor Data Science shows there is no much concern or fear over inflation and rate hikes. It makes sense because there is direct evidence that the economy has the potential to keep on running in the form of a further pickup in labour-force participation and productivity. Uncertainties over major items like Brexit, NAFTA, quasi-populist politics and trade wars are pushing businesses toward cheaper and more flexible factors of production like labour and technology rather than moving capital in rigid and expensive plant, machinery and equipment. Weeden Strategist Michael Purvis views this phenomenon "as a return to corporate conservatism that could help the business cycle run longer--albeit a little slower, for now--by promoting stronger corporate balance sheets."

Monitoring of Economic Conditions:

The DXY/ Copper ratio	D/C	Higher is Better
The Copper/Gold ratio	C/G	Lower is Better
The S&P 500/Gold ratio	S/G	Lower is Better
Inflation expectations	I.E.	Lower is Better
CRB Y/Y Increase	CRB	Higher is Better

	D/C	C/G	S/G	I.E.	CRB
SEP 21 /18	33.18x	.236x	2.44x	2.18%	194.0
DEC 24 /18	36.31x	.209x	1.85x	1.71%	168.4
FEB 16 /19	34.23x	.212x	2.10x	1.85%	178.2
Comment	The above set of numbers shows that global growth is moderately slowing down.				

Macro View cont.

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Weekly Highly Sensitive Data

Mortgage Application	M.A.	Higher is Better
Jobless Claims	J.C.	Lower is Better
St-Louis Fed's Financial Stress	F.S.	Lower is Better

	M.A.	J.C.	F.S
Current	365	239	(99)
Previous	379	235	(91)
3-months ago	341	214	(93)
6-months ago	364	214	(121)
Comment	The above set of numbers indicate that the policy rate is on target.		

Monthly Highly Sensitive Data

Home Sales	H.S.	Higher is Better
Auto Sales	A.S.	Higher is Better
New Orders	N.O	Higher is Better
ISM-Mgf	ISM-M	Higher is Better
ISM-Service	ISM-S	Higher is Better

	H.S.	A.S.	N.O.	ISM-M	ISM-S
Latest month	657	16.7	58.2	56.6	56.7
Previous month	562	17.6	51.3	54.3	58.8
3-months ago	601	17.5	58.0	57.5	60.0
6-months ago	653	16.8	63.5	58.4	56.7
1-year ago	653	17.2	65.4	59.1	59.9
Comment	The above set of numbers indicate that the neutral rate is attained.				

Macro View cont.

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Daily Monitoring of Financial Conditions:

The ERP/VIX ratio	E/V	Higher is Better
The VIX*CNN(fear & Greed)	F&G	Lower is Better
Baa minus 10-yr Treasury yields	C.S.	Wider is Better
The Real Cost of Money	R.C.M	Lower is Better
MZM Y/Y Change	MZM	Higher is Better
MB yearly absolute Change	M.B.	Lower is Better
The Policy minus the Natural rates	P-N	Lower is Better
10-year minus 2-year treasury yields	10-2	Wider is Better

	E/V	F&G	C.S.	R.C.M	MZM	M.B.	P-N	10-2
Sep 21/18	21x	864x	184	(9)	3.4%	N/A	(84)	26
Dec 24/18	209x	72x	235	17	3.0%	N/A	(24)	18
Feb 13/19	20x	1,049x	267	82	3.1%	N/A	(7)	17
Comment	The above set of numbers suggests financial conditions have improved.							

Daily Monitoring of Equity Valuation (S&P 500)

P/E Multiple	P/E	Lower is Better
Equity Risk Premium	ERP	Higher is Better
Price/Book	P/B	Lower is Better
Price/Sales	P/S	Lower is Better
Earnings Yield minus Inflation Expectation	EY-I.E.	Higher is Better
Rule of 20	R-20	Lower is Better

	P/E	ERP	P/B	P/S	EY-I.E.	R-20
Sep 21/18	18.1	247	3.50	2.39	3.38%	20.3
Dec 24/18	14.4	419	2.82	1.78	5.18%	16.6
Feb 13/19	16.4	339	3.25	2.07	4.23%	18.0
Comment	The above set of numbers suggests that the S&P 500 is trading somewhat below fair value.					

Macro View cont.

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Market and Economic Statistics that Matters:

1) Job openings totalled 7.3 million in December, much stronger than expected and the highest going back to 2000. There are more job openings than the number of people who are unemployed, suggesting that the labour market's momentum remains intact.

2) The NFIB small business optimism, which more than 60% are very tiny businesses, decreased to 101.2 in January. That is down from 108.0 last September, but comfortably above 80.0 when the Great Recession ended.

3) The Bureau of Labour Statistics reported that the CPI rose 1.6% in January from a year ago and that core inflation increased 2.2%. Nevertheless, diminishing slack could lead to lingering inflation fear even as growth slows towards what is considered potential. In my judgment, it may be overly pessimistic because the labour force participation and productivity are still on the rise.

4) Retail sales were disappointing in December increasing only 2.3% from a year earlier.

The Recession Risk as of February 14, 2019:

1) Moody's Analytics is predicting that there is a 17% chance of a recession in the next six months.rs
2) The Yield-Curve-Based N.Y. Fed model is currently calculating that there is a 23% chance of recession in the 12 months.
3) Longview Economics' Ù.S. Recession Indicator is signalling a 22% probability of a recession in the coming quarters. Based on 50 years of history, the Indicator needs to be above 60% to call a recession.

Estimates for Real GDP Growth in Q/4, 2018 as of February 14, 2019

1) The Atlanta Fed's R-GDP estimate is 2.7%
2) Moody's R-GDP estimate is 2.7%
3) The St-Louis Fed's estimate is 2.9%
4) The Cleveland Fed estimate is 2.8%

Macro View cont.

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The Outlook for U.S. Economic Growth in Q/1 as of February 14, 2019

The NY Fed's first quarter GDP Tracker made an upward adjustment to 2.4% from an estimated 2.2% last month.

The Outlook for Inflation in Q/1 of 2019 as of February 14, 2019:

The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to increase at the annual rate 0.9% in Q/1 and the CPI at 0.7%.

The NY Fed UIG inflation index is rolling over.

Oxford Economics predicts that year over year increase in Consumer prices will remain below 2.0% in 2019.

The Global Energy Complex:

The WSJ reported that Saudi Arabia and its Persian Gulf allies are backing a formal partnership with a 10-nation group led by Russia to try to manage the global oil market. The purpose of the alliance is to put a floor on oil prices. The American lawmakers have taken a dim view of this proposed alliance. A bipartisan group of U.S. senators rolled a bill last Thursday that would allow the Justice Department to sue members of OPEC violations, if found them guilty of trying to control the price of oil. Senator Chuck Grassley of Iowa tweeted: "the oil cartel and its member countries need to know that we are committed to stopping their anticompetitive behaviour." It should be noted that there is opposition from international oil companies and various business groups. They are concerned about the potential threat to their operations. This movement is not new. It has been tried several times in the past 20 years without success. Some believe that it has a good chance of becoming law, given Trump's hostility to OPEC.

OPEC sharply cut oil production by 797,000 barrels a day in January, to average 30.8 million barrels. The reduction caused Brent oil Price to trade up, rising above $60 a barrel. In December the cartel and a group of allies agreed to reduce crude by 1.2 million barrels a day. In its monthly report OPEC reduced its forecast for global demand in 2019. On the contrary, the IEA has left its global growth demand forecast of 1.4bpd for 2019 unchanged from last December.

Goldman Sachs is doubling down on its bullish oil outlook. It sees Brent peaking at $67.50 a barrel next quarter.

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New Technical Perspectives as of February 14, 2019

1) Based on the Dow Theory, the trend for the S&P 500 is bearish with key resistance at 2790 and key support at 2582 - on Thursday morning the S&P 500 was 2738
2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $59.87 and key support at $49.41 - on Thursday morning crude traded around $54.55
3) Based on a proprietary model, the trend for gold recently turned bullish with key resistance at $1359 and key support at $1256 - on Thursday morning gold was selling for $1309
4) Based on a proprietary model, the trend for ten-year treasury yield recently turned neutral with key resistance at 2.74% and key support at 2.50% - on Thursday morning the yield was 2.71%
5) Based on a Palos Currency Model, the trend for the Canadian dollar recently has mildly bearish with resistance at 76.25 us cents and key support at 73.90 us cents - on Thursday morning the Loonie was trading for 75.48 us cents, The Purchasing Power Parity Rate is 77.33 us cents.

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