PALOS

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Palos Weekly Commentary

Issue **No. 5** | **JANUARY 31** 2019

Macro View

By Hubert Marleau

The Weekly Narrative of January 31, 2019

The Fed Policy Is Officially Taken a Wait and See Approach. Patient Rates and Flexibility on QT.

We know that sentiment and momentum influence market performance. Yet, it remains that when it comes to the investment process, the fundamental drivers that count the most are: valuation, growth and interest rates. Unfortunately, these big factors are usually intertwined and, therefore, difficult to isolate. The best to way to start the investment process is with monetary policy. The Fed formulates monetary policy by taking into consideration economic and financial conditions. Therefore, I've devised several indices the purpose of which is to identify at the current monetary stance ought to be.

The FOMC met for two days this week and decided to pause the path to higher interest rates and to take the selling of treasuries off autopilot. Given that policy mistakes have occurred in the past, it begs the question to whether the Fed's present decisions were the right ones. Opinions on the subject are of little value, if they are not backed with hard facts. In this case, I think that the Fed's current monetary stance is the correct one. It would have been a substantial disappointment and risk, if Chairman Powell had not officially completed the about turn from an earlier view that the pre-set balance sheet reduction and gradual rate hikes were untouchables. The decisions were probably made easier because the ECB, the Bank of China and the Bank of Japan have openly capitulated and turned dovish. But in the end, it was hard facts that eased the Fed's task to relax. Allow me to explain why.

Firstly, the inflationary content of the misery index which is the addition of inflation and unemployment rates currently stands at 5.8%. Inflation accounts for 33% of the index—just about where it should be— suggesting that the policy rate (2.38%) is near the natural rate of interest (2.58%). A natural state is reached when the economy is operating at full employment under stable prices. And, that is the exact place where the Fed wants the economy to be.

Secondly, real cyclical expenditures that are ultra-sensitive to interest rates have started to claim a smaller proportion of R-GDP. Residential construction is down, consumer spending on durable goods is slowing and investment plans are being revised downward. Proxies like auto sales, housing starts, and inventory levels are also suggesting that the current policy rate (2.38%) is where it ought to be.

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Thirdly, the economy is in a state of equilibrium. The balance of payment is viable and economic growth is positive, at a time when the inflation is stable around the target level and the economy is running at full employment. As matter of fact, monetary policy indices that consider the variables are sliding down, suggesting again that the Fed should take a rest.

Investors should note that financial conditions also point to the idea that the Fed's monetary stance should operate on an even keel basis. The Fed's earlier contemplation to pause has rectified the December market disaster. Credit spreads have narrowed, the equity risk premium has fallen, real rates have risen and movements in the yield curve have stabilized. These financial variables presently suggest that the market should trade at fair value. As a matter of fact, the latest Bloomberg survey which is summarized below implies a forward P/E of 15.5 times which historically represents fair value.

Consequently, there was no need for the Fed to change anything but simply let financial and economic forces do their natural job of keeping inflation in check and allowing moderate growth to continue. Accordingly, the Fed felt that it should leave the economy alone because it is in a state of equilibrium—-neither too hot nor too cold. That is as good as it gets. The market is conclusive on this one, it believes that the Fed has basically gone far enough unless it wants to break the economy. According to Goldman Sachs, the underlying strength of the economy is 1.75% and that is pretty much where the U.S. growth rate will be in the next two years. Thus, I'm of the opinion that if the Fed is not behind the right ball. As a matter of fact, if the Fed was not such a slow-moving machine, it could have hinted that it was flexible enough to increase the balance sheet and/or decrease interest rates, should the future data points permit.

New Technical Perspectives as of January 31, 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 2507 - on Thursday morning the S&P 500 was 2682
2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $59.87 and key support at $48.77 - on Thursday morning crude traded around $54.09
3) Based on a proprietary model, the trend for gold recently turned bullish with key resistance at $1348 and key support at $1250 - on Thursday morning gold was selling for $1321
4) Based on a proprietary model, the trend for ten-year treasury yield recently turned neutral with key resistance at 2.91% and key support at 2.60% - on Thursday morning the yield was 2.66%
5) Based on a Palos Currency Model, the trend for the Canadian dollar recently has mildly bullish with resistance at 76.58 us cents and key support at 73.95 us cents - on Thursday morning the Loonie was trading for 76.08 us cents, The Purchasing Power Parity Rate is 77.50 us cents.

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The Recession Risk as of January 31, 2019:

1) Analysts surveyed by Bloomberg in January see a median 25% chance of a slump in the next 12 months.
2) Moody's Analytics is predicting that there is a 17% chance of a recession in the next six months.
3) The WSJ January survey predicts that there is a 38% chance of a recession in the next 12 months.
4) A January poll conducted by Reuters, showed that the probability of a U.S. recession in the next twelve months held steady from last months at 20%.

The Outlook for U.S. Economic Growth in Q/1 as of January 31, 2019:

1) Oxford Economics predicts real growth of 2.0% in Q/1.
2) Morgan Stanley revised its Q1 GDP forecast to 1.7% from 2.5% due to the 35-day government shutdown. Provided there isn't another shutdown in two weeks, there should be a partial rebound in Q/2 to 2.1%.
3) The January WSJ survey predicts that growth will grow at the annual rate of 2.2% in Q/1, 2.2% in 2019 and 1.75 % in 2020.
4) The IMF cut its global growth forecast last Tuesday from 3.7% to 3.5%.
5) The latest Reuters poll of over 100 economists taken January 16-23 showed that real growth in Q/1 should rise at the annual rate of 2.1%.

The Estimated Real GDP Growth in Q/4, 2018 as of January 31, 2019:

1) Moody's Analytics predicts that the U.S. economy grew at the annual rate of 2.5% in Q/4.
2) The Atlanta Fed predicts that the U.S. economy grew at the annual rate of 2.8% in Q/4.
3) The St-Louis Fed predicts that the economy grew at the annual rate 2.7% in Q/4.

The Outlook for Inflation as of January 31,2019:

The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to fall to an annual rate 1.4% in Q/1 of 2019 and the CPI to 1.2%.

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Market Facts that Matter:

The S&P 500 Earnings Per Share Estimates for 2018, 2019 and 2020: ($)

Q4/18	Q1/19	Q2/19	Q3/19	FY18	FY19	FY20
41.61	39.45.	42.50	44.48	158.20	170.20	188.40

Source: Based on the latest survey compiled by Bloomberg

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