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## CONTENTS



# Palos Weekly Commentary

Issue **No. 10** | **MARCH 7** 2019

# Macro View

*By Hubert Marleau*

## The Weekly Narrative of March 7, 2019

**The Bank of Canada Held the Target Rate at 1.75% Because the Neutral rate Is 1.75%.**

Canada is in too much economic trouble for the Canadian monetary authorities to contemplate anything else. Let's have a look at the broad facts. In the quarter ended December 2018, Canada's N-GDP increased 2.1% from a year ago compared to 5.3% for the U.S. That is a big hole that will be hard to fill. Inflation in the U.S. is on target - not in Canada. The U.S. GDP-Inflation deflator is 2.1% above last year whereas the comparable Canadian deflator is up only 0.5% - a whopping` gap of 1.6%. In the quarter ended December 2018, employment registered a yearly increase of 1.2% compared to 1.8% in the U.S. - even though the population of Canada increases faster than that of the U.S. - due to easier Canadian immigration rules. In the quarter ended December 2018, productivity (output per worker) in Canada increased 0.4% compared with 1.3% in the U.S. - a third of what it was in the U.S. There, you have it. Canada is far behind the U.S. in all the three main ingredients that compose an economy - employment, productivity and inflation. The Canadian economy is a sea full of serious economic imbalances. Let's have a look at a few.

1) Canadians only saved 1.1% of their disposable income. We are overtaxed. People don't invest enough. Hence low productivity. Security commissions are too restrictive.
2) The ratio of export to import prices was 91.6 during Q1 and keeps on declining. This tantamount to a loss of capital. We need a pipeline to move oil east.
3) The trade balance is negative. On average, Canadians spent over $50 billion more on foreign goods and services than they sell to foreigners. The export industries need tax breaks.
4) Canadians spend in real terms less than $35.9 billion a year on software, research and development. That is only 1.5% of R-GDP. The U.S. allocates almost $1.0 trillion in real terms to the sector or 5.0% of GDP. Hence, low productivity gains.
5) In constant dollars, Canadians spent $1.3 billion on residential construction or 7.0% of the R-GDP. The U.S. allocates only 3.25% to housing.

# Macro View cont.

*By Hubert Marleau*

6) Toronto and Vancouver are among the least affordable cities in the world. Expensive homes have pushed households' debt-to-income ratios to 178% across Canada. It's 200% in Toronto and 240% in Vancouver.

At this rate, if nothing is done in the upcoming March Budget to rectify these enormous imbalances something big could break because Canada is vulnerable to external shocks. Structural changes are needed like 100% depreciation allowances, a 5% corporate tax rate, elimination of redundancies and regulations. Cheap university education is a good idea for both domestic and foreign students - but they must commit to stay and work in Canada for a specific period.

**Economic, Financial and Market Statistical Data that Matter for the Week ending March 7, 2019**

- Canada:
  1) Statistics Canada reported that the Canadian economy grew at the low annual rate of 0.4% during Q4 of 2019 for a year-over-year increase of only 1.5%.
  2) Statistic Canada reported that labour productivity of Canadian businesses decreased 0.4% in Q4.
  3) Canada's merchandise trade deficit widened to $4,59 billion in December 2018 from $1,97 billion in November. It was the largest shortfall on record due to lower prices and lower sales of energy products.
  4) The Ivey Purchasing Managers' Index fell in February from 54.7 to 50.6. Fifty indicates the cut-off point between expansion and contraction. It means that the economy is at a standstill.
  5) The value of building permits fell by 5.5% in January from December.

- The United States:
  1) Agricultural prices received by farmers started on the wrong foot in 2019, decreasing 4.5% in January due to global oversupply of grain and live stocks.
  2) The University of Michigan Consumer Sentiment Survey recovered in February to 93.8, but softer than it was when it peaked at 100.1 last September.
  3) The ISM Manufacturing Index dropped to 54.2 in February from 56.6 in January. It's above 50.0 and therefore the sector is expanding but much less than it did when the index peaked at 60.8 in August of 2018.
  4) Personal Income remains strong but cooled down, registering a 0.1% decline in January. The decline is attributable to a sharp dive in dividends and proprietors' income. Disposable income was 4.4% higher than it was a year ago. The personal saving rate was 7.6% in January.
  5) The Core PCE Deflator, the preferred inflation gauge of the monetary authorities, continues to flirt with the Fed's 2% inflation target. On a year-ago basis It increased 1.9% while the headline PCE Deflator was up only 1.7%. The numbers are not high enough to change the dovish tone on the Fed.

# Macro View cont.

*By Hubert Marleau*

6) Total vehicles sales decreased in January to 16.57 million - the lowest data point in 12 months. The problems with the auto industry range from cyclical decline like too many cars on the road to structural difficulties like climate regulations and city dwelling, to disruptive changes like changing consumer preferences and ride-share companies.
7) The ISM N.Y. Current Business Conditions Index decreased for six time in a row in February to 19. The index was 61.1 in August of 2018.
8) Construction spending decreased 0.6% in December from a month earlier to a seasonally adjusted annual rate of $1.29 trillion.
9) The CoreLogic Home Price index increased 4.4% from a year earlier, plunging more than 1% in the last eight months. Year-over-year growth has retreated to the slowest pace in seven years.
10) The ISM Non-Manufacturing PMI index jumped to 59.7 in February from 56.7 in January, beating expectation. This will move the needle, pointing strong expansion in the services sector of the economy.
11) The IBD/TIPP Economic Optimism Index increased 5.4 points in March from 50.9 in February. The measure shows that consumers feel good about the economy's prospect for the next six months.
12) New-home sales rebounded in December, increasing 3.7% from November. However, they are still down year-over-year by 2.4%. On average it took about 6.6 months to sell new homes in December. It took 7.2 months in October, but 5.2 months in May.
13) The U.S. trade deficit widened to $59.8 billion in December of 2018. It was the largest deficit since October of 2008. In 2018, the trade gap swelled to $621 billion, increasing 12%. Excluding services, the gap grew 10% to $891 billion
14) The ADP's monthly employment report showed the U.S. private sector added 183,000 jobs in February. In the week ended March 2nd, jobless claims fell 3,000 to 223,000 - the U.S. labour market remains strong.
15) Banks in February left their forecast for oil prices in 2019 unchanged from January's projections. West Texas Intermediate is expected to average $60 a barrel in 2019 and end the year around $62.50.
16) U.S. productivity rose 1.9% at an annualized rate in Q4 of 2018. On a year-ago basis, productivity increased 1.8%. Unit labour cost is up only 1% year-over-year.
17) The Moody's Analytics Beige Book reported a rating of 100 for March's edition of the Fed report. The previous index was 127.8. It shows a broad cooling of growth because it was the second decline in aa row.

- China:
  1) At the annual National People's Congress, the government announced that the GDP growth target for 2019 is 6%-6.5%. The lower bound of the GDP target is the slowest pace of growth in 30 years--a consequence of the official policy of reining debt risk, cleaning the environment and alleviating poverty. The officials insist that the

# Macro View cont.

*By Hubert Marleau*

deceleration is structural and not cyclical. Nevertheless, the policy makers introduced a wide-range of tax cuts totalling 2.0 trillion yuan, signalling fiscal support rather than monetary stimulus. The government report pledged to keep China's leverage ratio basically stable.

2) At the end of 2018, total debt – household + corporate + government – as a percentage of N-GDP was 255%. It was 179% in 2012. In this connection, the authorities set the 2019 budget deficit at 2.8% of N-GDP and promised to keep the money supply in line with nominal GDP growth. The latter point interestingly shows, contrary to western practice, that the Chinese are followers of classical monetary principles.

- The Organization for Economic Cooperation and Development (OECD):

  On Wednesday last, the OECD cut its forecast for 2019 global economic growth to 3.3% from its November forecast of 3.5%, citing worries around China and Europe and high policy uncertainties in all G20 countries.

- The Euro Zone:

  The ECB signalled a major policy reversal, flagging plans for fresh measures to stimulate the E.U.'s faltering economy. The ECB decided to hold interest rate at their current levels through the end of the year and give cheap long-term loans to banks. Recent data show few signs of a rebound in eurozone growth. R-GDP increased at the annual rate of 1.0% in Q4.

**The Recession Risk as of March 7, 2019:**

Moody's Analytics is presently predicting that there is a 20% chance of a recession in the next 12 months.

**The Outlook for U.S. Economic Growth in Q/1 as of March 7, 2019**

1) Cleveland Fed yield curve model is predicting that the economic growth will average around 2.2%.
2) The NowCast Model of the NY Fed is pointing at a 0.8% growth
3) The Goldman Sachs GDP Tracker is showing a 1.0% growth.
4) The NowCasting Model of the Atlanta Fed raised its view on growth from 0.3% to 0.5%.
5) The High Frequency Economic Model of Moody's Analytics increased growth expectation to 0.6% from 0.3%.

# Macro View cont.

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**The Outlook for Inflation in Q1 of 2019 as of March 7, 2019:**

1) The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to increase at the annual rate 1.0 % and the CPI at 0.7%.

**Technical Perspectives as of March 7, 2019**

1) Based on the Dow Theory, the trend for the S&P 500 is bearish with key resistance at 2868 and key support at 2665 - on Thursday morning the S&P 500 was 2780
2) Based on a 7-AM proprietary model, the trend for crude oil is neutral with key resistance at $61.59 and key support at $52.45 - on Thursday morning crude traded around $56.88
3) Based on a 7-AM proprietary model, the trend for gold is bullish with key resistance at $1344 and key support at $1253 - on Thursday morning gold was selling for $1287
4) Based on a 7am proprietary model, the trend for ten-year treasury yield recently turned neutral with key resistance at 2.89% and key support at 2.64% - on Thursday morning the yield was 2.69%
5) Based on a Palos proprietary model Currency Model, the trend for the Canadian dollar turned bearish with resistance at 76.15 us cents and key support at 74.12 us cents - on Thursday morning the Loonie was trading for 74.50 us cents, The Purchasing Power parity Rate is 76.25 us cents.
6) The Equity Risk Premium for the S&P 500 is 333 bps, the P/E multiple is 16.6x and the earning yield is 6.02% - 4.11% above inflation expectations and 1.10%. Baa bond yields (4.98%) are 301 bps above the average dividend yield ( 1.97%).
7) The Rule of 20, which is the addition of the 12-month forward P/E multiple and 5-year inflation expectation, stands at 18.5 - market neutral
8) The Equity Risk Premium for the TSX 300 is 478 bps, the P/E multiple is 15.1x and the earning yield is 6.60% - 5.41% above inflation expectations. The TSX, foreign exchange adjusted, trades at 4.37 times the S&P 500 compared to 4.37x one month ago and 4.14x three months ago. The 5-year long term average is 5.75x.
9) The U.S. Palos Monetary Policy Index is 456 down from a recent high of 686 on November 9, 2018. The index considers inflation, international trade, employment and growth. The current index suggests that the economy could take another rate hike. But the downward trend support the idea that the monetary stance should be on an even keel.
10) The Canadian Palos Monetary Policy Index is 100, down from 130, supporting the BoC decision to maintain the its target rate at 1.75%.
11) The St-Louis Fed Financial Stress Index continues to show steady amelioration. The touched -1.20 on March 7 compared to -0.62 on December 24. The more negative the index, the less stress there is.

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