PALOS

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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative of March 14, 2019

Are We Stuck with Monetary Stimulus forever? Perhaps Yes

The U.S. bull market for stocks turned 10 years old last Friday. The S&P 500 closed at 676 during the financial crisis and rose to 2750, increasing 307% excluding dividends and 401% including dividends. Goldman Sachs (GS) came out with two very interesting observations about financial assets versus real economic outcomes.

GS observed that the annualized increase in the S&P 500 of 15% did not match that of the 4% annual rate of growth in N-GDP for the period under review. The observation is a faulty perception because it is mathematically difficult to relate a change in flow (N-GDP) with a change in stock (S&P 500). A flow is a second derivative and a stock is a first derivative - different factors are involved in the GS conclusion.

Also, GS noted that earnings growth was the main driver of the bull-run, accounting for 73% of total equity returns. Forty-four percent of the growth in earnings was due to sales and 56% to margins. GS also figured that the expected growth (9%) and the forward P/E (18%) accounted for the remaining 27% of the March 2009-March 2019 equity returns. I'm not sure how GS figured that one out but suffice to say you now have what they believe created the returns. The aforementioned "tour de force" is worthy of consideration; but, unfortunately, it's raw and does make any references to the reasons which indirectly permitted the latter to happen. Indeed, it gives another faulty perception because it takes the factors for granted. A seasoned investor would dig a little deeper.

The point is that we often kid ourselves into believing superficial opinions reflect the reality of the outside world rather than constructing a version of it. In my judgement, the transmission channel between liquidity and markets is far more able to induce risk taking by investors than allowing it to the stimulate the economy. Hence, the difference between economic and market performance. It would have been a very different world if Bernanke and company had let creative destruction do its job and abstain from providing liquidity. The whole idea of cutting interests down to zero and buying bonds to boost the Fed's balance sheet was to rescue the economy from disaster, design a virtuous circle, and create incentives, whereby corporations could benefit from a monetary policy-assisted recovery.

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I'm sure that there is consensus that the last ten years of S&P 500 EPS growth would have been very different if the monetary authorities had not allowed it to take place. The impact of monetary policy on financial assets can be tremendous and investors should not underestimate it. We did see what can happen in the later months of 2018 when it became obvious to the market that the monetary stance had tighten too much. During 2017-18, the U.S. Treasury was issuing huge amounts of bonds to finance budget deficits, the Fed was raising rates to make government debt attractive and sucking in cash to normalize its balance sheet. Gradually but surely, the triple-fisted tightening had a negative transmission effect on liquidity and all at once, speculators and traders sold virtually every risky asset known to man in a jiffy.

We are all aware that the Fed has two mandated objectives - full employment and price stability. That's a given. But it also has two implied mandates - foreign exchange and financial stability. If the financial and/or foreign exchange systems are not operating efficiently, the Fed will react hard and fast. That's the "Fed Put". The Fed is not ignorant of the fact that markets tend to go down five times faster than they go up, based on the belief that there is a significant change in the financial environment. By the same token all the other major central banks in the world - even the smaller ones like the Bank of Canada and the Bank of Australia - have the same awareness because it is well understood how reliant on liquidity the global monetary system has become. There are various ways to measure global liquidity. Given that the U.S. dollar is the dominant international reserve currency, I add the U.S. monetary base to the amount of treasury bonds held in foreign hands and look at how much the addition changes over a year. At the end of December, the total was $9.6 trillion, down more than $600 billion from a year ago. That indeed drained global liquidity. Another way to measure global liquidity is the addition of the asset side of all major central banks. The conclusion is similar.

In Q4/2018, the concern was therefore not inflation nor employment--it was wild volatility and the absence of liquidity. It was not about economics or worries about a coming recession. Rick Rieder of Black Rock in a conversation with Allison Nathan of Goldman Sachs made an interesting comment that is worthy of careful thought and deliberation. He said: "I think the nature of today's economy has made boom/bust business cycles a thing of the past. In goods-oriented economies driven by manufacturing, industrials, materials, chemical, and energy you'd close the output gap, create inflation and then force the system to recalibrate. Today, we have a services-oriented economy driven by technology, education, healthcare, and experiences in which these dynamics aren't relevant." It makes sense. It does appear that monetary policy is pushing on a string. I can think of several reasons why this is going on.

Firstly, one cannot store a service and it is impossible to bank or store like durable goods. It means that it is hard to finance over term because it tends to perish fast. Consumers are more likely to use their income to enjoy services immediately - unlike durable goods. Secondly, society is aging, and income inequality is widening. These two forces have been going on for two decades. Consequently, the U.S. is having a saving glut - Americans are saving 8.0% of their disposable income. Thirdly, a huge structural "de-massification" of the economy is becoming obvious. Larry Summers, the promoter of "Secular Stagnation" explains it well - goods now go straight from warehouses to homes, offices needs less storage space, cell-phones are replacing desktop computers, cameras, stereos, books, etc… People

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are more content to live in smaller apartments without cars. The structure of the economy is changing as the service sector takes over. Thus, debt is less needed. The consumers of the service industries do not like to finance themselves when the interest cost of debt is real - 1.50% appears to the limit. Accordingly, a tremendous amount of cheap debt is necessary to push the economy forward. It now takes a lot more debt to produce $1 worth of N-GDP. Twenty- years ago, it was one for one. Today, every dollar of monetary base and credit added to the financial system results in less than a dollar of GDP. Global velocity of money has fallen far below 1. The fact is that a very large portion of the printed money is either saved, hoarded, invested in financial assets or used for balance sheet restoration.

There is another thesis that explains the incomplete variance to cyclical swings and policy changes on inflation since the 90's. As a matter of fact, there's been a negative correlation between inflation and changes in retail sales. Statistical analysis shows that most price changes have been largely due to big moves in oil prices and foreign exchanges. It's hard to take because we have always been taught that inflation occurs when demand hit a potential level as it normally did in the 60's, 70's, and 80's. The idea was that the difference between actual and potential GDP was the best way to predict inflation. That is, inflation falls when actual GDP is below its estimated potential and rises when it is above it. Evidence is falsifying the theory. There is growing evidence that that potential output is not a fixed thing. A study by Igal Hendel and Yossi Spiegel shows that the closing of the "output gap" leads not to rising prices but to higher productivity. The steel industry among many others is a good example. In another study, Jonathan Haskel and Stian Westlake demonstrated that the notion of potential output does not apply to the intangible economy because of its scalability.

In this connection, central banks have found it very hard to withdraw monetary stimulus because the short-term utility of the service sector cannot afford real rates. The output gap theory does not work well in today's service and internet environment as new businesses are very scalable without the need of much capital.

Thus, central banks, using the pretext that the durable side of the economy needs help, may never abandon monetary stimulus. Maybe Rich Miller of Bloomberg is right that central banks are reconciling themselves to a new normal of historically low interest rates and bloated balance sheets - one that Japan has long since become used to. Japan arrived at zero twenty-two years ago. The forces that made what Japan is today are now worldwide. I would not be surprised at all if we end up with the Japanification of the capital markets - low interest rates for a very long time.

Now, every central bank of any consequence has either officially paused or officially turned around - all dovish. The positive significance of a very low equilibrium rate of interest on the stock market as a semi-permanent feature should not be understated. For those of you who are math-inclined, imagine what a zero-discount rate does on valuations - if everything else remains equal, valuations go through the roof. I don't get overly excited with the proposition because high corporate leverage, higher input cost and larger wage rates are likely to put some pressure profit margins. Yet, for as long as the growth projections don't turn too dour, the dovish monetary tilt should bring about some more pent-up demand for risky assets. I'm not ready to sign the death certificate on stocks, despite the constant prediction of their imminent demise. Ed Yardeni, my favourite economist, said that generally investors have

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been worried about a recession ever since stocks bottomed in 2009. As a matter of fact, Google word surveys shows that the next recession is the most anticipated of all time and for the longest of time. Despite the fact that the primary characteristic of current bull run is how much scepticism is generated, the rally has not succumbed to all of the worries that have made front page news.

Since 2009, it's remarkable that there has been a combined net outflow of $300 billion out equity, mutual, and equity exchange funds. This is good news for the contrarian investor for this level of scepticism might mean that the bull market will last longer than anyone thinks possible. Aside from a few brief flirtations with bitcoins and cannabis, the numbers do not show any abnormal amount of euphoria in the markets. The Barron keeps tabs on euphoria, the statistics are normal. It is reasonable to expect pauses in the upward trajectory, yet the actual risk-reward profile of the stock market is favourable. Looking out to year-end, I see the S&P 500 at 3100. I'm counting on valuations, monetary policy and an economy that generally produces 2% growth and 2% inflation.

Economic, Financial and Market Statistical Data that Matter for the Week ending March 14, 2019

- Canada:
  1) Employment increased by 56,000 in February, far exceeding the consensus expectation for no change. Because the labour participation rate rose to 65.8%, the unemployment rate remained unchanged at 5.8%. Another positive note was the acceleration in the year-over-year growth in average hourly wages from 2.0% to 2.3%.
  2) Industrial capacity utilization dipped 81.7% in Q4. It was the second consecutive decline. Manufacturing and construction were the culprit.
  3) New residential construction backpedalled in February. Housing starts totalled 173,153 at an annualized rate compared to 206,809 in January. The decline was the third one in a row.

- The United States:
  1) The Challenger Report showed that job cuts swelled to 76,835 in February, the highest number in more than three years, driven primarily by cuts in retail sellers of hard goods and industrial goods.
  2) The Bloomberg's Consumer Sentiment Index hit the highest level at 62.1 since 2000.
  3) Construction on new homes, known as housing starts, leaped nearly 19% in January to an annual rate of 1.23 million, rebounding firmly from a big drop at the end of 2018. Housing starts in December were running at the annual rate of 1.04 million. Meanwhile, permits to build new homes rose 1.4% to annual rate of 1.35 million.
  4) Nonfarm payrolls gained just 20,000 jobs in February, well below estimates of 180,000 - the biggest miss in 10 years.

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5) Headline consumer credit is off to a strong start in 2019. The January gain was $17 billion, exceeding the consensus projection of $15.5 billion.
6) FRB reported that household wealth fell sharply in Q4 to $104.3 trillion as the stock market tumbled and house price appreciation slowed. The decrease was $3.7 trillion.
7) Retail sales recovered a small portion of the December decline in January, but the January revisions were unkind. Sales fell sharply at both the auto dealers and gas stations. On a monthly basis, retail sales rose 0.2%. On average retail sales MoM average 0.35% from 1992 to 2018. In January, sales were up 2.3% year-over-year. Excluding autos and gas, sales did much better, increasing 3.7%.
8) The CBO in its latest monthly budget review showed that February tax receipts rose 5.0% from a year ago, while income tax refunds fell 13%. It appears that tax receipts from rising income have offset lower receipts from the ct in tax rates and 100% business expanding. This trend may not continue, but the deficit surprisingly decreased by $12 billion in February.
9) The NFIB Small Business Optimism Index was 101.7 in February compared to 102.5 in January. Not much of a change and encouragingly some of the forward-looking details did improve.
10) According to a most recent survey conducted by BofAML, respondents are notably less concerned about the “usual suspects” whether it’s China, the trade war and/or a U.S. recession. The only greater concern is the decade-long slow recovery. This is why Modern Monetary Theory (MNT) is gaining popularity. I will soon have a piece on MNT.`
11) Stockpiles grew by 0.6% in December line with consensus expectations. Most of the increase was concentrated in retail and wholesale.
12) The mortgage market is picking up. Mortgage applications increased 2.3%.
13) New orders for durable goods increased 0.4% in January, beating expectations. It was the third consecutive monthly advance.
14) Producer prices pose little threat to U.S. inflationary dynamics. The PPI for final demand rose 0.1% in February for a year-over-year increase of 1.8%. The small monthly increase snaps a streak of three consecutive monthly declines.
15) U.S. policy uncertainty index came in at 128.9 this week. The index has been jumpy over the past several weeks. Yet the trend is down because monetary policy is easing, and financial conditions are better.
16) Real wage growth registered a healthy increased in February. Average hourly earnings are 1.9% above the CPI yearly increase of 1.5%. And quests what productivity is also up 1.8%—-its means that unit labour cost is below the 2.0% inflation target.
17) U.S. construction put in place clocked in at $1.298 trillion in January, 1.3% higher than in December.

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18) Internet sales totalled $132.8 billion in Q4, 2.0% higher than in Q3 and 12.1% higher than a year ago. E-Commerce as a % of retail sales was 9.9% versus 9.1% one year ago. Internet sales is growing 4.0 times faster than retail sales taken as a whole.
19) New home sales drop 7% in January to an annualized rate of 607,000.
20) Import prices decreased 1.3% in February from a year ago. Inflation remains mute.
21) The labour market is in good shape because jobless claims are low at 229,000. They were 253,000 six weeks ago.

- China:
  1) The 20.7% January decline in China's exports was substantially worse than the consensus forecast of 5.0%.
  2) China's economy isn't done slowing with industrial activity and home sales cooling, despite a good rebound in investment driven by Beijing's policy to shore up growth.

- The World:

  Bloomberg's new GDP tracker puts world growth at 2.1% on a quarter-on quarter annualized basis, down from about 4% in the middle of last year. Bloomberg Economics says that there a very good that the economy may find a foothold and arrest the slowdown.

The Recession Risk as of March 14, 2019:

1) Moody's Analytics is presently predicting that there is a 20 % chance of a recession in the next 12 months.
2) UBS in a public note said that the probability of a contraction, whether a recession happens or not, shot up to 73% form just 24% December last. The bank attributes the risk to the deterioration effect of the trade war tariffs on consumer durable spending.
3) Gavyn Davies of the FT wrote that the probability of a strong expansion (3.0% +) has fallen to 20% he puts the chance of two successive quarters of negative growth in the eurozone at 25%.

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The Outlook for U.S. Economic Growth in Q1 as of March 14, 2019

1) Cleveland Fed yield curve model is predicting that the economic growth will average around 2.3%.
2) The NowCast Model of the NY Fed is pointing at a 1.4% growth
3) The Goldman Sachs GDP Tracker is showing a 0.5% growth.
4) The Penn Wharton Budget Model is projects 2.2% growth this year.
5) The NowCasting Model of the Atlanta Fed increased its view on growth from 0.2% to 0.4%.
6) The High Frequency Economic Model of Moody's Analytics increased growth expectation to 0.4% from 0.6%.
7) The Sun Trust expect a Q1 annual rate of expansion of 1.3%, followed by a strong recovery in Q2.
8) Oxford Economics is predicting quarterly annual of 0.5% in Q1, 3.0% in Q2, 2.5% in Q3 and 2.0% in Q3.
9) Naroff Economic Advisors estimates that Q1 growth could be well below 2.0%, but that a recession scenario is far off.
10) Based on an internet search by Arbor Data Science, high frequency NowCast models are pointing on average to a 1.9% annualized rate of change in 2019.
11) According to Goldman Sachs (GS) the weak growth in the working-age population limits the number of jobs the economy can create. Once the "slack" labour force is depleted, job creation will slow. Thus, GS figured that the rate of unemployment would have to be 4.5% to keep the inflation rate around 2.0%. It means that the economy needs to generate 20,000 a month. If. on the other hand, full employment is 4.25%, which is incidentally`` my number, 50,000 jobs are needed.

The Outlook for Inflation in Q1 of 2019 as of March 14, 2019:

1) There is no noticeable acceleration in U.S. inflation. The consumer price index rose 0.2% in February for a 1.5% year-over-year increase. Core inflation which eliminates food and energy is up 2.1% from a year ago.
2) 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 14, 2019

1) Based on the Dow Theory, the trend for the S&P 500 is bearish with key resistance at 2828 and key support at 2597 - on Thursday morning the S&P 500 was 2817
2) Based on a 7-AM proprietary model, the trend for crude oil is neutral with key resistance at $59.87 and key support at $50.78 - on Thursday morning crude traded around $58.11

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3) Based on a 7-AM proprietary model, the trend for gold is bullish with key resistance at $1344 and key support at $1242 - on Thursday morning gold was selling for $1299
4) Based on a 7am proprietary model, the trend for ten-year treasury yield recently turned neutral with key resistance at 2.83% and key support at 2.50% - on Thursday morning the yield was 2.61%
5) Based on a Palos proprietary model Currency Model, the trend for the Canadian dollar is undefinable with resistance at 76.02 us cents and key support at 74.12 us cents - on Thursday morning the Loonie was trading for 75.21 us cents, The Purchasing Power Parity Rate is 76.25 us cents. Rising oil prices is helping the Loonie while the monetary conditions dictate otherwise.
6) The Equity Risk Premium for the S&P 500 is 332 bps, the P/E multiple is 16.9x and the earning yield is 5.93% - 4.01% above inflation expectations and 1.04%. Baa bond yields (4.89%) are 288 bps above the average dividend yield (2.01%).
7) The Rule of 20, which is the addition of the 12-month forward P/E multiple and 5-year inflation expectation, stands at 18.8 - market neutral
8) The Equity Risk Premium for the TSX 300 is 484 bps, the P/E multiple is 15.2x and the earning yield is 6.59% - 5.42% above inflation expectations. The TSX, foreign exchange adjusted, trades at 4.33 times the S&P 500 compared to 4.28x one month ago and 4.19x three months ago. The 5-year long term average is 5.75x.
9) The U.S. Palos Monetary Policy Index is 571 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% and the idea of a rate cut.
11) The St-Louis Fed Financial Stress Index continues to show steady amelioration. The touched -1.22 on March 7 compared to -0.62 on December 24. The more negative the index, the less stress there is. Financial conditions are good and above average.

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