To subscribe to our Newsletters www.palos.ca/register

PALOS

CONTENTS

Palos Weekly Commentary

Issue **No. 9** | **FEBRUARY 28** 2019

Macro View

By Hubert Marleau

The Weekly Narrative of February 28, 2019

Recession Predictions Always` End Up Right:
We Just Don't Know When They Will Happen.

It's been a big two months for all the markets - stocks, bonds and commodities. This is founded on the belief that monetary policymakers around the world will not accept a global slowing of business activities whatever the cause until there is enough assurance that the inflation risk is no longer containable. Unfortunately, the new dovish policy movements do not seem to be enough to get the press off the daily recession watch. The reason for this is because the yield curve has flattened. Modern history is clear that when 2-year Treasury yields exceed 10-year yields, we have always had an ensuing recession. It happened five times since 1975. Accordingly, there is compelling evidence that the odds of a recession are rising. U.S. growth is slowing down and is reflected in Q4 estimates and Q1 forecasts.

After a streak of disappointing data points including retail sales, industrial production and orders for new durable goods, high frequency models are projecting a 1.5% growth for GDP growth in Q1. Thus, employing a 2.6% quarterly growth rate for Q4 and imputing a 1.5% quarterly annual growth rate for Q1, the forecast for the yearly increase in GDP for the year ending March 31, 2019, is 2.9%. Acknowledging that the ten-year government bond yield (2.65%) is an excellent proxy when adjusted for the term premium (.50%), risk assets will be forced to eventually reflect a two plus two economy - two for inflation and two for growth. Consequently, we may get a growth scare, but the market is unlikely to price is a recession. It's the combination of commonly used economic data points, generally employed financial metrics and frequently utilized market statistics that reflects the reality of the business cycles. It's true that several of these indices are off their cycle peaks; but from very high levels and very long runways.

It's not a foregone conclusion that a recession is imminent. History is very clear that the yield curve must invert and that close to inverting is not a good enough reason to call a recession. Recessions come about at maximum inversion which can take a long time - many months and even years. The point is that even when the curve inverts, a recession does not become noticeable right away in the data - it only does after an undefined lag. Investors should note that a curve inversion that is not accompanied by a higher policy rate than the neutral rate, could result in a fake recession call. As a matter of fact, interest rate pauses that have occurred before the policy rate has become too high

Macro View cont.

By Hubert Marleau

above the neutral rate, has normally have resulted in soft landings. Recessions usually occur when the Fed stays hawkish too long. For now, the Fed has hinted but not officially decided to end rate hikes and balance sheet reductions. We are going to know a lot more on March 20. If the real economy does not perk up but grows at the pace that high frequency models are currently suggesting (1.5%), it will become official that the Fed's monetary stance has change for good.

Investors should bear in mind that during this economic expansion, there have been three distinct slowdowns. Each time the economy experienced a transitory spurt in growth, interest rates rose, cutting short the burst. It's happening again. The economy accelerated strongly from 2016-2018. Thus, interest rates rose across the curve and hurt the housing, auto and durable sectors. The deceleration in those industries is now reducing overall economic growth and lowering interest rates. However, I do not expect this regular pattern to bring about a recession. It would be unusual to have a recession while the Copper/DXY ratio is rising - copper prices have rallied 13% to $2.97 and the DXY has traded in a narrow range around 96.75 - the labour force participation is staging a strong turnaround and productivity is diffusing. In my judgment, the new monetary stance, the improved outlook for a trade resolution with China and the end to the government shutdown should bring back "Goldilocks". In a note dated February 26, Goldman Sachs wrote that some green shoots are emerging that suggest that sequential growth will pick up from here.

There is no statistical reason that this expansion could not last for many more years. The outlook for the economy is a moving target and changes happen out of the blue without regard to time and stem from credit stress. In this connection I do follow all the indices of financial conditions anchored by valid theory and empirical evidence that are produced by reputable houses. And none are pointing to a forthcoming disaster. It is not to say that there cannot be fear-driven events that could cause chaos, but a coming credit-driven recession is out of the question. There are some strategists that think that corporate high-yield debt and leverage loans will be the next subprime liquidity crisis; yet, it does not show up in any credit stress indicators. For example, the Chicago Fed National Financial Conditions Sub-Indices that measure 105 indicators of credit stress in banking, shadow banking, and financial markets have barely moved. If the Fed has already tightened too much, then why is it that it's not reflected in the Goldman Sachs financial condition index, in the St-Louis Fed's financial stress indicator or the NY Fed's market stress numbers. On the contrary, liquidity for the markets and credit for businesses and money for risk ventures is still available.

Q4 profit results are now booked and they registered a year-over-year increase of 14%. The market is aware that as the fiscal impulse waned and margins faced pressure from rising costs, higher interest rates, and tariffs. Now, the consensus sees profits shrinking in Q1 for the first time since 2016. However, should the thesis that the economy will softly land into a 2.0% growth path for the foreseeable future, one should expect businesses to adjust their costs to the new revenue outlook. Thus, profit could resume its upward path in the latter half of 2019.

That is not to say that I will not change my mind later. Right now, there is not enough evidence to change it. As Lord Keynes, a famous British economist, said: "when facts change, I change my mind, what do you do?" That is why one should follow the feed below.

Macro View cont.

By Hubert Marleau

Economic, Financial and Market Statistics That Matter for the week ending February 28, 2019

Canada:

1) Canadian retail sales ex autos have declined for 5 months in a row, decreasing as much as 0.5% in December.
2) Toronto and Vancouver home sales are trending lower and are below their 10%-year average. Housing prices are also trending lower.
3) Inflation decelerated significantly in January. Consumer prices fell 0.1% from the prior month, cooling the year-over year increase to 1.4%. Core CPI is up only 1.5% from last year. The Bank of Canada has its own set of measures. The CPI-common remained at 1.9%, the CPI-median at 1.8% and the CPI-trim at1.9%.
4) Average weekly earnings of non-farm employees showed a monthly increase of 0.1% in December producing a yearly increase of only 1.8%.
5) Canada ADP employment report shows that the Canadian labour market is bouncing back with strong gains in January. Payrolls grew by 35,400.
6) The Scotiabank Now Cast model is estimating that Q4 growth for the Canadian economy will be less than 1.0% versus a consensus of 1.25%

The United States:

1) The Chicago Fed National Activity Index declined to -0.43 in January from 0.05 in the previous month. The index's three-month moving average now gives a neutral reading.
2) The diffusion index of the Texas Manufacturing Outlook Survey continued to rise in February to 13.1 and 1.0 in January, after registering 4 decreases in a row.
3) Stockpile growth shifted into higher gear in December because sales suffered, rising 1.1% which was above consensus expectations.
4) New residential construction took a tumble in December. Housing starts fell 11.2% below November totals. Fortunately, housing permits stayed level. January and February numbers should be better.
5) The S&P CoreLogic Case-Shiller Home Price Indexes show that Existing-home price appreciation has slowed in the three months to December, reinforcing the deceleration trend that has been going on since the spring of 2018. Meanwhile, the FHFA Purchase-Only House Price Index rose 5.6% in December on a year-ago basis which is slower than during previous months.
6) The Conference Board Consumer Confidence rebounded in February, rising to 131.4 for a large gain of 9.7 over January to reach a three-month high.

Macro View cont.

By Hubert Marleau

7) The diffusion index of the Richmond Manufacturing Survey rose 18 points in February to 16.0 indicating that business conditions are improving for the better. The survey pointed to the fact the imposition of tariffs is adding cost.
8) Factory orders rose 0.1% in December, after two consecutive declines.
9) The pending home sale index increased 4.6% in January to 103.2 in January, partially offsetting a recent string of losses, rising to the highest point since last September.
10) U.S. stockpiles expanded at both the retail and wholesale levels in December. Inventories respectively increased 3.9% and 7.3% from a year ago.
11) The trade deficits in goods widened 10% in December from a year ago to reach $79.5 billion--a record high. Exports fell 0.3% while exports increased 3.2% quarter to quarter.
12) The mortgage market witnessed another expansion in the week ended February 22. Applications rose 5.3%, after increasing 3.6% in the week ended February 15.
13) Manufacturing activity in the Kansas City Fed District continues to expand, but a much lower rate than in the past six months.

The Recession Risk as of February 28, 2019:

Moody's Analytics is presently predicting that there is a 20 % chance of a recession in the next 12 months, down from 24%

The Initial Estimate for the Fourth Quarter Gross Domestic Product:

The BEA reported on Thursday that Q4/2018 R-GDP increased at the annual rate of 2.6% during Q4/2018 for a year-over increase of 3.1%. In nominal terms, the N-GDP is up 5.3% of which 2.2% was accounted by inflation, 1.8% by employment and 1.3% by productivity. The latter is on trend with the average of the last two years.

Real investments by businesses in intellectual property products like software, research and development increased 11.2%, guaranteeing that productivity gains should last. In the December quarter, cyclically interest rate sensitive sectors represented 27.0% of aggregate expenditures in real terms, suggesting that the Fed did well to raise interest rates. There were no visual imbalances.

Private inventories were up only $7.3 billion.

Consumers spent 2.3% of their disposable income on gasoline and other energy products - less than what they usually spent.

Macro View cont.

By Hubert Marleau

Personal savings are higher than they were last year and now account for 6.7% of disposable income

The trade balance deficit totalled $659.8 billion, 8.5% larger than last year. It now accounts for 3.2% - several academic research studies suggest that the gap should not cross over 3.0%. Investor should note that the U.S. dollar is the major international reserve currency and the trade de if it is needed to supply liquidity to the global money markets.

The Outlook for U.S. Economic Growth in Q/1 as of February 28, 2019

1) The NY Fed NowCast model for Q1 GDP growth is showing a slow 1.2% annual rate as a result of the December shutdown.
2) The consensus forecast for Q1 growth is 2.0%—WSJ
3) The Goldman's Current Activity Indicator (CAI) shows that the Chinese economy is stabilizing around the annual rate of 5.5%. China's PMI manufacturing has turned up and it seems as if credit growth has bottomed out.
4) Cleveland Fed yield curve model is predicting that the economic growth will average around 2.2% throughout 2019.

The Outlook for Inflation in Q/1 of 2019 as of February 28, 2019:

1) 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%.
2) The NY Fed UIG inflation index is rolling over.
3) Oxford Economics predicts that year over year increase in Consumer Price Index will remain below 2.0% in 2019.

Technical Perspectives as of February 28, 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 2789
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 $57.39
3) Based on a 7-AM proprietary model, the trend for gold is bullish with key resistance at $1382 and key support at $1280 - on Thursday morning gold was selling for $1338

Macro View cont.

By Hubert Marleau

4) Based on a 7am proprietary model, the trend for ten-year treasury yield recently turned neutral with key resistance at 2.74% and key support at 2.55% - on Thursday morning the yield was 2.65%
5) Based on a Palos proprietary model Currency Model, the trend for the Canadian dollar recently has been bullish with resistance at 77.10 us cents and key support at 74.98 us cents - on Thursday morning the Loonie was trading for 76.07 us cents, The Purchasing Power Parity Rate is 77.35 us cents. Richardson GMP came with a surprising note yesterday, suggesting that the Bank of Canada was more likely (35% chance) to increase its target rate than the Fed (5% chance). Plus, the BoC would raise rates before the Fed, if they were to raise rates. Interesting that Richardson has such a view given that the Canadian inflation (1.40%) is significantly below the Bank of Canada's policy rate (1.75%).
6) The Equity Risk Premium for the S&P 500 is 330 bps, the P/E multiple is 16.7x and the earning yield is 5.98% - 4.07% above inflation expectations and 1.10% above Baa bond yields (4.88%). The Rule of 20 is 18.32, suggesting fair value.
7) The Equity Risk Premium for the TSX 300 is 478 bps, the P/E multiple is 15.1x and the earning yield is 6.64% - 5.44% above inflation expectations and 1.76% above Baa bond yields. The TSX, foreign exchange adjusted, trades at 4.38x the S&P compared to 4.32x one month ago and 4.23x three months ago. The long-term average is 5.75x.
8) The St-Louis Fed Financial Stress Index continues to show steady amelioration. The touched -1.20 on February 22 compared to -0.62 on December 24. The more negative the index, the less stress there is.

Palos Weekly Commentary

Issue **No. 9** | **FEBRUARY 28** 2019

Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 276-0110

www.palos.ca