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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Fed Will Give Investors What the Market Wants--A Rate Cut in September

Jaded traders have been thoroughly whipsawed by the swirl of trade negotiations between the U.S. and China and the disorder of monetary policy caused by political interference over the past twelve months. The stock and bond markets have had several violent moves on relatively benign news. The cause of these is connected to extreme positioning of speculative quants and algos which tend to follow news flashes encouraging momentum.

However, when it comes to genuine investors, it is all about what ought to be done to reduce tail risk outcomes related to the proximity and severity of a potential recession. There is nothing new here. Market participants have been worried about the next recession since the last one was over. Yet, we are in the longest-running expansion in recorded history. Moreover, stock prices have energetically increased from the lows of March 2009 and negative yielding bonds have proliferated. As a rule, investors spend way too much time thinking of whether a recession is imminent. Ben Carlson came up with a compelling observation. "In general, stock market performance is positive 60% of the time in the three months to the onset of a recession and for the other times we only had minor corrections. The lead up to the downturn of 2001 is really the only meaningful correction that occurred just before the start of a recession." It was an exception. Interestingly, the U.S. since the end of 1945 has been in a recession 130 out of 896 months--that is about 15% of the time.

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Serious GDP contractions are rare and difficult to spot, nonetheless there is enough empirical evidence and theoretical validity to support the thesis that big recessions are basically driven by random forces--namely unforeseen external shocks like the energy crisis of the 70s or monetary policy mistakes that provoked the financial crisis of 2008. As a matter of course, most recessions are shallow and related to the cyclical sectors of the economy that are interest rate sensitive and upon which the output is frequently subjected to inventory imbalances because the consumption of their goods can easily be delayed.

Given that most stock market corrections are head fakes, investors who constantly fear extreme possibilities usually commit the sin of omission. In my view, getting one's head around monetary policy is the right place to start.

In an attempt to quantify the effect of the recent escalation of trade policy uncertainty, new research from the Federal Reserve suggests that the impact is likely to reduce economic output by more than 1% through the first half of 2020. Thus, President Trump may be forced by circumstances to act appropriately to maintain the undergoing expansion in dialing down the trade spat with China to avoid the negative effect that uncertainty over trade policy could have on economic growth.

Nevertheless, it remains that the Fed's interpretation of financial and economic conditions and its reaction to them will continue to be the active driver of asset prices. In this regard, we do know two big things about the Federal Reserve Bank. The Fed Chairman Powell wants to smooth the economic cycles. Vice Chair Clarida and NY Fed President Williams think that the estimated neutral rate is too high. It so happens that smoother cycles and a lower policy rate are exactly what are needed according to the market, to keep the desired expansion on track and eventually remove investors off monetary life support.

Echoing Franklin Roosevelt: "We have nothing to fear about a recession right now, except for the fear of recession." Scared investors are wondering if worries over a contraction could turn into a self-fulfilling prophecy. Yet, if the monetary authorities were to trim interest rates by 25bps to 1.88% on September18 followed by another 25bps cut in December, the actions would bring the policy rate in sync with the neutral

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rate which I established to be at 1.63% and recession fears would automatically abate. Interest rate futures indicate that the Fed will make those repeated cuts, but not to the near-zero level that may imply a recession. As a matter of fact, the scuttlebutt about a possible recession is heavily politicized. This is why I fall back on High Frequency Economic Tracker (HFET) and Recession Risk Models (RRM). Currently, all the HFET are pointing to a growth path of 1.5% to 2.1% in Q3 and most RRM are not alarming. Unfortunately, most readers have a fixation about the yield curve inversion. While it is true that all recessions were preceded by a Yield Curve Inversion (YCI), not all YCI brought GDP declines. Historically, the median and average lead-lag relationship between a YCI and a recession is 18 and 17 months respectively. Capital Economics produces a white paper on their new model built to spot an upcoming recession. The bottom line is that the raw shape on the yield curve suggests a recession is in the making but it is still far away. However, the shift in term premiums creates doubt. If term premiums were normal, 10-year Treasury yields would be 2.75% and in tune with a two-plus-two economy (2% for inflation and 2% for growth), and the yield curve inversion would disappear.

Jerome Powell struck a familiar chord during a speech on Friday in Zurich. He said that “the Fed is acting appropriately to sustain the expansion; and committed to use tools to support the economy and bring the inflation rate to the 2% inflation target. This why our expectation is not at all that there will be a recession.” He acknowledged that the neutral rate is lower than previously believed and that low inflation is a problem reinforcing the quarter percentage-point rate-cut bet and telling the market that the path is clear to act again.

Couple the above observations with two rate cuts, there would be a very good chance that deflationary gossips could turn into inflationary talks and news of an imminent recession could wane in favor of an ongoing expansion. Investors that take a macro view of how the world will unfold, should monitor closely the performance of the money supply because fiscal policy, trade war and interest rates are cancelling each other out. The money supply with zero maturity (MZM) is up 5.7% compared to 4.1% for N-GDP year-over-year. What is particularly interesting is that most of that increase was registered in the last six months at a time when the economy was running at full employment and at its potential while the velocity of money was stabilizing. It can only mean that some inflation is down the road. In August, Average Hourly Earnings rose 0.4% month-over-month, making the yearly increase of 3.2% well ahead of estimates. The CITI Surprise

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Index is the highest it's been since last February, partially because several inflationary signals indicate an upward movement.

The big story is the insane surge in corporate issuance of bonds. Nearly 50 deals in 30 hours for a record $75 billion in new bond issues were done last week. Even cash-rich companies like Apple were borrowing new money. The question is why this just happened. Given the magnitude of corporate issuance, my guess is that borrowers took advantage of low interest rates before higher inflation sets in and have cheap money to fund buy-backs.

P.S.1 Cheap value stocks found in the energy, material, financial and industrial sectors may end up being more alluring to investors than highly expansive dividend yielding bond proxies like Reits, Staples, Telcos and Utilities.

P.S.2 In August, the Canadian employment surged 81k, considerably above expectations, resulting in a robust year-over-year employment and average hourly wages increase of 2.2% and 3.8% respectively. Meanwhile, the Ivey PMI, which measures business activity, and residential construction picked up momentum in August. Consequently, good GDP results are assured for Q3. The new economic data drove the Lonnie to 75.91 on Friday. The exchange value of the CAD is now only 2 US cents below its PPPR.

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) 343-7772

www.palos.ca