ALPINEMACRO
A Unique Mind On The Markets

GLOBAL FIXED INCOME & CURRENCY STRATEGY

October 25, 2024

Jobs & Fiscal Policy

- September's strong employment report and growing odds of Trump winning the election have been pushing up bond yields and the dollar.
- Most U.S. labor market indicators are pointing to sluggish job gains and a higher unemployment rate.
- Regardless of who wins the presidency, the high likelihood of a split Congress should prevent any major easing in U.S. fiscal policy.
- Treasuries look appealing at 4.25%. However, yields may not decline until after the U.S. election and more evidence of a softening labor market.
- The Bank of Canada lowered rates by 50bps and will need to cut by more than what is discounted in the OIS curve. Stay overweight Canadian bonds.

EDITORIAL TEAM

Harvinder Kalirai
Chief Fixed Income & FX Strategist

Chen Zhao
Chief Global Strategist

Mark McClellan
Chief U.S. Bond Strategist

Henry Wu
Senior Strategist & Head of Quantitative Research

Tony Boeckh
Editor-in-Chief

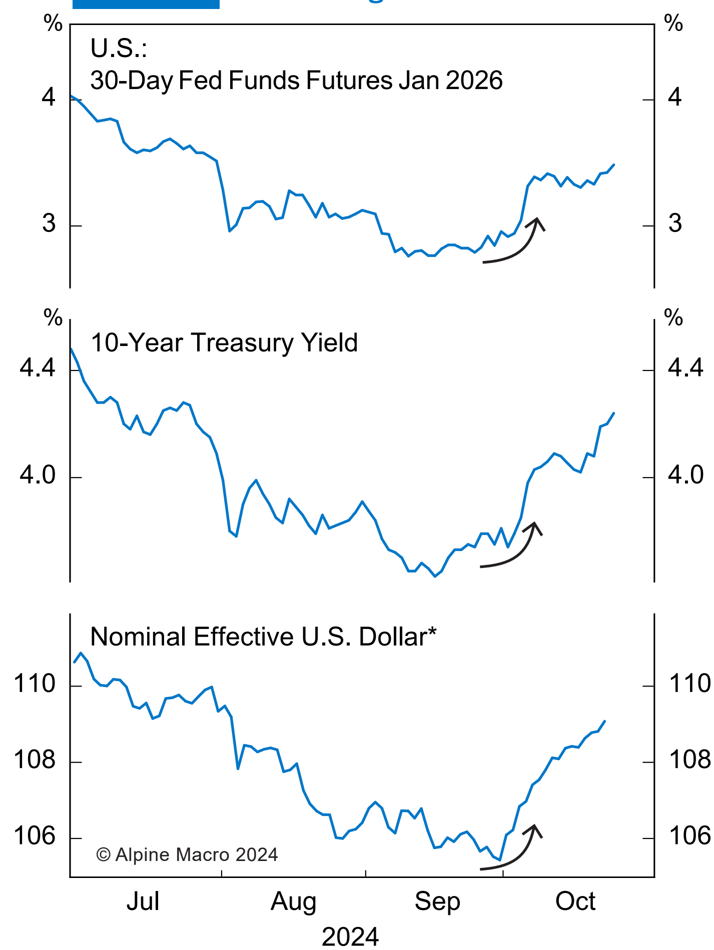
David Abramson
Chief U.S. Strategist & Director of Research

Bassam Nawfal
Chief Asset Allocation Strategist

Tenzin Chozin
Research Analyst

The release of the U.S. employment report for September earlier this month triggered a sea change in investors' perceptions of the American economy and Fed policy. Following the stronger than expected data, interest rate futures have pared back expectations for Fed easing. This has pushed up long-term Treasury yields and the U.S. dollar (**Chart 1**).

Chart 1 Re-Thinking The Fed



*Source: BIS

Chart 2 Did Seasonal Adjustments Inflate September's Nonfarm Payrolls?

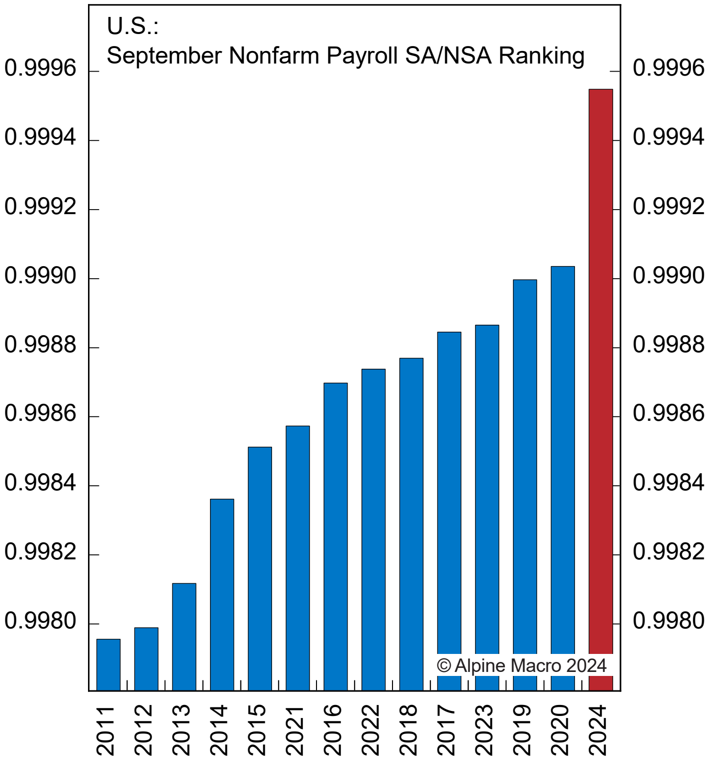
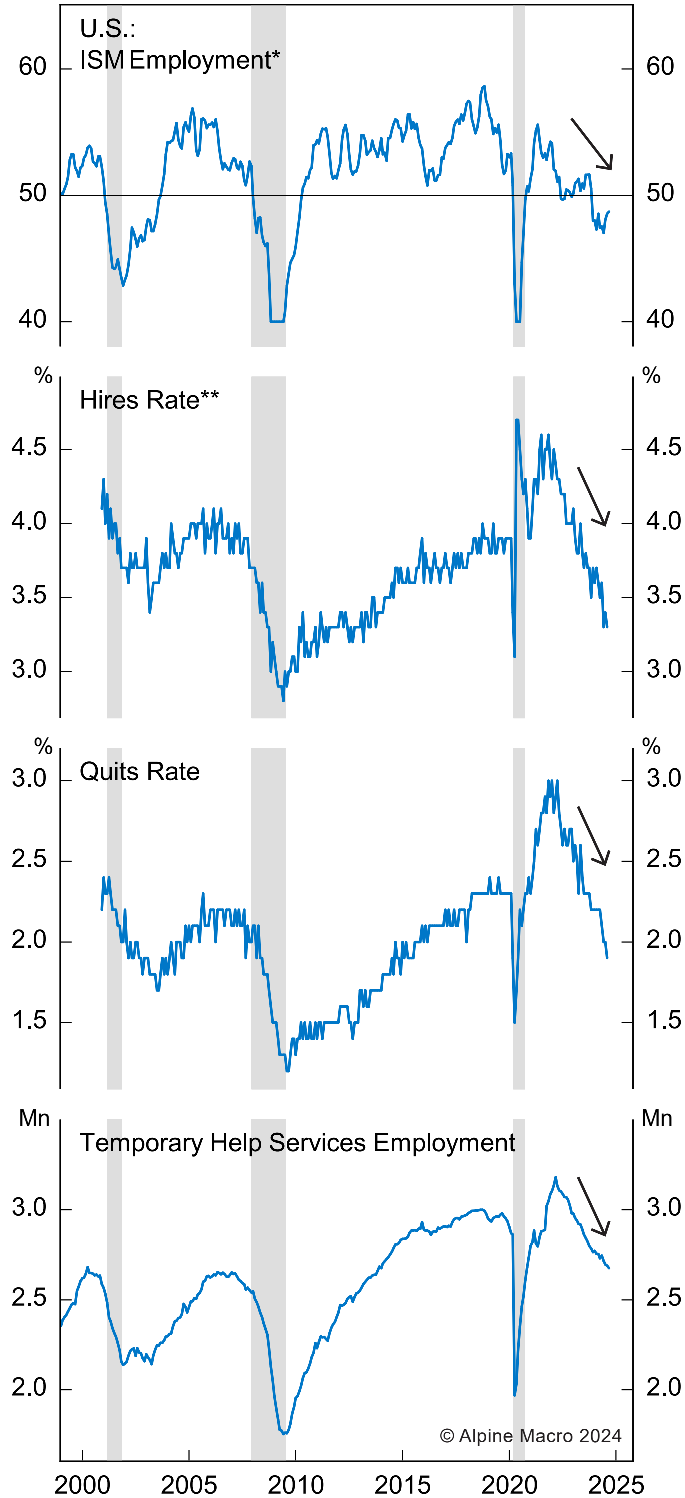


Chart 3 Many Signs Of A Softening U.S. Labor Market



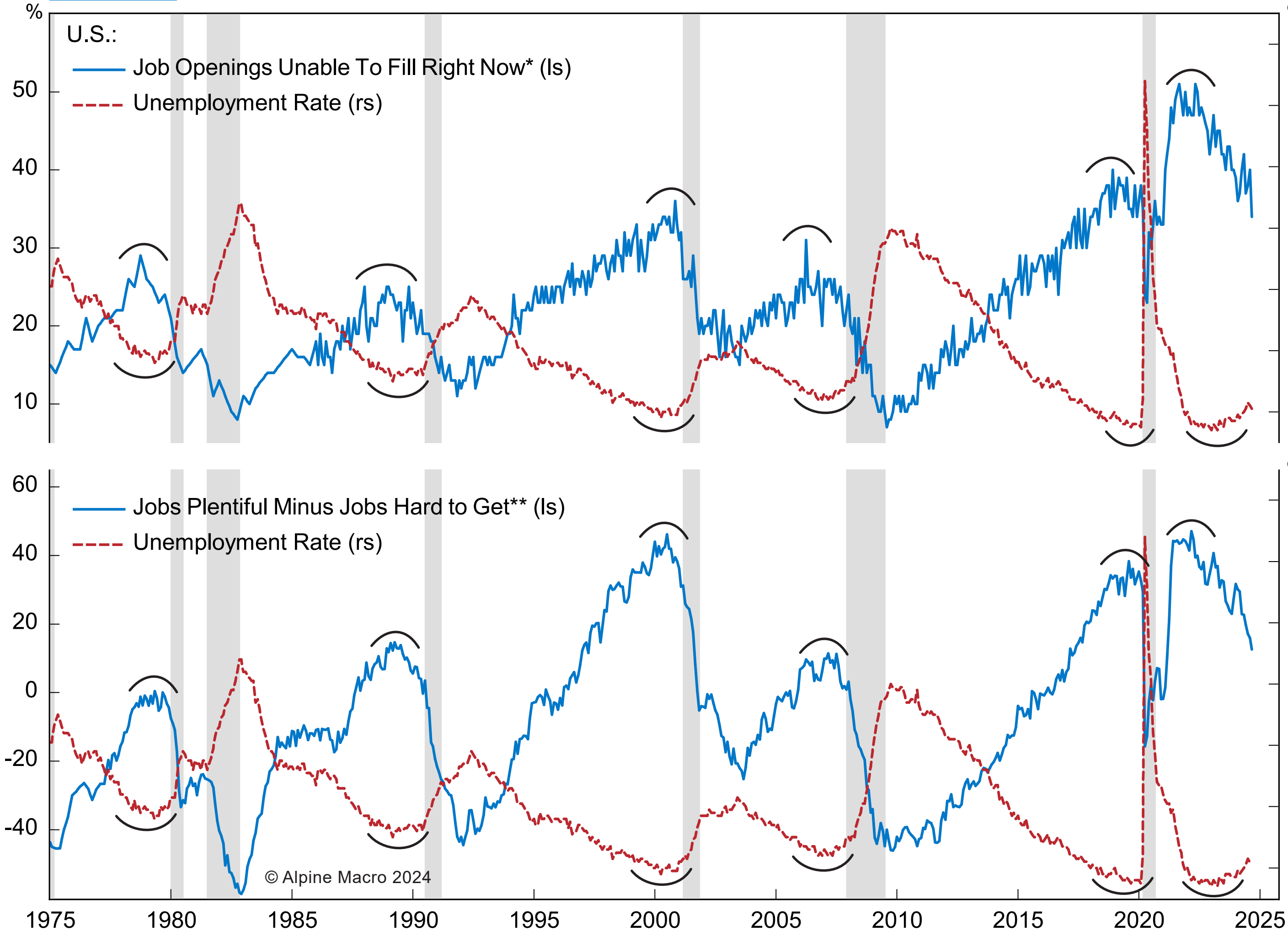
*Weighted 80% non-manufacturing and 20% manufacturing; shown as a 3-month moving average; truncated at 40
**Truncated at 4.7%
Note: Shading denotes U.S. recessions

At this stage, it is too soon to say that the pace of job creation is quickening. First, the September data could be flattered by statistical factors (**Chart 2**). A large seasonal adjustment factor may have inflated the figures. Also, the preliminary response rate to survey was particularly low. This could lead to significant revisions in the next two months.

Most importantly, a variety of labor market indicators are pointing to sluggish growth in new jobs. To name a few (**Chart 3**):

- The ISM employment indices for both manufacturing and services are below 50.
- Outside of the pandemic, the hiring rate has fallen to the levels seen just after the GFC.

Chart 4 Business & Consumer Surveys Point To Higher Unemployment



*Source: NFIB
**Source: Conference Board
Note: Shading denotes U.S. recessions

- With businesses less keen to hire, workers are not quitting their current jobs. This is a sign of fewer new career opportunities.
- Temporary employment is declining. These workers are the first to lose their jobs when labor conditions soften.
- This week's Fed Beige Book noted that *"employment increased slightly during this reporting period, with more than half of the Districts reporting slight or modest growth and the remaining Districts reporting little or no change."*

It is very likely that the U.S. economy is not creating enough new jobs to keep up with the growth of the labor force. Consequently, the unemployment rate should resume drifting higher. This is being flagged by business and consumer confidence surveys. **Chart 4** suggests that the jobless rate could soon rise to a level that will fail to meet the Fed's mandate of "maximum employment".

While the September employment report may have got the ball rolling, it has not been the only factor pushing up U.S. bond yields and the dollar. Investors are also faced with the growing probability that Trump could win the presidency.

Our *Geopolitical Strategy* service has consistently argued that the odds are tilted slightly in favor of Trump winning the election.[1] Since the beginning of October, the betting markets also began to show Trump as the front runner (**Chart 5**).

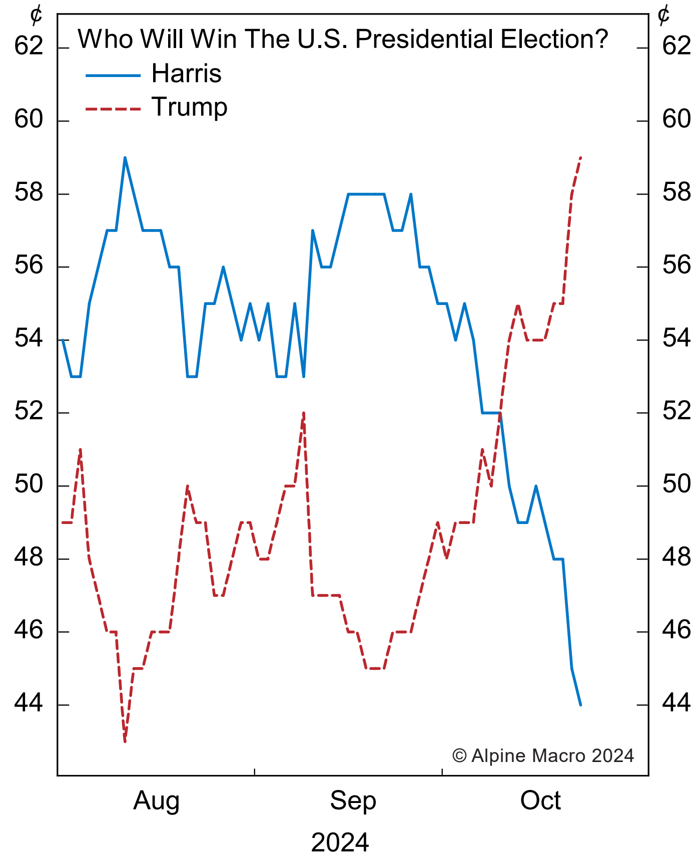
Investors are worried that a Trump victory will bring easier fiscal policy. This will result in stronger growth and higher inflationary pressures, which would prevent the Fed from easing policy in a significant manner. As per the classic Mundell-Flemming model, expectations for looser fiscal policy and tighter monetary policy have pushed up bond yields and supported the dollar.

But rather than who wins the presidency, control of Congress should be much more important for the path of U.S. fiscal policy. While presidents have the power to veto, only Congress can pass new legislation. Presidents cannot enact tax cuts or increase spending unilaterally.

It is important to note that Trump's tax cuts and Biden's spending programs were passed when their respective parties had complete control of Congress. Once the Republicans lost the House in 2018 and the Democrats in 2022, neither Trump nor Biden were able to push for any new fiscal measures.

It will take a "clean sweep" by the Republicans (or the Democrats) to increase the chances of a further easing in fiscal policy. Right now, the odds of that are low. The most likely outcome is that the Senate flips to the Republicans and the House flips to the Democrats.

Chart 5 Trump Is The Front Runner

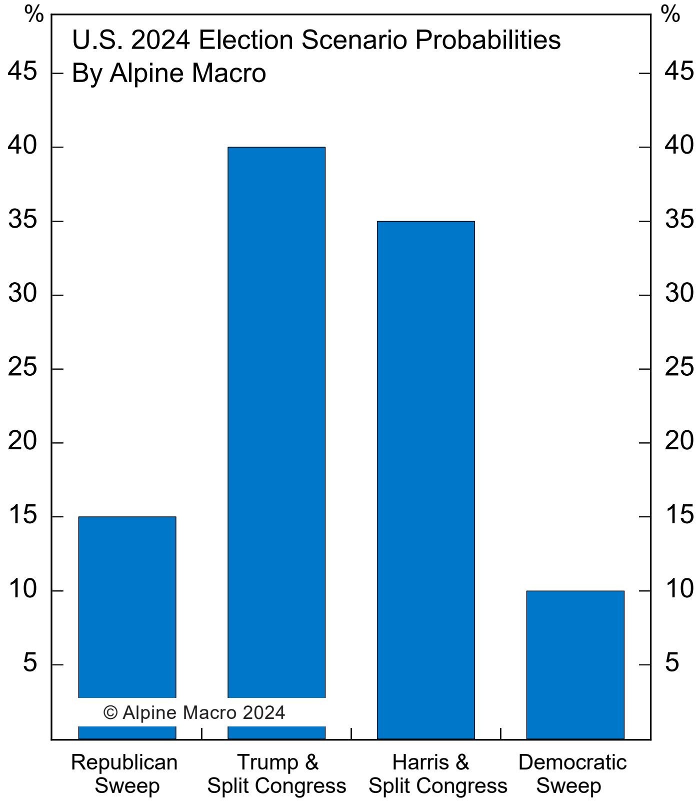


Source: Predictit

Our *Geopolitical Strategy* service puts the probability of a Republican sweep at just 15% and even lower for the Democrats (**Chart 6**). The likelihood of a split Congress should prevent any major easing in fiscal policy. The political atmosphere is not conducive for bipartisan cooperation. The Democrats will balk at making all the 2018 tax cuts permanent, let alone support any new tax cuts that Trump would want.

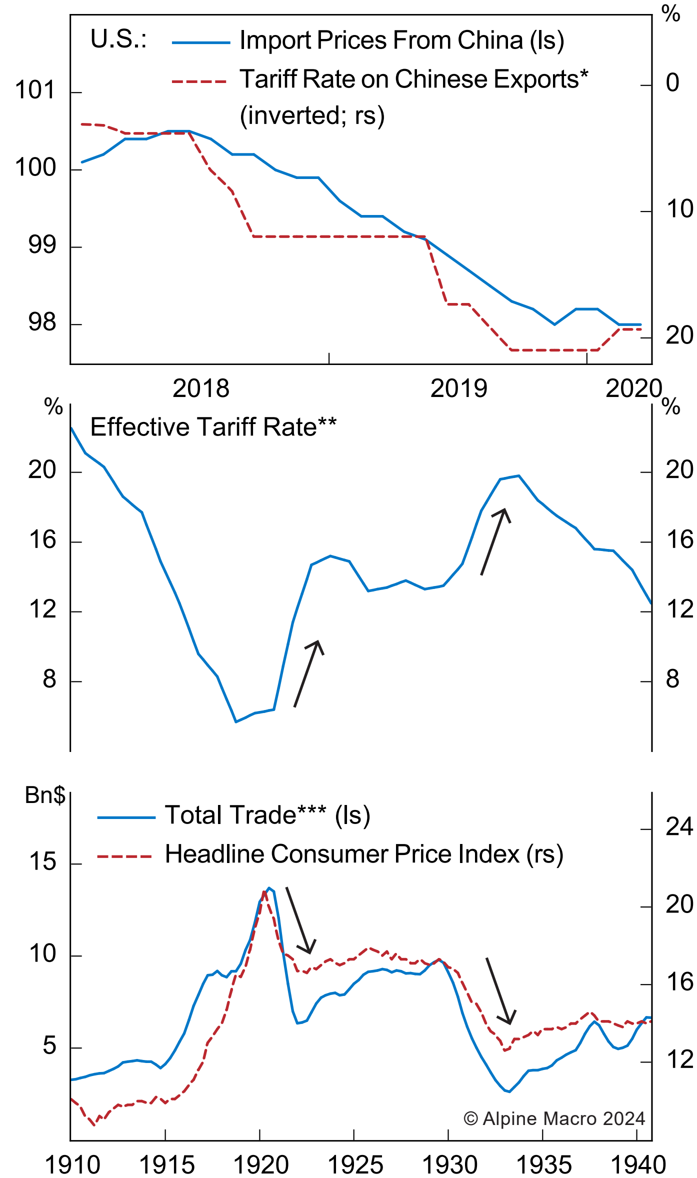
1 Alpine *Geopolitical Strategy* "United States: (Still) Trump's Election To Lose" (Ocotber 24, 2024).

Chart 6 Low Odds Of A "Clean Sweep"



Note: Split Congress assumes that the opposition party has a majority in at least one chamber of Congress, and possibly both

Chart 7 Are Tariffs Inflationary?



*Source: Peterson Institute for International Economics
**Total import duties as a % of the total value of imports
***Sum of imports and exports; shown as 12-month moving sum

The key point is that a further loosening in U.S. fiscal policy is by no means assured, even if Trump wins the election. While the focus is on the presidency, investors should keep a close eye on whether any party is on track to win both chambers in Congress.

Presidents can act without Congressional approval on tariffs. Trump has threatened to raise duties on Chinese goods to 60% and levy a 10% tariff on all other American imports. Investors are worried that this will lead to much higher inflation. These fears are misplaced.

A tariff is like a consumption tax. Therefore, raising tariffs is equivalent to hiking taxes. If cutting taxes boosts real spending, tariff hikes reduce it. The overall impact of rising tariffs is contractionary for disposable incomes and deflationary for prices over time:

- The top panel of **Chart 7** shows that the 2018/19 China-U.S. tariff war coincided with a decline in U.S. import prices from China.

- From a historical perspective, the tariff hikes in the early 1920s and the 1930 Smoot-Hawley Tariff Act resulted in price deflation (**Chart 7**, lower two panels). The latter is widely believed to have worsened the Great Depression.

In terms of investment implications, if the strength in September's employment report turns out to be a one-off and gridlock in Congress blocks an easing in U.S. fiscal policy, then the recent back-up in bond yields and uptrend in the dollar are unlikely to persist.

We recommended to cut duration to neutral in early August. With the 10-year Treasury yield rising to 4.25%, adding to duration is beginning to look more appealing now. However, bond yields may not decline until the U.S. election results confirm a split Congress and signs of a softer labor market become more evident.

The BoC Declares Victory

"[W]ith inflation back to 2%, we want to see growth strengthen."

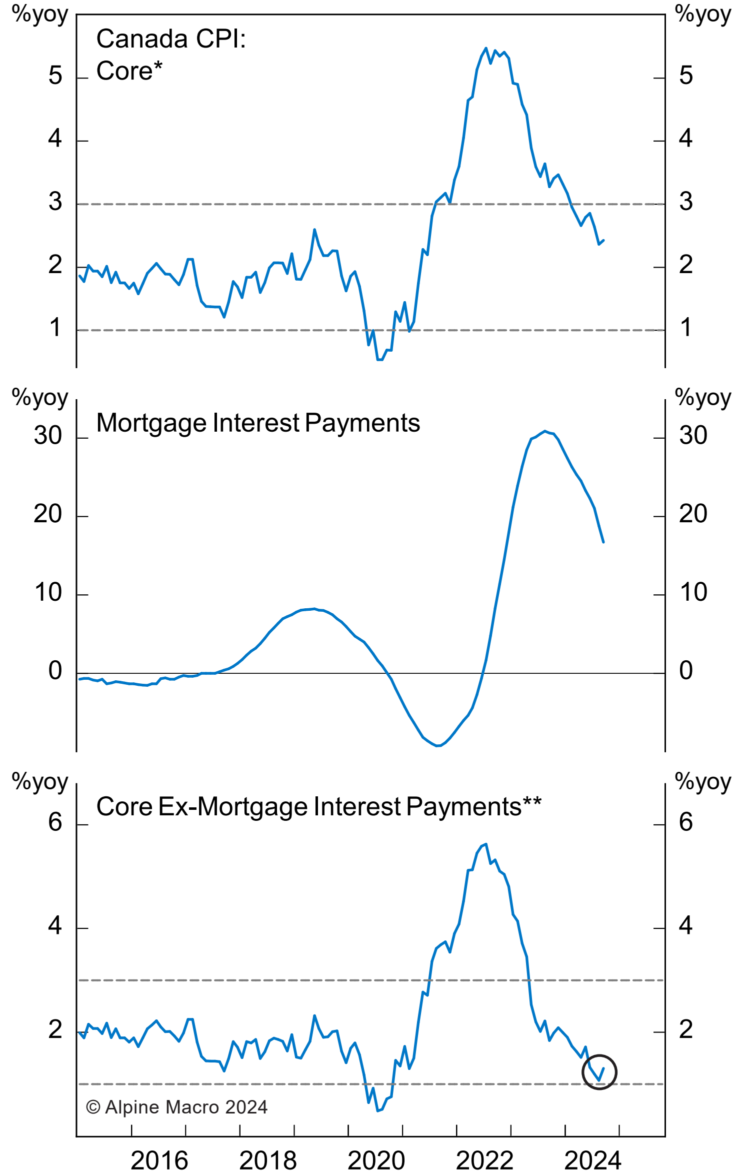
- BoC Governor Tiff Macklem

The Bank of Canada delivered a 50bps rate cut this week, bringing the cumulative easing to 125bps. This makes the BoC the most aggressive G10 central bank in lowering interest rates. No other major bank has cut rates more than 75bps thus far.

The BoC justified the large rate cut by declaring that inflation is back to its 2% target. We believe that the BoC's assessment is much too cautious.

As we have shown in previous reports, outside of mortgage interest costs, Canadian inflation has fallen close to the floor of the 1-3% target band (**Chart 8**).

Chart 8 Ex-Mortgage Interest Costs, Core Inflation Is Near 1%

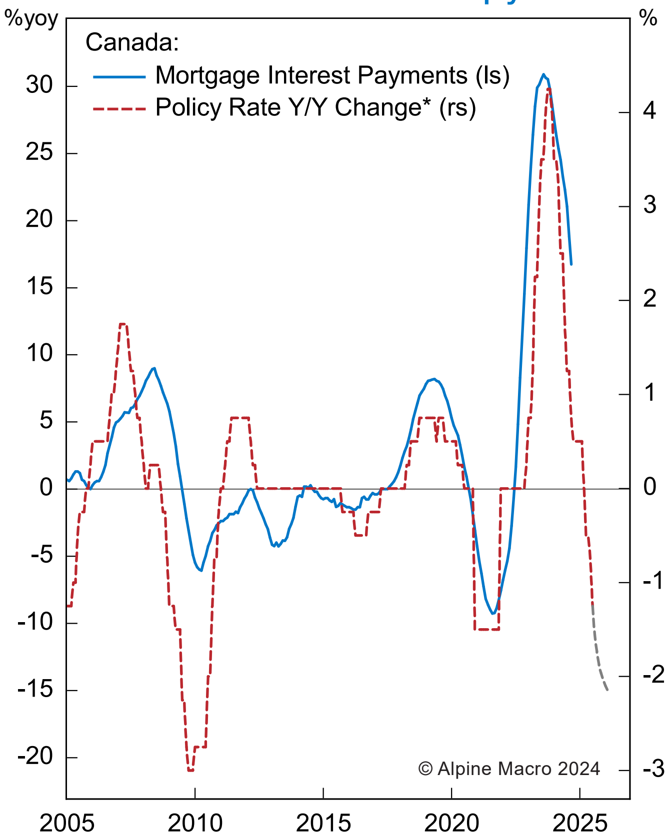


*Excluding food and energy
**Alpine Macro calculation
Note: The dotted horizontal lines show the BoC target range

Higher interest payments are a direct consequence of the BoC's tightening cycle and should not be considered inflationary.

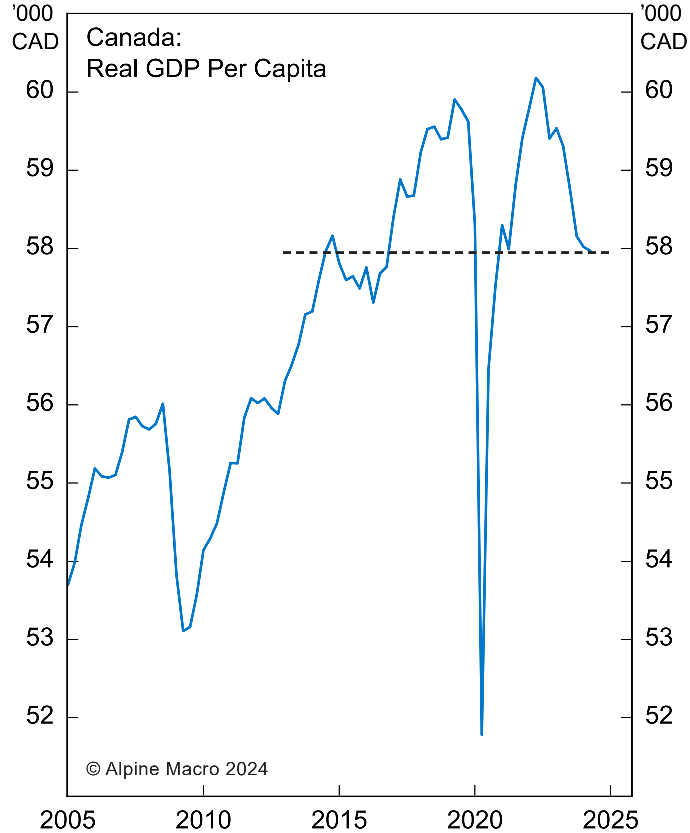
Mortgage interest costs have rolled over and will continue to decline. From the current rate of 17% y/y, mortgage interest payments are likely to turn

Chart 9 Mortgage Interest Payments Will Decelerate Sharply



*Advanced by 9 months; dotted gray line denotes market expectations from OIS curve

Chart 10 Canada's Lost Decade



negative (**Chart 9**). As this happens, the overall core inflation rate could fall to 1%, and quite possibly even lower.

With inflation being tamed, the BoC's focus is now on supporting growth. We have long flagged that the Canadian economy is much weaker than the headline GDP numbers would suggest. GDP growth has been unable to keep pace with Canada's population boom. Even 2% real GDP growth in the first half of this year fell short of the growing population. It is no wonder that the unemployment rate is rising.

Canada's real GDP on a per capita basis has been declining since mid-2022 (**Chart 10**). Outside of the pandemic, per capita GDP is back to the levels of 2015. To put it another way, the average Canadian has been experiencing a recession for the last two years that has pushed living standards down to where they were nearly a decade ago.

Due to growth running behind the supply-side potential, the BoC believes that the Canadian economy is operating with a degree of slack. To prevent inflation from falling further and undershooting its target, the BoC wants growth to strengthen to an above-trend pace and absorb the excess supply.

For the output gap to close, monetary policy needs to move from restrictive to stimulative. The BoC believes that the neutral nominal interest rate is between 2.25-3.25%. Chart 11 shows the market's pricing for short-term Canadian interest rates versus the mid-point of the BoC's estimate of the neutral rate.

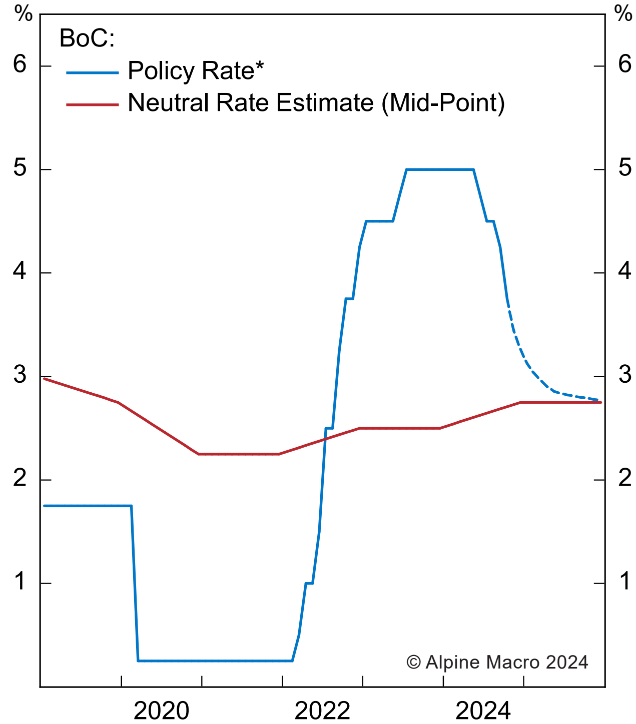
The OIS curve is pricing further rate cuts by the BoC, but the trajectory could be too tepid. The market sees the BoC cutting its policy rate to neutral by the middle of 2025. However, interest rates would need to fall below neutral to generate strong growth and close the output gap.

Admittedly, there is a lot of uncertainty about the neutral policy rate. It is unclear that the Canada's neutral rate has increased significantly following the pandemic. Stronger population growth could push the neutral rate higher, but this is being offset by Canada's poor productivity growth.

Bottom Line: The BoC will need to cut rates more than what is discounted. Global fixed income investors should remain overweight Canadian bonds. The Loonie will stay on the back foot unless energy prices move higher or the Fed turns more dovish.

Harvinder Kalirai
Chief Fixed Income & FX Strategist

Chart 11 The BoC Will Need To Cut Rates To Below Neutral



*Dotted blue line denotes market expectations from OIS curve

Currency Outlook

Vs THE DOLLAR	1-3 Months	9-12 Months
EUR	~~UP~~ FLAT	UP
JPY	~~UP~~ FLAT	UP
GBP	~~UP~~ FLAT	UP
CHF	~~UP~~ FLAT	UP
CAD	~~FLAT~~ DOWN	UP
AUD	~~UP~~ FLAT	UP
NZD	~~UP~~ FLAT	UP

Vs THE EURO	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*	
U.S.	3
Japan	1
Eurozone	4
Core	5
Periphery	2
U.K.	3
Switzerland	2
Norway	2
Sweden	3
Canada	4
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L Spot	P&L Carry	P&L Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	4.35%	-4.08%	0.27%
Long Gold	2022-03-04	1,928	-	-	41.91%	-	41.91%
Short USD/JPY	2024-08-23	146.23	-	-	-3.82%	-0.87%	-4.70%
Long GBP/USD	2024-08-23	1.3094	-	-	-0.93%	-0.04%	-0.97%
Long AUD/USD	2024-09-27	0.6896	-	-	-3.76%	-0.02%	-3.78%

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	86.38 bps

ALPINEMACRO

A Unique Mind On The Markets