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Weekly Commentary

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CONTENTS

Macro View

By Hubert Marleau

Pulling Out of the Induced Contraction

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What Happened In the Market Last Week Ending June 5:

Despite wide scale racial riots and viral sickness stemming from pervasive inequality of all sorts along with aggravating geopolitical tensions, stock indices kept on climbing, extending their persistent rallies. In the week ended June 5, the S&P 500 advanced a whopping 4.9% to 3194. Since the low of March 23, U.S. equities are up 43%. I've revised my trading range for the S&P 500 to 3125 to 3386. It might be the capitulation needed for the S&P 500 to completely regain the 1149 points that were lost from the February high of 3386 to the March low of 2237. As of Friday's close, the S&P 500 had recovered 957 points, or 83% of the total decline.

Many market observers are confused and are wondering why in the hell the stock market has gone up so aggressively amid all the mayhem. There is a feeling, among conscious day traders, informed retail investors, specialized dealers, cognizant speculators and sophisticated traders that the economy will, with the aid of monetary and fiscal generosity muddle-through without serious financial stress or solvency issues. CrossBorder Capital has a global liquidity index (GLI) which measures the excess liquidity in the global monetary complex. It's a very powerful tool--read "Capital Wars" an excellent book by Michael Howell. Put simply, the GLI shows that the world is awash with money, suggesting that a V-shaped recovery is not out of the question. What is particularly interesting is that the enormous availability of capital will remain intact for a longtime, perhaps until the end of 2022.

On Thursday, Christine Lagarde added another 600 billion Euros to the ECB's pandemic purchase program (PEPP), bringing total firepower to 1.35 trillion and extending the program to the end of June 2021 without attrition until the end of 2022 -- an upside surprise. Meanwhile, President Trump will surely be ok with more stimulus, it's an

Macro View cont.

By Hubert Marleau

election year. Goldman Sachs expects $1.5 trillion in additional measures over the course of 2020-2022. It is generally acknowledged that the first trillion were basically designed to help businesses and households to bridge the gap between the time incomes stopped to when they resume. Now the economy is awake, and what it needs is one last shot of fiscal stimulus to bring it back to where it was in the last quarter of 2019.

The pandemic has not fulfilled the worst fear. Editorialists and their armchair doppelgangers turned out to be totally wrong. At this time, there is no evidence that a second wave is about to return in a serious way, the damage to the economy will prove to be structural. Personal savings which are concentrated in transactional bank deposits with zero maturity will find their way into the spending stream. The unemployment situation will not be permanent. While the upcoming election might be spoiled by domestic upheavals, it will unlikely end in a disputed result.

Thus, it looks as if the bears are giving up one by one, as small but consistently encouraging green shoots on the economic front are reported day-by-day. According to the latest mobility chart from Apple, trends in driving have clearly recovered. Moreover, the CITI Economic Surprise Index has shot-up around the world. To top it all, a huge data print on employment on Friday surprised the world. US employers added 2.5 million jobs in May, sending the jobless rate to 13.3% from14.7% in April. The expected surge to 20% has gone with wind.

Mark Zandi, an economist for Moody's Analytics, thinks that the market believes there will be a replay of the post-2009 playbook. He sees the unemployment rate remaining at an awful 10% at the end of 2020. In this connection, mediocre wage growth and a wide economic gap between potential and actual growth is assured. It would basically guarantee the Fed to keep the policy rates way below the neutral interest rates, creating another Goldilock scenario for investors.

Productivity Is Coming Out of the Woodwork

This one may come out of left field, but another favourable surprise in the form of higher corporate profits than consensus forecast might be in the offing. Labour productivity is showing up much better than generally expected. Business output is not declining as much as hours worked. As a matter of fact, Markit and ISM data both indicate that productivity is broadly increasing, which should translate into more optimistic profit margins than bottom up

Macro View cont.

By Hubert Marleau

analysts are projecting. Improvement in earnings has a lot to do with widening spreads between revenues and labour costs. We had many many lay-offs and a lot of pay cuts. It's conceivable that earnings per share may not be as downbeat as the street believes. As a matter of fact, S&P 500 forward earnings, after dropping every week since the week of March 5, have started to rise. Many businesses are realizing that they get more done with stay-home workers and with less of them.

The consensus believes that earnings underlying the S&P 500 could fall to $125 this year from $162 in 2019. If the surge in productivity were to boost profit margins as it normally does, the estimators at FactSet might recompile their 2020 estimates by a few more dollars and strategists at BofA Global Research could raise their earnings above $180 for next year. Valuation metrics do produce optical illusions. P/E ratios could be misleading investors into thinking that stocks are outrageously expensive.

Lower Bond Prices and Dollar Value Are Marking a Shot of Confidence

The stock market is not the only market sniffing out if a recovery is in the making. The stock market is a leading indicator. It's not perfect but when other markets collaborate it gives confirmation that the current momentum in stock prices should not fade and some assurance that the economy is coming back with few serious hiccups. Three interesting yet simple market developments occurred this week that are very supportive of the idea that stock prices may unbelievably return to their former highs of 3386 registered last February and that a V-shaped recovery may become an accomplished mission. Within a week, the US dollar indices and ten-year bond prices underwent serious declines while copper prices rose appreciably. These are reliable forward-looking spy glasses. Given the bond, forex and commodity market moves have coincided often in the past cycles with the ongoing rotation toward pro-cyclical stocks, it should give confidence to the equity stock managers who have missed the rise from the ashes, that the prospective economic recovery, perhaps in an unbalanced fashion, is both real and vibrant. They can set their eyes on sections of the market which are not overvalued.

The Broad Market Is Not Irrationally Exuberant nor Priced for Perfection

Jim Paulsen, Leuthold Group's strategist, broke the market into two groups, one containing the top quarter of stocks by valuation and the other the remaining 75%. He compared them going back to 1950. He wrote in the Barron's; "While the most-expensive stocks have gotten far more expensive---the average for the remainder of the market hasn't changed much. It's 14.5 times versus 13.2 times." Indeed, beneath the surface things are not

Macro View cont.

By Hubert Marleau

as disconnected as it appears on top. A few exaggerated winners have created the misconception that the overall market is priced out. Overall, of the 3470 stocks in the Wilshire 5000 index that have traded since the end of last year almost 75% have negative returns, says Jason Zweig of the WSJ.

Weekly Commentary

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