PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

To Buy or Not to Buy the Dips

Submitted June 13, 2020

What Happened In the Market Last Week Ending June 12:

In the week ended June 12, the stock market corrected 4.8%. Stocks were exhausted because prices ran too fast and too far, jumping ahead of economic realities. As a rule, stocks lead the economic cycle bottoms by about 4 months and this year they are running ahead of the historical average. This has happened because the big players are not behind this rally. It's the little guys who are running with the ball. There were signs of mental fatigue. Not surprisingly, worries over a possible second wave of the invisible enemy and jobless recovery have captured the headlines and rattled the sentiment of a market crowded with day-trade junkies. Their buy and sell decisions are solely based on price action.

However, this week's correction will more likely morph into a consolidation pause than a bear phase. The pouring out of liquidity by central banks, the growing abundance of greenshoots and the increasing capability of the health system should construct an S&P 500 floor around 2950. While it is true that in absolute terms equity valuations look rich versus history, they do not take into consideration context. Morgan Stanley made the astute observation that weaker stock markets and lower bond yields have pushed equity risk premiums higher, and now cheaper relative to the last ten years. The week might go down as a shot across the bow. The S&P 500 may not regain its February high of 3386 until there is a clear defeat over the coronavirus or, at least, a reasonable control of the disease. Accordingly, I adjusted my near-term trading range for the S&P 500 from 2950 to 3386.

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How Did We Get Here:

As of Friday June 12, the S&P 500 was up 36% from the March 23rd low. There are numerous reasons why this historic melt up occurred. The big one was the monetary carpet bombing of the financial and economic markets by the Federal Reserve Board (FRB), the Bank of Japan (BoJ), and the European Central Bank (ECB) with unprecedented amounts of cash at the lowest acceptable level of interest rates that their respective bond markets could handle without having an immediately negative secondary effect. Roughly, the balance sheets of these three entities have soared to $4.5 trillion. The FRB accounted for $2.5 trillion, the ECB for $1.5 trillion and the BoJ for $0.5 trillion. As of June 3, the total assets of these central banks totaled around $20.0 trillion. Is that a lot? Absolutely. It is 90% of the U.S. GDP in nominal terms. Moreover, I did not include all of the central banks of the world like the Bank of Canada, Bank of Australia, etc. Nor did I give any consideration to liquidity that is provided by the shadow banking sectors that CrossBorder Capital uses to calculate its Global Liquidity Index. The enormous injection of money prevented a liquidity and solvency crisis from occurring.

Consequently, seasoned and insightful equity investors made the only decision that a conscious risk taker would do--buy promising stocks that have promising futures because they have strong healthy finances, widely known brands, growth prospects or outstanding values. Why not? It worked in 2009 when ten-year treasuries were almost 3.00%. Back in March, ten-year treasuries were yielding 0.50%. Theoretically, an investor willing to take the plunge started with a 2.50% hedge that works out to more than 25%+, if one cares only about the long term.

What's Next?

Many investment strategists opined that what we have just had was a bear rally. I understand their preoccupation and concerns, we had big bear market rallies in the past. Ed Yardeni, my favorite modern-thinking economist, pointed out that big bear market rallies occurred during August-September 1932 (up 109.2%) and May-June 1933 (up 73.2%). On Wednesday, the OECD and Federal Reserve came out with their economic forecasts for 2020 and 2021. The market was not prepared or ready to absorb pessimistic outlooks after many economies were awash with green shoots that implied a V-type recovery. The OECD forecasted that the global economy would shrink 6% in 2020 and rebound 5.2% in 2021. It made the outlook even grimmer if a second wave were to hit the world, making the 2020 contraction 7.6% with a tepid recovery of only 2.8% in 2021. The IMF is set to release economic projections on June 24 and they will likely be worse than it had in April. Gita Gopinath said that one has to be quite concerned about the path of recovery, citing the depth of the crisis and the need for labour reallocation among other scary issues. Meanwhile, the Fed, barring a second wave, sees the

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U.S. economy contracting 6.5% in 2020 and recovering to expand 5.0% in 2021. Not one of these institutions expressed any hope that the global economy including the U.S. would, in terms of employment, be back to where it was in 2019 before 2022.

I hate to say it but this time is different. The market had a heart attack caused by a surprised pandemic in the middle of a bull market. Thankfully, the economy was resuscitated by Dr. Powell & Co.. Now, the economy is in an ICU in need of care and attention in order to get businesses back on their feet. In this connection, the Fed and the Treasury have decided not to let go. Their objective is not about potential asset bubbles but the state of the economy. The focus is the pursuit of full employment, stable prices and financial stability, even if it means inflating asset prices.

Firstly, the Fed has done what it needed to extol the strength of the banking system. The St-Louis Fed's Financial Stress Index shows the financial conditions have greatly improved and volatility has been kept to a minimum. It's also important to watch the behaviour of bond traders, bond speculators and bond investors to see if volatility is overtaking the system. It is not the case at this time. Traders can finance bonds for a profit, speculators can arbitrage term because the yield curve is not flat, and investors can buy bonds that yield more than the current rate on inflation.

Secondly, the Palos Monetary Policy Index stands at 1. The index considers the stability of inflation, the viability of the balance of payments, the employment situation and economic growth. The index would need to be around 100 before one could expect a policy change.

Thirdly, the misery index which combines the rate of inflation (0.2%) with the unemployment rate (13.5%) stands at 13.7. The inflation content of the index is presently 1.5%. As a rule, the Fed does not change gear unless the content of inflation exceeds 25%. What the Fed likes is 2.0% inflation with a 5.0% unemployment rate.

Fourthly, the Fed is aware that monetary policy is a blunt instrument and it transmits its actions through the banking system and financial markets. But it also knows that the reserves that it creates and the cost of money

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that it controls have the biggest of effect on the interest sensitive and cyclical sectors of the economy—durable goods, residential construction and business capital formation. During the Q/1 of 2020, approximately $5.0 trillion was spent on those items, accounting for 26% of the N-GDP. I cannot say for sure how much will be spent on those sectors in Q/2, let alone what will be the level of aggregate economic activity, but I'm pretty sure that interest rate sensitive sectors did worse than the overall economy. Perhaps the percentage went as low as 15%. No idea! But I know that the Fed has to drive that percentage back to 25%+, if we are going to get back to full potential under decent growth.

The bottom line is that the Fed had to and did deliver last Wednesday a dovish hold and told the world that it will not take its foot off the accelerator until the recovery is established and/or inflation pressure resumes. Thus, the Fed will keep the policy rate near zero until the end of 2022 and will buy $120 billion of assets for a very extended period of time. Again, on Wednesday, the Treasury said the deficit for May was $398 billion, double what it was a year ago. April's gap was $738 billion--a record. The Congressional Budget Office estimates that the pandemic relief will swell the budgetary deficit by $2.2 trillion this fiscal year. Lawmakers approved as much as $6 trillion in stimulus so far. Both Kevin Hasset, White House Economic Advisor, and Secretary Mnuchin are working around the clock to introduce another major fiscal spending program. According to Kudlow, it will be a supply-side playbook—tax cuts, free trade deals, infrastructure spending and capital incentives that will help industries adapt new technology, retain workers and raise productivity.

Market psychology is about trends. The market moves. It's not static. Currently, the trend of events has a positive note. The monthly Wall Street Journal survey, released on Thursday, found that 68.4% of business and academic economists expect the economic recovery to start in the third quarter and 22.8% said that it already began, suggesting that the 2020 GDP will shrink less than previously presumed-- 5.9% versus 6.7%. The majority of the polled economists expect the recovery to look like a "swoosh". The Atlanta Fed's High frequency Economic Model shows that the Q/2 GDP numbers are not going to be as bad as originally considered. Additionally, the University of Michigan reported that consumer confidence is ticking up for the second month in a row.

While I respect that broad market movements are dependent on the waxing and waning of the reopening narrative, the headlines about a coronavirus resurgence are probably overblown. State governments are not

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likely to keep their economy in a coma. The idea of a second broad based lockdown is not an option. In this respect, I'm buying Marko Kolanomic's point of view.

JP Moargan's Marko Kolanonic, dubbed half-god by Wall Street admirers for his unique ability to make accurate calls, offered some solace to investors on Thursday even though domestic unrests and Sino-US tensions remain glaring issues. He argued that the dynamics of the elevated retail trading activity were not about to change. Rather than quibble over the apparent incongruity, professional investors who missed the first trip are likely to become the new dip-buyers. Given the nature of equity portfolio managers, they will be more inclined to buy dips in stocks of companies whose sales and profits are likely to trend higher than zombies that only look cheap. Interestingly, Goldman Sachs noticed that last week money VIP-money managers outperform retail favoured junk stocks for the first time in four weeks.

The up-leg of these types of cycles--a robust jobless recovery accompanied by low money costs for an extended period of time under huge budget and trade deficits--is often distinguished by a weaker dollar, higher inflation rates and rising long term yields which often lead to higher commodity prices and equity prices of companies with large foreign operations. They can profitably benefit from foreign exchange translations and better product prices.

This time around the international accounts at the NY Fed are flush with U.S. notes as a result of the Fed's effort to head off a dollar-supply shortage last April. Foreign central banks may not be keen to buy more U.S. treasuries. They may be more inclined to restore original security positions. On June 10, international accounts held $3.407 trillion of U.S. assets at the NY Fed, $54 billion less than last year. To keep the money there, it needs to be alluring. And, that means either higher long-term rates and/or lower foreign exchange value.

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