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Weekly Commentary

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Macro View

By Hubert Marleau

Push-Backs and Pull-Ups Are Ongoing

Submitted July 4, 2020

What Happened In the Market Last Week Ending July 3:

The stock market feels the optimistic pull of excellent economic prints and the pessimistic push of rising covid-19 cases. The price of the robust economic recovery is an annoying spike in new virus cases. It could cut the recovery short.

On the one hand, we had a litany of strong economic reports showing that the recovery has legs and on track to return the level of activity to where it was in the last quarter of 2019. Consumer confidence, factory output, pending home sales and employment data are up and significantly more than consensus expectations.

On the other hand, the coronavirus trends are dark. Covid-19 cases have crept up in many states and are surging in several others. Dr. Fauci said: “It seems to be mutating in a manner that makes it easier to spread”. A raft of new data shows that everyday more and more people are leading the way by deciding not to self-isolate regardless of official lockdowns orders. It's concerning because it may change the trend line for deaths which have fallen from 12.5% of total cases at the end of April to 2% on June 30. Because the trend line for deaths lags the one for cases, a big upswing in the death toll that could cut the recovery short will not be known for another twelve days. Unfortunately, what will happen may become very challenging because it is imperative for the U.S. to break the cycle so that more people can get back to work without imperiling public health.

So far, the restoration of economic activity has squarely been in the corner of risk assets. In the shortened week ended July 3, the S&P 500 climbed 4.0%. Another encouraging sign for speculators is the fall in the volatility of

Macro View cont.

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equity prices to the lowest level in a month and the rising number of stocks trading above their 200-day moving average. Technically, it means that the consolidation phase is over and that a bullish breakout is in the making that could take the S&P 500 to 3300.

In my judgement, this bullish scenario can only come true if speculators continue to believe that 1) the thousands of researchers who work for drug companies, universities and institutions will timely come up with an effective vaccine or drug treatment, 2) Congress will soon pass another trillion dollar stimulus bill, 3) the scars of Covid-19 will not overly induce frugality, 4) street violence and racial strife will be suppressed, 5) international trade tensions will fade and 6) geopolitical issues will not get out of hand.

Unfortunately, anyone of these competing factors could at any given time buffet the currently favourable technical position of the stock market. In this respect, it's easy to be bearish even though the economic recovery has been more robust than anticipated. Data lags and all the June prints are stale. I'm not suggesting that the outlook is calamitous. What I'm saying is that there are many interconnected unknowns that could temporarily injure the bullish trend and potentially contract the S&P 500 back to 2800. While aware of that risk, my base case scenario is that the market will tread water around 3100 throughout the summer. I like what John Kolovos, chief technical market strategist at Macro Risk Advisors, said: "The market is giving us a correction through time, not price". And there is another big reason.

The earnings season which starts in two weeks may bring numbers that will beat the appalling estimates of analysts. It seems that they have been doubly cautious about predicting earnings because of lack of corporate guidance. Top down estimates might be more revealing. While increases in employment have significantly surprised them to the upside, economic reports have been much more robust. In other words, businesses have produced and sold products with less input cost. Producing more with less leads to output productivity, operating efficiencies and, in the end, profitability. Ben Levisohn wrote in the Barron's on the weekend that FedEx might have given us a glance at what 's coming on the earning sides. FedEx reported a profit of $2.53 a share on revenue of $17.4 billion, easily topping the street consensus of $1.57 a share on sales of $16.5 billion. The stock jumped 12% on Thursday without forward guidance. In such a scenario where less is more, there could be many more exciting surprises, (outside of the hospitality, in-dining restaurant and passenger airline sectors), over the coming weeks as businesses report their June quarter cash flows. Stay calm and carry on.

Macro View cont.

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Allocation of Capital for the Long Haul

The road to inflation will likely be a long one. Yet, I urge investors to keep a close watch on it because the current environment is fertile. The trajectory may have finally started. As matter of fact, investors should be mindful that inflation expectations have considerably risen in the past eight weeks. For example, the bond market is predicting that it will rise over the next five years at the annual rate of 1.3% compared to 0.5% two months ago. Currently, there is no inflation. Thus, the rate will have to increase well above 2.0% if it is going to average 1.3%. Meanwhile, the gold, oil and copper markets are collaborating with significant price increases.

There are only four ways to resolve the looming debt crisis-- defaults, wealth taxes, growth or inflation. The first three ways are politically difficult to do because their methods are too direct and very pointed. The best way is with inflation because it can be done in slow motion. Therefore, it's politically acceptable. It explains why politicians are keen on this idea. Given that the Fed is losing its independence from the government, it is implementing policies that hopefully bring the rate of inflation to 2% next year and run-up to as high as 4% in 2023, 2024, 2025 etc. Jeremy Siegal, an economist with the Wharton School of Business, has figured out that if inflation were to rise 3% over five years--that is about 15%-- it would wipe out $3 trillion of debt. In other words, inflation is a form of tax that would be paid by bondholders and also unbelievably by the Fed who have already accepted to hold low bond yields.

This may occur while other forces that drove the disinflation of the past 40 years are in retreat. Corporations have expanded their objectives beyond the pursuit of maximizing profit. The reversal of globalization is forcing businesses to leave cheap overseas outsourcing and replace it with onshore production where cost is high. Moreover, costly environmental, social and political factors are playing an increasingly important role. Now we have this whole affair of being against austerity in favour of human safety, fiscal deficits and inequalities. And guess what? This is happening as the money supply is rising at its fastest rate in history. It would not take much of an increase in the velocity of money to throw the disinflationary forces overboard.

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