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Weekly Commentary

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Macro View

By Hubert Marleau

Modelling is Difficult Because Circumstances Are Not Normal or Cyclical

Submitted August 8, 2020

What Happened In the Market Last Week Ending August 7:

American stocks finished higher again with the S&P 500 making another recovery high at 3351 for a weekly gain of 2.4%--1% shy of its all-time high. The market appreciated reports of better than expected earnings and economic prints. Acknowledging that productivity is rising, the greenback has fallen, and economic growth is increasing, corporate profits may surprise the market to the upside once again in the forthcoming October earnings season. Numerous analysts have revised upwardly their outlook for Q/3 and Q/4. If one were to extrapolate from the historical relationship between GDP and corporate profits, S&P 500 EPS could be as high as $135 for this year and $170 in 2021. Should these forecasts come through, the equity risk premium would be an acceptable 450bps. The Atlanta Fed's GDPNOW model estimates for real growth in Q/3 is 20.5%.

Nevertheless, last week's surge in stock prices did surprise many market analysts. Capitol Hill was unable to head off an economic calamity with another round of emergency relief. With scant signs that the urgency of the situation will yield a breakthrough for renters, jobless and small business owners, the market could have reflected the political impasse. It did not happen. The market ascertained that the talks won't completely fall apart or collapse for good, assuming that an eleventh-hour solution will be found to bridge the $1.0tn chasm--$2.4tn versus $3.5tn. At worst, under the justification of national security or executive power, the market suspected that Trump could resort to executive orders to extend benefits, forestall evictions and even imposed a payroll tax holiday.

Macro View cont.

By Hubert Marleau

The circumstances are not normal and it's a partial by-product of the Fed's monetary stance. This is not a new or unknown reason, but it is the main cause of the higher price for risk assets. The U.S. monetary authorities have aggressively lowered the cost of money, brilliantly raised inflationary expectations, surreptitiously lowered the exchange value of the dollar and generated enormous amounts of liquidity. In my judgement, the Fed will not shift away from these policies until it becomes totally satisfied with the employment situation. How long will it take? A very long time.

The July employment report showed that the labour market continues to improve, despite setbacks from the increase in coronavirus infections. The U.S. economy added roughly 1.8 million jobs in July, bringing the total gains to 10.0 million. --38.5% of the jobs that were lost in the depth of the pandemic. There are 260.4 million people who could have work in July. Of that cohort, 61.4 % were officially in the labour force (159.9m) of which 89.8% were employed (143.5m) versus 63.5% and 96.5% respectively last February. In order to get back to where employment was pre-pandemic, the math shows that 16.1 million jobs need to be created.

The Barron observed “that more than 80% of the gains in private employment in July came from sectors that accounted for only a third of pre pandemic private employment-retail, restaurants, bars, hotels, casinos, nail salons, barbershops, temporary help services and dentists’ offices. Employment rose by 3.4% in those sectors in July, compared with just 0.3% in the rest of the private sector. If the employment momentum experienced in the personal services sector peters out as it did in the other sectors, the economy could not on average do much better than 500,000 new jobs per month. Thus, it would take 32 months to satisfy the Fed. That is why Powell is not even thinking about changing his thinking.

The Palos Monetary Index stood at 3166 after Friday’s employment report strongly suggesting that the Fed should maintain its current stance. Under price stability, full employment and normal labour force growth, the index would be 100. The Misery Index which is the addition of the inflation rate (0.6%y/y) and unemployment rate (10.2%) was 10.8. of which the inflation content was only 5.6%. Under full employment and price stability defined by the Fed, the index would be 6.0 with an inflation content of 33%.

Macro View cont.

By Hubert Marleau

P.S. The wisdom of the market was correct that something was going to be done to provide some economic relief to those hurt by the pandemic. On Saturday, President Trump took unilateral actions signing four executive orders to provide temporary financial help to those in need. The impact will be limited because the actions are not comprehensive and will be legally challenged by the Democrats in Congress. Nevertheless, the focus on extending unemployment benefits, keeping the moratorium on evictions, deferring student loans and suspending the payroll tax will be sufficient to avoid an immediate fiscal cliff.

How the market will interpret Trump's actions is anyone's guess. It's a gambit. Both sides will likely dig in. It may delay a compromise until late August once the summer recess is over. What I know for sure is that the market will eventually demand finality on this issue and force Congress to pass a deal despite the impasse.

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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