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CONTENTS

The Market Crossed the Rubicon 1
Canaccord Genuity's Explanation 2
The Pandemic Has Caused 80 % of the Global Sectors to Have Supply Chain Issues 3
Disclaimer & Contacts 4

# Weekly Commentary

Issue **No. 36** | **AUGUST 24, 2020**

# Macro View

*By Hubert Marleau*

## The Market Crossed the Rubicon

Submitted August 22, 2020

**What Happened In the Market Last Week Ending August 21:**

In spite of all the media talk of having a market completely disconnected from economic reality, it took only six months for the S&P 500 to cross the Rubicon. It took eight years for Cesar! On Friday, the S&P 500 closed at 3397 for an all-time high and a weekly gain of 0.7%. Once again investors brushed aside the economic concerns of the Fed and the disappointing numbers surrounding jobless claims. They were focused on reports that new Covid-19 infections were slowing in the Sun-Belt and Pfizer's announcement that it was on track to submit for regulatory review a Covid-19 vaccine as early as October.

Meanwhile, most data points on the economy continued to surprise everyone with higher prints than consensus expectations.

1. The housing market is well past the recovery phase. As a matter of fact, the construction industry is booming. Lumber prices ($831per random length) are up 130% from last year. Existing-home sales rose 24.7% in July from June to a seasonally adjusted annual rate of 5.86 million, the highest rate since December 2006. At the current sales pace, there is only a 3 month-supply of homes on the market. Understandably, housing starts increased 22.6% in July and building permits, which are a good gauge of future home construction, rose 18.8%. Consequently, this should lead to a secondary level of demand like renovations, appliances, cars, and furniture.
2. The IHS Markit reported that total new business rose for the first time since February and at a solid rate. The survey revealed that manufacturing firms registered a steep expansion in new order inflows in July while service providers got a renewed increase in sales. Markit noted that businesses are hiring blue-collar workers because new business inflows are increasing pressure on capacity. Perhaps the employment

# Macro View cont.

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situation may improve. Surveyed companies reported that they were slow in rehiring in the beginning but are now able to expand their workforce numbers because they now have safe business practices and protocols.

3. The money supply (M2) increased by $140bn in the week to August 10 while the Fed balance sheet expanded by $53.4bn to $6.97tn. Meanwhile, the Treasury General Account (GTA) fell to $1.636tn from a high of $1.83tn. Government cash balances are moving into the public deposits, activating money that would otherwise be dormant. Incidentally, as much as $1.95tn of Fed loans to non-banks are awaiting allocation. When one adds the implications of the massive improvement in household balance sheets and the $1.3tn increase in checkable deposits since the start of the pandemic, there has to be a whole lot of unplanned savings waiting to be spent. A return of confidence would lead to a ticker-tape parade. The University of Michigan Sentiment Index has inched up every month since March when it fell out of bed to 71.8 from 101 in February. It's currently 78.1.

The big question is whether there are any justifications for the market to have crossed the Rubicon. The Guardian came up with five reasons--Federal Reserve Action, The Tech Giants, Normal Life resuming, A Medical Breakthrough and There Is No Alternative.

Canaccord Genuity's explanation is that "the current recovery is startlingly similar to the one after the global financial crisis." For as long as economic prints keep on being positive, the Fed keeps on printing money and Pharma keeps giving hope that a drug treatment or a vaccine is on the way, Canaccord may be right that the market will technically follow the same upward path. There is room because conjectures are lopsided. The companies that compose the S&P 500 other than the FAMANGs which are Facebook, Apple, Microsoft, Amazon, Netflix, and Google have not done much better as a whole than stock indices of other countries, including Canada--particularly if one takes into account the fall in the exchange value of the dollar.

There are three unstoppable and dominant structural shifts in the making--Digitalization, Onshoring and Inflation. While socially unfair and economically uneven, the Covid-19 is an accelerator of Schumpeter's creative destruction. The process should bring productivity growth across the board with some inflationary demand increase for strategic materials. In this connection, I expect governments will continue to ease the pain of the ongoing disruptions with supportive fiscal and monetary measures.

# Macro View cont.

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It's no secret. The S&P 500 is now ahead because of the FAMANGs which have strongly benefited from low interest rates and high growth rates. The thing is that technology has permitted us to hold the line against the coronavirus. Home learning, home working, home entertainment, home deliveries and home shopping have kept the economy going. E-Commerce sales are on fire. Retail sales that take place on the internet grew 31.8% Q/2 over Q/1, accounting for 16.1% of total retail sales. Should these sales rise another 25%, companies with online services would end-up with 20% of the retail business. In absolute terms, when a sector of an industry ends up with 20% of the business with a 20% growth factor, it does not take too long to completely transform it.

The pandemic has caused 80 % of the global sectors to have supply chain issues. Adding trade disputes, national security concerns and climate change, it is not surprising that industries are in the process of localizing or re-shoring their production. There is a shift to stakeholder capitalism which essentially means that business must include a broader community of shareholders, consumers and employees. It's the only way for corporations to receive favours from the state. In this connection, a series of countries have promised tax breaks, low cost loans and subsidies to those who will acquiesce. BoAML estimates that the cost of moving manufacturing out of China will be around $1.0tn over 5 years. The unravelling of globalization will introduce more robotics, automation, machinery, engineering, electronic equipment and application software. All of these are very promising for productivity enhancement.

The Federal Reserves will soon present changes to the conduct of monetary policy. There is still some uncertainty as to what they will actually be. Nevertheless, the bottom line is clear. Guidance will certainly be more specific, like unemployment and inflation would have to reach desired levels before they change course. The language surrounding asset purchases will be sharper in terms of fostering accommodative financial conditions and supportive economic recovery. When it's all said and done, the Fed will definitely embrace a more relaxed approach to inflation, directly allowing consumer prices to exceed the 2% target, surreptitiously permit the dollar to sink below its purchasing power parity rate and indirectly accept prices for resources to be above their marginal cost of production.

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