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Weekly Commentary

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Macro View

By Hubert Marleau

Navigating the Economy for Higher Inflation: Don't Fight the Fed

Submitted August 29, 2020

What Happened In the Market Last Week Ending August 28:

Another week, another gain. The market continues to be on a bullish path, the S&P 500 recorded a weekly gain of 3.3% to close at 3508 —a new all-time high. Prints on economic activity were all positive and only a few data points like jobless claims and consumer confidence did not beat consensus expectations. The Atlanta Fed's GDPNow model estimates for real GDP growth in Q/3 rose to 28.9% from 25.6%.

Meanwhile the number of people infected with the virus and the death toll stemming from it, fell significantly in recent weeks. Moreover, Abbott Laboratories won authorization for a Covid-19 portable antigen test that delivers results within 15 minutes for a little as $5.

To top it all, the Fed announced a structural shift in favour of more inflation flexibility, making it easier for the monetary authorities to attain full employment. It adds up to low cost of money and heavy purchases of Treasuries, enshrining the "Fed put" that will likely last for years to come. The output gap which is the difference between potential and actual GDP growth is around 8%--a lot of ground to cover.

Overall, the move is market bullish. It gives investors better assurance that the Fed will be able to have more time and weight to bring the economy to full employment when the pandemic ends. That is why the yield curve widened, the dollar slumped, inflationary expectations increased while asset and commodity prices rose.

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This past week, I came across three market notes worthy of consideration. One was made by BofA's Michael Hartnett in his latest edition of his popular weekly "Flow Show", another by Leuthold Group's Jim Paulson and a last one by Gavekal Research's Anatole Kaletsky.

Michael Harnett made the observation that "the S&P 500 is trading on a 23.6 multiple, which means the third-most expensive market in 120 years". In 1999 and 1921 it traded for 30 and 25 times respectively. The thing is that the S&P has become synonymous with just five names (FAAMG) which have benefited disproportionately from the social and economic conditions brought about by the pandemic. In other words, the pandemic rally is almost entirely attributable to Facebook, Amazon, Apple, Microsoft and Google who's continued dominance is now virtually assured. Take these out and the multiple falls closer to 15. Interestingly, from 1900 to 2020, the average multiple was 15. Today, the yield on ten-year treasuries is 0.75% compared to an average of 5.00% for the aforementioned 120-year period. He added that the S&P 500 is the most negatively correlated to the S&P 500 equal weighted index except 2017, 2000 and 1999." If one thought that corporate America has no meaning outside of the FAAMGs, and, in turn, thought that the S&P 500 was just the tech sector, it would be trading at 4322. However, if corporate America were just banks, energy and materials, the S&P would be 2043.

Jim Paulson made the astute observation that despite the biggest economic shock suffered in generations, corporate earnings have not suffered nearly as much as one could have expected. Trailing 12-month earnings per share are down 15% from their peak compared to 50%, 26%, 26% and 39% for the previous four recessions. As a rule, corporate earnings fall much more than the economy does during recessionary periods. This time around, growth in S&P 500 sales per share fell but did not turn negative and gross operating profit did fall but not by very much. There are a number of reasons why earnings have not followed the usual script. Rising monopolistic conditions, rapid digitalization of business models, payment protection for those who lost jobs, and de-leveraged households, are Paulsen's explanation.

Anatole Kaletsky, possibly the best student of markets, admitted that he was wrong to turn bearish earlier this year in one of John Authers' missives dedicated to the Bloomberg audience. He made a bad call because he underestimated how far central banks and governments would go to arrest the economic effect of the pandemic.

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Now, he sees a chance for a “Keynesian phoenix” to arise from Covid-19, as the crisis, jolts individuals, governments and companies into taking the right actions to build growth.

His core economic argument rests on two notions that could rapidly transform the economy. First, the pandemic, de-globalization, digitalization and climate change have administered an economic shock to parallel a world war by destroying vast amounts of capital. Second, Keynesian fiscal stimulus financed with negative real interest rates should boost private and government investments replacing lost capital to generate above-trend productivity growth.

His key historical analogy is based on what happened after WWII. The sudden end of combat brought a year of wrenching upheavals in countries where capital was destroyed. Yet, an economic boom quickly ensued as interest rate controls were implemented and broad-based fiscal measures were introduced.

A Memorializing Monetary Pivot:

The Federal Reserve has tremendous power. That is why one should not be in the investment business without knowing what the FED IS UP TO. It can move interest rates, turn government deficits into money supply, heal unhealthy financial conditions, raise the reserves of the banking system and print money by buying private bonds. In this respect, the Fed has immense influence over inflationary expectations, economic growth, asset prices and the exchange value of the US dollar --the dominant reserve currency.

August 27, 2020 will go down in economic history as a pivotal moment. The Fed formally ended Paul Volcker’s doctrine that the Fed should be willing to accept high interest rates to crush inflation even if unemployment increases. Instead it introduced Jerome Powell’s doctrine that the Fed should be willing to keep interest low to achieve maximum employment even if it increases inflation.

Thus, the idea that too much inflation is bad was replaced with not enough inflation is bad. The bottom line is that in the future the Fed will target inflation to average 2% over time removing the obligation to raise interest rates

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even if it believes that the economy is running at full employment. Bloomberg's John Authers showed that the basic philosophy can be easily traced by looking at how the wording in its central strategy document has changed.

The Federal Reserve wrote: "The inflation rate over the longer run is primarily determined by monetary policy, hence the Committee has the ability to specify a longer-run goal for inflation. The committee reaffirms its judgement that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the long run with the Federal Reserve's statutory mandate. The Committee judges that longer-term expectations that are well anchored at 2%, foster price stability and moderate long-term interest rates and enhance the Committee's ability to promote maximum employment in the face of significant economic disturbances. In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

The above statement implies that the Fed would not raise interest rates even if employment were to run at or above real time estimates of its maximum employment level, unless accompanied by signs of unwanted increases in inflation or broad evidence of unwarranted financial speculation.

Thus, the various gauges that I monitor that have been helpful in the past to make sensible judgement as to what ought to be and is the current monetary stance, will have to be significantly modified to better reflect the Fed's new way of conducting monetary policy. I haven't made any changes yet. Why? There is plenty of time to examine them for appropriateness. Presently, a low interest rate environment is here to stay for several years. It's safe to say that the Fed will double down on its low-rate, quantitative easing and guidance bets until we get rid of the negative effect of the virus on the economy.

Unwanted Inflation:

The inflationary content of the misery index which is the addition of the inflation and unemployment rates, is only 9 percent. Under the old doctrine, I would have expected some tightness if the content rose to around 25%--now it may be as high as 50%. Based on a three year moving average (2017-2018-2019), the PCE index would need to

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rise at the annual rate of 3%+ to create a 2% moving average over the next three years. That conclusion doesn't include the initial deflationary shock of the pandemic. The Fed will likely have a different inflation calculation than mine to make policy decisions. Nevertheless, my method makes the point that the Fed can keep interest rates low for a long time to bring back maximum employment. In this context, employment as a percentage of the working age cohort may become an important gauge of what constitutes maximum employment.

Unwarranted Speculation:

From here on, I shall pay more attention to the Debt-to-GDP ratio to figure out if societies are over financing unprofitable zombies and governments are overspending on unproductive programs. Economic systems must be sufficiently efficient to clear if they are to avoid disturbing economic imbalances.

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