To subscribe to our Newsletters www.palos.ca/register

PALOS

CONTENTS

Weekly Commentary

Issue **No. 41** | **SEPTEMBER 28, 2020**

Macro View

By Hubert Marleau

The Near-Correction Removed the Froth

Submitted September 26, 2020

What Happened In the Week Ended September 25, 2020:

U.S. stocks had a volatile week. If they had not reversed course on Friday, the S&P 500 would have had an official correction. It turns out that the benchmark's weekly loss was only 0.6% even though the progression of the coronavirus was unacceptable. Again, recent economic prints have been passable to respectable with new home sales, home mortgages, home refinance applications, existing home sales, job claims, new orders for durable goods and the PMI Composite, all continuing to move in the right direction.

What is uniquely interesting is that while there was chaos in the stock market since September 2 when the S&P 500 turned in an all-time high of 3581, there has been only limited changes in the other markets. For example, copper prices are down only 1.3%, ten-year U.S. treasury yields are still hovering around 0.65%, oil prices have hardly moved, gold prices are down only 4.0% and IG corporate bond yields have not budged. Indeed, there has been no credit breakdown. We had a decent correction in junk bonds, but it has not spilled over into investment grade corporate bonds which are the belly of the beast.

In my judgement, what we had was a topping process that got rid of a lot of froth. What we witnessed in the last three weeks is definitely not an omen for a long-term bearish mood. BofA's Michael Harnett in his latest edition of his popular weekly "Money Flow" calls the September episode a "midlife crisis". His upside scenario takes the S&P 500 back into the 3300-3600 range.

Macro View cont.

By Hubert Marleau

He may be right because it is an historical impossibility to think that we are in the midst of a bear movement when the monetary stance of the Fed is clearly expansionary, corporate earnings for Q/3 could be better than consensus and the money supply keeps on growing fast. In the last five weeks, the annualized monetary growth was 18.2%.

There is a close relationship between money stock and the stock market. They tend to move in tandem. On September 2, the money supply/S&P 500 ratio was 5.15x versus 5.67x on Friday. These are historically low ratios and out of whack, suggesting upside potential for stock prices. A return to the money ratio of September 2, implies a 10% upward move in the S&P 500 to 3600.

That is an interesting observation, especially when one considers that the “Fed Put” is the real McCoy. Central banks no longer lead the market, they follow it in the same way governments follow the path of the virus. To believe that these guys are not going to react if they need to before the U.S. election is missing the point that we are living in a new world of intervention. Policymakers and lawmakers stand ready to support markets and incomes even if they have to pay workers for staying home. Come “Hell or High Water'' a fiscal package is coming even though vaccine expectations are strong.

Above all, according to the Addepar Tech Platform, high- net-worth investors must be flush with cash because they have been net sellers of equities from April through August. In this last cycle, they have shown an unusual contrarian behaviour that may have cost them---“the sin of omission”. They may want to take advantage of the opportunity that the current situation is offering. The Equity Risk Premium (ERP) and the Bull/Bear market risk indicator (GSBLBR Index) give reliable signals in timing good entry points. Currently, the GSBLBR Index is now pointing to very low risks of a bear market being in the offing and the ERP strongly suggests excess returns from equities over bonds.

Contrary to popular opinion, a weak greenback is bullish both for U.S. stocks and commodity driven equities. Since September 2, the DXY is up 1.9%—it worked against the stock market. I can only conclude that foreign investors were not sellers of U.S. equities, the sell-off was a domestic affair. Plus, foreign central banks were not sellers of U.S. government bonds held at the NY Fed. Generally, interest rate differentials against Britain, Germany and Japan move in favour of the U.S.. I think that the above situation will prove to be temporary. We are nearer the

Macro View cont.

By Hubert Marleau

end of the pandemic than the beginning, which will likely bring about synchronized global growth next year and, in turn, bring about a weaker greenback.

The personal savings rate in the U.S. should recede sharply from the 18% registered in July, perhaps to a low of 8% by the end of 2020. Meanwhile, the federal budget deficits could explode to 16% of N-GDP. That is where the Congressional Budget Office has its peg. Such an occurrence would trigger a need for an unprecedented amount of foreign capital because the current account deficit would just balloon. Declining savings equate to a rising current-account balance deficit when budget deficits rise. In order for this not to happen, business investments would have to decline a lot more than they did in Q/2 and/or corporate cash flow would have to rise very significantly--two unlikely events for now. This scenario is not based on some complex economic theory-- but on a pure axiom, better known as an accounting identity.

Given that there is no way that the Fed or the Treasury would try to save the dollar from exchange weakness with higher interest rates or other methods, foreign money inflows to cover the current account deficit would come about only if the dollar was attractively priced. In other words, there is no way that they would lean against a tide. It's far more likely that they would support the stock and bond markets than lean on the side of deflation. They will do “whatever it takes” to get some inflation. This time around, rising inflation should be supportive of equity returns. The key idea here is that we might get higher profits without a corresponding increase in interest rates and possibly create a pleasant environment for stocks.

Firstly, higher nominal interest rates are not in the cards. Under the Fed’s new framework, the threshold for rate hikes is higher. According to Goldman’s David Kostic, “in previous cycles inflation generally had a negative impact on valuations when core PCE neared 2%, in part because of anticipated rate hikes”. He added that “ the Average Inflation Target (AIT) means the Fed will temporarily lift its inflation target to roughly 2.5% and as a result, the headwinds to valuations from inflation should also only occur near the new target inflation rate”.

Secondly, demand pull inflation in its initial stages usually causes corporate revenue growth to outdo cost push pressure and therefore lift corporate earnings.

Macro View cont.

By Hubert Marleau

Follow us on LinkedIn:

Weekly Commentary

Issue **No. 41** | **SEPTEMBER 28, 2020**

Disclaimer:

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