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Weekly Commentary

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CONTENTS

Macro View

By Hubert Marleau

From "Blue Wave" To "Blue Wall" To "Blue Sky"

Submitted November 14, 2020

What Happened In the Week Ended November 13, 2020:

History is clear that in the aggregate, stock prices oscillate around a secular trend. However, short term price action is usually dictated by "soup du jour" narratives because day traders care more about what's going on right now than what's likely to happen in the future. When narratives and the secular trend work in tandem, stock prices do very well. The S&P 500 rallied almost 10% from October 28 through Friday.

Secular stock market trends are essentially tied to the direction of the economy for as long as monetary policies and financial conditions allow them to take place. As in almost all of the previous weeks since the end of April, economic and monetary prints showed that the economy is on a solid growth path as it continued to gain ground without any apparent stress in the banking system or financial markets despite the pandemic surge. The new WSJ survey conducted on November 10 revealed that forecasters expect the recovery will remain on track following the Presidential election, with much more certainty that upside potential exists with less recession risks than in previous surveys.

In the two weeks the stock market was blessed with three bullish stories that can be characterized as "Blue wave", "Blue Wall", and "Blue Sky". The "Blue Sky" was characterized by Pfizer's Monday announcement of a miracle for genetic medicine and a significant fast-moving scientific breakthrough that may well end the pandemic. Pfizer said its Covid-19 vaccine was effective in preventing 92% of infections compared with a placebo, in a large-scale study of 43,500 volunteers, with no serious safety issues which could be ready for distribution by Christmas. The press release left no room for equivocation for it said: "Today is a great day for science and humanity." The watershed phrase injected jet fuel in the ongoing market rally and rocket fuel in the ongoing rotation to reflation because it was not only viewed as a victory for science but as a major economic game changer.

Macro View cont.

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Thus, the market got a quant shock that mathematically shouldn't happen because the event stretched the limits of physics. JPMorgan wrote that Monday's crash in momentum was a 15-sigma event. It means: "that's something that might be expected to happen every 1.090e+048 years." A figure with far too many zeros to make the event possible. Yet, the medical breakthrough catalyzed the largest one-day momentum crash and the biggest single-session value squeeze in market history. It confirms that life is what matters most.

Science may leap forward, but the diffusion of the vaccine process will likely take time because it will be logistically and politically complicated. Stunning news will invariably make market losers and winners move too far and too fast, bifurcating the market with short stretches of rapid ups and downs.

Yet, it is very probable that the underlying market and economic trends may resemble the "Roaring Twenties Redux" -- a generational inflationary shift that followed the Spanish flu. Business will soon step into a dream scenario on the other side of the coronavirus period. The bottom line is that there has been a huge transfer of wealth from the government to the private sector; a phenomenon that will likely continue under a Biden-Powell administration. Surpluses in the money supply have been created by the Federal Reserve and extra private savings by the Treasury, which are running in the trillions of dollars. Consequently, the economy has an enormous amount of monetary power and spending potential to absorb its unutilized physical capability and beyond.

It explains why many market strategists with outstanding records are not taking notice that the coronavirus is making an ugly comeback. For example, Goldman's David Kostin expects the S&P 500 to hit 4100 by mid-2021 and 4300 by the end of next year and perched around 4600 towards the end of 2022. Goldman 's baseline assumptions are not far-fetch, instead they look probable. There are seven assumptions:

1. A vaccine is approved by the FDA.
2. Congress remains divided.
3. Reduced policy uncertainty.
4. The economic recovery continues.
5. Corporate profits rebound.
6. The Fed remains on hold.
7. The yield curve only moderately steepens.

In conjunction with Goldman's economic outlook, Kostin sees 2020 S&P 500 ESP of $136, $175 for 2021, $195 for 2022, $207 for 2023 and $218 for 2024. Investors should note that it is difficult to reconcile the metrics of absolutes versus relative valuations. There is no doubt that on an absolute basis, valuations look expensive. But the S&P 500 index and its median are actually undervalued on a relative basis compared with US Treasury

Macro View cont.

By Hubert Marleau

and corporate bond yields. Thus, further P/E multiple expansion is possible. Furthermore, P/E multiples can increase as much from rising growth as it can from declining interest rates. As a matter of fact, Jim Bianco of Bianco Research has looked back at the calendar year returns for the S&P 500 from 1928-2019 and found that rising interest rates in and of themselves are not necessarily a bad thing for stocks. Ben Carlson wrote a piece on the subject that is worthy of consideration----"The average performance of the S&P 500 during these past rising rate environments was almost 22 percent in total returns. Only three times did stocks fall when the 10-year Treasury yields rose by 1 percent or more, and the largest losses were just under 2 percent. So, stocks have held well in the face of rising rates over 50-plus years."

Palos is currently employing an unleveraged barbell strategy that tactically combines small-overweight exposure in companies that operate in cyclical industries like banks, reits, industrials, mining and conventional energy companies that are undervalued. Additionally, we have long-term positions in selective growth companies in the technology, digitalization, infrastructure and energy renewables sectors which have superior business models and strong balance sheets.

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