PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

True North

Submitted December 5, 2020

A Snapshot of the Week Ended December 4, 2020:

The S&P 500 continued to climb higher in spite of higher Covid cases, hospitalizations and deaths, rising 32 points, or 0.9% to a new all-time high of 3699. Economic prints were generally in line with expectations. However, the employment numbers were disappointing but not terrible enough to halt the trajectory of the stock prices and other important markets. Commodity prices, like oil, copper and gold and long-term bond yields, rose strongly. Meanwhile the dollar continued to slump against a basket of its peers, bringing the decline in the DXY to 90.79, 7% for the year---the lowest level since April 2018. I'm not surprised. In the past five weeks the U.S. money supply (M2) has accelerated to an annualized rate of 18.2% because of a whopping $212 billion drawdown of government deposits. Investors should note that M1, the most transactional part of the money supply, is up 56.8 % year over year and now accounts for an amazing 33% of the aggregate money supply. That could lead to a significant increase in the turnover of money.

Interestingly, it always seems to come back to a few key indicators; the rising ratio of the S&P 500 to the price of an ounce of gold and a pound of copper, plus the price of bitcoins. Together these ratios are telling that the markets are betting on productivity increases, higher cyclical growth and rising inflation. A record $115 billion went into stocks over the past four weeks. The BofA's Bull & Bear Indicator has accelerated towards extreme bullishness, surging from 4.7 to 5.8 in just one week. Technically 5.8 is still neutral. Extreme bullishness is 8 to 10. It should be noted that the aforementioned indicator is an expression of momentum and not of valuation. Michael Hartnett of the BofA noted that over the last 10 months, investors have witnessed the "quickest bear market of all-time" and "the greatness Wall Street rally of all-time" and now "rushing to discount the greatest Main Street recovery of all-time." Bloomberg's John Authers pointed out on Thursday that if one excludes the FAANG +M, on a relative basis the S&P 500 is fairly valued.

Macro View cont.

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The bullishness is ubiquitous. Importantly, it's happening when buy-backs are cratering and less mergers are taking place while there is a deluge of IPOs and secondaries. As a result, the S&P 1500’s divisor is up this year for the first time since 2009. Instead, corporations borrowed more than $2 trillion in the loan and bond market in 2020. Assuming that the vaccine rollout goes smoothly as the new Bloomberg survey shows, it wouldn't be surprising to see publicly traded companies plow their extra cash into EPS-inflating buybacks.

It should be borne in mind that a V-shaped recovery doesn't necessarily mean a V-shape in the labour market. The current downturn is not a normal recession. It was caused by a sudden shock that was imposed by governments in order to help the public health services deal with the pandemic. The hit was awful but human ingenuity has figured out ways to depend less on labour to generate a desired level of output. It’s being achieved through Digitalization, robotics and entrepreneurship.

It explains why Americans are starting a staggering number of businesses, turning old jobs into new businesses to fill the gap. The Census Bureau data center shows that more than 1.5 million business applications were filed in the September quarter, on average, around 800,000 applications are filed per quarter. The pandemic has shifted how Americans eat, play and socialize and more importantly how they work. Bear in mind that starting a business is a fundamentally optimistic endeavour. It's a bet that things will be good enough or get better to make money out of a venture. Some say that applications are likely to be huge in the December quarter.

Curiously, the employment picture may have not been terrible, but just bad enough to make a case for more fiscal relief and monetary stimulus. Close to noon on Friday, President-elect Joe Biden, President Trump and House Speaker Nancy Pelosi said that talks about the $908 billion bipartisan spending bill were gaining momentum to pass it on December11. There are several landmines left in the economy which could influence the level of macro risks at any given time. The vaccine will not be sufficient to immediately normalize business activity. Thus, it has become necessary for both the Democrats and Republicans to act in advance of the Senatorial runoffs in Georgia. According to my little birds in Georgia, there are political reasons that both sides want to appear concerned about the pain of workers that are without a job. The runoff is putting pressure on Mitch McConnell to accept a deal that hopefully will be concluded before year end and presented as a Christmas gift.

Macro View cont.

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The North Star:

The exchange rate of the Loonie touched 78.25 US cents on Friday---very near to our estimated target that we published last April and our then estimated Purchasing Power Parity (PPP). Extracting highly sensitive commodity prices from our calculation of the PPP, the Canadian dollar is worth about 79.25 US cents. Given that traders seem to like round numbers, I'm comfortable with a forecast of 80.00 US cents for 2021. Coincidentally, our forecast is the average of the past 20 years.

It could end up higher if the three ingredients that determine exchange rates remain in place over the coming year. Targets as high as 83.25 US cents have been made by several reputable forecasters who think that the PPP of the Loonie is grossly undervalued when one factors in the price of commodities. In this connection, history shows that the Loonie can deviate as much as 15% either side of the PPP.

Canada's terms of trade have considerably improved with the rising price of energy and other exportable commodities. According to the Bank of Canada, metal prices converted into Canadian dollars are at an all-time high. Secondly, monetary policy is a tad less expansionary in Canada than it is in the U.S., in spite of lower long-term government bond yields. For example, the Canadian neutral rate is 20 bps lower than the overnight rate compared to 30 bps in the U.S.. While there has been a sharp expansion in the balance sheet of the Bank of Canada to 23% of N-GDP, the same ratio is much higher in the U.S. (34%). Thirdly, Canada is attracting foreign capital because there is an abundance of highly alluring investment opportunities, particularly if the world-wide reflation scenario proves to be the right one going forward. Value that is normally found in the financial and resource sectors represent 61% of the Canadian equity sector compared to only 21% for other developed markets. On Friday the ratio of the TSX/S&P adjusted for the foreign exchange rate was 3.71x----a ratio that could easily ramp up to 4.25x representing a possible 15% of better performance. A relative augmentation that would be shared between Canadian stock prices and the Lonnie.

The Shifting Factors of Production in a Post Covid World: The Preface

Over the past few decades, the western economies were characterized by falling inflation, rising employment and declining productivity. After the pandemic, the course of the economy will profoundly change. We are about to enter a new era of rising productivity, increasing inflation and declining employment growth. In other words, the long-term N-GDP growth will be very different from that of the past. There are signs of structural changes in our society where the old elite is being replaced by a new and younger elite which will likely be much more adventurous politically and business wise.

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Firstly, we are in the midst of a major demographic reversal. The cohort of people of working age will be negatively affected by the slowdown in population growth and the reduced willingness of working-age people to join the labour force. Secondly, artificial intelligence, robotics, blockchain and digitalization are rapidly diffusing throughout the world. Thirdly, gross income and wealth inequality will revise and reset fiscal and monetary policies in highly inflationary ways that were inconceivable by the older elites.

The Changing Elite:

Professor Turchin at the University of Connecticut has introduced the idea of cliodynamics as a polymathic effort to give the study of social and political history a sense of scientific rigour. My interpretation of his work is that the asset-rich and highly educated boomers who have all the glamorous jobs, are increasingly confronting tremendous pressure from an overabundance of young people who are also highly educated and rich. These younger aspirants who want elite positions in governments, large companies, universities and Wall Street are putting up a hard fight to push the antediluvians out and take their elite positions. Hence the political turmoil. The millenials believe that it is a fixable issue. They're applying political pressure to replace the boomers in order to involve themselves more decidedly in the academic-industrial-government complex. Professor Turchin's social mathematics argues that we are in the middle of this structural demographic change. A phenomenon which should bring about a major cultural and societal reset which will transform the investment, financial, and economic landscape. To be continued…

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Macro View cont.

By Hubert Marleau

Special Event:

Marleau Conference with University of Ottawa.
Guest Speaker: Renowned Professor Andrew W. Lo (MIT and the Santa Fe Institute)

The Department of Economics and the Faculty of Social Sciences at the University of Ottawa is open to the Marleau Conference "Financial Market Dynamics and Systemic Risk in a Post-COVID World" on Thursday, December 10, 2020.

This year's keynote speaker at the Marleau Lectures is renowned Professor Andrew W. Lo (MIT and the Santa Fe Institute). His current research focuses on systemic financial system risk, evolving approaches to investor behaviour, limited rationality and financial regulation, and new funding models for biomedical innovation.

http://secure.campaigner.com/csb/Public/show/ch5q-2bxqtp--sktfi-5ke75yq4
video
https://www.youtube.com/watch?v=VHClmP4MWww

Registration

Participation is free. You need to register to get the Zoom link. A registration confirmation will be sent by CITEwebi2@uOttawa.ca.

Sign up today!

(The event will be held in English.)
We look forward to welcoming you!

Thanks

The Marleau Lecture Series on Economic and Monetary Policy was created in 2019 with a generous donation from Mr. Hubert Marleau (Palos Management). Please visit our website to learn more about the series.

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