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Weekly Commentary

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Macro View

By Hubert Marleau

Pockets of Speculative Activity

Submitted December 12, 2020

A Snapshot of the Week Ended December11, 2020:

The S&P 500 pulled back to 3663, registering a weekly decline of 36 points for a 1.0% fall. The market needed a pause to digest recent outlandish gains as Covid-19 caseloads continued to surge and as the employment situation darkened. Since November 2, the S&P 500 has risen almost 11%. Traders felt compelled to manifest their disappointment that Congressmen did not come to some sort of agreement on a stimulus to bridge the economy from virus-lockdowns to vaccine-reopenings. I suspect that many commentators will highlight the lopsided frenzy of the bullish sentiment without regard for values in the IPO, Electrical Vehicle and SPAC segments of the market. Although there appears to be a limitless amount of supercharged money heading towards potentially hyper growth stocks promising that we are going to eat (DoorDash), sleep (Airbnb), move (Tesla), live (FB) and work (Zoom) very differently than we did in the past. It will happen, but overnight? No. At this time, these pockets of position overextension appear to be a by-product of the crowdedness of momentum traders and speculators.

Thus, a shakeout is likely in these sectors because a buying frenzy that turns into autonomous investing rarely ends well. A situation that will likely bring about some consolidation in the aggregate market until companies prove that projected earnings for 2021 will in fact materialize.

However, I do not believe that we are at the beginning of a new trend. The BofA Bull & Bear Indicator is still neutral. Yet, in bull markets, sudden 10% corrections are frequent, but they do not turn into bear ones when the market is in the process of recalibrating its aim and about to enter a changing world of increasing productivity arising from innovated applications, along with rising inflation stemming from a shortage of commodities and declining employment growth emanating from lower working-age population. In practical terms, investors gauge progress on the direction of interest rates, the growth of the economy, the outlook for earnings and relative valuations. The prospects for these factors are favourable.

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Investors should bear in mind that job claim figures still show that the recovery is on, albeit at a slower pace. The University of Michigan supports this view. Its headline sentiment indicator printed 81.4, handily beating the optimistic estimates (76) of economists. What is particularly encouraging is that expectations rose handsomely even though conditions have deteriorated amid a recent resurgence in Covid-19 infections and implementations of lockdowns. While economists generally think that the economy will crawl through the early days of 2021, the brand-new December WSJ survey is overwhelmingly expecting that the rollout of coronavirus vaccines will be a boon for the economy in the second quarter of 2021 and beyond. The annualized pace of GDP growth is expected to top 4.2% in Q/2 and 4.3% Q/3 up from the 3.6% forecast for both quarters in the earlier survey. For the global economy, the big Wall Street firms have forecasts ranging from 5.0% to 6.0%

Currently, valuations for the S&P 500 are stretched in absolute terms--trading at 21 times the next twelve months earnings estimates. That is above the long-term average of 15 times. But it does not look that excessive when one acknowledges for the comparable period riskless 10-year bond yields have average 4.25%. Stocks compete with bonds. Presently, ten-year U.S. Treasuries are yielding 1.00%, effectively a P/E multiple of 100 times. In this regard, Ray Dalio said last week, “there is no good reason that stocks couldn’t trade at 50 times earnings”. He went on to add that “just like you might have never expected bond yields to be at or slightly above 0%, you might not be comfortable with these kinds of multiples for stocks; but all investments compete with each other and where would you prefer?” Perhaps it’s indeed a non-stop secular trend as people become more aware and accept that government bonds amount only to money with duration. Afterall, government bonds are essentially the reserves behind the money supply.

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

Over the past few decades, the western economies have been 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.

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

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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 Clio dynamics 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 millennials 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.

One area which seems to have lost its original meaning is "what is a libertarian". Libertarianism is about free choice--but not between good and evil but between two goods. In other words, it should not conflict "rights" with "common sense". Free choice comes with responsibility. Unfortunately, this noble idea has been hijacked by politicians, pundits, bloggers, critics and the media. Yet, it created a movement to restore civic responsibility which believes, rightly or wrongly, that it can only be achieved by reducing extreme wealth and unjust income inequalities. This will bring on the one hand a lot of government interventions in the profit objectives of corporations (ESG) and reforms in the privacy of individuals (cyber security) and on the other hand money independence and secrecy through the use of bitcoins to transact business.

We now have a growing belief that Milton Friedman was wrong on what is the main duty of the corporation. In a NYT article he wrote in 1970 that the objective of business was to increase its profit. Fifty years later, it does not hold any longer, even though his then objective was to give a clear objective, and simple answer to what a corporation was all about. Now the libertarian idea is being twisted around to demonstrate that shareholders are no longer shareholders but stakeholders. Incredibly, those companies who have the ESG stamps do better in the marketplace.

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Inflation Will Come Back:
Technological Disruptions Will Boost Productivity:
Demographics Will Lower Population Replacement:
To be continued...

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