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Weekly Commentary

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CONTENTS

Georgia, Oh Georgia You Turned Blue!	1
The 2021 Outlook	2
Inflation Is the Risk: It Could Temporarily Get Out of Control	3
What's on The Fed's Mind	4
Disclaimer & Contacts	5

Macro View

By Hubert Marleau

Georgia, Oh Georgia You Turned Blue!

Submitted January 10, 2021

A Snapshot of the Week Ended January 8, 2021:

The Wednesday turmoil in Washington distracted attention from the economy, will be remembered as a shameful day and may have gravely injured the prestige American democracy. Yet, it thankfully showed that the political system can reject radical menaces, reactionary threats, insurrections including attempted "coup d'état" directed at upending legitimacy. The Republic proved that it has strong pillars of democracy, capable of applying the rule of law to all citizens. Washington still sits on a hill. The White House is not a House of Cards. The U.S. is not a failed state. In the end, Congress counted the Electoral Votes and Presidential certification was done.

Firstly, the mob violence instigated by infamous white supremacists, cannot defeat the will of the people. Secondly, freedom knows that doing Faustian bargains for short term favours is a falsehood. Thirdly, public institutions can arrest and beat insurrections. Fourthly, the incident summoned some national unity on reforming the electoral process in the hope of arresting or at least consoling the extreme right movement.

The thing is that the institution of democracy is too firmly embedded for autocracy to take over. A major out of proportion domestic conflict would be needed. In any case, it is something that cannot be allowed to happen, and it won't happen. All the central banks and finance officials know that the U.S. dollar is the dominant reserve currency. Without its existence it would not be possible to grease the workings of the international financial system and recycle savings into investments would spell worldwide disaster. Contrary to what one would have thought, the U.S. dollar firmed up on Wednesday, Thursday and Friday.

That is why the stock market overlooked the Capitol riot as a farcical sideshow and decided to start the year in the green. The point is that we do not live in a society but in an economy. What was more important was the elimination of the gridlock brought by the Georgia runoffs without the feared modifications the highly liberal Progressives would have liked to see. In this connection, it will be interesting to watch how Joe Manchin (D-WV),

Macro View cont.

By Hubert Marleau

a very conservative Democrat that champions bipartisanship, will maneuver in the Senate. When it was all said and done, investors took comfort in the prospect that a new management team was about to take over.

The market quickly reverted back to its usual practice of watching the flow of economic data which is giving assurances that business is gearing up for a post pandemic reopening. Data prints on labour conditions were troublesome, but the ISM numbers for both manufacturing and services were impressively robust, suggesting that the economic recovery was still ongoing. The Atlanta Fed's GDPNow model is presently estimating that the economy will have grown at the annual rate of 8.7% in Q/4. In the week ended January 8, the S&P 500 rose 1.8% to reach another all-time high of 3825.

The 2021 Outlook:

The best way for investors to start the new year is to be aware of where certain crucial financial numbers stood on December 31, 2020. Indeed, it is easier to frame one's view around something that we know for sure. At the end of 2020, the U.S. 10-year yield, the global benchmark for borrowing, was 0.90%, the S&P 500, the world most followed stock market benchmark, was 3756 and the DXY, the represented exchange value of world reserve currency was 89.92. A general consensus is forming that 10-year bond yields will move up to 1.25%, the DXY will shrink to 85.00 and the S&P 500 will reach 4100 in 2021.

The view is based 1) on the Goldman Sachs' prediction that for the full year U.S. GDP growth will be of 6.4% (+5% in Q1, +9% in Q2, +7.5% in Q3 and +5% in Q4) and 4.0% in 2022 and 2) on the reasonable assumption that the Fed will wait until early 2024 before raising rates. Thus, the predictable budgetary and current account deficits will require a lot of foreign capital to make ends meet, either through a lower exchange rate of the dollar and/or by the introduction of higher interest rate differentials with the rest of the world to draw in foreign capital. Given the state of mind of the Fed, it's more likely that the monetary officials will opt for a lower exchange value.

Inflation Is the Risk: It Could Temporarily Get Out of Control

The Biden administration will need to compose his ambitious legislative agenda for the economy--health care, infrastrures, clean energy and tax increases--with the same secular deflationary trends that the Trump administration was confronted with. These are the massive debt load, rapid diffusion of technological advancements, changing demographic factors and the permanence of globalization.

Macro View cont.

By Hubert Marleau

Inflation is a very tricky concept to understand. Nevertheless, it doesn't mean that we should not listen to inflation predictors. There are reasons to believe that the inflation rate could rise over the coming year. Monetary largess, powerful fiscal policy, major supply-chain disruptions and huge pent-up spending could temporarily overtake the aforementioned deflationary secular trends. They could engender cost push stress and incite demand-pull price pressure later in 2021.

Monetary Largess: In the week ended December 28, the M2 money supply was up 25% from last year. Interestingly, the bulk of the increase is attributed to an extraordinary increase in M1–the most transactional part of the broadly defined money supply.

Fiscal Stimulus: The Biden administration is expected to pass another stimulus package in mid-February which could total as much as $750 billion including additional Covid-19 relief, aid to states, municipalities and broader eligibility for unemployment benefits.

Supply Chain Disruptions: The ISM numbers revealed last week that the price paid for supplies to produce goods and services rose to the highest level since 2018, reflecting the impact of bottlenecks. Every industry reported the same problem—material shortages, labour interruptions and supply splitting. The ERCI Industrial Price Index is up 26% from last year. So far firms have been able to partially absorb higher input costs because volume and efficiency increases have been pretty good—however in time higher input costs will be passed on in the form of higher selling prices to protect profit margins.

Pent Up Demand: There is approximately $1.1 trillion of extra savings in the system. That is about $600 billion more than the spending hole attached to the service industry which the pandemic has caused. Given the $900 billion in extra relief passed by Congress just before Christmas, plus the expectation of another advancement of $750 billion by mid-February, as much as $2.150 trillion of extra spending is forthcoming—accounting for about 10% of the 2020 N-GDP.

What's on The Fed's Mind:

The Fed is not likely to react immediately or forcefully to the potential rise in inflationary pressures. The monetary authorities are not likely to lose sight of the aforementioned long-term secular backdrop. There is no way that they will suddenly disappear. Moreover, the Fed is also cognizant of three important restraints.

Firstly, the extraordinary heavy government debt load is a major constraint on the future growth of the economy. Given that the neutral rate of interest--a rate that keeps the economy running at lukewarm temperature--is lower

Macro View cont.

By Hubert Marleau

than it was previously, a small upward movement in the cost of money would have a bigger negative impact on the business cycle than in the past.

Secondly, the Fed has changed its policy focus on inflation averaging, suggesting its willingness to tolerate a much higher inflation rate--perhaps as high as 3.0%. Thirdly, what matters the most for the Fed is the employment situation. Presently, the inflationary content of the misery index--the inflation rate (1.2% y/y) plus the unemployment rate (6.7%) --is only 15%. Moreover, the Palos Monetary Policy Index which takes into account the employment situation, price stability, viability of the balance of payment and financial conditions stands at 11. The inflection point is 100.

In this respect, the Fed is bound to focus mostly on the employment growth and the unemployment rate. Historically, full employment is usually attained when the unemployment rate minus year-over-year employment growth is around 3.5 points. The index is currently 12.3 points. From this perspective, it looks as if we may end up with an unconventional monetary environment where the destination of short-term rates and of bond yields may not precisely match the expected upward path of the economy. Accordingly, the economic and financial system will likely remain flush for a considerable period of time. There is little to be gained in opposing the mighty Fed because there is no “clear and present danger” of a coming recession. Significant declines in stock prices are caused by recessions. Yardeni found that during the previous six Blue Waves, the S&P 500 did well each time producing on average a 56% gain.

In this connection, fossil energy, small -caps industrials, chartered banks, insurance companies, and cyclicals like material stocks are likely to be the winners. I would not sell utilities that are involved in clean energy, real estate that is hosting big tech industries or revamping their business models and big technology companies--but I wouldn’t add more exposure to these sectors. Moreover, a few small positions in hospitality, restaurants and travelling areas are appropriate for those who believe, as I do, that in the end the vaccine rollout will eventually be successful. One may want to consider putting some mad money into a Bitcoin or a SPAC just to be cool. In practice, investing is sometimes only about marketing.

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