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Weekly Commentary

Issue **No. 2** | **JANUARY 18, 2021**

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Macro View

By Hubert Marleau

Pondering a Bifurcated Economy

Submitted January 17, 2021

A Snapshot of the Week Ended January 15, 2021:

The stock market was remarkably indifferent to Powell's assurance that the Fed was not about to change its current monetary stance anytime soon and to Biden's $1.9 trillion plan to reinforce the recovery. It looks as if the financial markets have discounted the anticipated benefits of the Blue Wave scenario. By the end of the week, the U.S. dollar was stronger, government bond yields were lower, gold was weaker and so was copper and oil. Interestingly, financial conditions including narrower credit spreads improved. For example, JPMorgan released credit reserves of $2.9 billion because "the improvement in the macroeconomic scenarios and the continued ability of clients to access liquidity and capital markets" permitted such a decision. Nonetheless, traders have been publicly calling for a pullback, proposing that the rally had gone far enough for now and suggesting that the adage "buy the rumor and sell the news" may have come into play.

Instead, investors turned their attention to a series of economic prints---retail sales, consumer confidence, jobless claims and industrial production---which overwhelmingly showed the extent to which the performance of the economy is bifurcated. In a nutshell, there is decreasing inflation, falling employment and declining output in industries considered non-essential or where social distancing is an obligation. Contrarily, there is rising inflation, employment gains and output growth only in sectors considered essential or where social distancing is not required. Unsurprisingly, the Atlanta Fed's GDPNow model for real GDP growth for Q4 is now running at the annual rate 7.4% versus an 11.0% registered two weeks ago. Ergo, the S&P 500 slid 57 points to 3768, registering a weekly decline of 1.5%.

While the speed at which the vaccination can be disseminated is critical, it remains that the future clip of stock prices will also depend on whether the Biden administration gets Congressional approval to implement all or part of its aggressive fiscal stimulus and on whether the monetary officials remain steadfast in keeping its present course. Without help from the Fed, the multiplier effect of the proposed budgetary spending

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deficit on the economy will be limited even though it will help to reduce income inequalities. In order to maximize the effect of a budget deficit on real business activity, a degree of financing from the Fed and some income redistribution to those who have a very high propensity to consume is necessary when the economy is operating below potential as is currently the case. Based on what we know about the current employment situation and inflationary conditions, the chances are pretty good that 1) several features of Biden's fiscal plan will be adopted and 2) the Fed will willingly volunteer help.

On the employment front, the labour market is decelerating with nearly one million Americans filing for unemployment last week, A disconcerting development that comes on the heels of a disappointing December employment report showing that 140,000 jobs were lost. There are approximately 10 million people who had jobs this time last year who do not have one today. If one were to take into consideration the labour participation rate, the unemployment rate is around 10.0%—not the advertised 6.7%.

On the Inflation front, there is no indication that the economy is overheating. It is true that the pandemic has an inflationary side, most notably via supply chain disruption and production shortage in several commodity markets. In other words, the reflation is concentrated in the durable sectors of the economy and not broadly diffused. For example, although industrial prices are up some 30% over last year, they are still much lower than the cyclical highs and they have not overwhelmingly affected producer prices. Indeed, these prices in general are still about 1.0% less than they were one year ago. Presently, consumer prices are only rising at the annual rate of 1.4%. Investors should note that import prices, in spite of the nearly 10% trade-weight decline in the exchange value of the U.S. dollar, are still lower than they were a year ago. It's not that over time higher selling prices in autos, building materials, hardware and household appliances will not be replicated across a widening range of discretionary services once the Covid is beaten--it's just that we are months away from this happening.

The New American Rescue Plan:

Last Thursday, the President-elect outlined a $1.9 trillion Covid expenditure program, which comes on top of the $900 billion Congress appropriated last December and the $2.9 trillion of last spring. There are no guarantees about how quickly this blowout proposal will get through Congress and for that matter how much of it will be accepted. The new administration will need several GOP votes and all the Democrats for this big package to pass the Senate. The red markers will be all over it. Nonetheless Biden, who presents himself as a consensus builder, will be keen to show his brinkmanship and bipartisanship. Based on editorials and

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commentaries of people who are in the know, we are probably going to end up with a $750 to $1,000 billion fiscal program--an amount that would more than sufficient to bridge the estimated 4.0% output gap.

The New Fed Monetary Plan:

On the grounds that the Fed has switched to a system of flexible and averaged targeting and price increases have been below the 2.0% target for years, the initial reaction to above 2% inflation will be to push back. Last week, Federal Reserve Chair Jeroime Powell dropped a hammer on those officials who in his opinion spoke prematurely of tapering the QE program. He put an end to that topic saying, “Let me start by agreeing that now is not the time to be talking about exit. I think that--another lesson of the global financial crisis is to be careful not to exit too early and, by the way, try not to talk about exit all the time if you’re not--you know, if you’re sending that signal, because the markets are listening. The economy is far from our goals. And as I mentioned a couple times, we’re strongly committed to our framework and using our monetary policy tools until the job is well and truly done. And I think the taper tantrum, you know, as you asked about the taper tantrum, it highlights, I think, the real sensitivity that markets can have about the path of asset purchases. So you know we need to be very careful in communicating about asset purchases”. Richard Clarida, the second in command at the Fed, made similar remarks. Late last November, Clarida provided the market with a framework as to how investors should interpret the Fed’s new principle. In a speech to the Hoover Institute, he said: “the FOMC chose a one-year memory for the inflation threshold that must be met before liftoff is considered”.

It means that the Fed will react warmly to any fiscal package by signaling an intent to effectively accommodate Biden’s fiscal push. No tapering or rate hikes until we get inflation at 2% for a full year. Eventually, the Fed will start talking about tapering and rate hikes, but I suspect that it will not be before next winter at which time the virus will probably be cleared away.

Conclusion:

I acknowledge the path of the vaccine rollout is plodding and the end of the pandemic may be further away than thought earlier. Eventually, logistical confusion, shortage of doses, unequal distribution and bureaucratic hurdles will be solved and, in turn, allow the rollout to proceed at pace. The mortifying death count is leaving politicians with no option but to accept Biden's $160 billion spending blast that deals with the idea to accelerate the vaccine rollout and the tracing of the virus. This an area where partisanship and

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bigotry will likely be put aside. In the end, we are going to end up with a vaccine shot in our arm, cash in our jeans and a renewed eagerness to enjoy a “joie de vivre” without encumbrances. Overall, the backdrop for risk assets remains constructive because the world is at the early stage of an economic expansion with ample slack in the labour market under low inflation and with lawmakers and central banks focused on growth. My baseline projection for GDP growth is 6% for 2021 and 4% in 2022 with a 2%-plus inflation rate. Under such a scenario, S&P 500 EPS should reach $175, $200 and $210 respectively in 2021, 2022 and 2023. That should be enough juice to take the benchmark to 4500 sometime in 2021. It's hard for me to avoid this optimistic conclusion because the aforementioned earnings forecast will bring the market back to an attractive equity risk premium should ten-year bond yields remain below 2.25% for the period under consideration.

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