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Weekly Commentary

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Macro View

By Hubert Marleau

Will Reflation Lead to Runaway Inflation?

Submitted February 14, 2021

A Snapshot of the Week Ended February 12, 2021:

The market remunerated the speculators who believed that the precipitous fall in stock prices caused by the raiding frenzy in misfit stocks was an unsustainable event and just too crazy to last. Michael Harnett called the idiosyncratic episode a “tempest in a teapot”. The S&P 500 regained previous week’s loss and registered a whopping weekly gain of 4.7%, as strong earnings underpinned the market. Meanwhile, the economic prints were either on side with expectations or much better than consensus. The Atlanta Fed’s GDPNow model has a new Q1 growth estimate of 6.0%, up from 5.2% on January 29. Interestingly, the plunge in the VIX, a reliable indicator of forthcoming volatility, from 33.2 to 20.87, is a clear sign of optimism. The enthusiasm of the market the S&P 500 ended the week with a 1.2% gain and an all-time high. The increase was mute in comparison to many other high-flying weeks. This should not come as a surprise for there is a bit of conservatism in the press. Several traders are taking profits. Yet, trading was calm, as volatility abated. The Vix, a reliable short-term indicator of future volatility, fell below the 20 point threshold. According to EPFR data that is compiled by the BofA’s weekly “Flow Show” equities received their largest inflow on record, taking in $58.2b last week.

The earnings season has been great. Two thirds of the 367 firms representing 84% of S&P 500 companies which reported, have beaten estimates for both sales and profits, on track for a new record. Profits have already surpassed their pre-pandemic level by 2%. Heading into the reporting season, consensus expected S&P 500 profits to fall 11% y/y.

Underlying the bullishness is the cresting of America’s third wave of the coronavirus--the pace of new confirmed cases is down 60% since the start of the year while the inoculation rate is accelerating. To top it all, the Biden administration said it would purchase enough Covid-19 vaccines to inoculate 300 million people by the end of July.

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Other than the disappointing uptick in jobless claims and a sizable downtick in consumer confidence, economic prints continued to show that the upward trajectory of the economy is unabated. The new WSJ survey shows that forecasters are increasingly optimistic about economic growth in 2021. On average, they expect R-GDP to expand by 4.9% in 2021 with a solid 62.5% believing that there is upside and only 17.5% seeing a chance of a recession in the next 12 months. A plurality of forecasters think that if the vaccination rollout were to provide immunity faster than currently projected combined with Biden's $1.9 fiscal plan, 2021 growth could easily propel to 6.5%.

Given that corporate sales are basically tied to the performance of the economy, the expected mini boom should not only bring earnings per share in 2021 to its well-established trend line ($181) but drive forward earnings estimates per share to $205 in the early months of 2022. If one were to blend these numbers, the earnings yield is around 5.00%. This number is less than the historical average of 6.50%. But when one takes into account that ten-year treasury yields have averaged close to 4.00% over the years, there appears to be upside to the stock market. Assuming that I'm correct that the annual pace of the N-GDP will return to its two decades mean of 3.5% and the relationship between ten-year bond yields and N-GDP will be restored, then the benchmark risk less yield is heading to 1.75% from today's 1.20%. This would not be enough of an increase to upset what would still be a relatively attractive 3.25% equity risk premium. The historical average is 2.50%. There is a lot of empirical evidence and theoretical validity that the equity market can rise alongside higher interest rates as long as the increase is driven by growth. In any case, the Fed will not allow a disorderly rise in rates.

The Current Employment Situation:

Jobless claims came in higher than expected at 793,000. The report comes after a disappointing January jobs report which stressed that several sectors were still in severe distress. The unemployment rate was 6.3% compared to an April peak of 14.3%. An excellent drop, but the statistic doesn't capture the full extent of the slack in the labour market. A broader measure would put the rate around 10.0%. The share of working-age Americans who are participating in the labour force has plunged 2% from a year ago to 61.4%. The number of help-wanted ads have returned to pre-pandemic levels in January. However, they are unfortunately concentrated, in industries--warehousing, housing and logistics--benefiting from the pandemic and in sectors--technology and finance-- which have long term opportunities. The thing is that job postings need to be filled. That is a difficult problem to address. Approximately 4.3 million people left the labour force and the remaining skills are in areas like--restaurants, hair salons, wellness jobs and hospitality--where laying off help can be done quickly. The number of unemployed workers as a ratio of job openings which recorded a record low of 0.81 during October 2019, was twice as high in December, suggesting that there are more people looking for jobs than there is availability. As it stands, there are presently about 10 million less jobs than a year ago. The bottom line is that the labour market is stuck in the mud and its recovery is stalled.

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Current Inflationary Conditions:

So far, fears of rising inflation are over the near term unfounded. Headline and core price in January were both 1.4% higher than last year, slightly below consensus. Although manufacturers are paying more to produce goods because of bottlenecks stemming from supply chain disruptions, difficult logistics and lack of raw materials, they have not passed on their higher input costs to the consumers. The volumes of demand for desired goods have been exceptional making it unnecessary to raise prices to protect profit margins. Corporate guidance on earnings calls suggest that current cost pressures were transitory. The only exception is gasoline prices. The bottom line is that the January BLS report on realized inflation, disappointed the inflationists. Investors should bear in mind that reflation is not the same as inflation. Reflation is a vague-murky term. It has more to do with what may look like a pro-cyclical circumstance than a general inflation occurrence.

The New Mantra is Full Employment:

The U.S. wants to return to full employment as quickly as possible to mitigate the potential of lasting scars on the labour market that the pandemic may have caused. Powell and Yellen have publicly manifested that the goal of full employment takes precedence over inflation. The Fed and the Administration are of similar mind. Both intend to take any actionable means, big and small, to attain full employment. They share the opinion that this can be done without upsetting the apple cart. Inflation is subdued making the cost of money and capital low. Moreover, the CBO is projecting that the 2021 budget deficit will fall $874bn from the 3.132tn in 2020. That does not include the assumed $1.9tn stimulus plan. Thus, the government objective of full employment is anchored. The goal is data and time dependent. They will keep at it until it gets done. As I explained in last week's commentary, full employment will be reached if and only if R-GDP rises 7.5% or $1.408trn from Q4/2020 to Q1.2022 or about 10.0% in nominal terms representing an increase of $1.880tn in aggregate spending.

Will the New Motto Bring Unwanted Inflation?

There are approximately $1.5tn of extra personal savings which are mostly in the highly transactional part of the money supply. It's almost enough pent-up demand to satisfy the amount of spending needed to not only return the economy to its pre-pandemic level of Q/4 2019 but also bring it to its original 3.5% trend line. Take note that the above observation does not take into consideration the $900bn December fiscal program nor any new government initiatives. I'm sure this is exactly what Olivier Blanchard and Larry Summers were worrying about when they argued that Biden's $1.9trn stimulus may not be necessary to attain full employment and hinted that too much stimulus could push inflation to an undesirable rate. I assume that it's all about the output gap. Larry Summers noted that the Biden relief package will inject around $150bn per month into the economy. The CBO says the monthly gap between actual and potential GDP is currently $50bn and will decline to $20bn once the

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pandemic is over. The big question is where will the extra $100bn go. Perhaps to inflation, but not everybody agrees. A minority of economists believes that new-found money the government is generously transferring from its coffer may end-up in savings accounts, paying down debt and leaking abroad. In other words, it could simply become a wealth transfer from the big brother to the private sector.

It is the main reason why more than half of the economists surveyed by the WSJ said the amount of fiscal aid the economy needs to fully recover from the coronavirus is less than $1.0tn. Only one economist believed that more than $2.0trn was required. In this context, the same economists projected that on average consumer prices will rise by as much as 2.8% by June of this year. Investors should bear in mind that from April on, consumer prices will be compared to depressed and declining prices that the pandemic brought last spring. Plain arithmetic guarantees that inflation will certainly rise in the months ahead. Nonetheless, the generic reflation/ inflation narrative applies here. Put simply, the commodity, bond and cryptocurrency markets testify that rising inflation expectation is generalized. The ECRI Industrial index stands at 125.0, up 40% from a year ago. The bond market across all maturities is flashing expectations that inflation will run well over 2.0% for the next five, ten and thirty years. On Friday, bitcoins were trading for $47,000, 366% higher than last year. Acknowledging that cryptocurrencies are more a store of value than a medium of exchange, the wild price increases authenticate that inflation is in the air.

Given the recent performance of the Baltic Dry Index and ratio of copper-to-gold, it appears at this time to be more of a case of reflation in cyclical centers of the economy than runaway inflation. I am pretty sure that the forthcoming resurgence in N-GDP will consist of a normal rise in cyclical prices that are usually associated with rapid increases in business activity.

Jeff Currie, the head of commodity research at Goldman Sachs, has put together a research paper claiming that over stimulation combined with Biden's priorities for a "Green Economy", will bring forth a new bull-market super cycle for commodities that will manifest itself in a price boom in oil and several key industrial commodities. His bullish conjecture will be fortified by the ongoing retreat in raw material investments and political efforts to change the economic redistribution equation.

JPMorgan's Marko Kolanovic has a similar view and warns about a right tail commodity investment opportunity, particularly in the energy sector. He claims that "the low level of new investing in traditional energy and inability to quickly change the popular investment, ideological and geopolitical paradigms'' is a formula for higher all energy prices--fossil and renewables. A post-Covid boom-like economic recovery could collide with underinvestment in traditional energy sources at a time when sustainable energy isn't yet ready to take the baton to shoulder the world's energy needs, resulting in a price crisis. Given that active investor allocations to energy have fallen from 7% in 2015 to 1.5%. Any retracement of this decline could lead to a "high tantrum repricing risk" in energy stocks.

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The investment implications of this view are intriguing. I'm keeping my high growth technology exposure and reducing my thematic EFT schemes; but I'm putting all new-found money from dividends and savings into a variety of companies that mine strategic commodities, produce energy and/or own real estate.

P.S.1 MacroStrategy Partnership, the best economic letter bar none, in a morning note on February 12, Andrew Lees wrote: "Bitcoin soared to an all-time high of $48,929.25, taking its market capitalization to USD 911bn and the whole cryptocurrency space to USD 1,438trn, equivalent to 1.4% of the dollar value of the world money supply. Not delivering any productive return for this, it will suck money out of the real or financial economy and will therefore be a tax on that economy. At this level, it is estimated that Bitcoin alone is consuming 77.782 TWh of electricity per year running the computers behind it, equivalent to 24% of UK annual electricity production, 1.77% of U.S., or 0.28% of world electricity consumption. There are hardware costs that also need to be included, with specifically designed chips for the purpose of mining. Given that the average transaction cost is USD152.233, around 100,000 times as expensive as an average Visa transaction, a ratio that has been going up rapidly rather than down, it wouldn't appear to be making anywhere near a sufficiently productive return to pay for itself. Nevertheless, I would expect it to continue to rise as the central banks continue to pump money into the system, adding more imbalances to prevent the system from clearing."

It may be a long wait. Comparatively, the total dollar value of all gold mined is about $11.1trn at the price of $1850 per troy ounce that is 8 times more than the total dollar value of all the cryptocurrencies that are presently stored. In my judgement, bitcoins will eventually get accepted as a medium. It may look like a struggle, but over time bitcoins buyers are willing to risk the high prices believing that they will likely win recognition as a medium of exchange. Consequently, this anticipation partially accounts for their price—along with a store of value to hedge inflation.

P.S. 2 There is a growing school of thought that believes that 2020 will mark the secular low for inflation/rates and the new decade will be one of ascending inflation and interest rates and mounting relevance of labour over capital. Charles Goodhart and Manon Pradham co-authored "The Great Demographic Reversal", an extraordinary book which gives a compelling argument that changing demographics are about to lead to a new era of rising inflation and interest rates combined with falling income and wealth inequality. It's a "must read". Next week, I will attempt to make a brief resume of the book, including implications for long term investment strategies which are just too important for serious investors to neglect...

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