To subscribe to our Newsletters www.palos.ca/register

PALOS

Weekly Commentary

Issue No. 7 | FEBRUARY 22, 2021

CONTENTS

The New Regime Is Fiscal-Monetary Cooperation 1

Current Employment Situation 2

A Political Macroeconomic Regime Shift Is in the Making 3

Permanent Inflationary Policies Should Bring a Bullish Supercycle for Commodities 4

Disclaimer & Contacts 6

Macro View

By Hubert Marleau

The New Regime Is Fiscal-Monetary Cooperation: Commanding Heights

Submitted February 21, 2021

A Snapshot of the Market for the Week Ended February 19, 2021:

The stock market experienced moments of temporary anxiety. Yet, it was generally indifferent to good news around Covid-19, excellent earnings reports and a likely infusion of more fiscal relief. The S&P 500 fell 28 points, or 0.7%, to end at 3907. The selling pressure was evident in growth stocks as these are in general more sensitive to rising interest rates, which reduce the value of future cash flows. There are concerns among traders that a large and rapid spike in yields north of 2.00% for ten-year Treasury could turn into an inflection point. However, value stocks tend to perform best when the economic outlook brightens, and inflation expectation rises. The ten-year Treasury yield jumped 20bps from a week ago to 1.34% and 43bps since the end of 2020. The yield curve is much steeper than it was a few weeks ago indicating a fast economic recovery is underway and Tip rates are much more negative than they were, expressing higher prices are forthcoming.

Ten-year bond yields around 1.35% is not much by historical standards. Based on the reduced volatility of the Vix index, it does appear that an increase in the 10-year Treasury yield to around 2.00% will upset the equity markets. Interestingly, price movements in gold prices are not reflecting an inflation narrative stemming from government profligacy. On the contrary, the market is spinning the inflationary signals as positive to the extent they bolster the feel-good idea that is all about reflation. In other words, what is ubiquitous is reflation and not inflation. The US labour market is still mired in recessionary doldrums, even though it is now a certainty that the economy will recover from the pandemic.

Indeed, economic growth is very promising. All the other important economic prints like retail sales, industrial production, factory output, housing statistics (starts, permits, sales) and producer prices were very positive and significantly above consensus. On Friday, the Flash PMI's beat expectations worldwide. The US Composite was a 58.8. That's strong. These solid prints are obviously visible in the Citi Economic Surprise Index, which captures the

Macro View cont.

By Hubert Marleau

degree to which data is beating or missing consensus expectations, up to 79.8 from last week 48.5. Unsurprisingly, the Atlanta Fed's GDPNow model estimate for R-GDP growth (seasonally adjusted annual rate) in Q1 is 9.5%. It was 4.5% at the end of last week. As a rule, stock prices tend to rise for as long as the economic outlook remains positive. Wild movement in the discount rate can be a detractor. However, rising economic activity brings rising profits. Personal savings as a percentage of rising disposable income, which represents 80% of N-GDP, is 14%. That is well above the historical average of 7.0%. Thus, the savings boom has enhanced the cyclical and secular economic outlooks.

Some say that a higher savings rate may become a future characteristic of the economy. If this turns out to be so, we shall likely end up with a much-needed enormous boom in fixed capital formation, causing a reflation without generalized inflationary consequences. That's why stocks mostly go up over the long term.

Current Employment Situation:

Not only does jobs seem to have lost momentum at this time, the foreseeable future is under question. For the second consecutive week, jobless claims in the US have been higher than expected. There were 861,000 Americans who filed for unemployment benefits. That is a disconcerting spike because there is growing evidence that millions of jobs may not come back for a long time even after the pandemic is over. The good news on productivity isn't translating into robust hiring. There appears to be a permanent shift in how and where people work. According to McKinsey Global Institute, many businesses are planning for a future where more people are working from home, travelling less for business and replacing workers with robots. Companies are using this period of layoffs to experiment with new technology for ways to minimize the number of employees in their workplace. When businesses come out of a crisis and are in a rebuilding mode, everything is on the table including the workforce. Atlanta Fed President Raphael told The Post, "we've seen real changes in the willingness of businesses to leverage technology to deliver their services."

A recent report written by the Pew Research Center shows that two-thirds of the jobless are seriously considering another field of work. It means a lot of training and credentialing programs. Job postings show that there is a rapid decline in help wanted for administration assistants, human resources personnel, food service workers, beauty consultants, pet groomers, valets, professors, brand ambassadors, physical therapists and audiologists. There is a lot of economic carnage in the labour market that may be difficult to play out. Over time, the economy will likely end up with the same number of people that it had pre-pandemic, but it will take more time than previously believed.

Macro View cont.

By Hubert Marleau

Current Inflationary Conditions:

The reflation story got another boost this week. The Producer Price Index increased 1.3% in January, the largest since December 2009 and the Import Price Index rose 1.4% following a 1.0% gain in December. The Friday's IHS Markit Read showed that input costs in both the manufacturing and service sectors are soaring as demand is comfortably outstripping supply. The pandemic-related supply chain issues have not totally worked themselves out. Given the blockbuster increase in retail sales, a swift uptick in selling prices is due. Companies are eager to partially pass-through higher costs to consumers. The question of whether the uptick is just related to the demand shock of the initial stages of the global shutdowns or due to underlying pressures that are about to take off. At this time it appears that the path towards higher prices is related to benign cyclical reflation. The copper-to gold ratio clearly affirms this. Growth is the hallmark of this recovery. Moreover, the market's gauges of inflation expectations are up and above 2.0% over the near term, but secondary derivatives imply that this upward course is temporary and will be slightly below 2.0% over the next decade.

A Political Macroeconomic Regime Shift Is in the Making:

For more than half a century, monetary and fiscal policies have been countercyclical. Expansionary during recessions and contractionary during recoveries. These policies stopped in 2017 with the Trump Administration. Fiscal policy turned pro-cyclical while monetary policy tried to be anti-cyclical but failed to hold on when a taper tantrum erupted in 2018. For most part, the Fed was neutral until the 2019 Jackson Hole Monetary Conference when it announced that full employment had become a more important objective than price stability. It is now pretty clear that the Biden Administration is of the same opinion as the Fed. Treasury boss Janet Yellen has taken this shift to a new level by thinking big, introducing two enormous trillion dollar spending packages--The $1.9tn American Rescue Plan and the $3.0tn Build Back Better Plan. What is particulary intriguing and unnerving is that neither the Fed nor the Administration have given any forward guidance to reassure investors, businesses and households that if major inflation is unleashed, they will remain guardians of price stability and install anti-cyclical measures. Unless we were to get some intelligence from Powell or instructions from Yellen anytime soon, I'm assuming that orthodox macroeconomic policies are out of the window and replaced not only with procyclical measures but with inflationary permanency.

Permanent Inflationary Policies Should Bring a Bullish Supercycle for Commodities:

Industrial metal prices are powering up on bets that the very positive cyclical and secular economic outlook combined with a worldwide push for green energy will bring about a vast amount of demand for copper, nickel,

Macro View cont.

By Hubert Marleau

zinc, lithium, platinum, and a variety of other minerals. Cash prices on the London Metal Exchange have spiked to historic premium over futures, suggesting deep anxiety about dwindling inventories and rising fear that the net-zero emissions goal will lead to a major rollout of packages around the world for environmental initiatives.

David Jacks, an economic historian, made an astute observation in Reuters last week. He said that over the past 120 years, there have been four extended commodity price booms. He affirmed that “each had a unique driving force--two from war recoveries, one due to the Opec shock and the last one from China’s rapid industrialization. Supercycle adherents believe that the aforementioned demand condition is present, suggesting that Biden’s “Build Back Better” resembles Jonhson’s “Great Society” initiative of the 1960s. Thus, lack of mining investment combined with a surge in energy projects and permanent inflationary government policies are bound to raise demand beyond current supply capacity. David Jacks added that when demand-driven episodes interact with acute supply constraints of energy, metals and minerals, the reaction can generate above-trend commodity prices for years.

Large scale government spending may have kick-started a nascent supercycle. More importantly, there are three other potential triggers that could turn it into a breakout and therefore, in a larger-than-normal upswing which could last for years----the industrialization and urbanization of India, a spontaneous and sustainable burst of economic activity in Africa and the energy transition. Investors should bear in mind that supercycles are low in frequency but long in duration. I’ve invested a chunk of my capital in this idea because multi-year commodity supercycles are very lucrative and very different from the usual routine of rapid rise and fall in commodity prices. However, I shall monitor fundamentals closely because not every upswing in commodity prices will become supercycles. David Jacks gave a good cautionary warning, “Once such a demand shock emerges, there is generally a countervailing supply response as formerly dormant exploration and extraction activities take off and technological change takes hold. Thus, as capacity constraints ease, real commodity prices revert back to--and below--trend.”

The Great Demographic Reversal

As I mentioned in last week’s commentary, there is a growing school of thought that 2020 will mark the secular low for inflation/rates and the new decade will be one of ascending inflation and interest rates along with 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''. The implications for long term investment strategies are too important for serious investors to neglect.

Macro View cont.

By Hubert Marleau

A brief summary of the book by Barry Eichengreen follows, “In this thought-provoking book, Goodhart and Pradhan seek to explain the rising inequality, stagnant wages, and disinflationary pressures of recent years. They describe how the integration into the world economy of China and other emerging markets, with their initially young populations, added billions of workers to the global labor force. In the advanced economies, these disadvantaged less skilled workers, reduced the power of workers and labor unions, and increased inequality. In addition, a flood of new supplies into the global markets, together with China’s high savings, put a lid on global inflation. But as the population now ages, including in China, and as the high savings rates of more elderly populations come down, the same dynamics will run in reverse. This will make for falling inequality, rising wages, and higher inflation. Perhaps, as the authors argue, demography is destiny. Still, one wonders whether politicians might also have something to say about what happens to the distribution of wealth and income and whether central banks will really be powerless to shape the course of inflation.”

Follow us on LinkedIn:

Weekly Commentary

Issue **No. 7** | **FEBRUARY 22, 2021**

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., “Palos”). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos’ written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. “S&P” is a registered trademark of Standard and Poor’s Financial Services LLC. “TSX” is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market value weighted index engineered to measure publicly issued noninvestment grade USD fixed rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca