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# Weekly Commentary

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# Macro View

*By Hubert Marleau*

## What Will the Brave New World Bring?

Submitted February 28, 2021

**A Snapshot of the Market for the Week Ended February 26, 2021:**

Stock prices fell hard last week, especially on Thursday, as ten-year Treasury yields went another leg higher, jumping to a high of 1.61% and wreaking havoc across markets. Inflation is what is on the mind of investors, creating concerns that the Fed is not worrying enough. Yet it was the 30bp jump in real yields for ten-year Treasuries that caused the global bond tantrum. The swiftness reflected the growth prospects of the economy. Better growth is consistent with higher real rates. That is why I do not believe that the current level of interest rates is a threat to equity valuations. Goldman's David Kostin argued in a weekend note to clients that S&P 500 EPS will be 10% higher than pre-pandemic levels in 2021. His key takeaway is that "keeping the current P/E constant, the 10-year yield would have to reach 2.1% to bring the yield gap to the historical median of 250bp." Kostin's target remains 4,300 for the S&P 500.

I understand that the new monetary regime of favoring full employment over price stability is plunging the bond market into an unknown. However, it remains that the Fed does not like to lose. It usually does what is needed to win. It's why investors say that "one should not fight the Fed". The Fed has not raised too many hackles just yet. But it should not be forgotten that the monetary authorities have the power to run over bond vigilantes who love to test the monetary authorities. The Fed has a way to tamp down yields without explicitly declaring price discovery dead. The Fed is quite good at figuring out how to arrest markets that are running too fast and explain later how they can artificially suppress interest rates and root for higher inflation at the same time.

Nevertheless, S&P 500 had a wild ride, falling 95 points or 2.5% to close at 3811, even though all the economic prints comfortably beat consensus expectation including jobless claims and consumer confidence by comfortable margins. The string of economic data has kept the Citigroup Economic Surprise Index in solidly positive territory since last June. The Atlanta Fed's GDPNow tracking model is presently predicting that Q1 will generate an 8.8% annual rate of increase in R-GDP. Moreover, the vaccine rollout is on a course to reach herd immunity by this

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summer. The stock market was fixated on the rise in interest rates, but economic data and corporate earnings will take the center stage in due time. On the back of reopenings the prospects for these two items are excellent.

I'm chalking this tantrum as a typical profit taking after a spectacular run-up--5% to 10% pull backs are not uncommon during bull runs, occurring three to four times a year. They are not fun because they often force investors to make wrong decisions. In my view, bond yields need to go back to the 1.75% level that more or less prevailed before the pandemic struck. The reason is that the level of economic activity in nominal terms is very close to where it was a year ago. Let's look at the facts. If one was to inspect what is going on under the hood, one would find that price increases, wages and salaries have recaptured most or all of the losses that the pandemic produced. Treasury Secretary Janet Yellen commented that the U.S. "could be back to full employment next year."

Price indexes for both headline and core personal consumption expenditures which were declining badly during the April-May period are currently running at the annual rate of 1.5% compared to 1.7% a year ago. Wages and salaries totalled $9,667 billion (saar) in January, $241 billion more than in Q/4 2019. Personal income increased 10% in January because the government delivered $900 billion in relief payments. Government transfer payments totalled $5,734 billion (saar) in January, indicating that personal income generated from private sources totalled $15,720 billion (saar), nearly the same as in Q/4 2019 ($15,658 billion).

What is particularly interesting is that the $2,625 billion (saar) increase in government transfer that took place in January was entirely hoarded into personal savings accounts. Personal savings are now $2,726 billion higher than they were a year ago. This wealth transfer from the government to the private sector is bound to prime the economy for a burst in growth, especially in the service and real investment sides of the economy as these regain their former clout. Oxford economics predicts output will grow 7% in 2021. Jeffries has an 8% forecast.

The big question is whether the ten-year treasury yield will breach the crucial 1.75% level. I don't think so. Fundamentally, ten-year treasury yields should reflect the long-term growth trajectory of the N-GDP. History shows that when interest rates are left to the free natural force of the market, BAA bond credits trade a bit above the pace of the N-GDP whereas ten-year treasuries yield around 50% of it. In my judgement, as soon as the economy regains all which it has lost and what it would have gained had there not been a pandemic, a nominal growth rate of 3.5% is the right number to hang on in making mid-term market conjectures. In this respect, it looks as if the bond rout was more of a flash in the pan than a deep divide between traders and central bankers over whether the ongoing reflation will lead to a surge in inflation.

Interestingly, the U.S. dollar index jumped, and gold prices struggled, begging the question of how wide the interest rate differentials with the rest of the world can be tolerated. Moreover, Biden's deficit spending stimulus

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plan may have passed through the House, but there is a Senate movement including a few Democrats to reject the $15 minimum wage hike and the size of the rescue package. The $1.9tn bill is not a slam dunk.

The Fed had an outage of its key financial services caused by maintenance mistakes, which prompted banks to initiate emergency protocols raising questions about reliance on critical financial plumbing. It may have caused the spasm in Thursday's infamous seven-year auction market. The primary dealers called the auction a “stunk”. Central banks reacted quickly and were able to calm down bond investors.

Atlanta Fed’s President Raphael Bostic made the point that the economy can run pretty hot without seeing significant spikes in inflation. The Fed is likely to put its foot down and use persuasive rhetoric to prevent more spasms. Inflation may be in the air and especially in the commodity markets. Yet many deflationary trends and factors have not disappeared. The weakness of organized labour, diffusion of technological innovation, lingering slack in the job market and worldwide excess capacity excess are still about. It's true that inflation does not turn on a dime. Bloomberg observed that for all the palaver, the market’s main gauge of price pressures shows a path very much in line with the Fed’s objective. “Looking at the breakeven curve, it's clear how the main recent boost in inflation-adjusted yields has been in the five-year sector. This suggests traders see the consumer price index peeking over a five-year horizon, and then subsiding to just above 2% over the longer timeline”. It appears that the market has confidence in the Fed’s ability to keep prices anchored, even if the money guys allow them to run a little hotter throughout the recovery.

As a matter of fact, the recent emergence of higher prices has a lot to do with a concentration of demand for durable goods that are in short supply. There are kinks in the supply chains resulting from years of capital underinvestment in fixed capital formation and natural resources. Bloomberg made another astute observation stating that “a good way to visualize this dynamic is to look at the level of fixed investment--the construction of home and factories and purchases of equipment-- minus how much of that capital is consumed or worn out every year, as a share of the GDP”. For decades, the metric would ebb and flow with the business cycle. Outsourcing production and mining explorations to foreign countries has made it unnecessary to add to the nation’s capital stock at the historical rate of 2.5% per year. In fact, since the financial crisis, the economy has actually consumed more capital than it produced. It appears that both the public and the private sectors are ready to change this investment deficit. In this regard, it's unsurprising that the inflation is concentrated in those specific areas. In truth, inflation is needed where it should be to restore a linear equilibrium between consumption and investment. What a better time than this to accomplish this task when the households are flush with cash, suggesting that they have the savings to finance productive investments. This is bound to affect production patterns and the distribution of any economic surplus.

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**What Will the Brave New World Bring?**

Robert Shiller, a Nobel Prize winner, wrote "Narrative Economics" --a groundbreaking account of how stories can shape people's economic expectations. As a rule, decisions about where to invest and in what, are essentially driven by either rational expectations or emotional feelings stemming from viral narratives. Shiller argues that the power of narratives is both broader and deeper than contemporary economics is prepared to accept. Regarding the future one cannot predict episodes like the Great Depression without understanding the narrative that underpins them. For example, the cult of frugality caused the Great Depression. The thing is that important economic decisions are the result of the masses giving in to storylines like Laffer's curve on a napkin which led to an intense public debate for tax cutting.

In point of fact, narratives are either strongly influenced by the past or the future as they shape people's expectations, even though they are not reflected in standard economic analysis. Paul Krugman, another Nobel Prize winner, argued that the balance between looking back to the glories of the past (rational) and feeling optimistic about the future (emotional) determines how fast an economy can grow. He concluded that expectations about the economy, whether rational or emotional, are self-fulfilling. Thus, the story that we presently believe in today will not only shape today's decisions but determine what will determine our future.

While it is theoretically conceivable that pre-pandemic economic practices will be restored, there is general agreement that many things have changed. What is particularly important is the society's inclination to not want a return to the pre-pandemic status quo. I don't think that we are at an historical hinge point like the Great Depression, the second world war, inflation chaos of the 1970s or the fall of communism. However, I do believe that a paradigm shift in the public's political preferences has taken a critical turn from individualism and globalization to collectivism and nativism. There is a talk among people that things cannot go on as they were.

In a recent FT article written by Martin Sandu, he makes reference to two studies-- one by Ronald Inglehart and Martijn Lampert and the other by the IMF-- that focus on the development of a new narrative. The first survey showed that people are concerned about health like the pandemic and classic economic issues like growth and employment. While the aforementioned focus is understandable, the study made it very clear that there is a progressive tilt toward economic issues like inequality, liberal beliefs like tolerance for sexual and domestic freedoms, rejection of traditional gender stereotypes and the fraternity of communal values like preferences for sharing or feeling involved with one's community. Traditional values like manners, law and order, and masculine superiority have weakened, while expression of epicureanism and hedonism have risen. In the IMF study, Alexander Klemm and Paolo Mauro investigated how the pandemic has led to more progressive tax policies like support for one-off solidarity taxes and a permanent progressive shift in the tax structure, especially on the top earners and wealth accumulators.

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If these surveys are a true reflection of what is the new narrative, significant social and political changes are in the wind. What is shining here is not only the public expression of wanting change but a readiness for change, challenging old orthodoxies about public spending, central banking and government intervention. We are possibly facing the biggest monetary and fiscal policy defiance of a generation. That is what played out in the marketplace over the past four weeks. History shows that lawmakers tend to yield to public pressure and their choices can easily frame the contours of the economy for decades to come.

While I respect the public wishes to confront economic injustices and enhance social liberty, trusting governments to encourage the movement of capital into the enhancement of productivity is stupid and dangerous. It would be disastrous if governments were not going to embrace productivity growth and technological upgrade of jobs by demanding more from employers than just promoting distributive entitlements financed with regressive taxes. Wage egalitarianism is much more efficiently achievable by making labour uneconomical and incentivizing investment in productivity-enhancing capital.

Indeed the pandemic showed us how potent science is. If it had not been for the effort of science in pharmacology, mechanization and digitalization, we could have been just three meals away from barbarism. Modernity along with basic jobs like nurses, sanitation workers, truck drivers, cashiers and delivery people were the thin red line that held civilization and the physical world together.

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