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Weekly Commentary

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By Hubert Marleau

Monetary Authorities Wrestle with the Bond Vigilantes

Submitted March 7, 2021

A Snapshot of the Market for the Week Ended March 5, 2021:

Bonds became the main event. The market closed out a wild and volatile trading week that turned into a boxing match between the monetary authorities and bond vigilantes. In the green corner, the monetary authorities believed that they were doing enough to bring the economy to full employment and saw no reasons why they should come to the rescue of investors who are invested in growth stocks. In the red corner, the bond vigilantes believed that the Fed were not doing enough to calm the bond market and felt that it should implement interest rate controls. The green and red trunks won rounds. The broad market registered strong gains on Monday and Friday bookending strong pressure in the middle of the week. The S&P 500 was up 31 points or 0.8% ending at 3842.

Over the past few weeks, I illustrated that the U.S. economy has for all intents and purposes recuperated most of the economic activity in N-GDP and Personal Income terms that were lost because of the pandemic, after government transfers. In order to get back to where the economy would have been without the pandemic, another $550 billion of business activity will be needed in the service sectors of the economy. The US economy added 379,000 jobs in February. A blockbuster print given that the January employment report was revised markedly higher. More importantly, four-fifths of these new jobs came in food services and bars. Employment in leisure and hospitality remains 3.5 million jobs short. As vaccine rollout ramps up, this wide- gap will definitely diminish.

In this connection, would it not be appropriate to think that the bond yields should be close or even equal to where they were last February before the epidemic struck. Pre-pandemic, the S&P 500 reached an all-time high of 3386 with a forward P/E of 21.0x and ten-year treasury notes were settling for 1.65%. On Friday the forward P/E for the S&P 500 was 22x and ten-year treasury notes were trading around 1.55%. Thus, the equity risk premium is the same today as it was back then. The only striking difference with last February is the divergence in short term inflationary expectations. These were running around 1.6% while the year-over-year increase in core

Macro View cont.

By Hubert Marleau

consumer price indices was 1.7% pre-pandemic compared with 2.5% and 1.4% post-pandemic. The differential in long term inflationary expectations is significantly less, suggesting that the forthcoming increase in the rate of inflation is perhaps transient.

The big question is whether economic prospects are better now than they were 13 months ago. I believe that they are. The economy is firming. Inoculations are spurring reopenings whilst fiscal stimuli combined with extra personal savings ensure that money will find its way into the consumer spending stream, along with fixed capital formation, corporate profits and government revenue. The Atlanta Fed is estimating Q1 GDP will come in at 8.8%. Other forecasts have full-year GDP growing at 7%--the fastest in four decades. Apparently undeterred by the bond tantrum and equity jitters, investors (according to the BofA's Money Flows) poured a sizable $22.2 billion into stocks last week. According to an online survey conducted by the Deutsche Bank, people between the age of 18 and 55 plan to put between 37% and 50% of the anticipated grubstake coming from the government into the stock market. In a weekend note to investors, Goldman's David Kostin reminded market participants that money market funds are swollen with cash which are yielding next to nothing for the foreseeable future. The allure of stocks and bonds will likely be strong. It suggests that they are dip-buying, refusing to abandon the market which is squarely in the firing line of higher Treasury rates. Micheal Harnett, BofA chief strategist, argued that in spite of rising interest rates, market sentiment should remain bullish because of the immediate outlook for excess fiscal stimulus, booming economic data, an accommodating Fed and social/political desire for more inflation and less inequality.

Surely, there will be more speculative assaults, given the usual aggressiveness of bond vigilantes. Nonetheless, the Fed is not about to capitulate and literally administer treasury rates going forward, more than it already does. The argument is that the bear steepening of the year curve is a manifestation of economic optimism. Given that the shifting zeitgeist from heavily weighted growth stocks to lightly weighted cyclical stocks is being a drag on the broader market, the momentum behind the reflation trade is unmistakably strong. Moreover, a lot of the speculative froth has been removed. I still maintain that the bullish forces behind bank, energy and metal shares are still present and likely able to push the overall market higher.

In a nutshell, Powell is right and therefore willing to take hard punches from the vigilantes because he knows that an additional $1.9 trillion in stimulus which is winding its way through Congress is sufficient to keep the recovery on track to full employment.

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