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Weekly Commentary

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Macro View

By Hubert Marleau

The Extra-Saving Is More of a Wealth Transfer than an Income Transfer.

Historic Times Usher Historic Markets

Submitted March 14, 2021

A Snapshot of the Market for the Week Ended March 12, 2021:

President Biden's message of hope on Friday that all adults will be eligible to get a vaccine no later than May hit the market, especially the tech sector. Yet the S&P 500 was up 101 points or 2.6% to end the week at 3943. The arrangement is clear. The equity market is seeing a sector rotation but not a correction as the bond market is seeking a new equilibrium in light of a vastly improved economic outlook. As bond yields rise, the greenback rallies, but when rates settle, the dollar falls. Based on past cycles, this pattern is likely to continue until the ten-year Treasury yields reach a level that is in sync with the long-term path of N-GDP. I'm placing my bets on 1.75% to 2.00% yield. On this one history is pretty clear that rising interest rates which are not central bank induced are not usually adverse to stock markets.

As with the previous weeks, economic prints beat consensus expectations as the rebound continues on both the employment and inflation fronts. February core CPI came in at 1.3% y/y suggesting very mild underlying inflationary pressures. Interestingly, the core rate is near a record low and could even fall coming out of the recession when productivity usually surges. Meanwhile, the labour market continues to improve as the vaccine rollout is narrowing the labour-activity gap. The bulk of jobs lost during the pandemic were in the contact-intensive industries and that is where the job openings are located. Atlanta Fed is projecting an 8.4% annualized rate of increase in R-GDP for the March quarter.

The tenacity of the Fed to resist the bond market's invitations to intervene will persist because it believes it is unnecessary to do so. The prospects of reaching the 2% inflation target and full employment are excellent, now that President Biden has signed into law the $1.9 trillion rescue plan. Investors are adjusting to the cyclically

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changing landscape from deflation to reflation. The new environment will lead to higher bond yields, but not beyond 2.00%. Thus the movement from growth to value is intact.

Only a Persistent and Meaningful Increase in the Inflation Rate Can Interrupt the Bull Run:

The stock market is in a continuing upward trend, except when an abrupt interest rate spasm occurs even if its brief. Outside of the temporary negative effects of the pandemic, the bond tantrum of 2013 and the Christmas accident of 2018, the long-lasting economic recovery has propelled the market to higher levels for 12 straight years. I believe this phenomenon will endure for as long as recovery is not interrupted by recessionary conditions which are associated with unhealthy bursts in inflation or adverse financial crises.

Given that financial crunches do not occur, no matter how unfavourable economic imbalances may be, without an abrogation of the present monetary stance, a 2008 type financial crisis is unlikely. Thus the bull market can only end if the reflation scenario makes an about-face in an outright inflationary mayhem. While 2020 may mark a secular low point for inflation and rates, I don't think that the probability is high enough to warrant a pull-out from the market. There is a big difference between reflation and inflation. What we presently have is a cyclical asymmetry between supply and demand which has been brought about by kinks and disruptions in the supply chains. The end of the pandemic will restore the S/D equation toward a better equilibrium and reestablish what constitutes a normal inventory-to-sales ratio.

Assuming some form of herd immunity will appear by June, normalization will start in earnest in those service sectors where social distancing was practiced. There is no doubt that some of the savings and new government checks will flow into the economy as families face fewer financial constraints, more people are vaccinated and restrictions on traveling, dining, drinking and other social activities are lifted.

Starting with the March price data, the so called “base effect” will push up the headline inflation rate, because sharp price reductions at the start of last year will influence the year-on-year calculations. Consequently, even small price increases during March, April and May will cause the annual measure to jump over 2.0%. While these forthcoming CPI and PCE numbers will likely create a split debate on the inflation outlook, I view it as being transient. Why? It is fair to say that most of the increase in spending will be in the service industry. Unlike the physical sector, capacity in the services sector is people. Somebody needs to make the bed, serve the food, cut the hair, etc... So businesses will need to hire. Getting capacity back may not be a big ordeal because there are millions out there waiting to return to their original jobs. Most of these openings are just a phone call away. It happens to be one of those industries where hiring actually helps to alleviate price pressures.

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The big question is what the private sector will do with the extra savings (currently totaling around $2.5 trillion) and the $1.0 trillion in excess savings that Biden's $1.4 trillion stimulus checks is expected to create. I agree that the massive nest egg that households amassed during the pandemic and the forthcoming $1.9 trillion, which brings the whole to $6.0 trillion in total relief funds since the pandemic started, will meaningfully affect economic growth. Although this historic experiment will end the slow-inflation era, it will not erupt into the sweeping inflationary swell which many pundits are hashing over. The manner on how household savings and corporate profits will be disposed of will determine the trajectory of inflation. There seems to be a belief out there that all of the excess personal savings which could amount to as much as $3.5 trillion (when all of these stimuli are included) will be spent. So the fate of the anticipated boom depends on what the consumers will do with all that extra money. It's ridiculous to think that they will spend it all. The $550 billion economic hole is in the contact-industry. In my view, any discretionary spending will be concentrated on close proximity services like restaurant meals, travelling and personal services.

An inquiry into what they have done with the extra money may be telling. According to the Federal Reserve Bank of New York, "consumers saved 71% of the government money they received a year ago while spending 18% on essentials, just 8% on nonessentials and 3% for donations''. That exercise was repeated with the year-end stimulus---about 82% of the increase in after-tax income was saved, pushing the household saving rate from 13.4% in December to 20.5% in January. A survey conducted by the Deutsche Bank reported that people between the age of 18 and 55 plan to keep as much as 50% of the grubstake for investments. The BofA Research Investment Committee survey showed that 79% of the higher income recipients and 53% of the lower ones will not spend their future government checks.

Gary Shilling, a highly reputable economist, wrote in a Bloomberg article that "Americans are using their savings to build assets and reduce debt, a long-term trend that was already underway pre-pandemic. Back in the 1960s and 1970s household debt averaged 60% of after-tax income. That debt includes home mortgages, auto and credit card loans as well as student loans. But starting in the early 1980s, free-spending and big-borrowing consumers pushed that ratio to 134% in 2007. The rate began to fall with the financial crisis and has nosedived recently. Nevertheless, at a recent 92% in last year's third quarter, it's still a long way from the 60% norm, and I'm a believer in reversions of long-term trends."

In this regard, the stimulus sugar high on inflation could sour. If inflation fears are not warranted, there must be an additional explanation for the rise in bond yields. The 10-year notes touched 1.62% on Friday. Supply indigestion stemming from budget deficits, concerns that the Fed may change its monetary stance sooner rather than later and fear that reserve exemption to primary dealers will not be extended, have brought about a big increase, perhaps as much as 41bps, in term premiums. Thus, it possibly could have been a bigger factor in the rise in the break-even rate than higher expected inflation. Term premiums are essentially the extra yield investors

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demand over what they think is appropriate for a Treasury to compensate for the possibility that their view is wrong. Unfortunately, term premiums are not directly observable, they are inferred with models. The Federal Reserve Bank of New York shows a term premium on the 10-year Treasury of -0.34% versus -0.75% at the end of October. Therefore, investors are less concerned about an eventual recessionary shock than they were back then.

The aforementioned thesis leads me to conclude that the excess in private savings, (household and corporate) resulting from government income transfer are more of a wealth transposal--government debt to private saving--than a spending transfer. Consequently, these extra savings in the private sectors may end up somewhere else than presumed. In my judgement, the economy is gearing up for a post-covid boom in business, residential and public capital formation. People have the cash reserves to match the needed investments and therefore the ability to supplement decades of underinvestment--a neglect which is showing up here, there and everywhere. The American Society of Civil Engineers has given a C-minus for the overall quantity and quality of its infrastructure--mining, transit systems, utility lines, ports, sewers, broadband networks, airports and manufacturing facilities.

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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