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## Weekly Commentary

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# Macro View

*By Hubert Marleau*

# Figuring the Inflation Risk

Submitted March 28, 2021

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

The market had several false dawns of late with new concerns about inflation and interest rates running around. Indeed it may be naive to be too overconfident. Moreover, several economic prints relating to housing, factory orders and manufacturing surveys which were seemingly affected by the Texas freeze were generally disappointing. Meanwhile the Federal Reserve reported that growth of the money supply in February slowed from 18.2% over the last 12 months to an annual rate of 12.8% and 7.2% over the last six and three months respectively.

Fortunately, the deceleration rate in money supply will likely not last. The US Treasury is drawing down its deposits at the Fed to pay bills while the Fed's balance sheet is expanding roughly in line with the $120 billion per month QE purchase program. Additionally, the banks are lending out more of their reserves because they are in good shape and less worried about delinquencies eating up their capital. The recovery is now entrenched. The IMF is also in the expansion game. It intends to add more monetary fuel. It is proposing an allocation of $650bn of SDR in the hope that it will boost confidence and growth in the world economy. SDRs are special drawing rights that are labelled as official reserve currency which can have a multiplier effect on lending money.

The Citi macro surprise index fell to 24.1, still positive but considerably less bullish than it was just a few weeks ago. The Atlanta Fed's GDPNow model is predicting that real economic activity increased 4.7% in Q1, several notches lower than last week's estimate. In the nick of time, the Thursday report on jobless claims handsomely beat consensus, suggesting that the employment recovery is reaccelerating, but stoking media concerns about inflation. Strangely, the troubles escaped the market for bonds, commodities and currencies. The dollar has clawed back losses, commodity prices, including ultra-sensitive gold, copper and gold, gave back some of their recent gains and bond yields fell.

In the end, the stock market finished on a high note after a few choppy days in the earlier part of the week while asset management firms shifted billions of dollars from stocks to bonds, cyclical to defensive positions and value

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to growth. On the money flow side as much as $45.6 billion showed up in money market funds, the largest inflow since last April when the air was full of the pathogen. The S&P 500 was up 62 points or 1.7 % to end at 3975. Even though the S&P 500 touched the 50-day average, it stayed comfortably above the 200-day average and advances outnumbered the declines suggesting that the bull is still running. Consumers are becoming more confident day by day. The University of Michigan sentiment index hit the highest level in a year, (84.9) representing a sizable advance from February's 76.8. In this connection, stock prices could register new highs in Q/2, but it would require lower-than expected inflation given the super-consensus that the economy is in a broad booming pattern.

We may be at an inflection point on the macroeconomic and geopolitical fronts due to the experimental features of the current fiscal-monetary policy supposition and strained geopolitical relations between the U.S. and China. BofA's Michael Harnett thinks that the odds are skewed in favour of a short correction, fearing that inflation and international tensions could be perceived as getting out of hand, considering commodities as a hedge. Whereas Goldman thinks the risk of a drawdown is low, advancing the conjecture that the economy will likely transition to a goldilocks scenario into the year-end when the strong macro background starts to fade. In this respect Goldman remains optimistically buoyant on growth issues. My position is simple. I'm sticking with my growth stocks and my inflation sensitive ones but not adding to either positions. However, I've started to build an exposure in stocks that are likely to benefit from the expected above average increase in business capital formation and public infrastructure spending.

**Is There an Inflation Risk?**

I agree with the consensus, supported by repeated pronouncements by Fed officials, that the economy is not heading toward a stymied hot inflation-- the risk is much less than 50%, perhaps only 20%. Nonetheless, we are at a fragile point for markets and the risk should not be discarded. If inflation were to heat up when the Federal Reserve expects it to cool down, the outcome would vehemently agitate all the markets. Thus the outlook for the stock markets will completely depend on the future performance of inflation.

It is generally accepted that sharp year-over-year percentage increases in the CPI will be registered this spring. As a matter of fact, inflation readings for April, May and June may show 3.5% to 4.0% year-over-over increases. What is important is what will happen to the rate of inflation from July on. Anything above 3.5% to 4.0% could become problematic. Traders, speculators and investors have not seen this kind of inflation in decades and the younger participants have never encountered in any way an inflationary episode. I have not bet the barn on such a big outcome, but I expect it to be a challenge worthy of some consideration.

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We are in the midst of a reflationary regime change of fiscal dominance and monetary accommodation which could lead to an overheated economy. Julien Garran, a leading economist at MacroStrategy Partnership, in a new take on overheating and inflation, argued, "unprecedented pent-up demand, rapid money supply growth and the transition from covid relief to infrastructure spending will bump up against supply side constraints from resource underinvestment". A situation which could alarmingly create a lot of smoke.

We've been through this kind of discussion several times, over the past months. A recapitulation is that from a monetarist and keynesian point of view, the combination of the excessive amount of savings and of monies, could lead to a sharp increase in consumption at a time when the tight condition in many production facilities is making supply inelastic. The systemic problem is not lack of demand but insufficiency on the supply side.

**Rediscovering Supply-Side Economics:**

Over the years supply-side problems received only fleeting notice in the U.S. media. The realization that supply inefficiencies in key industries and the lack of strategic materials are of national security, supply-side economics may no longer be politically and corporately neglected. The Biden administration will soon introduce a $4 trillion investment plan and many corporations have decided to add new production facilities and re-shore them. The Biden administration wants to incentivize business capital formation with larger depreciation allowances, grants and subsidies. The timing couldn't be better for corporations to follow suit, given the low interest rates environment and the glut of private savings that is ready to be taken. For example, Intel plans to move full speed ahead with $25 billion to produce high quality semiconductor chips by putting a few factories in the U.S.

Bryce McDonald came out with a very revealing article in the FT, reporting, "American Compass analysed 50 years of NYSE and NASDAQ public-company financial data. It shows that firms neither tap financial markets to fund growth nor reliably reinvest in their own health which is contrary to what traditional models teach and what they once did". The study argues that companies are either growers, sustainers or eroders of capital. Growers are companies which have capital expenditures in excess of cash flows and raise money on the markets to close the gap. Sustainers are businesses whose capital expenditures exceed their consumption of fixed capital and profits. Eroders are firms which have sufficient profit to both replenish the assets they consume and return cash to shareholders but choose to do only the latter. From 1971 to 1985, eroders accounted for 6% of total market capitalisation. By 2017, that had risen to 49%. The sustainers had fallen to 40% from 82% and growers to 3% from 9%.

It is my understanding that young CEOs along with Biden's commerce and trade officials want to address the aforementioned capital issue. Mr. Biden's forthcoming $4.0 trillion "Build Back Better" is the pivot of its core

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economic agenda, rebuilding infrastructure and revitalizing America's industrial competitiveness. The administration along with industries are being asked to present creative policies to combat and rival China and find ways to allocate more capital towards productive activities such as building structures, installing machines or creating intellectual property.

As an aside, based on data provided by the BEA, in the last three years (2018-2020) corporate cash flows net of dividend paid--excluding buy-backs--averaged around $1.0 trillion, compared to $1.8 trillion for capital consumption. It shows the stupidity of corporate taxes. More to come on this one at a later date.

**How and When Shall We Know If the Economy Is About to Overheat?**

It will take some time to know for sure whether a problematic form of inflation will take root. That is why we need a method to determine in advance if a sustainable surge in the inflation rate is on the horizon. In a Bloomberg article, Liz McCormick warned her audience that bond traders consistently tend to be too aggressive. They have not been good at timing when the Federal Reserve will change its monetary stance and where interest rates will end up. The best way to get an idea if inflation is about to break away is to regularly review what the money-market derivatives are signaling in the context of where the economy stands.

The relative performance of the unemployment and inflation rates combined with economic growth usually reveals the current state of the economy. Manoj Pradhan, founder of Talking Heads Macroeconomics, makes the persuasive point that the breakdown of the Phillips curve—a decline in the unemployment rate which engenders a rise in the inflation—is being fixed by rapidly changing demographics. The globe is currently experiencing a fast world-wide growth deceleration in the working age population. In this connection, I would reference Palos' Economic Condition Index which is the inflation rate divided by the unemployment rate less the growth rate as a mechanism to assess what is the status of the economy. Assuming that price stability equates to a 24-month average increase of 2%, full employment is 4.0% and goldilocks growth is 2.0%, 100 could be bluntly considered as a perfect state. Presently, the index is 17.2, far below what could be roughly considered as economic perfection. In its simplicity, the index explains why the Fed is firm on not wanting to change its monetary stance until there is confirmation that the economic recovery reaches all levels of American society and is effectively completed.

At this time, the money market derivatives are not suggesting that inflationary expectations are unmoored. The five-year break-even, which refers to the level of future inflation prices in the Treasury bond market, based on the price of inflation-protected securities, is predicting that inflation over the next five years will average 2.75%. This projection is not creating a substantial risk of macroeconomic reactions. Firstly, it is what is mathematically needed to bring the average rate of inflation to 2.0%. Secondly, the "five-year, five year" forward rate which is the

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annual inflation, priced into the bonds for the five-year period starting five years in the future is equal to the Fed's target by 2%.

If the Palos Economic Condition Index were to rise and pass the 100 mark by a margin of 25 points and the "five-year, five year" forward rate crosses the 2% threshold by an extra 1.0%, it would definitely spell trouble for stock market returns. We are not anywhere near these limits and too far away for thoughtful and mature investors to panic. Credit Suisse Global 2021 Investment Returns Yearbook showed a very low chance that the next decade will produce negative stock market returns. The S&P 500 index has dropped just 6% of the time over 10-year periods going back to 1929. Nevertheless, I'm prudent. I shall closely monitor the state of the economy, watch the money-market derivatives and keep my readers informed about whether inflation is about to change the investment landscape.

**The Geopolitical Order Is in Flux. Is it Another Risk?**

The quick answer is yes. Unlike the inflation risks, I think it is long-term one. I'm keeping this one for another day. I'm reading up on it. I trust that I shall have a novice-like opinion by next week.

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