PALOS

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Weekly Commentary

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Macro View

By Hubert Marleau

Everything Rallied But Keep An Eye On the Hydra

Submitted April 18, 2021

A Snapshot of the Market for the Week Ended April 16, 2021:

The stock market had a very impressive week. Everything rallied from earnings reports, economic prints and movements in interest rates. Investors loved it. The S&P 500 broadly added 56 points, or 1.4% to end at a record 4185, registering its 4th straight positive week. The BofA's money flow showed that another $25.6 billion poured into equity funds last week, bringing the year-to-date total to a record setting amount of $413 billion.

Bank earnings beat estimates handily because they released billions of dollars of reserves which were set aside to absorb bad loans while other sectors also showed up with strong reports. According to data compiled by Credit Suisse, S&P 500 companies are beating Q/1 ESP estimates by 36% with 7% of the index's market capitalization having reported thus far. Additionally, all of the new business data registered beats with wide margins, painting a very positive economic picture and convincingly reassuring speculators that the rebound is widening. Retail sales for March rose 9.8%, better than the expected 6.1%, industrial production increased 1.0%, beating consensus and initial job claims were 576,000, much lighter that the expected 710,000. A 3.8 million shortage of dwellings is feeding a red-hot housing market. Meanwhile the growth of the world money supply accelerated to an annual pace of 17.5%. Consumers felt even better as vaccinations continued, cash was abundant, and business activity rose. The University of Michigan consumer sentiment index came in at 86.5 in April, up from 84.9 in March. The Atlanta Fed's GDPNow model estimate for the real GDP growth (saar) in Q1/2021 jumped to 8.3% from 6.2% a week ago.

Lastly, bond yields took a nosedive with yields on 10-year treasury notes falling steeply to 1.50%, 10 and 110 bps less than core and headline inflation respectively. A confusing dynamic and an odd development, given that inflation expectations held firm, the dollar fell, and commodity prices rose, including gold.

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In this regard, several pundits expressed geopolitical concerns over growth in China and sanctions on Russia while traders were caught with short positions, stemming from the very rapid upward move in bond yields over a very short period of time. Stripping out the statistical distortion from last year's low base of comparison, economists at HSBC in HK estimate that underlying year-over-year growth in Q1 was about 5.4%, lower than the previous trend of roughly 6% growth. HSBC expects the Chinese economy to perform below the pre-coronavirus trend for the foreseeable future. As a matter of fact, the Chinese economy expanded just 0.6% in Q1. Chinese officials expressed concerns over nascent signs of inflation, asset bubbles, rising debt levels and worries about rising geopolitical tensions that could hurt trade. They have manifested their intentions to tackle financial risks and introduce domestic measures to stimulate a lagging consumer recovery.

Interesting, but I don't buy the explanation for the conundrum. The argument is just too weak. In my judgement, the reaction in the bond market was certainly not macro-driven. It is more likely related to pension funds and life insurers which opportunistically move money into ultra-long zero-coupons that offer maximum interest rate advantages and recipients that decide to park their relief checks into bond and money market funds.

Goldman Sachs and JPMorgan avariciously jumped on the occasion and offered jumbo-size amounts of newly printed bonds to willing takers, believing that the recent trend of falling yields will not go far. Neither bankers modified their respective mid-term forecast or year-end estimate of 1.80% and 2.00% yield on ten-year Treasury notes.

The Hydra:

At this time, we are either in an early-stage structural inflationary boom trend or mid-stage reflation cycle. In either case, we are in a “Goldilocks Moment”. Unfortunately, there are several important tail-risks that could emerge as obstacles which could either dent the boom-like economic expansion or bar the reflationary rebound, and in turn upset future market returns. Valuation, inflation, geopolitical, taxation, monetary policy, productivity and political risks must be closely monitored and frequently reviewed. I intend to briefly touch on these seven cardinal risks every week because they will likely make headline noise from hereon.

On Tuesday last, Michael Harnett, BofA chief investment strategists and his team, reported in their widely read April survey that macro and market optimism among global investors is running high with prospects of a taper tantrum, inflation and higher taxes seen as the pressing risks. The survey said, “only 7% of investors think the U.S. equity market is in a bubble, 25% think early-stage bull market and 66% late-stage bull market.” I’m favouring a value-titled balance between cyclical and growth names, neglecting defensive positions like bonds and bond proxies. Additionally, my year-end target for the S&P 500 is still 4400.

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The Valuation Risk: What Does the Stock Market Do After Huge Gains?

The S&P 500 is up 87% from the pandemic low of 2237 and 24% from the pre-pandemic high of 3386. Acknowledging that market performance is not a straight line, and the future is always uncertain, it's understandable that many investors are worried that these gains have come too far, too easy and too fast. Ben Carlson took a look at what comes next when stocks have risen by a lot. He examined S&P 500 returns over the ensuing one, plus the three and five year periods since 1950, after it had risen 50% or more. It appears that returns in one year don't really impact the returns in the next year all that much; but the further out one goes, the better the returns. On average, gains, excluding dividends, following a 12 month gain of 50% or more since 1950 were -1.5% for one year, 42.4% for three and 65.6% for five.

Presently, S&P 500 EPS estimates for 2022 are sitting at $210, suggesting that on average stocks are trading on 20.0 times next year's earnings. For those who argue that we are in a new age of valuations, the average equivalent multiple since 1998 is around 16.0 times. Based on this premise, the 2022 EPS would have to be around $250. Adjusting for bond yields which are about 225 bps lower than the average of the last 25 years in a turbocharged economy supported with unprecedented fiscal-monetary stimuli and without an elevated inflation or recession risk, the current p/e multiple may indeed be justifiable. As a matter of fact, earnings could even catch up.

The Taxation Risk: Undoing Trump's "Corporate Tax Cuts" Is a Non-Negotiable Red line and Biden's "Country-by-Country Reporting" Is an Exaggerated Hoax--a Canard.

The momentum is growing for a dual track approach that could move Biden's package as a bipartisan legislation on taxation and other segments through reconciliation where Democrats move through a simple majority. Executives are lamenting being frozen out of plans to bolster America's infrastructure. Biden's tax-and-spend approach to building projects is disappointing asset managers who want public-private partnerships. Private capital vehicles have amassed $655bn in assets since last June from life insurers, pension funds, sovereign funds and family offices dedicated to infrastructure--enough to pay for trillions of dollars of investment, once debt financing is added on top. Many economists--left and right--are opposed to the traditional method of having the government spending tax revenues on projects because an entire infrastructure industry's been born. The world of big project development has changed. Politicians who were reared in the 70s and 80s are being made aware that fund-it-through-the-government does not reflect the new thinking. The rationale is that infrastructure should earn commercial rates of return by charging the users. Indeed, why should the government bother with more debt and corporate taxes when the private sector is loaded with excess savings?

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The Monetary Policy Risk: No Change In the Fed's Monetary Stance Until 80% of Americans Are Vaccinated.

St Louis Fed President Jim Bullard offered a clue on when the Fed may consider changing its monetary policy. He said, "when you start to get 80% vaccinated and CDC starts to give more hopeful messages that we are bringing this under better control, then I think the whole economy will gain confidence and it will be time to start assessing where we want to go next". Given the current vaccination rate, something like herd immunity could be reached by the "Fourth of July". Bloomberg said that the 80% number would be reached by early August, just before the Jackson Hole Symposium, a venue known for key policy announcements. In this regard, the tapering could begin early next year.

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Macro View cont.

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(An English message follows)

Le Département de science économique et la Faculté des sciences sociales de l'Université d'Ottawa vous convient à la Série de conférences Marleau sur la politique économique et monétaire. Joignez-vous à notre prochain webinaire avec la professeure Emi Nakamura (Université de Californie, Berkeley).

Date : Vendredi 30 avril 2021

Heure : 15 h – 16 h 30, heure d'été de l'Est (19 h – 20 h 30 UTC)
Où : En ligne sur ZOOM
Titre : *The Slope of the Phillips Curve: Evidence from U.S. States*

Résumé

Nous estimons la pente de la courbe de Phillips avec des données transversales des États américains en utilisant des indices de prix nouvellement construits pour les biens non échangeables depuis 1978. Nos estimations indiquent que la courbe de Phillips est très plate et qu'elle l'était également au début des années 1980. Nous n'estimons qu'un modeste déclin de la pente de la courbe de Phillips depuis les années 1980. Nous utilisons un modèle multi-régions permettant d'inférer la pente de la courbe de Phillips agrégée à partir de nos estimations régionales. L'application de nos estimations à l'analyse de la dynamique récente du chômage ne produit pratiquement aucune désinflation ou réinflation manquante au cours des derniers cycles économiques. Nos résultats impliquent que la forte baisse de l'inflation de base au début des années 1980 était principalement due à des anticipations changeantes concernant la politique monétaire à long terme, plutôt qu'à une courbe de Phillips pentue, et que la plus grande stabilité de l'inflation depuis les années 1990 est principalement due à un ancrage plus solide des anticipations inflationnistes à long terme.

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Inscription
La participation est gratuite. Il est nécessaire de s'inscrire pour obtenir le lien ZOOM. Une confirmation d'inscription sera envoyée par CITEwebi2@uOttawa.ca.

Inscrivez-vous aujourd'hui !
(l'événement se déroulera en anglais)
Nous avons hâte de vous accueillir!

The Department of Economics and the Faculty of Social Sciences of the University of Ottawa invite you to the Marleau Lecture Series on Economic and Monetary Policy. Please join our next webinar with Professor Emi Nakamura (University of California, Berkeley)

Date: Friday, April 30, 2021

Time: 3 p.m. – 4:30 p.m., Eastern DST (7 p.m. – 8:30 p.m. UTC)
Location: Online on ZOOM
Title: The Slope of the Phillips Curve: Evidence from U.S. States

Abstract
We estimate the slope of the Phillips curve in the cross section of U.S. states using newly constructed state-level price indexes for non-tradeable goods back to 1978. Our estimates indicate that the Phillips curve is very flat and was very flat even during the early 1980s. We estimate only a modest decline in the slope of the Phillips curve since the 1980s. We use a multi-region model to infer the slope of the aggregate Phillips curve from our regional estimates. Applying our estimates to recent unemployment dynamics yields essentially no missing disinflation or missing reinflation over the past few business cycles. Our results imply that the sharp drop in core inflation in the early 1980s was mostly due to shifting expectations about long-run monetary policy as opposed to a steep Phillips curve, and the greater stability of inflation since the 1990s is mostly due to long-run inflationary expectations becoming more firmly anchored.

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Registration

Attendance is free. Registration is required to obtain a ZOOM link. You will receive confirmation of your registration from CITEwebi2@uOttawa.ca.

Register today!

We look forward to welcoming you to our virtual event!

Acknowledgement

The Marleau Lecture Series on Economic and Monetary Policy was established in 2019 through the generous contribution of Mr. Hubert Marleau (Palos Management). Please visit our website to learn more about the series.

Faculté des sciences sociales | 120, rue Université, Ottawa ON K1N 6N5
Faculty of Social Sciences | 120 University Private, Ottawa ON K1N 6N5

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Disclaimer:

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