To subscribe to our Newsletters **www.palos.ca/register**

PALOS

Weekly Commentary

Issue **No. 17** | **MAY 3, 2021**

CONTENTS

Macro View

By Hubert Marleau

Big Changes are Coming

Submitted May 2, 2021

A Snapshot of the Market for the Week Ended April 30, 2021:

The U.S. economy is booming, and it certainly looks as if it will continue for a while longer. Fresh data was bullish. Jobless claims fell, pending home sales rose, retail inventories are low, durable orders were strong and consumer confidence came in at 121.7 in April, way above expectations.

Moreover, America’s largest companies beat profit and revenue estimates by a country mile. As a result, the cash to asset ratios are at record highs. Goldman Sachs predicted that publicly traded companies will invest a lot more on growth than buybacks from hereon. Spending on R&D, software, equipment, information processing will jump materially in 2021 and 2022. The BofA Global Fund Survey shows that CIOs have expressed a clear preference for companies which are moving cash into productive capex.

Yet, investors were apathetic even though news on the economy is good. The S&P 500 has come up flat, closing at 4181 compared to 4182 a week ago. Globally, equities attracted only $10.5bn compared to a weekly average of 57bn in the last 13 weeks. Indeed, data from fund flow trackers reflects caution. EPFR showed investors moved 57.3bn of new money into cash and ICI showed money market funds took in $59.4bn. The Fear & Greed Index which reflects what emotion is driving the market now stands at 56 compared to 70 in January. It is still slightly above the 50 neutral level. Extreme greed is 100 and extreme fear is 0.

Maybe it's about the adage--sell in May and go away According to data from LPL Financial dating back to 1950, the average S&P 500 return for May is minus 1.0% and minus 1.5% in the six months after May. Broadly, the market is up 23% from the pre-pandemic high. A better explanation might be that the markets need a pause or a small technical adjustment to reflect on whether Bidenomics will work for investors. Nevertheless, Wall Street strategists are not budging their bullish projections. Credit Suisse is the biggest bull, overtaking JPMorgan’s 4400 forecast for the S&P 500 by year-end. It has a 4600 call. Many top-down analysts have raised their 2021 EPS to

Macro View cont.

By Hubert Marleau

$205, arguing that the economy is in the early stages of a three-year economic cycle. In my judgement, Credit Suisse's 4600 forecast has a much better chance of being accurate than any doomsayer's call for an Armageddon.

Big Tech Stocks:

I came across an article in Seeking Alpha which shows the incredible success of the FAAMG stocks. If you own them keep them and if you don't consider buying the dips. I agree the vaccine is doing all the work to restore the world back to normalization, but without Facebook, Microsoft, Apple, Google and Amazon, I do not believe that the world would have had the patience to wait. In the three months ended March 2021, the "Magnificent Five '' generated $67 billion in after tax earnings--that is 13% of all after tax earnings that the U.S. economy generates in any given quarter. Meanwhile their revenue was 6.5% of the N-GDP. Please note that all of that revenue is included in the GDP numbers. It gives one an idea of their economic importance. It is not likely to stop. Eric Savitz wrote in this week's Barrons; "There is no stopping the cloud, the PCs are back, E-commerce won't slow, Advertising has returned and Chips are in''. Unfortunately, people in political power from time to time make decisions which are totally irrational, obstructing productivity and growth.

The First Quarter Economic Report:

The Bureau of Economic Analysis released its initial read on Q1 GDP. It showed that the R-GDP rose at the annual rate of 6.4%, slightly below the 6.7% consensus, but not far enough to change the view that a summer boom is in the offing. That left real economic output just 0.85% below the Q/1 2019 peak of $19254.0. Given the broad expectation that R-GDP will increase at the annual rate of 10% or more in Q/2 2021, economic output will likely recuperate all that it lost by June and probably surpass in Q/3 what the economy would have produced in a hypothetical pandemic free world. Overall, the R-GDP is about 3.3% below where the economy would have been. Goldman Sachs and many other investment banks are bullish on the economy, forecasting sequential annualized GDP growth to clock 10.5% in Q/2, 7.5% in Q/3, 6.5% in Q/4 and 2.8% for all of 2022. Interestingly, it would not take much of an increase in the turnover of money or decrease in the personal savings rate to produce the aforementioned forecast, given the slack in the labour market, the ascent of productivity and the lending power of the banking system. The loan-to-deposit ratio is less than 50%, a record low.

By contrast, it took more than three years for R-GDP to reach a new high after the Great Recession of 2007-08. The latest recession was very short, and the economy robustly recovered because vaccines quickly vanquished the virus and the level of fiscal and monetary support was second to none. The U.S economy may indeed be back on track, but it's a far cry from what it used to be.

Macro View cont.

By Hubert Marleau

Firstly, it's travelling alone. Coming a day after the US disclosed that its economy expanded 1.6% Q/Q in Q1/21, the Eurozone succumbed to a double dip recession decreasing 0.6% for the comparable period and presenting an unusual contrast of fortunes.

Secondly, the central reality is that the economy is profoundly unequal across sectors which could have implications for businesses and workers. The Federal Reserve Bank of New York survey showed that many people are not planning to go back to work. About 2.7 million Americans aged 55 or older are contemplating giving up work, earlier than they'd imagined. Moreover, the number of people expecting to work beyond 67 fell to a record 32.9% in March. There is a dramatic jump in the number of business owners (small and large) looking to retire. They feel comfortable. Assets for Americans ages 55 to 69 rose by $4.2 trillion in 2020, including $2.2 trillion in equities and $750 billion in real estate assets. Bloomberg pointed out, "as the lucky head for an easier life, their exit carries an economic cost depriving companies of skills, productivity and mentors. Older workers are especially strong in soft skills that develop over time and are hard to teach. It explains the spending surge in information processing equipment, increasing 7.4% in Q1--that is 23% higher than the pre-pandemic trend.

Thirdly, Americans (Household and Businesses) are spending an unusually large amount of money on things that are ultra-sensitive to cyclical changes in interest rates. In real terms, aggregate spending on durable goods, residences, business capital formation and gross government investments accounted for 36% of the R-GDP in Q1. As a rule, 30% is considered high and normally associated with rising bond yields and commodity prices. Unsurprisingly, the current rise in inflation and the bottlenecks in the supply chains are attributable to the extreme shifts in the composition of what people desire, which is directing economic activity to producers of hard goods.

Fourthly, the economy is full of promise for 2021 and 2022. However, the extent that the changes in the economy become semi-permanent is an inflation worry because the 5.0 million who are still seeking work are generally ill-suited to become machinists, construction workers or software engineers.

Fifthly, there is the question of personal savings and the money supply. In terms of seasonally adjusted numbers to an annual rate, personal income totalled $24.2 trillion dollars in March, accounting for 107.5% of the first quarter N-GDP of $22.0 trillion. Normally it's roughly 85%. A lot of personal income was not spent. Consequently, the personal savings as a percentage of disposable income was 27.6%. Normally it's around 7.5%. The money supply totalled $19.9 trillion in March or 90% of the N-GDP. It is normally around 70%. These numbers are dramatic. If for any given reasons, the velocity of money was to rise as banks moved their excess reserves into loans and personal savings were to be depleted to fund expenditures and respectively return to their pre-pandemic levels, it would bring about a major demand shock. Bear in mind that the disruption in the supply chain is caused by demand which far exceeds the production schedule of most business models. Businesses are used to a regular and slow upward demand--not to abrupt changes.

Macro View cont.

By Hubert Marleau

While I do not give this outcome a probability of more than 20% and perhaps only a tail risk, the potential is real---enough to justify higher inflationary expectations and related increases in bond yields. Indeed, the rationality of the yield curve reveals that inflation expectations for the next five years (2.6%) and the following five years (2.2%) are above the Fed's inflation target of 2.0%.

While I made the decision not to reduce my exposure to the tech sectors, I've nevertheless tilted my portfolio to cyclical and non-Covid sensitive names. Why? Over the long term, the earnings of the techs will beat inflation, those of a cyclical nature will beat it in the medium term and the consumer discretionary in the short term.

The Triumvirate Wants to Radically Restructure the Economy into a Welfare State:

On Wednesday last, President Biden said to a joint session of Congress, "America is on the move again" while Chairman Powell said that the "economy is moving ahead with real momentum". Meanwhile Treasury Secretary Yellen's job is to make sure that the Biden-Powell pledges will tax the super rich and the rentier class to finance the lives of middle class citizens from "Cradle-to-Grave". What is underway is an era in economic management that will undo the macro-policy overhaul of the Regan-Volker period. Bloomberg's Rich Miller explains, "while Reagan fought to limit the role of government and Volker to contain prices, Biden is championing a muscular assault on poverty and inequality and Powell is signaling that he won't get in the way". This proposed restructuring can only come about if the Triumvirate can win the hearts of American under the idea "America First But Never Alone".

Biden insisted that the "Build America Better" program is absolutely necessary, if the US and its allies are to beat China. Acting firmly and quickly is crucial because China is closing in fast. Biden was forceful when he said, "China is deadly earnest about becoming the most significant, consequential nation in the world. He and others, autocrats, think that democracy can't compete in the 21st century with autocracies. It takes too long to get consensus".

The Triumvirate hopes that Biden's slogan will translate into an ideological mantra at home and abroad. In other words, create an inspiration to prove that democracy is better than autocracy to stay ahead of China and preserve Western global hegemony. On the outcome of the U.S.-China competition, Biden said, "Autocrats will not win the future, we will".

He may want to be the most transformative President since Franklin D. Roosevelt, but he sounds like Eisenhower and/or Walter Cronkite. He's marshalling the spirit of decades past. The context may be different than it was back then. Nonetheless, the nation is callous and the political divide is vengeful, but there seems to be a consensus

Macro View cont.

By Hubert Marleau

that China is a troublesome and vexatious enemy. Agreement on this one big idea might be the way for Biden to win the minds of Americans.

Making the populace believe that the US must retake leadership and aggressively compete with China to hold on to its dominance may be what is needed to push Bidenomics through legislation. It may not fall on deaf ears because this Chinese thing is the emerging political zeitgeist in the West. America wants to believe that China will never catch up. That is why Biden is as adamant as Trump on giving America's partners and others a stark choice between US and Chinese technology, culture and national security. European policies seem to be headed in the U.S. direction since Biden took office. The EU and U.S. seek to put infrastructure on the G7 agenda to counter Beijing's Belt and Road Initiative. What we have here is Trumpism from a left angle.

Monetary Policy: Stabilization to Accomodation to Normalization

The Fed kept policy unchanged because it is still too early to roll back its monetary support. Chairman Powell said, "we are a long way from our goals. It's going to take some time to find 8.5 million missing jobs". He added, "whilst inflation is rising, it will be of a passing nature". However, Powell assured his audience his awareness that amid progress on vaccinations and strong fiscal policy support, indicators of economic activity and employment have strengthened. As a matter of fact, he admitted that the growth risk remains but is no longer considerable and that inflation, albeit transient, represents a risk that the monetary authorities would not let go out of hand. In this regard, he surreptitiously suggests that a discussion on tapering is not a noisy matter. Thus a pivot to normalization can be expected to happen sooner than later. Fed officials do not speak frankly until they have too.

Fiscal Policy: The $6.0 Trillion Dollar Man

Biden aims to push a broad legislative 6 trillion dollar agenda that is spread across three distinct packages through a very narrow political window. So far, the first portion (America Rescue Plan) totalling $1.9 trillion has gone through Congress and passed. This plan is financed with drawdowns in Federal cash balances at the Federal Reserve and with monthly bond purchases by the N.Y Fed. The second portion (American Jobs Plan) to be financed with a "Made in America Tax Plan" and third one (American Families Plan) to be financed with higher income and capital gains taxes, come up to $2.3 trillion and $1.8 trillion respectively. It's a tall order. At least, we know where the starting points for these spending and tax proposals are. Surely, these will look different when all is said and done. Nevertheless, in a modified manner the administration will likely get something through Congress that will reorganize the economy in a more European image.

Macro View cont.

By Hubert Marleau

Follow us on LinkedIn:

Weekly Commentary

Issue **No. 17** | **MAY 3, 2021**

Disclaimer:

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