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Weekly Commentary

Issue **No. 21** | **MAY 31, 2021**

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Macro View

By Hubert Marleau

A Mild Monetary Pivot Is in the Making

Submitted May 30, 2021

A Snapshot of the Market for the Week Ended May 28, 2021:

Inflation fears abated and stretched corners of the stock market deflated. Early in the week, the volatility markets took a turn for the better. For months, demand for derivatives skewed to the downside had been insatiable. On Monday, those signs of volatility waned. Retail investors' euphoria cooled off and institutional investors were waiting to see what the Fed's next move would be. The market went quiet and trading volume trended down. The biggest risk to the current relative market stability is higher than expected inflation, which could lead to a central bank policy error.

So far so good. Inflation data is very binary. Volatility has been concentrated with items whose prices are extremely cyclical like energy and food or affected by supply disruptions. At the moment, however, cyclical forces are not having a magnetic effect on core inflation. Respondents to a survey conducted by the National Association of Business Economists see the personal consumption expenditures price index, minus food and energy, cooling to 2.1% in the fourth quarter of 2021 from a projected 2.6% for the April-June period. Consequently, the two-year underlying inflation rate is below the 2.0% target, giving the Fed comfort. Additionally, the five-year, five-year break-even, which effectively measures expected inflation from 2026 to 2031, and which spiked to 2.5% at the beginning of the month, has fallen to 2.2%, making the inflation outlook tolerable for the stock market. The Barron' s had a long and detailed explanation on inflation which concluded with the following paragraph: "The outlook for PCE inflation is a bit different than for the CPI, with healthcare price increases due to the end of pandemic aid probably offsetting any changes in rents. Just as PCE inflation was steadier during the 2020 downswing, it will probably be less volatile in 2021. That's consistent with what investors are betting on--and helps explain the Fed's willingness to stay the course."

The bond market has been boring for weeks in spite of all the talk about inflation. Indeed, bond prices and the yield curve have been remarkably stable for the better part of two months. It's rumoured that foreign central

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banks and private investors in Europe and Japan have been lured to the U.S. bond markets by the cheapness of the dollar and the attraction of U.S. interest rates. According to Bloomberg, the U.S. corporate pensions are fully funded for the first time since 2008, making it possible for them to invest new contributions into low-risk Treasuries.

The bottom line is that the market thinks that the sudden shift in expenditure patterns, which brought about a huge demand shock for durable goods, caught manufacturers off guard. Yet, companies have been able to protect their margins because they had enough pricing power to pass on higher input costs to end customers. The BEA reported that net corporate cash flow in Q1 totalled $2589 million (saar) representing 11.7% of N-GDP compared to 11.5% for 2019. Patrick Palfrey, senior equity analyst at Credit Suisse, makes the point that transmitting higher costs is not easy or painless, but the honest truth is that well-managed companies, after a short delay, are able to safeguard their margins either by cutting costs, improving yield or raising prices.

From hereon personal income and the excess savings which were accumulated during the pandemic will likely find their way into the reopening sectors. As spending normalizes, the supply-demand gap will recalibrate, narrowing the demand-supply gap and easing pricing pressure in the manufacturing space.

Economic theory tells us that strong up-cyclical demand pressure has a way of creating new supply capacity. History actually shows that the private sector tends to be somewhat pro-cyclical. It usually finds a way to squeeze more out of existing resources and draw more people into the labour force when desired demand exceeds supply capacity: a phenomenon which has often led to overcompensating supply in a relatively short period of time. Interestingly, the Baltic freight rates did decrease 15% in the past two weeks and the rise in commodity prices has stalled.

Meanwhile, most economic prints might not beat expectations anymore, but they remain solid and risk-friendly. For example, new jobless claims came in strong at 406,000: within spitting distance of the pre-pandemic level of about 220,000. The Atlanta Fed's GDPNow forecasting model is estimating a GDP growth rate of 9.3% for Q2, down from a recent high of 13.6%. The elevated rate of increase in the level of business activity is moderating, as has inflation expectations: old news was enough to underpin the market. The S&P 500 was up 48 points, or 1.2%, to end the week at 4204: a new all-time high. Perhaps the fear of high inflation may turn out to be the misdirection of the year. That will of course depend on what the Fed does. A mild monetary pivot would be great. It would send the message that the Fed does not want inflation to cause a policy error.

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A Mild Monetary Pivot Is in the Making:

Investors should note that monetary policy is not a leading indicator which many pundits claim. On the contrary, the Fed rarely gets in front of the economy. Monetary officials do not guide the economy; they react to it. History is pretty clear on this one. A full economic cycle has four stages—recession, repair, recovery and expansion. Simply put, an investor only needs to know where we are going in the cycle to know what the monetary stance will be. Why? As a rule the Fed cares more about actual outcomes than projections. Typically, monetary policy reacts to trends rather than sets them.

The Gross Domestic Product (GDP) will reach its previous peak in Q/2, suggesting that the recovery stage is over. It may have happened in April even though the service side of the economy was not fully open for business. Personal disposable income, less government social benefits, which account for 62% of N-GDP totalled $13.693 billion in April compared to $13.304 billion in February 2020. Voila! An increase of 2.9%. Plus, the saving rate is 15%: wages and salaries are rising and there is an extra $1.5 trillion of potential pent-up consumer demand. Therefore, the GDP will likely exceed its pre-Covid trend line before the calendar year is over. Plainly, the recession is over, the repairs are done, the recovery accomplished and a new expansion phase has started.

Although the fast pace of the economic recovery is certainly satisfying, the Fed must be even more pleased with recent productivity and wage gains since both are accelerating at approximately the same rate. The pandemic has accelerated technological implementation. Big volume spending on productivity enhancements like automation, IT equipment, artificial intelligence and digital software, has risen to an all-time high. Thus, the prospects for further productivity gains are excellent. Productivity increased 4.0% y/y in Q1 of 2021.

It must be very gratifying for the Fed officials, because productivity may allow the new regime to shift the balance of power from capital to labour without incurring excessive inflation. It has the tendency to kill structural inflation because of its dampening impact on input costs of labour. Assuming that productivity gains will comfortably and sustainably surpass the trend of the last 20 years, the policymakers' objective of getting aggregate wages, which presently account for only 45% of N-GDP, back to the normal 50% without incurring intolerable rates of inflation is very possible. In this regard, a return to a "two-plus-two" economic expansion (2% for growth and 2% for inflation) may not be in the bag, but it's absolutely probable. Such an outcome would shrug off inflationary fears and keep the bullish trend for the stock market onward and upward.

One way to assure this kind of not-too-hot, not too cold situation is for the Treasury to sell more bonds to finance the government budgetary deficits to the public than to the Fed. A tapering program would mop up the money supply and in turn kill the main narrative on which inflationary expectations are built. Researchers at the Fed are aware that structural inflation is the biggest tail risk for the economy. It starts slowly, bit by bit, and seems

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temporarily benign, item by item. But taken as a whole, inflation is much harder to ignore. In this regard, I'm not surprised that several monetary officials have publicly insinuated that the discussion of a monetary pivot is about to start. The University of Michigan survey of consumers shows that households expect Headline CPI to be 3.4% over the next five to ten years. That is a lot more than what the Fed wants even under its new regime of tolerance. I'm certain that the monetary authorities are ready to open talks on reducing the Fed's bond-buying program. My assessment is based on five reasons:

Firstly, they surely do not want a mounting risk of higher inflationary expectation to upset the delicate balance between employment, productivity and inflation.

Secondly, financial conditions are remarkably easy and credit markets are flush. More importantly, the banking industry is resilient. The money centre banks have strong capital positions and high reserve levels, enabling them to support loan demand and swallow potential losses.

Thirdly, the housing market may need to be cooled off if a crash is to be avoided. The Fed might have to head off a housing boom before it turns into a bust. I realize that the U.S. is short 3.5 million houses. Nonetheless, the 15% percentage of home purchases that are not owner-occupied, which are bought to flip, rent or to vacation in, is troublesome. It's an unusually large slice resembling what occurred in 2007.

Fourthly, the White House is proposing a $6.0 trillion budget plan for 2022, including a $2.3 trillion infrastructure program, a $1.8 trillion education and family plan and a $1.5 trillion worth of discretionary spending. The budget deficit will go from 16.7% of N-GDP in 2021 to 7.8% in 2022. Moreover, projections show that budget deficits would exceed $1.3 trillion for a decade. These numbers are meaningless and totally aspirational. Biden has very narrow majorities in both chambers, and the American people will only go so far with radical economic and cultural changes. In a recent FT article, Janan Ganesh made a very astute comment. He exposed the hypothesis that there is only so much change a society will bear at one time. He wrote, "If the rules of economic life are in flux, people crave stability and even regression." He referred to the strife of the 1960s. The point is that too much change on too many fronts in too little time brings spasms. Nonetheless, it shows that a lot of direct fiscal stimulus is in the cards and, in turn, less need for a complementary, aggressive or accommodating monetary stance.

Lastly, the greenback has lost a lot of ground against major trading currencies. The DXY, a market-preferred dollar index, decreased 10 % over the past year, even though the performance of the U.S. economy has surpassed that of other major trading nations and interest rate differentials have favoured the U.S. On balance, the dollar looks vulnerable. The closeness of the relationship between the twin deficits (trade and budget) and the dollar's performance suggests that the greenback might be in a prolonged period of weakness. It could force the Fed to take extraordinary tightening measures to prevent this from happening.

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On Tuesday, the Fed's Vice-Chairman Richard Claridge. said, "There will be a time in the upcoming meeting, we'll be at the point where we can begin to discuss scaling back the pace of asset purchases. It's going to depend on the flow of data that we get." Recent numbers on the economy prove that substantial progress on both the employment and inflation front has been made.

Richard Quarles, the Fed's vice chair for supervision, literally said, "if my expectations about economic growth, employment and inflation over the coming months are borne out and especially, if they come in strong, it will become important for the Federal Open Market Committee to begin discussing our plans to adjust the pace of asset purchases at upcoming meetings."

The monetary authorities may have surreptitiously started to smooth the way for a policy shift. Lately, the Fed has sold Treasury securities via overnight reverse repos to counterparties. This operation is effectively draining liquidity from the market. It may be a temporary manoeuvre, but it nevertheless amounts to stopping the monthly QE purchase of bonds. The Fed is not explaining itself in that fashion because they are not ready to admit that they are removing some money out of the banking system.

Macro Strategy Partnership's Andrew Lees astutely observed, "Adjusting for USD500 billion being sterilized, U.S. commercial bank deposits, a proxy for M2 money supply, rather than growing by USD421.4 billion since the end of March will have shrunk by USD78.6 billion. On an annualized basis, rather than growing 16.5%, it will have shrunk by 2.8%. This could have serious implications for inflation expectations, depending on how long it lasts, and if it reverses. From the beginning of the year, this would reduce monetary growth from an annualized 15.5% to 7.6%."

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