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

PALOS

CONTENTS

Weekly Commentary

Issue **No. 22** | **JUNE 7, 2021**

Macro View

By Hubert Marleau

Obsession, Suspicion, and Confusion Over Inflation

Submitted June 6, 2021

A Snapshot of the Market for the Week Ended June 4, 2021:

It was a relatively quiet trading week until the BLS reported goldilock employment numbers and the Fed's inner circle manifested a willingness to start a discussion on tapering its bond-buying program. The S&P 500 had not moved more than 0.4% in either direction for the last seven business days. It ended at 4230, registering a weekly gain of 26 points, or 0.6%.

The Barrons reported that Mike Roman, CEO of 3M, told an investment conference that there are two sets of investors. One set is bullish because it believes that current signs of inflation are temporary, and the other is bearish because it believes that the signs are insidious. He added: "Raw materials and logistics fall into the transitory camp and labour cost inflation falls into the dangerous camp." If the latter proves to have staying power, it could be positive only for industrial automation equipment.

The Fed took a noteworthy and cunning step this week, suggesting that the direction of the monetary stance may have finally changed. The central bank said it will immediately unwind its ''secondary market corporate credit facility" with sales from a portfolio of roughly $13.8 billion in bonds and exchange-traded funds. Although the Fed says the move has nothing to do with monetary policy, it remains that this decision is contrary to Powell's strategy of "buy-and-hold". I would not dismiss that it is the beginning of a monetary pivot. Commentaries from Fed officials have surreptitiously alluded that discussions about tapering their bond-buying program are on.

Interestingly, the stock market shrugged the probable pivot off as investors concentrated on the parade of bullish economic prints while the bond market took it in stride as inflationary expectations fell.

Firstly, the ISM numbers conclusively showed that the reopening of businesses is propelling a burst of economic activity and ameliorating the employment situation. Employers added 559,000 jobs in May and the

Macro View cont.

By Hubert Marleau

unemployment rate fell to 5.8%. The outlook for the labour market is also promising. As infections ebb, vaccinations spread and relief measures cease, more and more of the 7.6 million souls that are still unemployed will likely find jobs. The labour participation rate rose in May to 61.7%.

Secondly, to step away from too much monetary easiness will prove to be very beneficial for the markets. Basically, quantitative easing (QE) is inflationary. Currently, the consensus is misconstruing the effect of QE on interest rates. Eventually, traders will come to their senses and realize that the forthcoming taper will reduce inflation expectations.

It is very hard for me to believe that the stock market will roll over, given that the economy is bound to give good economic prints for the next three to four years, with little chance of incurring a recession along the way. Moreover, the economy has dodged a financial crisis which usually scars the markets and the lawmakers, and the monetary authorities have embraced a new regime of tolerance. Additionally, the household sector has not been in better health with unprecedented levels of extra savings and, in turn, positioned to spend lavishly. Perhaps there are good reasons for valuation metrics to be high in just about everything. U.S. productivity growth has been strong since the economy emerged from the Covid-19 recession. It increased at an annualized rate of 5.4% in Q1. Comparatively, unit labour cost rose only 1.75%. On Friday, the BLS printed a year-over-year 2.0% increase in average hourly earnings. It would have been lower if front-line workers, whose pay is generally low, were all working in the services-driven economy.

Nonetheless, institutional investors who fear structural inflation or stagflation, are raising their discount rates and retail traders are reducing their speculative appetites. In this connection, I suspect that market returns will be abnormally below trend until the economic expansion brings valuation metrics back to historical standards. It may not feel appealing. Yet, I am staying in the market. In a recent interview with the FT, Howard Marks, the legendary founder of Oaktree Capital Management, said: “You have to be in the market. Successfully avoiding a bubble requires two decisions, to get out and to get back in, and most people blow one or the other.” However, I’m avoiding what is wildly crazy. Plainly put, I’m keeping what I already have invested in cyclical or growth stocks but not adding new money to either. Instead, I’m realigning my portfolio at its outer edge with companies that have attractive PEGs—that is PE/growth ratios under 1.75 times.

Obsession, Suspicion, and Confusion Over Inflation:

Inflation has become an obsession. That is clearly manifested in the University of Michigan’s gauges. Mentions of higher prices have surged to the highest level in 40 years. Regional surveys conducted by the Fed are pointing to acute price pressures in the manufacturing sector, labour market and logistics industry.

Macro View cont.

By Hubert Marleau

It is impossible to know how durable the ongoing surge in the inflation rate will be. We've never witnessed how fast an economy can collapse and how fast it can pick itself up. New businesses are popping up at the fastest pace on record. There are more job openings than there are unemployed people. Consumers are loaded with trillions in extra savings. Businesses are investing an unprecedented amount of money in human capital and productivity enhancements. And all this is going on while fiscal and monetary support is enormous. This environment is without historical parallel. In this connection, I've decided to avoid making precise predictions about inflation. It's just too crazy and too many things are out of control. Nevertheless, it is imperative to try to figure out whether the current inflation pace is transitory, cyclical or structural, because it will determine what will be the future dynamism of the economy.

Right now the inflation surge isn’t scary enough to offend investors. The belief is almost universal that the spike will pass soon enough. This notion is based on the observation that today's abrupt increase in the level of inflation results from the base effects of declining prices which prevailed at the start of the pandemic. Some say that inflation expectations may have got ahead of reality. Economic

theory teaches that above-trend inflation can become disinflationary. Why? It brings about demand destruction, substitution and efficiency. Outside of energy and food, there are some faint indications of diminishing pressure. That is what the Fed is banking on.

While the aforementioned points make good common sense, the odds that inflation expectations could arise from other factors should not be neglected. Bloomberg thinks that the Fed’s inflation logic could be flawed: “Rather than discarding the spike is related to base effects, the CPI rose at the annual rate of 5.2% in the last three months and PCE at 4.8% compared to yearly increases of 4.2% and 3.6% respectively.” The observation is telling that the bottlenecks might not ease over time and does also make sense. Inventories are extremely low, prices that industry must pay for parts and material are rising fast, and delivery and transportation costs are absurdly high.

Thus, it could turn out that inflation may also have to do a lot with the medium-term risk of rising cyclical impulses stemming from lack of material and/or a long-term one related to declining demographic forces. In this respect, investors must explore the nature of inflation to determine the future dynamism of the economy. In free markets, producers need price signals to respond. As a matter of fact, cyclical price increases can be very beneficial for an economy when desired demand is up there, and supply capacity is down there.

It brings about innovations, efficiencies and profitability, which in turn lead to real investments followed by productivity. That's called good inflation. Unfortunately, policies which allow the destruction of capital, or insatiable demand, or deliberate reduction in production to take place for extended periods, particularly when

Macro View cont.

By Hubert Marleau

labour becomes less abundant, can cause structural inflationary expectation. That's bad inflation and an obvious worry. If the cohort of people between the ages of 18 and 64 is to shrink as expected, and is less willing to participate in the labour force, wages would rise, forcing businesses to raise prices, leading workers to demand even higher wages, and creating an inflationary spiral. The Fed would need to fight back and to end up with stagflation.

The pandemic has caused tectonic disruptions in the production of goods and services and seismic changes in consumption patterns. The dislocation has made it very difficult, even impossible, to understand, interpret or analyse the official measures of price changes. According to Harvard professor Alberto Cavallo, inflation may have been underestimated by 5.5% over the course of 2020. However, if you look at the Dallas Fed Trimmed Mean PCE measure on a year-over-year basis, it looks quite mild and well below 2019 and early 2020. I'm just as lost as the next guy.

Over the coming weeks, I plan to closely monitor changes in money velocity, wages, saving rates, price expectation, and alternative measurements of price changes, to get a better idea of what is going on with the actual inflation dynamics. At this time, I think that the odds that today's inflation rate is transient is 25%, cyclical 60% and structural 15%.

P.S. A Global Minimum Corporate Tax: Headlines

Financial Times:
G7 Strikes Historic Agreement on Taxing Multinationals
Deal paves the way for a global accord at the G20 meeting in July.

New York Times:
Finance Leaders Reach Global Tax Deal Aimed at Ending Profit Shifting
The Group of 7 nations agreed to back a new global minimum tax rate that companies would have to pay regardless of where they are based.

Wall Street Journal:
G-7 Nations Agree on New Rule for Taxing Global Companies
Deal marks step toward adopting a 15% global minimum corporate-tax rate sought by the Biden administration.

It is still unclear whether a truly global tax will ever come to pass because it is unsure if countries like China and Russia among many other developing countries will accept a Western idea and go along with a prescription or

Macro View cont.

By Hubert Marleau

rules not designed by them. In any case, the worm has turned on corporate tax levels. Companies that make more than 50% of their income internationally and have both foreign effective tax rates and consensus 2022 effective tax rates below 15% will clearly be hurt.

Oddly, Google, Facebook, and Amazon said they welcome the G7's move. Perhaps, they are content with the second part of the deal which is the removal of all the digital service taxes. Also, they could reduce their tax load by increasing their debt levels at the margin and store the proceeds to protect their credit standing. Isn't it what they did in the past year?

Follow us on LinkedIn:

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