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Weekly Commentary

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By Hubert Marleau

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Submitted June 27, 2021

A Snapshot of the Market for the Week Ended June 25, 2021:

The stock market was upended last week after the Fed signalled it would begin to dial back the monetary stimulus that helped fuel the recovery. This week, the market regained its footing. The fall in equity prices was technical, adjusting to a growing awareness that we are in a mid-cycle market after a strong early-cycle rally within an ongoing bull market. The economy continues its post-pandemic recovery, but it is becoming increasingly clear that the pace is slowing down.

Based on Friday's Bureau of Economic Analysis report on personal income for the month of May, the level of economic activity in the household sector is back not only to where it was in February 2020 but equal to where it would have been without the pandemic. Americans' total wage and salary income is now more than 5.0% higher than before the pandemic, even though millions are jobless. Another big takeaway is that big changes are occurring under the hood. Spending at movie theatres, amusement parks, restaurants, photo studios, and passenger trains jumped 15% to 20% in May, compared with April, while expenditure on motor vehicles tanked 10% after surging earlier in the year. The change in spending patterns are consistent with a healthy rebalancing of demand from goods to services. The same can be said for inflation. The PCE price index was up 3.9% year-over-year compared to 1.8% before the pandemic. The 2.1% gap can be explained by the normalization of prices for oil, hotels, restaurants, air travel and idiosyncratic trouble in the auto market.

Normalization should bring back economic growth to a more natural pace--two percent for growth and two percent for inflation. As a matter of fact, positive macroeconomic surprises are less frequent than they used to be, and while growth estimates for Q2 are still elevated, they have inched down. Over the past six months, the money supply rose at the annual rate of 6.0%. That is the average speed needed to generate normal pre-pandemic rates of change in both inflation and growth. The GDPNow model estimate for real GDP growth in Q2 is 9.7% (saar). The high was 13.5%. Many cyclical indicators are rolling over, including the price for DRAM chips.

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Federal Reserve officials and bank economists told investors not to sweat over current economic prints. Things will fall in place. The market likes the idea of having slower growth. What kills bull markets is persistently high inflation not high unemployment. It gives credence to the notion that current inflationary pressures may indeed be temporary. The narrative allowed Biden's $1.0 trillion infrastructure deal and the removal of pandemic era restrictions on large banks to lift the spirit of the market. The S&P 500 moved further into record territory, increasing 2.8% or 115 points to end up at a new all-time high of 4281. Morgan Stanley's Mike Wilson reported that inflows of money into global equity funds are still good.

Rational Expectations: Inflation or Productivity

While headline measures of inflation have been hot, the perception is that they are all transitory. These pressures, which are believed to be driven by specific categories, supply chain bottlenecks and year-ago comparisons, are generally expected to ease as expenditure patterns normalize. This view, which is officially that of the Federal Reserve Chair Jerome Powell, is also the one the bond market adopted.

Nonetheless, Fed officials are being preemptive by publicly discussing why, how and when to taper their bond-purchasing program and raise their policy rate. A procession of monetary policy makers voiced their opinions this week, providing some clarity on the matter.

Neel Kashkari, president of the Minnesota Fed said: "I prefer to keep rates at zero at least through the end of 2023. That is ostensibly necessary in order to give the labour market time to heal and achieve maximum employment and I do believe that these higher inflation readings are going to be transitory."

Mary Daly, president of the San Francisco Fed said: "I am bullish on the recovery. Substantial further progress toward full employment and the inflation is within our line of sight. I think it's possible we could even get there sometime late this year, or early next year. Meanwhile the idea is to keep the boat steady."

Jim Bullard, president of the St-Louis Fed said: "We are expecting a good year, a good reopening. But this is a bigger year than we were expecting, more inflation than we were expecting. I think it's natural that we tilted a little bit more hawkish here to contain inflationary pressures."

Robert Kaplan, president of the Dallas Fed said: "As we make substantial further progress, which I think will happen sooner than people expect, and weathering the pandemic, I believe we'd be better off from a risk-management point of view, beginning to adjust these purchases of Treasuries and mortgage-backed securities."

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Raphael Bostic, president of the Atlanta Fed said: "Given the upside surprises and recent data points, I've pulled forward my projections for our first move to late 2022."

John Williams, president of the NY Fed said: "The data hadn't progressed enough to warrant a change in policy."

Eric Rosengren, president of the Boston Fed said: "I think the Fed's expectation, that most of the price movement that's occurring is not sustained into next year, is actually a pretty common forecast. But it is important over time to watch for conditions that potentially raise financial stability issues. Housing prices are something worth closely monitoring."

Overall, the Fed's average inflation targeting framework might have been shaken, but it has not lost its credibility. Yet, what is exactly meant by compensating for periods of undershooting by seeking an average around the 2.0 inflation target, in terms of time and magnitude, is complicated by the lack of a precise mathematical definition. The Fed officials have no intention of divulging the arithmetic that they are using to calculate what constitutes "Average Inflation Targeting (AIT)". It's a closely guarded Coca-Cola secret. The Fed clearly wants to retain as much flexibility as possible by keeping the market in the dark on AIT. Indeed, it has not clarified what the look-back period is.

In order not to be behind the eight ball, it's important to devise a workable formula to estimate the patience of the Fed. JPM has come out with some interesting conclusions. Marko Kolanovic, JPM's chief Market economist, laid it out: "On a three-year rolling basis, core inflation would be averaging close to 2.0% before the end of this year, so there would be theoretically no need for the Fed to overshoot its inflation target over the next three years." Consequently, the bar appears to be low in terms of betting that the Fed will be surprised by inflation outcomes over the coming six months.

It sounds as if increases in the cost of money have gone from denial to acceptance, and it may come sooner rather than later, even though the general belief is that recent high readings on inflation will not last. Actually, the debate is more about creating some optionality for the committee, and manifesting responsibility should the economy overheat too much for comfort. In my judgement, monetary policy has already pivoted. The Fed did not walk back its hawkish lean inherent in the June dot plot. The monetary authorities want the market to know that the commitment to maintain its hard-earned reputation as a credible inflation fighter is ongoing.

A 2022 rate hike is now getting baked into investors' projections. Futures are giving a 40% plus chance of a rate hike at the FOMC's July 2022 meeting. The probability, according to the CME Group, was 28% one month ago and only 12% last January. Expectations for a first Fed hike in a JPM survey showed that participants believe that it will come a bit sooner than believed before the last Wednesday FOMC meeting. More important is the fact that

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hardly anyone now believes that the Fed will never hike. It makes a lot of common sense. Inflation isn't a dead idea just because the Fed says so. The components of overheating, like fiscal and monetary dominance is clear and present at a time when the cost of borrowing both money and capital is significantly lower than the returns on productive assets.

Nonetheless, long-term bond yields are lower, and the yield curve is narrower than they both were a few weeks ago. The bond market is telling investors that inflation expectations are heading lower from the current clip of 2.5% for the next five year to 2.1% in the following five years. What is behind these projections is the Rational Expectation Hypothesis (REH). REH is essentially a collection of opinions of traders, speculators and investors that understand how government and central bank policies can alter macroeconomic variables and how the economy works. The theory states these economic agents make decisions based on learning from past trends, mistakes and experiences and best available information. The REH unbiasedly reflects the wisdom of the bond crowd. The theory is skillful at anticipating broad economic factors such as inflation and interest rates. It's not good at explaining the reasons behind its accuracy. While the thesis has served me well over the years to compose broad market strategies, it does not tell why it is so often right.

In this connection, one needs to create a narrative based on a lot of research. The bottom line is that the market projection for lower inflation expectations will come about either because the ongoing inflation is transient or cyclical in nature, or the expansion rate of the economy will slow down enough to relieve supply pressures, and/or a lasting productivity surge is in the making.

While I agree that the first two reasons will play a role, I believe that not enough credit is given to productivity. A growing body of economists is convinced that companies have no choice but to produce labour-reducing business models. The growth rate of working-age populations is declining around the world. Edward Yardini, a seasoned and very reputable economist, predicted in a recent article in the Barron's that annual productivity gain will increase to 4% by the middle of the decade from about 2% currently. Investors have started to make productivity bets, buying into semiconductors, robots, 5G communication, 3D manufacturing, cloud and quantum computing. The productivity diffusion is broadening. Non-technology companies involved in healthcare, finance, professional services, and industries are spending enormous amounts of money in productivity enhancement machinery and software. Rising efficiency is a shock absorber that historically has helped cushion the impact of structural inflation stemming from a wage-price spiral.

Interestingly, millennials are poised to become the most important drivers of the next economy. They are addicted to work efficiency, digital technology, fast moving ideas and creative destruction. Productivity is cumulative. The millennials stand on the giant shoulders of fundamental science and applied technology, which was abundantly created in the last ten years. According to Fundstrat's Tom Lee, demographics are destiny. Since 1900, every single

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peak in the stock market has coincided with the peak of every single generation. With the prime age (30 to 50) of the millennial generation not expected to peak until 2038, the stock market has a long bullish runaway.

Morgan Stanley's Joyce Chang, one of Wall Street's most experienced and ablest analysts, made the best comment of the week in this week's Barron's. She said: "the speed at which the world is changing is wreaking havoc with a typical investor's long- term planning, expecting continued gains for stocks and oil--but no super-cycle for the latter." She thinks it's premature to talk about late-cycle dynamics. Public corporations will face pressure from investors to release excess cash via dividends, buybacks, and acquisitions. She reported that Morgan Stanley has raised its estimates for 2021 S&P 500 earnings per share to $200 and forecast for 2022 to $225 and $245 for 2023. The S&P 500 target is 4400.

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