PALOS

Weekly Commentary

Issue No. 26 | JULY 5, 2021

CONTENTS

Macro View

By Hubert Marleau

What Comes Next:
Productivity Revolution Plus an Inflation Uptick

Submitted July 3, 2021

A Snapshot of the Market for the Week Ended July 2, 2021:

Investors were treated to a plethora of data on the economy and the delta variant of the coronavirus, showing tentative signs that labour frictions are easing, upside inflation may be diminishing, and population immunity is taking hold. Overall, it was enough to ease wage rate expectations but not enough for the Fed to change its mind. A few weeks ago, every Tom, Dick and Harry worried about runaway inflation. Now concerns are waning. Google searches for the word inflation are down 80% from where they were during the second week of May; and even lower than they were a year ago. The amount of inflation priced into five-year Treasury Inflation Protected Securities (TIPS) has fallen to 2.4% from a high of 2.7% in May. Inflation expectations are back down to 2.0% for the following five years.

Employment growth has resumed. After a few consecutive disappointments, jobless claims were back on track. They declined to 364,000 from 415,000 the previous week below the consensus of 388,000, registering a new pandemic low. Meanwhile, the employment situation improved considerably in June as the pace of the job recovery resumed with a vengeance. The market wanted 700,000 new jobs. It got 850,000. It was good news, and the numbers were just right. Job openings got filled and many people returned to the labour market. In other words, the market is clearing. Should the labour market continue to successfully recruit workers as the June report suggests, an unclogging of the job market would alleviate many of the bottlenecks found in the supply chain. It would reduce the need to raise wage rates to attract workers and put to rest fears that jobs lost to the pandemic are permanent.

The prices that manufacturers have to pay for raw material, labour and transporting products are the highest in more than four decades. Yet, year-over year prices on many key items, which have contributed immensely to

Macro View cont.

By Hubert Marleau

higher inflation, are rolling over. Additionally, worker absenteeism related to unemployment insurance benefits, child-care, and health issues, is fading. In this regard, an absorption of the supply of unemployed workers is foreseeable: an eventuality that should rectify bottlenecks, reduce supply disruptions and sort out many logistical kinks. Given the anticipated increase in production capacity schedule, plus the expected rearrangement in consumption patterns, the inventories to sales ratio is bound to rise and in turn alleviate pricing pressures.

The delta variant of the coronavirus that causes COVID-19, which has been detected in both Canada and in the U.S., accounts for 20% of all cases. Observations made by the Centers for Disease Control and Prevention show that the fatality rate has not worsened in developed countries which have made strong progress in vaccinations. As a matter of fact, most deaths have occurred in unvaccinated people. Thankfully, the level of population immunity is rapidly rising.

These signals are giving market participants confidence that the intolerable high inflationary content of the misery index, which is the addition of the inflation and unemployment rates, will improve. It currently is 46% versus a pre-pandemic norm of roughly 25%. The Conference Board reported a big jump in the consumer sentiment index for June, suggesting that confidence in the economy will continue. This optimism caused the stock prices to drift higher for seven straight days for the first time in 24 years.

The S&P 500 increased 71 points or 1.7% to end at a new all-time record of 4352. At current valuations, pullbacks are destined to happen. But they will take place in the midst of a long-term bull run. Indeed, the stock market is acting as if it wants to go higher. Helping matters is that the market is entering a new period just ahead of what is expected to be another strong earnings season.

Throughout all of 2020 and the first half of 2021, the market has been able to pick itself up and keep on going up. Fundstrat's Tom Lee, a very able technician, expects the S&P 500 to rise on average around 6.3% in the second half, for a full year gain of about 23%: a textbook market recovery from a recession. Momentum does not roll over easily when money is pouring into the stock market. Global equity funds took another $9.9 billion last week, taking the year-to date haul to $585 billion. BofA's Michael Harnett in the latest edition of the bank's "Flow Show" series wrote: "2001-2020 stock inflow was a cumulative $0.8 trillion and in 2021 the inflow is annualizing $1.2 trillion."

What Come Next: Productivity Revolution Plus an Inflation Uptick:

The S&P 500 closed its second-best half since 1998. Bloomberg's John Authers wrote on Thursday morning: "The S&P 500 has gained 14.4% compared to 7.8%, in dollar terms, for the MSCI's index of the rest of the world. Exclude the information technology sector and the S&P's performance improves to 14.9%. Scrap market-cap weighting

Macro View cont.

By Hubert Marleau

and use an equal-weighted version of the S&P 500, which drops the representation of the highest five tech stocks from more than 21% to only 1%, and the S&P is up 18.3%. The rotation to the safety of the big internet groups benefited anyone invested in the U.S. index; but so has the subsequent rotation away from them."

This stock market outperformance has come about because of a stronger economic recovery, more successful rollout of vaccines and wider policy support in the U.S than elsewhere. This reality is that the big market gain has raised valuations and the robust recovery has increased inflation rates. This combination has heightened concerns over a more hawkish Fed and complacent market. Four Fed officials, Thomas Barkin, Randal Quarles, Christopher Waller and Patrick Harker, expressed the view that while an interest rate hike lies some way into the distance, they are ready for the central bank to begin tapering its asset purchases this year, favouring a phasing-out of Mortgage Back Securities (MBS) purchases first to cool the housing market. Moreover, several weighing macroeconomic questions need answers: like how fast will job openings be filled, how temporary will the inflation surge be, how much of the excess savings will be spent and will the big infrastructure investment programme be implemented.

These concerns are legitimate, but they are built on the questionable conviction that the pandemic has accelerated the forces that are causing a different labour-capital relationship, which could lead to a new equilibrium favouring wages over profit. It is based on the notion that the pool of the working age population is shrinking at a time when progressive politicians are taking measures to increase the leverage of labour. While the situation will likely give workers more clout, the proponents are not giving any considerations to the profit effect of the emerging productivity revolution and of persistent inflation on intangible and tangible investments.

Businesses are pass-through inflation vehicles. They invest to improve productivity or acquire competitors to get productive synergies. In a recent article in Bloomberg, Gary Shilling pointed out that productivity gains are the main drivers of earnings: "Over the entire post-World War 11 era, sales for the corporate sector rose 6.4% per year on average, while labor compensation climbed essentially the same, or 6.3%. So the average 6.5% yearly rise in pre-tax corporate profits was largely the result of the 2.7% annual climb in productivity. Interestingly of late, corporations have husbanded scarce labour and slashed labour costs--not wage rates. From the second quarter of 2020 to the first quarter of 2021 productivity has not only outrun employment increase but also hourly labour costs. Last week, I substantiated the reasons why companies have no choice but to produce labour-reducing business models. The growth rate of working-age populations is declining fast, and demographic power is abruptly shifting toward tech-literate millennials, which will have significant consequences on the diffusion of technology, globalization and national security. Annual productivity gains could level up 4.0% from the pre-pandemic rate of 2.0%.

Macro View cont.

By Hubert Marleau

I completely disagree with those who claim that there is no better time to get out of the market than now. Barron's Jacob Sonenshine showed that history suggests otherwise. He wrote: "Since 1979, the S&P 500 has gained 10% or more 14 times during the first half of the year, and the index has gone on to average a 6.3% gain over the second half of the year. What's more, the index finished the second half of the year higher in 11 of those instances, or 79% of the time. Even the losses, when they occurred, weren't all that bad. The S&P 500 dropped 1.9% in the second half of 1983 and 3.5% during the last six months of 1986."

Investors are noticing that the economy is in vastly better shape than it was six months ago. It still has enough industrial and labour capacity to transition smoothly from the recovery period experienced over the last 15 months to a new expansionary phase that could last for years. Although there are plenty of indicators implying that the economy will keep on rolling, the pace will definitely decline from hereon. Regional surveys by Federal Reserve banks and the latest ISM report, while still positively elevated, indicated their direction is down. It means that the growth rate is heading to what is considered normal and more manageable.

The policymakers have put the business cycle on ice. Given that the level of economic activity is now very close to where it was in Q4 of 2019, they will allow the economic cycle to thaw. Thus, the rhythm of the economy from where it was left it is about to restart. However, the cycle will probably be much longer in the tooth than the outlook was in 2019. The residual effects of excess savings and unprecedented stimulus are present, and easy credit conditions and low interest rates still reign. Yes, as the private sector gets back on track to its pre-pandemic trend-line, the public sector will retreat with lower budget deficits. But, it will not mean fiscal restraint. Governments have abandoned austerity approaches like the one they adopted in the aftermath of the Global Financial Crisis. The economy will sail into the horizon on its own.

Follow us on LinkedIn:

Weekly Commentary

Issue **No. 26** | **JULY 5, 2021**

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