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Weekly Commentary

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CONTENTS

Occam's Razor:
The Bond Market Says Growth Has Slowed,
Inflation Is Peaking and Credit Conditions Are Steady 1

Disclaimer & Contacts 4

Macro View

By Hubert Marleau

Occam's Razor: The Bond Market Says Growth Has Slowed, Inflation Is Peaking and Credit Conditions Are Steady

Submitted July 10, 2021

A Snapshot of the Market for the Week Ended July 9, 2021:

In bull markets for stocks, things about which investors should worry often get overlooked, like Occam's Razor, which is a problem-solving principle which states that an explanation with the fewest of assumptions is usually the correct one. Given that bond traders are the smartest guys in the room when it comes to the economy, it is worthwhile for stock operators to keep tabs on what is going on in the Treasury market. These smart guys know that bond yields broadly track economic performance; but over the short term they also know that changes in prior expectations can be disruptive.

The Treasury market has been telling stock traders with growing conviction to capitulate and accept the narrative that peak growth and inflation were behind them. Nominal bond yields, inflation expectations and credit spreads are all considerably lower than they were ten weeks ago. Meanwhile the gap between the neutral rate and policy is much narrower and the yield curve much flatter. It became harder to ignore the message that the bond market was posting.

On Thursday, investors awoke to a host of concerns that forced them to look at signals given by the Treasury market. The S&P 500 fell 0.9%. The rapid spread of the infectious Delta strain, the steep rise in the price of oil, the sharp deceleration in the growth of the money supply, collateral damage of Beijing's crackdown on Didi, and the rising number of central banks pulling back monetary support, have all in varying degrees knocked back growth optimism and bullish sentiment. Traders were taken aback by disappointing economic prints; speculators had a hard rethink about the prospect for inflation and investors got edgy over the outlook for global growth.

Macro View cont.

By Hubert Marleau

The ISM surveys, job claims and mortgage applications produced numbers that negatively missed the consensus predictions of economists. Citibank's macro surprise index has lapsed to zero after being in positive territory since last May. The Atlanta Fed's GDPNow Casting model is estimating an annual growth factor of 7.3% for Q2 compared to the high forecast of 14.3% at the beginning of May.

On Friday, the stock prices reversed and soared 1.1%, reflecting the old aphorism that markets do not react, they overreact. Investors realize that momentum may have faded, but not the direction. As a matter of fact, the data points were quite good. The market was just too accustomed to positive surprises. Accordingly, the growth, recovery and reflation trades got out of trouble and the S&P 500 registered a weekly gain of 18 points or 0.4% to end at a new all-time high of 4370.

If indeed the business cycle, which was put on ice by the policymakers over the past 16 months, is no longer frozen, the rhythm of the economy from where it was, is likely to restart. The current level of economic activity is very close to where it was in Q4 of 2019. However, the cycle is much longer in the tooth than the outlook was in 2019. Why? I have four good reasons:

1. The residual effects of excess savings and unprecedented stimulus are present, and easy credit conditions and low interest rates still reign.
2. 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.
3. The number of available jobs at the end of May set a net high in records dating back to 2000. They nearly matched the 9.3 million who are unemployed and seeking work.
4. The business sector is adding productivity enhancement technology to their business models at an accelerating clip. This vigorous business investment campaign to boost production with robots and digital connectivity to collect and optimize data will likely last for years to come. The boom is financeable at much lower cost than firms would have to pay workers in higher wage rates. Moreover, they have strong balance sheets and therefore are capable of attracting the excess savings of the private sector. Additionally, the financial system is coming out of the pandemic recession in an over-liquid position, not in an over-leveraged one as it was going into the GFC.

In this regard, investors should not be blindsided by the coming reset away from fast to moderate growth. As a rule, an economy which is neither too cold nor too hot, tends to eliminate sharp unwinds, mitigate inflationary pressures and normalize monetary conditions. By ricochet, it should ease the introduction of a much-needed

Macro View cont.

By Hubert Marleau

industrial policy and infrastructure plans. My base case is a balanced consumer pattern of spending, a cautious monetary stance and a durable business boom.

Thus, at the risk of sounding like a dreamer, a fast reduction in hazardous appetite, an orderly change in investor sentiment and a gradual alteration of portfolio positions can be expected. My base case for a more balanced growth and cautious monetary stance supports a gradual and beneficial reset.

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