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Weekly Commentary

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Macro View

By Hubert Marleau

The Bulls Eat Bears for Lunch

Submitted July 24, 2021

A Snapshot of the Market for the Week Ended July 23, 2021:

The S&P 500 closed at 4412 on Friday, up 85 points or 2.0%. Optimistic earnings results outweighed worries over the virus outbursts, inflation flare-up and growth setbacks. It's as if Monday's loud wipeout never happened. The earnings season is off to a great start. Over the next two weeks 3,032 stocks are set to report earnings for Q2. Market strategists are expecting many big beats. In this respect, global equities took in another $3.3 billion in new money. The pace may have slowed down a bit but the streak is remarkably bullish. Year-to date the inflow is over $600 billion, and it's probable that even more money is heading into the global equity market. There is still $4.49 trillion in money market funds which is sitting idle. That is a lot of dry powder to deploy. Dividend yields are higher than bond yields across the curve and earning yields are considerably above the real rates of short, mid and long term government securities.

The abrupt upturn in the number of Covid cases may damage parts of the economy, but will not derail business. Some economists have trimmed their forecasts, but there have been no major downgrades. The latest waves of the pandemic haven't been anywhere near as painful as the initial shock. Hospitalizations and deaths have not surged, demonstrating how the vaccination program has disrupted the earlier pattern by providing a strong shield against severe forms of the disease. Moreover, the dominance of the Delta variant is creating a renewed sense of urgency to get vaccinated. Citibank's team of economists has cut global growth for 2021 by only 0.1% to 5.9%. That is not enough to create worrisome downward pressure on industrial output. As a matter of fact, real-time data like foot traffic still has momentum, suggesting no reason to be alarmed. The population is adjusting to the reality that the virus is a permanent reality and awareness that it must cope with it voluntarily.

Macro View cont.

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Growth expectations may have ratcheted down but productivity is rising and the gap between the selling prices that businesses are getting and input costs that they must pay has widened, suggesting profit margin expansion. Given the pent-up demand stemming from excess savings, most companies have the pricing power to pass along cost increases. Economists at Goldman Sachs found that productivity gains since the pandemic started are pronounced in seven of the eleven sub-sectors of the economy. Only three sectors had productivity declines--leisure, personal services and transportations—and these industries are in the process of dramatically changing their business models to improve efficiencies: Miso Robotics. If productivity gains are going to replace employment increase as the new driver of growth, as is generally expected, supply capacity would end up exceeding demand. That would tend to push selling prices down.

Meanwhile price pressures are showing signs of abating as the rapid recovery phase morphs into a moderate mid-cycle expansion. A preliminary read on IHS Markit's gauge is showing faint signs of lessening inflation in the supply chain with both input costs and selling price indices falling for a second month in July. Post-pandemic shortages of raw materials like lumber and industrial components like semiconductors are easing. Additionally, the changing spending habits of consumers and the accelerating digitalization is structurally reorganizing the labour sector of the economy, causing a serious mismatch between workers' skills and employers' needs. Thus it looks as if the recent inflation surge is more about relative prices than monetary in nature. At this point in time, $3.0 billion of the $5.0 trillion increase in the money supply of the last 16 months is still resting with the Fed in the form of reserves and repos. Hypothetically, the money supply has increased at the annual rate of 9.0% since February 2020 and not the 24% which is being telegraphed by the media. This sterilization of the money supply might explain why the monetary authorities and the bond traders have confidence that the current spike in inflation is transient. The bond market's inflation expectations from one year out to two years out, fell from a high of 2.9% at the end of April to 2.1%. Concurrently, monetary growth in the U.S. and in the world has rapidly decelerated over the past three months.

The big central banks are not about to give up on monetary stimulus or to introduce counter-cyclical policies just yet. Policymakers want to make sure that they don't find themselves pushing on a string or take the risk of tightening should fiscal stimulus become politically impossible. The People's Bank of China cut banks' reserve requirement ratio and hinted that it may be followed with lower interest rates. Chinese premier Li Keqiang's idea of using cross-cyclical management to make smaller monetary policy adjustments early, rather than having to do future rounds of large debt-driven stimulus is gaining acceptance. Meanwhile, the European Central Bank (ECB) revised forward guidance to underline its commitment of maintaining a persistently accomodative monetary policy stance to reach the 2% inflation target durably. Overshoots will be tolerated. It sets a very high bar, which provides the ECB with excuses to persist with perma-easing. Moreover, the Fed is not likely to change its monetary stance at this week's FOMC meeting. The majority still

Macro View cont.

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believe that recent price pressures will subside, which could leave the Fed in the same position it has faced over the past ten years. It clearly does not want that to happen again.

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