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Weekly Commentary

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Macro View

By Hubert Marleau

Team Transitory Wins the First Round

Submitted September 19, 2021

A Snapshot of the Market for the Week Ended September 17, 2021:

U.S. consumer prices rose less than expected in August, snapping a string of hefty gains suggesting that some of the upward pressure on inflation is waning. The headline inflation gauge rose 0.3% from July registering a y/y increase of 5.3% while core prices rose only 0.1% m/m reducing the y/y increase to 4.0%. Meanwhile, import prices slipped 0.3% for August versus a consensus for a 0.3% increase, and July's 0.4% rise. Thankfully, inflation is not exploding and market confidence in the deflationary forces is present. Bond investors are predicting that over the next twelve months consumer prices will rise around 4.5%, then decelerate to 2.1% in the following four years.

In this regard, reports on inflation may have bolstered the transitory narrative, cementing the case against an official taper decision at the September FOMC meeting. Nevertheless, the inflation situation is troublingly strong and it's not all clear to those who are neurotic about much higher inflation than what the bond investors think, are going to be wrong. Despite shutdowns related to hurricane Ida and lower consumer sentiment related to the Delta Variant, both retail sales and industrial production surprisingly beat consensus firmly, suggesting that the economic expansion is still vigorously on. Based on these latest economic prints, the monetary authorities, which will meet on Wednesday, will likely state that it plans to introduce a tapering program very soon; but emphasize that they are not in any hurry to quickly follow with interest rate hikes.

It appears that the stock market is much more preoccupied with the dimensional uncertainties over the upcoming proposals for tax hikes, the possible debt ceiling shutdown, the rolling off of government stimulus, the rise in the Delta variant and China's Evergrande Real Estate leverage woes than what the Fed is up to. Stock market operators were well hedged coming into September. According to Goldman Sachs, about $3.4

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trillion of stock and index options and futures expired on Friday. Traders are usually cautious in the run-up to this quarterly event, known as “triple witching” and it may have weighed on the stock market.

Yet, the S&P 500 index notched its 21th consecutive trading day without a 1% move, the longest stretch in 20 months. The index’s nascent selloff comes amid a dearth of large moves. There is a conspicuous absence of a 5% pullback. In the past week, the S&P 500 lost 26 points or 0.6% to close at 4433, logging a second consecutive weekly decline. The broad market peaked on September 2, at 4537 and is 1.9% away from what constitutes a customary pullback or 83 points above the 50-day moving average (4350) where support exists. Interestingly, global equity funds took in more than $51 billion last week—U.S. equity funds took in $46 billion and of that $28 billion went into large cap funds—during a period which coincided with what counts as a selloff in US stocks.

In other words, stock investors have not completely ignored the fact that the economy is not at the end of a business cycle, but in the middle of one. Thus, I’m maintaining a constructive outlook because many names are already off by 10% or more, with earnings, buybacks and dividend payouts bound to increase while economic growth is about to reaccelerate, not to peak but to a manageable and standard pace. The Citi Economic Surprise Index has started to rise after falling for weeks and the upcoming taper of bond purchases by the Fed has been smoothly telegraphed.

Moreover, concerns over the tax hikes for companies and investors might be a bit overblown. I don’t like it, but Keith Lerner of Truist Advisory Services examined the historical impact of tax policy on market returns and found that what is proposed is far from outrageous. The corporate tax rate has averaged 42.1% over the last 60 years and tax on capital gain averaged 25.0% for the comparable period. The expectation is 25.0% a piece.

Market return is more about economic growth and the equity risk premium (ERP) These are at levels that have corresponded with stocks outperforming bonds on a twelve-month basis. I was encouraged by Eddy Elfenbein’s research on the influence of the 10-year TIPS (Treasury Inflation-Protected Securities) on the Wilshire 5000. He found that since 1983 when the 10-year TIPS yielded 1.67% or higher, the stock market has had a negative return. But when 10-year TIPS yields have been zero or lower, the stock market has delivered an average return of more than 38%. The tipping point appears to be 0.50%. Market Watch concluded that when the yield on the 10-year TIPS has been at least 0.50%, the stock market return has been 5.1%; but when it’s lower, the stock market has delivered gains of 23.3%. On Friday, the yields on the 10-year TIPS was -1.00%, which is close to a record low. In my judgment, Elfenbein's observation resembles the ERP idea, also offering a bullish signal. The market could find itself right back in its virtual cycle. The problem with the correction

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narrative is that none of it is new—on the weekend. Barrons called it information overload. Investors should be aware that tapering isn't tightening and should take relief in the notion that the low-interest rate punch bowl isn't going away—that is what matters. This time there could be no tantrum and if there is one, it is likely to be small and brief. Edward Yardeni thinks that the surprise could be a melt-up instead of a meltdown. Thus, it may be worthwhile to have a second look at cyclicals like industrial, energy, material and bank stocks that have earning potential and non-cyclical sectors like Telecom Services and Consumer Staples whose prices are far below their economic book value. Many of these stocks are significantly off their highs.

P.S. Best Read of the Week

In an interview with CNBC and Bloomberg News, Mike Wirth, Chevron Corp Chief Executive said two big things:

"The company prefers to return money to its shareholders rather than use it to invest in solar and wind power because renewable sources of energy generate low financial returns for stockholders. Their technology is mature, capital is readily available and returns are being bid down. We would rather dividend it back to shareholders and let them plant the trees. Chevron's lower-carbon investments will focus on areas such as renewable natural gas and hydrogen for use by industrial, power and transport customers, because the potential to create value is significant".

The day before Chevron announced it was tripling its capital investment in its lower-carbon energy businesses. The company is now expected to invest over $10 billion by 2028, up from prior guidance of $3.0 billion. Chevron generated $4.5 billion in net income in the first six months of 2021.

He added; "While the energy transition to greener energy will certainly play a big role down the road, there are forces like the resistance to drill, government policies, efforts to constrain capital into the industry and making it hard to access institutional money that are interfering with market signals. Eventually things will work out, but it could take a long time".

In this connection, the world is facing high energy prices for the foreseeable future because production is severely constrained. Looking out for the next few years, one may wonder if there is sufficient reinvestment in the traditional energy sector to support a global economy that continues to grow post Covid. (Afterall, the world still runs on fossil fuels.) Or are we turning away from fossil energy too quickly and, in turn, creating a dangerous shorter issue. According to Macro Strategy Partnerships, energy consumption as a % of world GDP

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is 7.5%. In April 2020, it was less than 2.0%. It peaked at 14.0% just before the GFC. History shows that any percentage above 10% is usually problematic for economic growth and counterintuitively deflationary.

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