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Weekly Commentary

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Macro View

By Hubert Marleau

A Bumpy Market That Rolls on

Submitted September 26, 2021

A Snapshot of the Market for the Week Ended September 24, 2021:

The S&P 500 ended the week mostly unchanged, registering a slight gain of 22 points or 0.5%, but managing to climb back above their 50-day moving average (DMA) to 4455–up 3.0% from their nadir and down 1.5% from their peak. History shows that the 50-DMA can provide excellent support for the stock market, especially over the last few years.

Investors pulled $24.2 billion out of global equity funds, the first weekly outflow of 2021. During the previous week, the same investors poured more than $51 billion into stock funds. Luckily, the dippers did quite well given that the Federal Reserve spoke hawkishly, a government shutdown was looming and there were contagion worries over the $300 billion financial woes of China's Evergrande Group.

In fact the "day-trading crowd" was undeterred and plowed nearly $5 billion into the SPY, QQQ and a hodgepodge of mega-cap techs, according to data compiled by Vanda Research. ICI data showed that money market assets received more than $50 billion. Meanwhile, there is a pile of "sideline cash" totaling $4.5 trillion. That's a lot of "dry powder" to buy dips. BofA's Michel Harnett made the remark, in a note to his clients, that global equity flows and global equity prices have been 93% correlated since 2002.

From a trading standpoint these factors were neither bearish or bullish because they were either already priced into the market or purposely neglected as inconsequential.

The stock market took Powell's remarks in stride. The Fed's announcement that tapering of its bond buying "may soon be warranted" and that interest rate hikes could be coming sooner in 2022, had been telegraphed for months and therefore the stock market was ready- including the bond market. The message did not signal

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that the Fed was going to taper rapidly. The tapering is going to be gradual and measured. Higher expectations for interest rates neither shocked the credit market nor caused investors to reduce their outlook for economic growth. As a matter of fact, real rates rose across the board. The Fed said: “We feel really good about the economy”. It wants the market and the people at large to react kindly. This is clearly probable. Since March 2020, the U.S. money supply has increased $4.6 trillion, of which $1.9 trillion merely swelled unused excess reserves by the same amount. Moreover, as much as $1.5 trillion was tied up in repurchase agreements between the money banks and the Fed. As such, most of the newly created money was not sloshing around the economy chasing goods. It was put into the hands of consumers through fiscal, not monetary, policies. In other words, the tapering will likely stop adding new reserves rather than reducing them; and for that matter also the money supply.

Wisely, investors are normally nervous ahead of and during shutdowns of federal agencies. However, during such occurrences, the stock market only takes breathers and remains cautious. In fact, it has rarely reacted badly to such potential problems. David Kostin stated; “In the 14 shutdowns since 1980, the S&P 500 posted a median return of -0.1% the day the budget was set to expire, 0.1% during the shutdown periods, and 0.3% on the day the shutdown was resolved”. A separate Dow Jones Market Data analysis found that during the last four government shutdowns that lasted more than five days, the S&P 500 made gains. The last shutdown lasted 25 days and the S&P 500 rose 10%.

It becomes apparent on reflection that the climax of the long-building financial stresses facing Evergrande, which nevertheless brought about an avalanche of selling, was not China’s analog to the failure of Lehman Brothers which set off the GFC. Until a few days ago, no one had ever heard of Evergrande. Evergrande may be in deep trouble in China and perhaps slow down the pace of the economy a bit, but international investors are getting more comfortable about any contagion risk. It did not take long for the market to become unconcerned with possible ripple effects. Firstly, the major U.S. banks are not highly exposed to credit risk in China--none of them have more than 1.5% of their assets tied to Chinese cross-border deals. Secondly, the People’s Bank of China injected $40 billion into the banking system to shore things up.

In this regard, it seems as if Marko Kololanovic, JPMorgan’s chief global strategist, has not forgotten the “Marty ZweigRule”. If there’s no extreme deflation and normal p/e ratios and a positive yield curve exist, then a decline of 10% is a buying opportunity with overwhelming odds you won't lose. He sees 4700 for the S&P 500 by year’s end and 5000+ for 2022. Put simply, if the market were to pullback again by another 5% related to technical selling, poor liquidity, and overreaction of discretionary traders to perceived risk, a selloff would be viewed as an opportunity to buy the dips.

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Unfortunately not all risks are well flagged. I do not want to over stress that latter point. The Old Lady of Threadneedle Street may not have the importance of the Federal Reserve or of the European Central Bank, but she has an excellent team of monetary economists and her opinion is thus well respected worldwide. The Bank of England has pointed out that an inflation risk is lurking in the background and it needs to be carefully monitored. There is a chance that inflation may not be as transient as believed. In this connection, the British monetary authorities have decided to exit from extreme monetary stimulus. There are two important price indicators that must therefore be watched--the price of riskless capital and energy. It is indeed necessary to monitor mounting cost of energy and of capital for they both play a crucial role in power generation, industrial process and construction.

Since mid-July, yields on ten-year treasury notes have risen 30 bps to 1.45% and fossil fuel prices have doubled from a year ago. Although these two things could sour the mood of traders and create choppy price movements, they shouldn't be catastrophic unless long-term government bond yields rise above to 2% and global energy bills cross 10% of the world GDP. The latter is presently 8.25% of world GDP.

While I recognize that only time will tell whether any of these vital indicators will ever enter the danger zone, we shall only know when the economy is at the end of its cycle, which is several years away. Until that point, there is still too much upside in the front to leave the market.

The Best Reads of the Week:

Steve Goldstein of Market Watch wrote: “It feels like almost every new company, particularly in the technology space, that is coming to market is loss making. According to Aswath Damodaran, the professor of finance at New York University’s Stern School of Business, most of the old-time metrics we use, price-to-earnings, price to book, EV to EBITDA, were designed for mature companies. To go into the mind-set that’s what the future looks like, already you have three strikes against these stocks. Mark Mahaney of Evercore ISI thinks investors need to look at revenue growth, and the total addressable market; what margins they expect at a steady state; and the level of reinvestment needed for growth. For Airbnb (ABNB), a company that Mark likes, their steady-state margins should be “sky-high” because it’s an intermediary model and it costs almost nothing to connect renters to homeowners. Reinvestment, in Airbnb’s case, is acquisitions. Tech companies might not have land, buildings, equipment and machinery, but they spend like drunk sailors on acquisitions and technology. Domodaran concedes that he will be “horribly wrong” in every company he values, but this is where the law of large numbers works in his favor.”

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As an aside, Damodaran says: “All I need is to match the market and make a little bit more. People who go out looking for 10 baggers off the top are asking to be scammed”.

He loves Amazon because Jeff Bozos wiped out competitors, doubts Salesforce.com because it's a wannabe without a consistent story or management, dislikes Elon Musk because he makes Tesla a drama about himself, likes Netflix if it controls content cost and realizes the huge potential in India. He learned that Uber and Airbnb have a market that is larger than their rivals with a limitless addressable market. He added that Ark Investment Management’s success is identifying macro trends and people's behavior towards technology, adding that sometimes when they do valuations, they are removing all doubt about the fact that they really don’t know what they’re talking about.

John Authers also had an outstanding article on whether Robert Arnott of Research Affiliates had missed the Value Turn. Arnott believes that value is cheap on a relative and absolute level. More on this one next week.

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