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Weekly Commentary

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Macro View

By Hubert Marleau

What Is the Market Focusing on?

Submitted October 3, 2021

A Snapshot of the Market for the Week Ended October 1, 2021:

I always find it hard to predict where stocks are going over the near term. The difficulty lies with how economic data comes in versus market expectations, without considering if the prints are good or bad in absolute terms. Yet it does not stop me from trying to understand what is going on from week to week. It helps me to fine- tune my expectations and reset asset allocation. If you trade like a fox, you need to know many little things; but if you invest like an elephant, you only need to know a few big things.

Last week the signals were particularly noisy, as the financial media was much more interested in amusing or teasing its readers than informing them. It appears that a decline in positioning in S&P 500 contracts, which was influenced by a hodgepodge of macro catalysts and debt-ceiling dramas, triggered a typical September seasonal pullback. Speculators and quants mechanically pruned equity exposure in general, and tech stocks to the tune of $73 billion— a Nomura's estimate.

While the backdrop of stepped-up regulations, congressional wrangling, tax increases, geopolitical tensions and still an uncontained virus may have all played a role, the surge in bond yields and essential product prices were definitely the big stories. In the short term, profit isn't everything: product prices and interest rates are the noisy drivers. For example, 10-year treasury yields rose 20 bps over the last 30 days. That is a lot. But what is even more significant is that all of the increase is attributable to higher real rates and not higher inflation expectations. There are a few explanations. Either growth optimism is resuming because the dovish position and view of Governor Brainard will prevail or the Fed's forthcoming monetary stance will be more neutral and therefore less repressive, allowing the market to be more free. The market reaction was sharp, resulting in a sudden bearish turn for stocks.

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The S&P 500 peaked on September 2 at 4537. By Thursday the benchmark had declined 5.1% from this all-time peak. The September fireworks showed the stock market's messy underside, putting investors on edge. Big techs did most of the damage. Broadly, however, the stock market fared pretty well. Global equity funds took in $9.2 billion in the final week of September, as financials, infrastructure and energy stocks saw large inflows. Flows to U.S. equity funds were a meager $1.2 billion, but enough to prop-up the NYSE's Advance-Decline Index in positive territory.

An opportunity for dip-buyers presented itself on Friday as they became aware that 1) the Skew Index, a measure of potential tail risk, was down considerably and 2) the Fed model and the Equity Risk Premium had hardly changed in spite of the steep spike in bond yields. It thus appears that the market was in a consolidation or adjustment phase because both earning and bond yields rose by the same amount. It is as if the bond and the stock markets had their overdue correction together. The S&P 500 rose 1.4% on Friday, finishing the week at 4357 for a loss of 98 points or 2.2%. Thus the market's primary uptrend is still on, even if October brings choppy waters as it historically does.

The coming earnings season is bound to beat expectations by relatively wide margins. Not all companies will be able to celebrate, But, on balance, earnings per share are expected to rise around 30% y/y. A look through some of the economic data suggests that profit margins aren't coming under undue pressure. It would appear that companies have been successful in passing their costs on. Excluding food and energy, prices consumers paid for finished consumer goods were up 7.6% y/y. By comparison, wholesale prices for the same goods are up only 4.7%—a 2.9% positive spread. Meanwhile, the prices that S&P 500 companies are charging are rising faster than wages.

From now on it will be a waiting game to see if the recent increase in the inflation rate is transient or permanent, and what the Fed's reaction will be. Inflation has made a serious and surprising comeback, as pent-up demand arising from huge increases in personal savings has bumped up against supply side limits. Indeed, consumer spending ramped up again in August. The PCE price index, excluding food and energy, which is the preferred inflation gauge of the Fed, is 3.6% higher than it was a year ago and stuck at a 30-year high for the third straight month.

Many Americans are worried that Biden's social spending plans and infrastructure bill could overload demand at a time when supply constraints could persist longer than previously believed, forcing the Fed to react hawkishly faster. The whole idea spells whiffs of stagflation, souring the mood of investors. According to a survey of more than 90 pension, mutual and hedge funds conducted by Citigroup, close to 60% of the respondents are gearing up for "sticky inflation" and only 23% see it as a "transitory" phenomenon. There

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has been a veritable collapse in the University of Michigan's gauge of consumer confidence in September, dropping to 109.3--below consensus and representing a third consecutive monthly decline. Higher inflation is expected, and spending intentions are lower. The Pew Research Center reported in a recent survey that 63% of respondents said that they were very concerned about inflation, especially food and energy, compared to only 29% for job availability. Moreover, the latest NY Fed's survey showed that consumers expect inflation to run at 5.2% in the coming year and at an average of 4% for the next three.

In this regard, stagflationary beliefs were awkwardly shared by both bond players and foreign exchange traders.

In the past month, the DXY, a broad measure which tracks the U.S. dollar against a basket of global currencies surged to 94.50, hitting its highest level in a year. Forex traders were betting that the Fed will have to become more hawkish down the road. Purposely denting economic growth and inflation is normally associated with a strong Greenback and U.S. bear cycles. It is a useful guidepost at times, but not all the time. Fortunately, there is a missing piece here. That's productivity growth. Actually productivity can easily screw up the aforementioned relationship. There is ample evidence that it has shot up during the pandemic. Unit labour cost, which is the compositional effects of wages and productivity, fell 0.8% y/y in spite of a 3.0% plus increase in wage rates. Productivity bumps are a standard feature of early-stage recoveries, as a good friend always reminds me. However, there are signs that it will last this time around.

A recession with rising profits is a very rare occurrence. New orders for durable goods from manufacturing sectors, a forward-looking gauge for business investments, have risen in 15 of the past 16 months. Businesses are loaded with cash and are eager to find cheap and efficient substitutes for expensive domestic labour and Chinese production. Companies are finding out that digitized activities are 20-25 times faster than they had hoped for or previously thought possible. They are certain that innovations can avoid a compression of profit margins. For the first time in decades, even left wing governments are embracing productivity and pushing businesses to spend more on digitalization, research and innovation. In a recent article in the FT, I read that a McKinsey Global Economic Conditions survey of executives showed that over half of the respondents said that they had increased investment in new technologies over the past year and that about 75% said they expected to accelerate such investments now. Companies across the globe have tapped investors for trillions of dollars in debt, bank loans and equity in the past nine months—$1.0 trillion in share sales, $4.0 trillion in bond issuance and $3.7 trillion in bank loans. The feeding frenzy is still going. The backlog of deals still to be done remains awesome.

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Meanwhile, the mathematical five-year inflation predictions generated by the bond market increased marginally even though the neutral rate (five-year bond yield), which is presumably where the policy rate should be to keep inflation on target, rose a whopping 30 bps to 1.00%. Perhaps inflation expectations do not matter after all, as a recent paper by Jeremy Rudd at the FRB argues. While I question the empirical robustness and theoretical validity of that kind of research, it reveals dissent and infighting within the Fed. Jerome Powell, the Fed's Chairman, conceded that there is tension between the central bank's two objectives of low inflation and high unemployment. This situation may have forced him to admit that current supply-chain bottlenecks could lead to a somewhat longer interval of high inflation and that he does not know how big the effect will be. Yet, he was quick to add that the process would have a beginning, a middle and an end. When it is all said and done, the Fed doesn't expect the current inflation spike will lead to a new inflation regime, in which inflation remains high year after year, because it knows that an exit from extreme stimulus is coming soon and that an eventual normalization of monetary policy will eventually happen. To guess what comes next is what counts. But it's probably unsolvable at the moment. However, I think I know three big things:

Firstly, the old age of abundance and globalization is being replaced by a new age of regionalization and productivity. Digitalization, artificial intelligence, DNA sequencing, robotics, energy storage and blockchain technology are promising innovative areas of efficiency. The big question is whether the anticipated increase in productivity will move away from what is nice to have like streaming services, luxury goods and social media, to what is actually needed like energy, health, transportation and food. Should the aforementioned productivity hypothesis prove to be correct and bring good deflationary and growth outcomes, the Fed would gain a lot of maneuverability, enabling it to raise the policy rate to keep inflation in check without the fear of killing economic growth.

Secondly, rising energy and food prices are changing the terms of trade. The Rogers Global Agricultural Index rose to 1102.38 and Brent oil prices to $80.00 a barrel, up 45% and 95% respectively from a year ago. It's far away from the highs of 2008, but technical charts look as if these crucial prices are about to surge another 20%. On Thursday, the energy cost as a percentage of world GDP was 8.9%. According to Macro Strategy Partnerships, the ability for the world economy to absorb those price increases is severely limited 1) by the growth of the dollar value of the world money supply, which is decelerating to zero and 2) by the incapability of technology and transportation to arbitrage price differentials at this time. As food and energy bills claim a larger share of disposable income, less money is available to buy other goods and services. History shows that when inflation accounts for the larger proportion of the increase in N-GDP than real economic activity as the growth of the money supply falls, (which it is now doing) inflation usually bears the brunt.

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Thirdly, the two houses on Capitol Hill may have agreed to continue funding the government until December 3rd, but it remains that the odds are stiffening as to whether the $3.5 trillion social spending proposal will pass, let alone the $1.0 trillion infrastructure bill. Biden is probably amenable to compromising on the top line spending figure but does not seem to have the capacity to bring the Progressives to heel. As one can see, it's the same old ineptitude and gridlock that has characterized American politics for two decades. Liberal democracy my eye! The people have an overwhelming distrust of Congress. In a recent poll conducted by Gallup, public approval of US lawmakers hit a 12-year high of 36%. It's a joke. It hasn't been above 50% in 20 years.

The bottom line is that the U.S. is exposed to economic contagion from the rest of the world. The weight of rising energy and food prices can become deflationary at some point. The final version of the University of Michigan's consumer sentiment survey shows that consumers do not view economic conditions as conducive to establishing an inflationary psychology. They are postponing purchases of many goods like homes, vehicles, autos and other durables whose price increases are considered transient. Ironically, households' declining expectations about financial progress (annual gains in household incomes were just 1.5% in September well below the 4.6% headline inflation rate) may help to keep inflation in check by short circuiting the self-fulfilling prophecy that can bring a price spiral. Additionally, the U.S. is also subjected to a growing public and political movement to justify the existing deficit and stop the spending that the progressives are demanding. Accordingly, the Fed may have to change its mind and kick the can down the road. An inclination to expand one more time the monetary base would be the exact opposite of where the market thinks the monetary stance is heading.

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