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Weekly Commentary

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By Hubert Marleau

Food, Energy and Interest Rates Are the Risks

Submitted October 10, 2021

A Snapshot of the Market for the Week Ended October 8, 2021:

Bets that speculators make on the stock market are essentially gambits, which usually turn out to be inaccurate because they are essentially unscientific. Stock market outcomes are hard to call. Basically, price movements are tied to changing odds, which are caused by shifts in the zeitgeist. Indeed, the media often changes the showcase just to attract attention. Forecasting tomorrow's headlines is crazy and impossible. Changing storylines can easily confuse investors with glib arguments. Yet both are widely read, giving them the power to change perceptions and odds over the near term. In this connection, it is important to assess whether headlines are valid and robust enough to change the basic economic scenario, which ultimately determines investment returns.

Since the beginning of September the stock markets have been afflicted with a laundry list of bad catalytic headlines. Bloomberg has enumerated 10 headwinds. These are: Perilous Brinkmanship Inside the Beltway Over Debt Ceiling; Spiraling Property Meltdown in China; Central Banks Tiptoeing Toward Tightening their Monetary Stance; Labour Shortage; Regulatory Crackdown in China; Energy Scarcities; Strained Supply Chains; Soaring Food Prices; Turmoil Over Bidenomics; The Threat of Higher Corporate Taxes and A Possible Shakout at the Fed.

Faced with this catalogue of woes, the September-October market setbacks are hardly surprising. For the first time since June, the S&P 500 moved 1% or more on several occasions. Last Monday, the S&P snapped a 227-day stretch without a 5% pullback. Market statistics pointed to the fragility of overvalued stocks. Astonishingly, the broad market only corrected 5.2% from the September 2, all-time high of 4537. Quickly bolstered by progress on U.S. debt-ceiling, initiated by Mitch McConnell, and easing concerns about the energy crunch initiated by Vladimir Putin, the S&P 500 rose 2.1% from Monday's low point of 4300 to end

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the week at 4391, for a weekly meager loss of only 0.14%. Interestingly, investors are either wagering that the selloff is over or taking profits on the derivatives they had bought to hedge themselves from further slides. I watch carefully on a daily basis the Cboe's Skew Index, which measures investor positioning in the US options market and acts as a gauge of interest for protection against a large drop in stocks. This fell to 131 from 162 in early September. That's not just a steep fall: it's the lowest level in 11 months. While I stand by my view that the taper is coming, the disappointment in the September employment numbers will probably either delay the announcement, reduce the amount or extend the process.

The thing is that the economy is in a cyclical inflationary boom. Investors see cyclical inflation and strong economic demand for now. Real rates and inflationary expectations are rising because both prices and real economic activity are rising.

Although the slower growth of the money supply, the plenitude of capacity constraints, and the precautionary behaviour of labour stemming from the Delta wave are handicapping economic activity, (guaranteeing that economic momentum is past its peak), the outlook for economic growth remains elevated. Both the ISM Manufacturing and Services are near 60, productivity is holding and the employment keeps on rising. Bloomberg consensus estimates call for R-GDP growth of 4.95% in Q3. The NY Fed's Weekly Economic Index (WEI) is holding at 7.78. Going forward, most forecasters believe that the pace of the economy will stay above its long-term growth trend until the end of 2022.

Meanwhile, what was supposed to be a temporary rise in inflation is turning broadly into a cyclical one that could last a while longer. In the beginning inflation looks temporary because price increases are usually isolated but when higher prices show everywhere, feeding people's expectations, it becomes cyclic. Of the current 5.0% inflation rate, about 3.0 % is cyclical. That portion is bound to stick for a while longer than it was originally anticipated. However, I have not seen any reasons to think that it might be structural at this time. The Unit Labour Cost Index would have to spike and it hasn't done so far.

In this regard, I'm maintaining a cautiously constructive opinion of the market because inflationary booms like deflationary booms are generally associated with either high or reasonable market returns. Generally, seasoned investors tend not to worry too much about the doom that the media sells to get attention or to perma-bears, who make daily predictions of impending disasters. That is why there is a much greater tendency to buy the dips than sell into them. Stuart Kirk, global head of research at HSBC Asset Management, remarked in a note in the FT that the market is extraordinarily resilient. He said: "It shows the enduring triumph of human ingenuity, productivity and resilience-measured in the value of US companies. Two World Wars, an oil crisis, suspension of the gold window, disruptive technological change, countless financial

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meltdowns, terrorism, and a global pandemic have not altered a steady upward trajectory. Buy equities on a dip if you can, or buy them high. It doesn't matter in the end". Major turning points occur when there is a quadrant change in the economy. These are Deflationary Boom, Deflationary Bust, Inflationary Boom and Inflationary Bust. Although I'm sure that we are presently in an inflationary boom, it's important to recognize that seismic shifts can happen.

Indeed, it's not that bad things cannot go wrong. They can do it from time to time. What the market doesn't like is inflationary busts like the one we had in the 1970s, and deflationary busts like the one we had in 2008. Although we are in the middle of an inflationary boom-business cycle, it does not mean that we should not pay attention to warning signs. Deflationary or inflationary busts are not out of the question. Recessions have happened on 30 occasions over the past 150 years. Business waves have three dimensions: frequency, duration and amplitude. As a rough rule, there is always a 20% chance that the U.S. economy is subject to a recession every five years on average. This is of course an unscientific conclusion, but it helps to understand why macroeconomic factors matter. Inflation seems to have been more often than not, the main economic variable that determined the frequency, duration and amplitude of past cycles and therefore the market risk. The Economist wrote: "A recent paper by Dennis Bonam and Andra Smadu, two economists at the Dutch Central bank, looks at the effect of pandemics on inflation and concludes that they in time lead to lower, not higher, price pressures." Not a good enough reason to neglect the nefarious effect of inflation. This time, as opposed to other times, the policymakers have responded with trillions of dollars of fiscal and monetary stimulus, propping up demand beyond the capacity of industry to accommodate.

In my judgement, outside of serious geopolitical issues (China/U.S.), there are three developments that need to be monitored closely and regularly. These are: Food Prices, Energy Prices and Interest Rates. I've discussed these three macro risks in many of my past commentaries, thus I shall not elaborate. Suffice it to say that if the inflationary boom is not going to be managed properly through responsible fiscal policies or properly contained by appropriate monetary policy, another surge in any of these three pressure points will likely occur, turning the inflationary boom into an inflationary bust, which is usually followed by a deflationary recession. The question is whether the cost of food, energy or money will rise too much and reach unaffordable levels, which could lead to a seismic shift in the current trend. Very high prices can negatively affect household finance and disposable income. Goldman's David Kostin observed that there were 41 quarters over the past six decades during which GDP growth was weak and inflation was high. During those stagflation periods, the median quarterly S&P 500 real return was -2.1% compared to the all-quarters average of +2.5%.

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According to the World Bank, the agricultural industry accounts for 4% of world GDP while Americans spend around 12.5% of their disposable income on food. The Rogers Agricultural Index (RAI) is now 1125, testing the highs of 2014 and 30% and 60% higher than the average of 2020 and 2018, respectively. According to the United Nations, food prices are at their highest level since the early 1970s. Empirically, another 20% increase in food prices, which would bring the RAI to 1350 could become problematic for world growth.

According to the MacroStrategy Partnership, the ratio of world primary energy bills to World GDP (W-GDP) rose to 9.5% last week, the highest since 2012 and close to the 11.5% to 13.75% range that have accompanied several past recessions. Energy needs have resulted in a significant supply-demand friction. Given the low level of new investing in traditional energy, and inability to quickly change the popular investment, ideological and geopolitical paradigms, a full-blown energy crisis is in our midst. Over the last 3 and 6 months, the aforementioned ratio has increased by 3.1 and 4.8 percentage points respectively relative to W-GDP. It comes up to a 6.4 % annual percentage increase, the highest on record, exceeding the 2008 high of 6.2%. The desire to go green and the urge to provide energy with the smallest of capital expenditures are laudable in isolation, but together they have created an inflexible, fragile and infungible complex. We are now stuck with two bad options, rationing or incentivizing the oil & gas exploration companies to drill. It's hard to know at what price crude tilts the quadrant. I say between $95 and $115 a barrel of crude oil. Marko Kolanovic, whom I respect immensely, is more optimistic. He remarked: “Adjusted for inflation, consumer balance sheets, total oil expenditures, wages and prices of other assets (housing, stocks, etc.), we (JPM) think that at $100 there is no problem, and even with oil at $130 or $150, equity markets and the economy could function well with some rebalancing and capital rotations.”

As for interest rates, the threshold for a sharp deceleration to zero growth is 2.75% for ten-year notes but only if the yield spread between 10’s and 2’s stays above 150 bps, (which is currently 1.25%,) the neutral rate stays comfortably above the policy rate (which is 90 bps) and the annual growth in money supply stays above 6.0%, (which is presently 13.2%.) In fact, the shape of the yield curve and the performance of the money supply seems to have a far better correlation with the forward path of the economy than the actual level of bond yields.

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