PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

Record-Setting Run for Wall Street Confounding Calls for an Imminent Pullback

Submitted November 7, 2021

A Snapshot of the Market for the Week Ended November 5, 2021:

Last Wednesday, the Federal Reserve announced that its monetary stance had officially changed direction. The Fed will start reducing its bond-purchasing program by $15 billion a month, with a plan to end all asset purchases by June of 2022. Presently, the annual QE equates to about 7.0% of the money supply. I would consider this move by the Fed as serious tightening because it is a relatively quick wind down. Bernanke, former Chairman of the Fed, said that $600 billion of QE was equivalent to a 75 bps rate cut. Thus, removing $1.4 trillion of asset purchases, which the Fed is planning to do over the next 8 months, is like adding at least that amount of tightening. Yet, it came with no surprise and no tantrums, even though the message was institutionally biased to appease inflationary expectations. Powell has said on several occasions that he has no intention to preside over a rerun of the 1970s inflationary experience.

The whole thing makes me wonder what all the fuss over tapering has been about. All market participants know that there is a palpable eagerness on the part of most central banks to throw the QE monetary tools back into the policy box as quickly as economic conditions permit. But those same banks don’t want money market and bond traders to think that rate hikes are imminent, either.

I think the Fed has calculated that with this tapering move, it will not be necessary to hike the policy rate until late 2022. In other words, Powell was able to communicate that he has not given up on full employment, or on the idea that the current bout of inflation is transitory and has no intention of draining accommodation too quickly. He cleverly separated the timing of the tapering process from future rate increases, insisting that the program was not on auto-pilot, and that adjustments would be made if economic conditions demanded

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them. The FOMC did not offer any new projections and there was nothing to suggest that forecasts had moved from centering on a one quarter-point hike next year.

While the switch to renewables, supply constraints and food shortages are creating inflationary pressures, they are essentially relative price movements. Persistent and growing inflation must be accompanied by monetary growth. This is not happening right now. Nor is it likely to happen later: the QE influence on money supply growth will completely disappear by June. Moreover, the USD value of the world money supply is decelerating fast. It's up 8.8% year-over-year, but has only grown at the annual rate of 3.9% and 2.5% over the last 6 months and 3 months respectively.

Interestingly, the Baltic Freight Index, which is a very reliable measure of global supply and demand for industrial products, is down 51% from 5650-30 days ago. It was 2769 on Thursday. 2000 is considered normal. I cannot say this will prove that the troubling world-wide supply chain problem is over, but I did notice that energy bills as a percentage W-GDP are now below the crucial 10% level: it was 8.7% on Thursday. I would not consider this to be a deflationary hit, but it certainly augurs well for interest rates. History is clear on this one: where energy prices go, interest rates are likely to follow. At this moment, global food prices, which are at an all-time high, with all the political uncertainties that go along with that, are eating into the disposable income of the average household. While elevated food prices are cause for concern, they have not been high enough for a sufficient amount of time to cause a major headache for the economy or for central bankers. But watch out, for herein lies the risk.

In a new study, economists at Nomura believe that the scars left by the pandemic, like debt, inequality, unemployment and political turbulence, will likely reduce the world economy's potential growth rate to 2.5% in the next decade, down from 2.8% in the post-financial crisis years and 3.4% pre-2008. This means that the neutral rate is much lower than it used to be and the Fed will not be able to top previous rate-hike cycles. The last time the Fed raised rates was in 2018 and it could not go any higher than 2.5% before creating chaos. I think the new level is 1.25%. Nomura goes on to say: "Central banks will not need to raise rates aggressively to tighten financial conditions to keep inflation in check or ease pressures in the economy."

While intuitively, the act of tapering could lead to higher interest rates, it may not lead to that at all. The Treasury will definitively moderate its issuance of new notes from the extreme pandemic budget deficits of 2020-2021. Additionally the banking system is flush with cash and therefore capable of stepping up its own credit creation by making loans and buying bonds.

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Meanwhile, the focus of investors was on bullish factors like blockbuster earnings, surging share-buybacks, positive economic prints, favourable seasonal trading patterns and promising trial results from Pfizer for its Covid pill. On a wave of good news, the S&P 500 rose 92 points or 2.0% to close at 4697 as global equity took in another $26 billion in the past week. The benchmark closed at an all-time high for the 64th time this year; it just needs 14 more highs to break the record set in 1995, when productivity was running the world.

Over the past few weeks, according to RBC Capital Markets, more earnings forecasts made by analysts have been increased than reduced. The Weekly S&P 500 ChartShort illustrated as an interesting follow-on that earnings are now officially back to trend. Indeed there is some empirical evidence and anecdotal observations that parts of the problems in the supply chain are lifting. It means that companies have less limitations on what they can produce or sell, as input and shipping costs are settling down. Thus, it is possible that earnings may now go above and beyond trend for the next while.

Howard Silverblatt of S&P Indices said that, with just two-thirds of the S&P 500 companies reporting, the market is heading for $230 billion in buybacks in Q3. Moreover, there are well-founded rumours that many countries with big trade surpluses and large official reserves are buying growth stocks--mainly the high tech ones.

In the past two weeks, there were few negative macroeconomic surprises. On the contrary, most of the economic prints showed that real economic activity is re-accelerating. The Atlanta Fed's NowCasting model is predicting that business activity in real terms will grow at the annual rate of 8.5% in Q4. U.S. employers added 531,000 jobs in October-a clear sign that growth is indeed resuming after a lackluster third quarter as two big headwinds-Covid-19 and supply shortages have begun easing.

Pharmaceutical giant Pfizer reported that its oral antiviral drug for the treatment of the Coronavirus cut risk of hospitalization or death by 89% in a late-stage study, thereby bolstering holiday and travelling-type shares. However, pandemic type stocks like Peleton and Zoom were hit hard. Barron's new headline is: "The Stay-at-Home Trade Is Over". However, Eric Saviks was quick to point out that one pandemic trend likely to stick is the accelerated adoption of digital technologies by companies. Cloud stocks like CRM, SNOW, DOCN, OKTA and companies like Bill.com, Shopify, LightSpeed, Microsoft Azure, Amazon Services and Google Cloud, which are part of the digital-transformation super trend.

November is typically a very good seasonal month for the stock market, especially when everything looks as good as it can get. So are December, January and February. On Friday evening, the House of Representatives voted in favour of the Senate-passed $1.0 trillion infrastructure bill, without obligation to the $1.7 trillion

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social spending package. The timing to bet on the rally's continuance for the next few months is perhaps very good because the stock market appears to be in a sweet spot.

P.S. I'm flying to St-Martin on Monday for a month of much needed post-pandemic vacation at the beautiful LaSamana Hotel on the French side. I may skip a few weekly commentaries. Maybe Bernard Arnault will be about to buy me a cocktail.

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