PALOS

Weekly Commentary

Issue No. 45 | NOVEMBER 22, 2021

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Macro View

By Hubert Marleau

The Stock Market Pauses for Refreshment:

Submitted November 21, 2021

A Snapshot of the Market for the Week Ended November 19, 2021:

The S&P 500 closed at 4698, registering a 15-point increase, up only 0.3%. Two weeks ago the benchmark was 4697. Interestingly, the aggregate total of the per-share earnings companies in the S&P 500 are expected to make over the next 12 months has risen 26% year-to-date, according to FactSet, matching the index gain in that time. Thus, valuations are basically equal to where they were at the beginning of the year. We have now reached a point where investors want refreshed forecasts.

Goldman Sachs told clients that households and corporations are going to keep buying stocks, driving the S&P 500 to 5100 by the end of 2022. Similarly, Sanford Berstein is encouraging continual buying even if real yields normalize. Meanwhile, Morgan Stanley has a contrarian forecast, suggesting that investors should resist buying U.S. stocks because the broad market could fall to 4400. This is not a huge difference in opinion. If one were to use these two forecasts as the S&P 500 price range for 2022, the upside is 9.3% and the downside 5.9%, excluding dividends. The question is ‘what are the probabilities’ one should give to these two forecast outcomes.

It is ridiculous to fit a narrative to assess the more likeable outcome because the probabilities are dynamic. I cannot help but believe that, by monitoring on a weekly basis how stocks generally respond to macroeconomic prints, price action in the highly sophisticated bond and foreign exchange markets, can be fruitful in timing purchases and sales.
Firstly, The Atlanta Fed’s GDPNow Model is predicting a R-GDP growth of 8.2% in Q4. The

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U.S. leading economic index jumped 0.9% in October, strongly suggesting that the economic expansion will continue well into 2022. What is particularly encouraging is evidence that the economy is making progress in easing freight congestion and supply shortages. Bloomberg reported that companies are managing the situation better with little apparent impact on margins. Industrial production is rising, the availability of industrial-oriented semiconductors is improving, and logistics are better. Not only are shipping costs falling, but businesses are able to secure containers, trucks and rail capacity to make on-time shipments and deliveries.

Secondly, the DXY index is another big indicator supporting the notion that demand- pull inflation is easing. This broad index is up quite a bit since last August and about 4.5% from a year ago. That may not seem like much, but for a currency of the stature of the greenback, it is a noticeable gain and indicative of changing prospects for raw commodities. The CRB, which represents commodities that are not influenced by futures, have started to trend lower in recent weeks. The index is off its high and so is the Bloomberg Commodity Index. As a matter of fact, spot pricing for the busy Shanghai-to-Los Angeles trade route and the Baltic freight index are down 20% and 60% respectively from their September highs.

Given that nobody really knows if inflation is transitory, permanent, semi-permanent, quasi-transitory, or something else, the probabilities of whether the market will follow the forecast of Morgan or Goldman can only be found in the bond market, for that is where the Fed will get its cue. In this regard, chances are much better that the S&P 500 will be higher by the end of 2022 than it is now. The U.S. bond market is telegraphing four important messages:

1) Two-year nominal bond yields have risen, suggesting the probability of a Fed rate hike in the second half of 2022 is very high.

2) Breakeven inflation rates have risen across the curve, reflecting the probability that inflation will end up being above the Fed's 2.0% target.

3) The spread between nominal ten and two bond yields has hardly changed, indicating that the market is neither predicting a policy mistake nor a recession.

4) The decline in real yields across the curve is actually pricing looser liquidity conditions, suggesting that the coming of a tightening of policy will not be severe.

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On this last point, real rates are deeply low and may rise if inflationary expectation changes direction as the tapering process rides out. While tapering should lift real yields in 2022, they may not rise enough to obstruct financial repression. There will be several offsetting factors in play. New issuance by the Treasury will moderate more than the tapering of bond purchases. Additionally, commercial banks have a lot of excess reserves and could easily take over from the Fed as creators of credit, especially if stricter capital and liquidity requirements for banks and the Fed's repo facilities were to predate tapering. Thus, the treasuries may be well bid even as the Fed tapers its own purchases.

Together these market messages explain why I'm siding with Goldman Sachs on this one. According to Ed Yardeni, president of Yardeni Research, expectations for record-high profit margins of 13.1% this year, 13.2% next year, and 13.8% in 2023 are proof that cost pressures aren't squeezing margins. Excluding the "magnificent 8"-AAPL, AMZN, NFLX, GOOG, MSFT, TSLA, and NVDA-, which represent about 30% of the S&P 500's market capitalization, the index's aggregate multiple would be 18 times the EPS expected for next year compared to 21. That's called fundamental support. Nevertheless, it is not a slam dunk. Forecasts have very little predictive value beyond three months. I'm chiefly worried about hydrocarbons and food. That is why I have my eyes constantly on food and energy bills-- specifically as a percentage of W-GDP, which is getting pretty high. Should the price of crude, which is presently around $80 a barrel, go above $95 and /or the Rogers Agricultural index, which is 1175, cross 1400, watch out! This explains why I'm not all in, keeping a small reserve of cash just to buy the next dip.

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