

PALOS

CONTENTS

Weekly Commentary

Issue No. 46 | NOVEMBER 29, 2021

A Snapshot of the Market for the Week Ended November 26, 2021	1
Opting for Continuity Muted the Market: Then a New Coronavirus Shook Sentiment:	2
Disclaimer & Contacts	4

Macro View

By Hubert Marleau

Opting for Continuity Muted the Market: Then a New Coronavirus Shook Sentiment:

Submitted November 28, 2021

A Snapshot of the Market for the Week Ended November 26, 2021:

The broad market for stocks has gone nowhere in the past three weeks. Suddenly, on Friday, international investors dashed for shelter in safe-haven assets as a new variant of the virus arising in South Africa may challenge the effectiveness of vaccines, imperiling efforts to fight the pandemic. Yields on 10-treasury bonds dropped to 1.48%, the DXY traded as high as 96.88 and crude prices tumbled 12%. The Barron's headlined: "Fear, Not Calculating Trading Was the Cause." Nobody knows anything about the new variant's transmissibility, severity or susceptibility. In this regard, the mini market crash was more about the fear of new government lockdowns and social distancing than of the variant itself.

Nonetheless, nothing can be more catastrophic than introducing a negative macro catalyst into holiday-thinned Friday trading to upset the apple cart. Thanksgiving is when the top traders and major investors take a holiday, leaving subordinate traders with the task of countering trades triggered by computer algorithms. There were hundreds of private planes in St-Maarten on Friday alone. Global equity funds logged their second weekly outflow of the year, but it was very small, totaling only \$2.7 billion. The total haul for the last 12 months has been immense, hovering around \$1.1 trillion. The S&P 500 was down 2.2% or 104 points to close at 4594. Interestingly despite this sharp decline, the skew index, which is a measure of a potential tail risk in the financial markets, hardly budged.

Macro View cont.

By Hubert Marleau

Notwithstanding what happened on Friday, it is somewhat surprising that the market has held pretty well. The field of gainers has narrowed, with fewer winners keeping the benchmark afloat. The number of Russell 3000 constituents hitting 52-week lows has spiked to 275 so far in November, but that's a long way from the depths of March 2020 and December 2018, when the figures were 2045 and 1263 respectively. The thing is that the pandemic flyers like Zoom, and PTON have fallen out of bed. On average, these kinds of stocks are down 60%. Yet investors should not be discouraged. The solid companies, which make up the S&P 500, are looking just fine. Strategists at Jeffries say the S&P 500 can gain 9.0% over the next year or so. The main elements behind this forecast are higher-than-expected earnings and higher dividend payouts. For example, Jeffries expects that aggregate earnings per share for the S&P 500 will come in at \$233 in 2022, compared to the \$220 baseline view among analysts tracked by FactSet. The Equity Risk Premium (ERP) is now 6.17%. Given where interest rates are, this is still an appealing Return

President Biden opted for continuity when he appointed Jerome Powell for a second four-year term. It was a good idea and good politics. By keeping President Trump's pick, the decision was presidential. It gave the Fed, from Powell to the staff economists, not only an enhanced sense of respect, but also confidence that independence can make both right and tough decisions. By and large, Powell has been a steadying hand. Mainstream investors are essentially happy with his stewardship during the pandemic and the economic recovery. Past the initial enthusiastic applause for his reappointment as commander-in-chief of the Federal Reserve Bank, the market quickly turned down as it realized that fighting inflation would be the new number one priority. Actually the minutes of the last FOMC meeting showed that there is a growing number of policy makers who are open to the idea of speeding up the tapering process and moving more quickly to raise rates.

Anxiety about inflation has taken root at the Fed. It is now more than a mere possibility that the monetary authorities may not want to repeat their last war, when inflation was incredibly stubborn. In other words, they may be reluctant to adhere too rigidly to the broader policy making environment, which they adopted last year at the Jackson Hole symposium. The DXY, which measures the greenback against a basket of other major currencies, is up more than 6% from a year ago. That is a lot for a currency of the stature of the dollar. Usually, the dollar is considered to be a sleeper, but this time it attests to the notion that the Fed is about to aggressively withdraw some monetary stimulus. Interestingly, the world's money supply has declined to a negative annual rate of 0.3% and 0.4% over the last three and six months

Macro View cont.

By Hubert Marleau

respectively. Moreover, the prospects for a reacceleration are not bright. The dollar is on an up-trend, QE is ending, and so is the drawdown on government deposits at the Fed. This is happening at a time when the personal savings rate fell 7.3% in October. The latter is now in line with the average of the ten-year period preceding the pandemic. It may be too early to make predictions, but these occurrences are real and could presage a brake on inflation.

The commerce department's core personal consumption expenditures index, which strips out volatile food and energy costs, rose 4.1% in October, compared with a year ago. This is the preferred inflation measure of the Fed. The monetary authorities attached a lot of importance to this gauge. While the jump was in line with expectations, it was nevertheless significant for it posted its biggest year-on-year increase since the 1990s.

Thus, interest rates rose, reflecting market expectations of a more aggressive tapering process. Bond investors raised the probability of a June rate hike to 79%, a second hike in September to 69% and a third hike to 64%. In this regard, it will be very important to focus attention on what the message the Fed will telegraph at the December FOMC meeting, in particular the median "dot plot" forecast. It may help to comprehend what comes next.

Given the 8.6% Q4 growth (saar) predicted by the Atlanta Fed and the immediate prospects for inflation, the N-GDP is probably running at or just above the seasonally adjusted annual rate of \$23,850 billion. This is about where the National Income would have run if there had not been a pandemic. Thus national output is back to normal, at least in aggregate terms. Assuming that the 4.25% pre-pandemic nominal trend will continue in the future, ten-year treasury yields should trade up to 2.00%. Over the near term, I'm giving cyclical and technical influences more weight than other considerations. Of course, this presumes that the new variant will not affect what seems to be baked in.

Fortunately for bond bulls, there are long-term drivers like the debt trap, productivity factor, taxation of productive capital and an aging population, which are going to continue to be a force for keeping rates lower than they would otherwise be. Without these compression pressures, the neutral rate, which I estimate to be around 1.25%, would be a lot higher. In other words, it shouldn't take more than two to three rate hikes to change the direction of the economy's growth and inflation patterns.

P.S. Damien Courvalin, an oil analyst at Goldman Sachs, wrote: "the fall in Brent prices was exacerbated by low trading on Black Friday (with similar moves in 2014, 2016 and 2018), the

Macro View cont.

By Hubert Marleau

breach of key support levels (50-,100- and 200-day moving averages) as well as likely negative gamma effects. At \$74/bbl Brent, we estimate, based on our pricing model, that the market is pricing a c.4mb/d negative demand hit over the next three months, with no offsetting Opec+ response.” Given that the global oil complex has returned to a monopoly pricing regime from a competitive pricing one- when U.S. shale production was rising and big oil producers ramped up output to defend their market share-oil isn’t actually expensive at all based on its historical relationship with other assets. JPMorgan’s Marko Kolonovic said: “If crude prices were to return to the median historical level relative to global stocks, bonds and commodities, oil would need to be trading at \$115/bbl.” He added: “if oil were trading in line with its historical median to the Nasdaq and the size of central bank balance sheets, it would be somewhere between \$300 and \$500/bbl.”

Follow us on LinkedIn:



[Register Here - Marleau Conference](#)

Weekly Commentary

Issue No. 46 | NOVEMBER 29, 2021

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., “Palos”). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos’ written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. “S&P” is a registered trademark of Standard and Poor’s Financial Services LLC. “TSX” is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market value weighted index engineered to measure publicly issued noninvestment grade USD fixed rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca