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Weekly Commentary

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By Hubert Marleau

Weird and Wild Swings Are Unwarranted

Submitted December 5, 2021

A Snapshot of the Market for the Week Ended December 3, 2021:

Fear stalks the markets for risk assets, on concerns that the global economy could be hit severely by the Omicron Covid outbreak and that the central banks will not come to their rescue. First there was Moderna's CEO, Stephane Bencel who said: "I think it's going to be a material drop regarding the efficacy of existing vaccines against Omicron." Second, there was Jerome Powell, Chairman of the Federal Reserve, who told the Senate Banking Committee: "The economy is very strong and inflationary pressures are high, and it is therefore appropriate in my view to consider wrapping up the taper of our asset purchases, which was actually announced at the November meeting, perhaps a few months earlier." The combination stunned the markets because neither the incident nor the response were expected.

However, markets did calm down when Pfizer and BioNTech said: "If adjustments are needed to combat the new strain, we are confident that we could create a new vaccine within six weeks and make and ship it out within 100 days." On Wednesday, the media reported an Omicron case in California. The yield curve pancaked because the market panicked about a prospective policy error. The market presumed that the Fed is boxed in by inflation and that it's no longer being treated as transitory.

On Thursday, U.K. pharmaceutical GlaxcoSmithKline said that "early analysis of its antibody drug has shown effectiveness against the Omicron variant." Needless to say, the equity market rebounded once again.

By the end of the week, the market had acted like a chicken with its head cut off. What would normally be considered bullish was suddenly not, the market figuring that a healthier labour market was not a good thing. Nevertheless, the labour market swelled with new workers and the jobless rate declined. The thinking now

Macro View cont.

By Hubert Marleau

is that the loosening of the labour market will keep the Fed on track to accelerate the tapering process and raise rates even if Omicron charges a toll on the economy.

The bottom line is that we don't have real answers. In this regard, the stock market doesn't wait around to get the details. It will continue to make daily adjustments to its discounting methods until we have certainty about the Omicron. Although retail dip-buying was prevalent, according to Vanda Research, knee-jerking algorithms forced the S&P 500 to drop 1.2% or 56 points to end the week at 4538. That is 3.5% from the all time high of 4705. Interestingly, the skew index has fallen, suggesting that contrarians' bullish bets are not being hedged against potential tail risk. That said, it is right to say worries and the resulting volatility are ebbing a bit.

Ultimately, the Omicron selloff in cyclicals, commodities and reopening themes is a buying opportunity. It will take time for the uncertainty to dissipate, but what is important is that each successive wave of Covid-19 cases has caused less economic damage than the one before it. It's probably a reflection of adaptation, vaccinations and reluctance to reimpose severe restrictions.

Stocks may still make new highs in 2022, as many investment banks are forecasting. GS, UBS, JPM, Jeffries and other majors have targets that are considerably above Friday's close. This optimism rests on the fact that risk of recession is very low and new data on earnings suggests that business can comfortably pass on all its higher costs. In the last two quarters, U.S. business has posted its widest profit margins since 1950. Comparatively, demand is stronger than consumer inflation. Volume increases, combined with higher price received, have surpassed input costs by a mile. This phenomenon could last for a few more quarters because rising wage rates, declining personal savings rate and shifting consumer preferences have not as yet changed direction. Americans are applying for credit cards at a rate not seen since before the pandemic. According to the NY Fed, close to 27% of U.S. consumers had applied for one in the past 12 months compared to 16% in 2020. The rebound in credit-card appetite suggests consumers will continue to drive the U.S. economic expansion. Moreover, credit-card balances remain $123 billion lower than they were at the end of 2019 and more and more cardholders are applying for credit-limit increases. The Atlanta Fed is predicting that R-GDP will increase at a seasonally adjusted annual rate of 9.7% in Q/4.

The takeaway is straightforward. The sell-off showed investors that high valued equities are not immune to bouts of volatility, and various valuation and momentum metrics are telling investors that the ride will be rough and bumpy, with large drawdowns and many relative price variations.

Macro View cont.

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The main reason behind this volatility scenario is that neither central banks nor governments are going to back away from providing monetary and fiscal stimulus like they did during the pandemic. The Fed's monetary put is perhaps gone. The markets will get confirmation of this in just a few weeks because both the Fed and ECB meetings are due.

For example, in the past three months, U.S. the money supply (M2) rose at the annualized rate of 6.75%, down from a y/y increase of 9.8%. According to Andrew Lees of MacroStrategy, of that USD399.0 billion increase over the past 3-months, USD 348.1 billion was from base monetary expansion, and USD 121.8 billion from the drawdown in government balances at the Fed.

Given the expected reduction in QE and the low level of government deposits, monetary growth could very easily decelerate further unless U.S. banks and firms take up the responsibility to allocate capital. Understanding that banks seek profit and are more price-sensitive than the Fed or public agencies, this shift is bound to inherently make both the economy and the markets more volatile. In this connection, the monetary authorities might be limited in how much they will be able to raise interest rates, once they have finished with the tapering process. Recent economic data shows that demand for durable goods is abating, shortages are easing, and input costs like prices paid for raw materials and shipping are declining, while the growth outlook for the money supply is moderating. Thus, the neutral rate is probably much lower than many believe. Measured by the five-year overnight index swaps, traders expect that the peak target rate is just 1.50%. Adjusted for inflation, real rates are not expected to get out negative territory in this business cycle.

Incidentally the neutral rate, a level of interest that is neither too cold nor too hot, may be even lower than 1.50%: a few weeks ago, I argued that it could be as low as 1.00%. I might end up being right on this one. The CBOE Volatility Index has risen and the CNN Greed and Fear Index has fallen as the yield curve has flattened. The yield spread between ten- and two- year Treasuries is 76 bps: it was 114 bps one month ago and the policy rate (0.13%) is exactly 100 bps lower than five-year treasury notes (1.13%). That favours my thesis.

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