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Weekly Commentary

Issue **No. 1** | **JANUARY 4, 2022**

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Macro View

By Hubert Marleau

A New Year's Day Year Snapshot of the Stock Market

Submitted December 31, 2021

The S&P 500 quietly ended the wild year at 4766, registering an annual increase of 26.9%, and posting 70 new record highs for 2021, the second most in history, having notched 78 in 1995. Dealogic data showed global M&A volumes reached $5.8 trillion, handsomely beating the previous record of $4.6 trillion in 2007. Meanwhile, four million Reddit day traders took on the hedge-funds, disrupting the "white shoes" experts of Wall Street and outplaying them at their own game by sparking short squeezes. Indeed, retail investors have proven themselves capable of mounting many successful "value captures" at the expense of large institutional investors. As the curtain closed, the collective net worth of the world's richest 10 people rose by almost $400 billion over the course of 2021 for a combined worth of $1.5 trillion. In Canadian terms that comes to $1.9 trillion–75% of the Canadian GDP in current dollars.

Nonetheless, when all is said and done, corporate earnings tell the story of 2021 better than any other. They powered the stock market, despite the Fed's hawkish pivot and the ill-effects of the new variants on the Coronavirus.

Yet, Americans were and are mostly miserable. The University of Michigan Index dropped 13% to 70.6, this year, the lowest since the GFC of 2008 as respondents cited that rising inflation is hitting their living standards and that Covid-19 was supposed to be over by now.

A combination of vaccine reluctance, virus mutations, heedless disregard for social distancing and reckless omission of wearing masks has led to an Omicron spike and a record number of cases. Thank God, the disease appears to be less deadly as it spares the lungs. The variant is not overloading the hospitals. Science is on the case. Boosters, drugs and pills are forthcoming. This nuisance should disappear over the coming month.

Macro View cont.

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Thus, what is in store for 2022 will depend on whether the macro pressure of persistently high inflation will bring about higher discount rates and/or force rising input costs to eat into profit margins, cutting profitability predictions. Surging inflation is weighing on sentiment, but its outlook is perplexing because there's a stubborn divide between the soothsayers. Some are saying that higher inflation will persist for years to come while others think it will go away soon. There are two schools of thoughts on this one big thing.

The "Inflation Team" essentially claims that mixing the lagging effect of the recent increase in the money supply provided by the central banks and the immediate effect of low interest rates administered by the monetary authorities combined with the spending largesse of governments at a time of economic populism, on-shore supply-chain problems and energy transition is very demanding of limited resources.

The "Deflationary Team" essentially claims that too much inflation could crush expansion. Resources are indeed limited, hence the aforementioned thesis that it may create too much weight for the limited resources of the economy to support. The population is ageing, inequality is skewing the distribution of savings and capacity in key industries is not up to par to meet the objectives of economic populism, on-shore supply-chains and the energy transition.

The bottom line is that it may not matter all that much if inflation stays within certain boundaries. Google searches for words like "discount," "cheap" and "coupon" are declining, not rising. Nicholas Colas of DataTrek Research believes that if consumers are not seeking out better deals, it's good news for corporate earnings power, especially among large companies that enjoy economies of scale and scope. Consumer pessimism is not reflected in their actions: they are up and about, buying stocks. Let's face it, the level of interest rates across the yield curve, in spite of foreseeable increases, will likely remain below both the rate of economic growth and inflation. Voila! Nevertheless a watchful eye on the performance of the US dollar, credit spreads, and food and energy prices will offer clues as to what one should do.

The Core Personal Consumption Expenditures (PCE) Price index, which is touted as the most accurate indicator of inflation and the Fed's preferred inflation gauge, peaked at 4.7% y/y in November. In each and every month in 2021 the inflation rate rose. Unsurprisingly, heading into 2022 inflation is the prime concern for investors. In a recent Bloomberg survey, respondents highlighted it as one of the biggest known tail risks. According to bond traders, acknowledged as being the smartest guys in the room, the inflation rate is expected to remain elevated in 2021, but fall fast in the following year. Specifically, they are predicting that inflation will be 3.5% in 2022, 3.0% in 2023, 2.7% in 2024 and 2.3% in 2025. It's a view that most investment bankers more or less share. On Thursday, Business Insider published the inflation view of Wall Street's "Who's Who":

Macro View cont.

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Bank of America: “Looking ahead to 2022, Ethan Harris expects an uneven recovery from the pandemic. An incomplete recovery means that inflation is likely to fall back to the target in most major economies, with the US being a notable exception.” US inflation should remain elevated at 4.6%. Ethan likes Energy and Financials.

BlackRock Investment Institute: “We see real yields gradually rising but remaining near historically low levels. We see inflation remaining persistently higher than its pre-pandemic level. Yet, we see it coming off its recent highsas supply constraints ease and consumer spending rebalances away from goods and toward services.”

Deutsche Bank: “Inflation has broadened and will take longer to dissipate. Rising underlying inflation, elevated inflation expectations and accelerating wages all support well above target through 2022 with core inflation at 3.5%. As supply chains mend, labour supply returns and commodities remain below their peaks, inflation should fall back closer to target by 2024.” They like Financials and German stocks.

Goldman Sachs: “No near-term solutions exist to solve the supply chain and input cost problems that plague so many industries. However, management has used price increases, cost controls, and technology to preserve margins, and many of the headwinds will ease in 2022. Our economists expect annualized US GDP growth will decelerate from 4.5% in 1Q to 1.8& in 4Q 2022. During the same time, core PCE inflation will subside from 4.3% in Q1 to 2.4% by year end.” They like Financials, Technology and Healthcare.

Jeffries: “The market appears to be discounting a stagflationary scenario, where the economy ultimately buckles under the weight of inflation and rate hikes. The US is entering the tightest labour market since the 1950s. Thus, even after supply chain bottlenecks are cleared, inflation is unlikely to go back to 2.0% and is more likely to settle in a 2.5%-3.0% range.”

JPMorgan: “In all, we expect global GDP gains averaging 4.6% in the three quarters ending in 2022, two percentage points above our estimated potential pace. Easing global supply constraints should cool price pressures and we look for global CPI inflation to moderate toward 35 during 1H22.” The team prefers Energy and Financials over Staples and Utilities; Consumer Services over Consumer Goods: HealthCare over Defensives: and Small-caps over Large-caps.”

Morgan Stanley: “While we continue to see core inflation at 2.4% in December 2022, the path between now and then is meaningfully higher. Core PCE inflation begins to glide off its peak after February, before slowing sequentially. In 2023, core inflation moderates further to 2.0% by year-end.” The analysts are constructive on Healthcare, Real Estate and Financials, but would avoid Tech Hardware and Consumer Durables.” They have a slight bias for Value over Growth, but only in the near term.

Macro View cont.

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UBS: “High inflation flips to low inflation in 2022. We expect an outsized deceleration in price gains in 2022. Core PCE inflation falls from a peak near 4,7% in early 2022 to 1.7% in Q4.” The bank likes small-cap names because they are relatively cheap, but they are embracing a return to a deflationary expansion in the later part of 2022. “We remain overweight Communication Services and Tech on strong growth and momentum and pricing power as well as historically strong returns at this stage of the cycle, preferring Media, Interactive Media & Services, Tech Hardware & Equipment and Application Software.”

Wells Fargo: “The pandemic simultaneously built up consumer demand and unspent cash but thinned out the production and transportation of goods-taken together, an unusual way for an economic expansion to begin. We expect average consumer price inflation of 4.0% in 2022. Inflation should remain above its pre-2020 pace but not high enough to end the expansion. The upside risk to inflation is that rent and wages become self-sustaining, but our conviction is that inflation should ease with supply shortages.” The bank favours U.S. large-cap and mid-cap equities over international ones, and cyclical and growth sectors over defensive sectors–that is Financials, Industrials, Information Technology and Communication Services.

I think we are in a short inflationary boom that will turn most likely into a long-term inflationary expansion that will be somewhat tolerated by the central banks and boosted by government spending plans. I think we are in the midst of a rotation out of large-cap growth names into more old-fashioned value types. The time may be ripe for a more rounded portfolio. While popular macro scenarios are the right place to start, one should not sell short contrarianism. While risky, Bloomberg’s John Authers is right when he says: “The big money came from reversals.”

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