PALOS

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Weekly Commentary

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Macro View

By Hubert Marleau

The Market Has Reassigned New Prices to Speculative Stocks

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Systematic flows weighed on equities this week. Acute fears were widespread that the Fed was about to jump the gun over inflation concerns, pushing up bond yields and, in turn, undermining risk sentiment in the stock market. Sensational and pretentious headlines in the press describe the Fed's tightening steps as unprecedented. In the past two weeks, speculation has been rampant that the Fed was so behind the curve that the monetary authorities needed to raise the policy rate by 50bps and start running down their holdings of government bonds immediately. Although the dramatic bond selloff, in terms of its pace and magnitude, felt like a panic attack, it did not meaningfully alter inflationary expectations, credit spreads or the shape of the yield curve.

Since the end of December, yields on 10-year US Treasuries have risen 21 bps; but the spread between 10 and 2 bond yields is 78bps compared to 77bps; the spread between BAA corporate bonds and 10 -year US Treasuries have narrowed from 188bps to 180bps and 5-year inflationary expectations have declined from 2.30% to 1.93%. Moreover, the U.S. trade-weighted exchange rate has not budged.

Consequently, bond traders gave no signals that a recession is imminent, that a financial crisis is forthcoming, or that inflation is unanchored. I wonder if the Fed may be willing to assume political responsibility for the economy at a time when inflation is peaking, real disposable income is falling, and growth is set to slow down to a normal pace. It is going to have a hard time hiking rates as fast or as often many pundits believe. The worst that can happen is one unsuspected, draconian 50bps rate hike; and that would be it. Rational Expectation Theory, which was invented by Nobel-laureate Robert Lucas, argues that there is nothing like a surprise to change prevailing expectation around for good.

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The neutral rate, where growth co-exists with price stability, has fallen rapidly over the past two years because low interest rates, quantitative easing (QE) and massive debt have created a lot of convexity. Macro Strategy Partnership pointed out that the Cato Institute had recently suggested QE of 1.5% of nominal GDP equates to about a 0.25% rate cut and vice versa. The Fed's balance sheet is 50.8% of M2 money supply. It begs the question: Is the "Fed Put" dead? Not exactly. This time is different. Asset prices are more vulnerable to tightening because of the amount and duration of QE. Put simply, it should take a lesser number of rate hikes to move the needle because the Fed could compensate by simply selling securities instead.

Thus it's the growing aversion to risk that has brought about a growth reassessment of future earnings. Investors are reassessing the pandemic-era playbook that focused heavily on outsize gains for pandemic-related growth stocks, rotating out of fast-growing tech firms into financials, energy and cash.

The technology-heavy Nasdaq index entered correction territory on Wednesday as speculators aggressively dumped tech stocks in favour of cheaper value-based equities. The benchmark is currently 13.0% below its all-time record set last November, compared to a 8.3% decline for the S&P 500. The ratio (NASDAQ-to-S&P 500) fell to 3.13x from 3.30x. On Thursday morning, the dip-buyers stepped in as the S&P 500 hit the magic line (that is the 100-day moving average), and when the PBOC lowered interest rates to ease pressure on the macro economy. This gave them two signals to return to the fray, hoping to be rewarded one more time. They failed as the rally-sellers also stepped in, having heard in the late afternoon that Peloton Interactive, a pandemic favourite, had reported that it was pausing production of its bike and other connected-fitness products.

It should be noted that pullbacks and corrections are common occurrences. Selloffs usually stop when a true bottom is found. Fourth-quarter earnings calls act as a saviour. So far, the dip-buying has been scarce, even though earnings reports have so far been very positive, beating expectations by more than 5%, and the likelihood of more earnings beats over the next three weeks are high. Corporate earnings should rise in excess of 24% during the fourth quarter with solid mid-to high-single digit EPS beats, according to Refinitive data. I recognise, however, that the surge in pandemic-related demand for specific consumer goods is unsustainable. Netflix is a good example. (Note that neither Peloton nor Netflix are members of the FAAMG team.) I rather like what Arun Sai, a multi-asset strategist at Pictet Asset Management said: "Peloton and Netflix are more of a distraction than anything else." Nonetheless, by the end of the week, the S&P 500 lost 266 points or 5.7%, closing at 4397.

There are some big names coming up, which should reap the benefits of solid growth. Mike Wilson, Morgan Stanley's chief U.S. equity strategist thinks that the Apple's of the world will earn more than anticipated. He

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said: “This fits with our narrative that rates will become less of an important determinant of equity index returns over the next few weeks as earnings season kicks off and earnings revisions take more of a center stage.” Indeed, pullbacks and corrections are common in all bull markets. As soon as we are over this readjustment of values, the bull run should resume. No matter how one looks at it, financial conditions are at the easiest level in history. Goldman’s US Financial Conditions Index sits at 97.5, some 120bps lower than levels, which prevailed just prior to the pandemic. Outside of the high- flying stocks that deserved to be re-evaluated, it is conceivable that market participants may have succumbed to some irrational actions.

Ben Carlson, in a post named “A Wealth of Common Sense”, wrote on how often one should expect a market correction. “In modern times, since 1950, the S&P 500 had an average drawdown of 13.6% over the course of a calendar year. Over this 72-year period, based on my calculations, there have been 36 double-digit corrections, 10 bear markets and 6 crashes. This means, on average, the S&P 500 has experienced: a correction once every two years, a bear market once every 7 years and a crash every 12 years.” These things don’t occur on a set schedule, but the latter two occurrences happened at the onset of a recession. We are definitely not in one now and there are no prospects of getting one soon. It's become obvious that we are about to cross the pain threshold. Not everything is synonymous with super-high growth. The Skew Index, which measures the perceived tail-risk in S&P 500, is down significantly to 127.58 from 155.48 on December 31. This gauge of extreme fear is at its lowest point in a year. It normally runs around 124.00. The average for the past year was roughly 145.00. Viewed in another way, the Equity Risk Premium (ERP) is still attractive at 5.60%.

While sticking with my current belief that value stocks are ready to bounce some more, after almost two decades of underperformance, I’m shopping for bargains in the Tech’s top names. Yes, there are ample reasons why investors should come to terms with the reality that the tech-momentum of the last couple years will recede. However, the time may have come to look at possible switches from the “Crazy, Overpriced Stocks'' and “Mini-Stocks” to the “Magnificent 20”: AAPL, ADBE, AMZN, AVGO, CRM, CSCO, DOCU, GOOG, FB, INTC, MA, MSFT, NVDA, ORCL, PYPL, QCOM, SHOP, TDOC, V, and ZM. Depending on their sensitivity to the new environment, they are off their record highs as much as 68% for ZM and as little as 12% for APPL. On average, they are off 30%.

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On the Economic Front: Inflation Has Peaked

On the economic front, the forces that have driven consumer prices higher are liable to change direction as fast and unpredictably as they have of late. Overall inflation is moderating fast. Monthly rates are falling, and Canada is showing the way here. The Canadian CPI rose 4.8% y/y in December. The headline in the press was that it was the highest data print in 30 years. Yet few analysed the numbers. The index was down 0.1% m/m, reducing the 3-month annualised rate to 3.24% from 4.40% in November and a high of 6.69% last March: in fact, it has been slowing for nine months in a row. Yet the money markets are predicting that there is a 70% chance that the Bank of Canada (BOC) will raise its overnight rate by 25bps on January 26, a full three months ahead of the BOC's schedule. That's crazy.

I think that inflation will fall by itself from its own weight. The Empire Manufacturing index posted a big miss in January, suggesting that consumers are exhausted with rising prices. The NY Fed's Weekly Economic Index (WEI), which puts together ten daily and weekly indicators of real economic activity, fell to 4.86 on January 20. It was 7.91 on December 31.

First, the rise in energy and food prices has started to chip away at disposable income. At $100 a barrel, spending on oil would amount to about 4.2% of global GDP. It's about 3.5% right now. Secondly, the unprecedented shift of spending from services to goods is ending. On January 27, the BEA will release GDP numbers for Q4 which will not only show how well the economy did in general, but will tell us whether the composition of its growth is changing. I would bet my bottom dollar that it is. The Baltic Freight Index has fallen precipitously from 2380 a month ago to 1474, registering a whopping 38% decline. Consumer demand is falling back to earth. The University of Michigan's Consumer Sentiment Index, a good indication of future spending intentions, slid to 68.8 in a preliminary January report. In another consumer survey, conducted by the NY Fed, the results showed that expected year-ahead inflation rate held flat in December. Thirdly, it's conceivable that excess savings accumulated during the pandemic might not get spent, but be kept as a precautionary reserve.

The Federal Reserve Bank of San Francisco wrote a white paper on the impact of 19 pandemics stretching back to the 14th century. The writers found: "Significant macroeconomic after-effects persist for decades, with real rates of return substantially depressed, in stark contrast to what happens after wars. Our findings are consistent with the neoclassical growth model: capital is destroyed in wars, but not in pandemics: pandemics instead may induce relative labor scarcity and/or a shift to greater precautionary savings."

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FT's Martin Sandu wrote: "For decades, overall inflation near 2.0% has meant services prices rising at 3% or more, and goods prices falling enough to bring the average down." I'm fully aware that wages for ordinary workers are rising much more than they have in the past decade; but so is labour productivity. Wage pressure is not the same as cost pressure. An awful lot of money is being spent by businesses to improve efficiencies, streamline operations and do more with less labour to lift productivity growth. This is clearly happening. Unsurprisingly, US jobless claims and continuing claims are rising and the economy is growing at an above-par clip.

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