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Weekly Commentary

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Macro View

By Hubert Marleau

Dovish Hawks and Hawkish Doves Have Put an End to Free Money, Creating Opportunities in a Yo-Yo Market

Submitted January 30, 2022

On Monday, a tremendous turnaround occurred in the stock market, in one of its most astonishing intraday reversals in history. The S&P 500 was up 13 points.

On Tuesday, at the opening, however, stocks were down sharply, before mounting a further valiant combat attempt to recover; but the comeback failed. The S&P 500 was down 51 points.

On Wednesday, investors got some answers from Powell as to how aggressive the Fed would be over the coming months. In the early part of the day, the S&P 500 was up a lot. The rally, which brought solid gains, quickly evaporated however, giving it all back during his subsequent news conference, when he said that the Fed could raise interest rates faster, further and more frequently than the markets had been expecting. The S&P 500 went down another 9 points.

Powell did provide some clarity to speculators as to coming interest rate rises and asset runoffs, the prospects of which had spook markets. The Federal Reserve (FED) left the federal-funds rate unchanged, but said an increase would soon be warranted, and that only one final round of asset purchases remains.

Meanwhile, the Bank of Canada (BOC) held its overnight rate at 0.25% but telegraphed that lending rates will need to increase to arrest inflation. While both central banks are of a mind to raise their policy rates in March, neither was conclusive or specific. They are keeping their options open, suggesting that they are still data-dependent in order to satisfy the hawkish doves.

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By Hubert Marleau

Nevertheless, one should not expect disappointing growth numbers or adverse market reactions to push the Fed nor the BOC off course. Powell and Macklem stressed that compared with the last tightening cycle, the job market is much stronger and inflation much hotter and both sides of their preoccupations-employment and inflation- are calling to move away from the highly accommodative monetary stance put in place to combat the economic effects of the pandemic.

All of that has been expected since earlier this month, when minutes from the previous FOMC, held last December, revealed that officials planned to raise interest rates four times in 2022; had started to hold balance-sheet discussions and favoured a more aggressive and earlier timetable than in the past. Although the Fed's $9.0 trillion holdings of assets are in need of a substantial amount of shrinkage, the unfamiliarity with the best way to deal with them will require a prudent blueprint. There is no way for the Fed to risk taking on an untried play. It's far more likely that it will use words and scare tactics to push inflation expectations down.

There was no surprise here. Powell probably believed that he also had to acquiesce to the dovish hawks. In the presser, he sounded as if the Fed would do whatever it takes to restore its inflation-management credentials. The monetary authorities do however, expect the inflation rate to moderate in 2022. Inventories, which fell for three quarters in a row in 2021, rose over $230 billion in the Q4, suggesting that the supply shortage is being rectified with slower retail sales. Moreover, in the past month, the US Treasury borrowed $600 billion from the private sector to restore its cash hoard, suggesting that the pace of the money supply will continue to decelerate. Nevertheless, they suspect that the inflation risk is still skewed to the upside because it is not known if and when wage pressures will ease.

Towards, the end of press conference, Powell probably felt that he had to be in accord with the dovish hawks and the hawkish doves at the same time when he said: "We will need to be nimble and humble so that we can respond to the full range of possible outcomes, and we're not going to stick with something that isn't working." Then he went on to state that the Fed will move steadily away from being highly accommodating. So it's steadily nimble.

It begs the question as to whether the Fed will ever have a definite policy path. A statement that is dovish and a press conference that is hawkish leads to confusion. That is what investors did not like. It created volatility. The Fed may not care about what happens to asset prices this time around, but might not want to tolerate a too narrow spread between the 10- & 2-year Treasury yield, which has flattened to 60 bps from 160 over the last six months. Watch, therefore for changes in the yield curve, the Fed's balance sheet and the dollar.

Macro View cont.

By Hubert Marleau

On Thursday, the market started on a very strong note, which turned into another day of dizzy trading, fizzling yet again in the afternoon, despite proof that the economy is well. The BEA reported excellent GDP numbers, yet many actors were quick to throw cold water on the report. They did not like the massive Q4 inventory rebuild, emphasizing the point that the build-up accounted for an unusual 53% of the q/q growth-a possible negative for future growth. I disagree with this notion. Since production still lags consumption, wholesalers and retailers have had to draw down inventories to fulfill demand over the past two years. Restocking warehouses will likely continue for many more months. It's a natural reaction. Nevertheless, the S&P 500 lost 23 points, falling below the magical 200-day moving average, and nearing correction territory.

As a result of vaccination efforts, and additional rounds of federal aid and cheap credit conditions, the R-GDP grew at an annualized rate of 6.9%. For the full year, real growth was 5.7%, the biggest increase since 1984. Given the short duration of the recession and the speed of the recovery, it can be classified as an impressive feat. Unfortunately, it has been stained by an inflationary surge. The price index for gross domestic purchases increased at an annual rate of 6.9% in Q4 and 4.2% for all of 2021. These numbers confirm that the US economy is in an inflationary expansion phase from what was once a deflationary expansion cycle before the pandemic hit. It is my impression that the economy will continue to be in an inflationary expansion cycle, but only for another 18 months.

Several characteristics of the economy are starting to resemble those which existed before the pandemic. Firstly, the economy has fully recovered. R-GDP is 3.0% higher than it was in the quarter of 2019, suggesting the actual growth rate ran at the annual rate of 1.5%. Secondly, the personal savings rate is now 7.4% of disposable income compared to 7.3% in Q4 of 2019. Thirdly, consumers spent 58.9% of their disposable income on services in Q4/2021 compared to 58.6% two years ago: this is a small +0.3% gap. In December, the personal savings rate was 7.9% and spending on services 59.0% of disposable personal income respectively.

However, there are two big differences. Productivity appears to be on an upswing and there is an overabundance of money. The economy is producing 2.9% more goods and services, with 1.7% less workers today than it did just before the pandemic hit. That amounts to a 4.6% increase, reflecting the huge amount of money that businesses are spending on information processing equipment, industrial machinery and software, plus research and development: $510 billion in Q4/21, 22% more than in Q4/19. In the 24 months ended December 2021, the money supply (M2) rose 41%, but only 14% if one were to exclude the $4.2 trillion of unused excess reserves that banks have with the Fed. In this manner, the pace of the money supply may not add any more undue inflationary pressure than it has already done when one considers that, for the period under review, the N-GDP increased 10%, especially if the Fed can use tools and influence to prevent the banking system from using them to expand its own credit.

Macro View cont.

By Hubert Marleau

On Friday, after a brief rise, the S&P 500 zagged downhill because traders could not stomach the 1.0% q/q rise in the employment-cost index. Then, out of nowhere, AAPL saved the day, showing that supply shortage and bottlenecks could be overcome, and zigging the S&P 500 up 2.4% to 4432 to end a wild and brutal week. In the week ended January 28, this broad benchmark increased 35 points or 0.8%. The dip-buyers outdid the rally sellers.

What we have had was not a “black swan” event, but a “mean reversion” occurrence between growth and value. It’s a non-recessionary correction: one which usually lasts for about 3 months. The current one began on November 2 of 2021.

Jim Paulsen, chief investment strategist at the Leuthold Group, commented in the WSJ that the bearish attitude of investors could be a bullish sign. Corrections are normally associated with rampant optimism and excitement, which is not the case at this time, because consumer confidence is at a low level. He correctly added that buying could re-emerge if news on inflation and Ukraine turned reassuring.

In any case, market corrections usually do not turn into bear markets when economic growth is on the rise. Bear markets are caused by recessions and lack of earnings. A third of the companies on the S&P 500 have reported fourth-quarter results, and 78% of them have beaten analyst’s estimates for earnings per share. I agree that the effect of Omicron has weakened economic growth in January, and that the economy will be weaker in 2022 than in 2021, but it will still be stronger than its structural rate of 2.25%. Actually, the US economy is capable of weathering higher interest rates. Credit spreads are low and have been steady while the Wicksellian spread between the marginal return on fixed capital formation and the cost of capital is healthily positive.

In this connection, I would keep only a bare minimum of assets like gold, which usually serve as hedges to runaway inflation, but tend to do badly when the Fed is on the warpath. Gavekal made this interesting comment in a note to clients: “Powell is now making it clear that he really is no Arthur Burns-who, as Fed chair in the 1970s, presided over roaring inflation. Such assets face significant headwinds.” On the other hand, he’s no Paul Volker either. Even though I'm aware that the Fed won’t have my back, I’m not sitting this opportunity out.

We should not readily assume the Fed’s plan to raise rates is bad for the stock market, according to Bloomberg’s Nir Kaissar. The notion that interest rates and stock prices move in opposite directions is grounded more in theory than data. Other than three major exceptions - the 2000-dot-com bust, the 2008-financial crisis and the 2020-pandemic, two of which involved historic stock market declines - the long history

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of interest rates and stock valuations doesn't show any reliably inverse relationship. The correlation between 10-year Treasury yields and the ten-year cyclical price-earnings ratio for the U.S. stock market is only slightly negative (-0.21) over the past 140 years, meaning very weak negative correlation, if any. Remove the three exceptions and there's none at all. By Kaissar's account, the Fed has embarked on 13 rate-raising campaigns since 1954 and rather than sinking the market, the S&P 500 Index moved higher during 11 of them, with a median gain of 14%, excluding dividends.

In another note to subscribers, the editors at Bloomberg narrated that there is nothing to fear, if history is a guide. They showed graphically that seven consecutive jumps in the so-called "fear gauge" for the S&P 500 index is a signal that it may be time to bet against volatility. Only 10 times in the past two decades has the VIX risen for so many sessions in a row. And speculators who wagered against the gauge after the previous nine streaks would have netted a tasty return of 19% after 20 days. Technically, the market is oversold.

In the meantime, according to UBS, the pace of weekly corporate flow from buybacks to dividends is set to jump fivefold in the next two to three weeks, as earning blackouts end. Additionally, end-of-January rebalance buying could be supportive, particularly with active fund positioning at 0.7 standard deviations below average.

The bottom line is that selloffs are not unusual. The Dow Jones Data Center shows that since 1957 when the S&P 500 was created, the index had on average about one 10% decline every year and more than three 5% declines. They create good deals. According to my readings and research, this time is unlikely to be different.

Thus, I'm dabbling in the tech sector, in search of bargains. The economy will eventually change cycle from an inflationary expansion to a deflationary expansion one, perhaps in 2023 or 2024. For now, I'm overweight banks, healthcare, energy, and materials, but slowly lightening up. (Take note that Canadian stocks are considerably cheaper than US comparables.)

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