

PALOS

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Weekly Commentary

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Macro View

By *Hubert Marleau*

If It's Too Complex To Follow, Follow Bond Market for Orientation

Submitted February 21, 2022

The Snapshot of the week:

The Ukraine situation slammed into the markets at a time when uncertainty was already rife, thanks to eye-popping inflation prints and the Federal Reserve's acceleration towards tightening policy. With a whole range of risky assets, including oil and commodities, looking vulnerable to either higher interest rates or slower economic growth, investors have turned to gold as an old haven. It's a bit counter-intuitive, because the yellow metal usually doesn't jive well with the prospect of rising bond yields. The warning of a possible land war in Eastern Europe is causing severe diplomatic tension among Nato members and between Nato and Russia. The geopolitical picture is awful. Western officials and Nato have contradicted Moscow's claim of troop withdrawals on the Ukraine border, evidence on the ground indicating that Russia is moving toward an imminent invasion. The market mood brightened on Friday as Washington and Moscow agreed to hold talks about the Russia-Ukraine standoff, but while a favourable development, it was not enough. Moscow-backed separatists in eastern Ukraine announced plans for mass evacuation of civilians to Russia, while the latter was making plans for nuclear drills to test ballistic and cruise missiles. This situation has proven difficult to ignore.

In the week ended February 19, 2022, the S&P 500 decreased 70 points or 1.6% to close at 4349, registering its second-consecutive weekly loss, and on the way to a shallow correction. The selling was broad-based with 75% of the names listed on the NYSE declining and new lows beating new highs by five to one; but even though the decline may have whipped out more than \$3 trillion off the value of US stocks, there has not been a purge or a cathartic capitulation to clear the deck. Last week's inflows to global equities were the weakest of 2022, \$2.2 billion. Nevertheless, the cumulative

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haul over the first six weeks of 2022 matched the amount seen for the same period of 2021: a year of record inflow.

Too Complex To Follow; Look To the Bond Market for Orientation

It's not going to be like it was during the past 10 years. The old way of trading stock may be over. Blame it on elevated inflation. Until recently, risk was on when the economic data was strong because inflation was so low the Fed was not expected to remove monetary support. Now that we have high inflation, risk is on only when the prints are weak, because it reduces the chances that the Fed might be too aggressive. In a world where everything seems weird, I go to the bond market for guidance. I rely on it as I would on a compass to set direction

We all know that the U.S. monetary authorities are preparing to raise interest rates in 2022. However, the question is no longer one of "if" and "when" but how frequently and by how much. The Fed has the tricky task of cooling prices, which have speeded to an annual rate of 7.5% in January, without hampering growth, which is predicted to slow to an annual rate of 1.3% in Q1, according to the Atlanta Fed's NowCasting model.

The best answer can be found in the bond market. The bond market is pretty good at signaling today what will happen to the economy tomorrow: inflation and growth. In this regard, it has the knack of being able to signal what is likely to be the Fed's monetary stance down the road. Evidently, bond investors cannot give us god-like predictions, but their reflections on what the future bears is worthy of serious consideration. Without the aid of the bond market, who knows what next month may bring? The point is that the bond market offers the best guess for where we are headed. Firstly, bond traders, unlike stock traders, can trade billions of dollars worth of trades without going to their bosses for permission. Secondly, they are the smart ones who incorporate the monetary and Keynesian theories in their thinking, diligently following macroeconomic developments, and interpreting data prints rationally. Thirdly, central banks rely on their expectations to orchestrate macroeconomic outcomes.

Bond traders don't get much attention from stock jockeys, yet the interest rate market is the single best forecaster of the economy. In the end, price inflation and economic growth will be whatever the bond market thinks they will be. James Carvill, Bill Clinton's political advisor, said: "I used to think that if there was reincarnation, I wanted to come as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market: you can intimidate everybody." This point is most valid, for herein lies a truth. What they expect is written in the yield curve: the gap between the neutral and policy rates, and 10-

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year real rates. For guidance and without much effort, stock market civilians should look there in order to see what the rational expectation of the bond experts is. Given that the future will in time become the present, the rationality of the bond market can assist investors pick a macro-path that will help the job of managing asset allocation.

The bond market is signalling:

- 1) That inflation is embedding itself in the economy everywhere except in long-run expectations.
- 2) A 100% chance that the Fed will raise its policy rate by 25 bps at its next meeting, to be held on March 15-16. The market sees only a 30% probability of a half a point rate increase, but has baked in 5 rate hikes over the next 12 months.
- 3) Based on the theory that the yield on five-year notes fairly represents a neutral policy rate that is consistent with output being at full potential with stable inflation, it's unlikely that the Fed will drive the Federal Funds rate any higher than 1.50%.

The narrowing yield curve is either telegraphing that the Fed is acting just as inflation is about to start falling back to its 2.0% goal, or just as growth is about to slow down close to its pre-pandemic path of 2.0%. Investors should note that the shape of the yield curve signals recession only when the 3-month interest rate and two-year bond yield are both higher than 10-year Treasury yields, not when the curve is flattening. The spread between 10-year and 2-year Treasuries is roughly 50 bps and 160 bps between 10-year and 3-month Treasuries.

- 4) If bond investors were really worried about a recession, they would completely avoid default-prone, high yield bonds. Some money has fled the junk bond funds—\$3.6 billion. However, it would be an over-stretch to say credit is cracking: junk bond issuance is still being snapped-up. The allocation of credit remains smooth, credit spreads are wider but anchored, and the capital market is open to triple-C-rate bonds.
- 5) The spread between the 5Y5Y rate, the Fed's destination (2.00%), and the 1Y1Y rate - the Fed's policy gap (4.50%) - defines the boundaries for its activity. The wider the gap between the short and terminal rates, the more scope for stock market volatility. As one can see the spread is wide. Hence volatility.
- 6) Real rates have risen considerably, not because prospects are for faster growth. Lack of visibility, when it comes to long-term forecasting, has brought about higher term premiums. Indeed, contrary to the past 20 years, bond investors now want to be compensated for the risk they take.
- 7) Bond market derivatives are predicting that the inflation rate will fall to 4.5% by February 2023, 2.7% in February 2024, 2.5% in February 2025 and 2.0% in February 2026.

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On the Inflation Front:

There is not a lot of good news on the inflation front. U.S. producer prices rose 1.0% in January and 9.7% y/y. Once volatile items, such as food, energy and trade, are stripped out, so-called core-producer prices increase 0.9% m/m and 6.9% on a year-over-year basis. This print came on the heels of another alarming report, which showed consumer prices had climbed 7.5% over the past 12 months. The BLS characterized price increases as “broad-based” and no longer attributed them only to sectors hardest hit by the pandemic.

In order to drive down the cost of goods, supply chains must normalise. Unfortunately, inflection points are difficult to spot, because directional changes usually come in small doses. But a careful examination of the numbers suggests that the rate of inflation may have peaked and is about to roll over. Price pressures are far from universal. Inflation is slowing in China, remaining largely dormant in Japan and, whilst on the rise in Europe, is not even close to American levels. Beyond the US and Germany, few countries are displaying signs of overheating or broad-based increases in prices.

The industrial heartland is dotted with examples of how links in the supply chain are adapting to keep the wheels of commerce turning in sectors like auto parts, consumer products and pharmaceuticals. A market flash produced by CNN Business, featuring UBS’ indicators, which tracks supply chain stress, reported that a quarter of bottleneck pressure has been reversed. UBS said: “We attribute the sharp improvement in global delivery time indices in large part to the shift away from ‘zero-Covid’ in Asia, and the jump in production as restrictions were removed, leading to greater availability of goods plus an immediate reduction in backlogs.” This is going on as a spending shift from goods to services is underway. DRAM eXchange reported that total Q4 DRAM output value decreased because shipments from chip makers had fallen due to poor end-user demand for TVs and consumer electronics, and because buyers’ inventories were flush. Capital Economics issued a composite indicator of labour and goods shortages, based on a range of surveys, where hard data had fallen from Z-scores of 4, to 2 for product and 3 for labour.

On the Growth Front:

The so-called Misery Index, which crudely adds inflation and unemployment together, is depressing sentiment because people are expressing their displeasure with the state of the economy. Meanwhile, over the past year, real average weekly earnings have not been able to keep up with energy and food prices, leaving less income disposable for goods and services. Yet, the consumer is not dead. In January, both retail sales and industrial production rebounded. Retail sales rose 3.8% m/m and 12.3% y/y, while industrial

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production increased 1.4% m/m, registering 4.8% y/y. Meanwhile, a hodgepodge of second-tier US data, like job claims, new orders and shipment and housing starts, paints a picture of slowing economic growth. The Atlanta Fed's NowCasting economic model is predicting that R-GDP will rise at an annual rate of 1.3% in Q1. I think it will be a bit better than that. Assuming a real consumption pace of 0.3% in February and March, the first quarter would tag an overall real growth factor of 2.0%. In contrast to previous cycles, the economy will get the benefit of fixed business capital formation. Businesses are in good shape without the side effects of a fragile credit market. Companies are able to finance capital spending from their savings and cash flows have not weakened. Survey evidence shows that capex intentions are accelerating.

Conclusion:

I have no doubt that Ukraine will remain in the spotlight over the next while. Eventually tensions will ease or a resolution will be found. At that point, stocks will get their cue from the bond and credit markets. It will help them to figure out if the Fed has a credible playbook to tame inflation and avoid a recession. The message that I get from the bond market is that withdrawing money from the stock market would be the wrong thing to do at this time. Bond traders are predicting that the Fed will execute a soft landing, extend the growth cycle and prevent runaway inflation.

Thus, yielding to the temptation to sell stocks in what is likely to be a volatile stock market might be silly. Barometers of risk-seeking speculative behaviour have collapsed but they work well as contrarian indicators. In spite of the significant increase in real yields, the Equity Risk Premium (ERP) of the S&P 500 has risen to 6.00%, making valuations about 20% cheaper than they were when this broad benchmark peaked on January 4, 2022.

According to Goldman Sachs (GS), retail investors have not lost their enthusiasm to buy the dips, contrary to popular opinion, while the press believes that retail buying has waned significantly, causing weakness in equities, thinking retail investor activity as being solely oriented to high growth stocks, IPOs and popular hedge fund shorts. The bank estimates that they bought a net \$7 billion of Russell 3000 shares since volatility spiked late last month, with the lion's share going to big-caps in Technology and Consumer Discretionary. Interestingly, data produced by the bank's electronic trading team shows that retail buying has actually accelerated. If you're wondering what they bought and sold, GS has been good enough to provide the public with a list.

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Retail investors bought: NVDA, AMZN, TSLA, MSFT, DIS, FB, BA, JPM, GOOGL, BAC, and PYPL.

Retail investors sold: BABA, AAPL, MRNA, ROKU, SHOP, SNOW, T, SNAP, BIDU, BNTX, GOOG, and REGN.

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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