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Weekly Commentary

Issue **No. 25** | **SEPTEMBER 5, 2022**

Macro View

By Hubert Marleau

For Those Who Missed the Last Rally

Submitted September 3, 2022

The upcoming Federal Reserve interest rate decision scheduled for September 21 will probably be the last bump. I expect a 0.75% increase. It will likely be followed in months to come with a narrative shift, but will enter a long period of inertia that may last as long as a year. That is about the amount of time needed to bring demand and supply into alignment. I rest my case on six reasons: the strength of the dollar, the application of quantitative tightening, the crushing weight of energy and food, the cooling of the job market, the easing of supply constraints and the fall of industrial prices. The bond market is already predicting that the annual rate of inflation will be 2.1% by next September mainly because monetary growth is collapsing. Monetary models, which track and correlate changes in the money supply with N-GDP, are suggesting, with a 6-to-12 month lag, that the inflation rate could fall precipitously from here to more acceptable levels.

As a matter of fact, inflation eased considerably in both July and August. According to the U.S. ISM manufacturing index, the price paid by businesses in August fell to 52.5, the lowest since June 2020 and significantly less than the 12-month average of 76.2. Meanwhile, MacroStrategy Partnership rightfully pointed out that the Citibank G4 inflation surprise index fell to 66.56 from 84.58 in July and from a high of 120.58. Overall wage gains are moderating also. Of course, August's CPI report will have the last word, but prospects are favourable.

By the end of this month, the policy rate will be at or near neutral where it neither spurs nor slows growth and the seasonal effect of the September-October period on risky assets will have ended. This is what patient investors have been waiting for. Soon the challenging technical factors will fritter away as the inflationary forces dissipate further, permitting these investors to turn their gaze to the third quarter earnings season. For what it’s worth, my June 2023 S&P 500 price target is 4450, which assumes an 18 multiple and $250 in aggregate EPS. Take note that energy stocks remain in a sweet spot, selling at deep P/E discounts to just

Macro View cont.

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about everything else. They have never been cheaper than they are now, even though the price of fossil fuels have never been more expensive in a less restrictive environmenmt.

In my judgement, corporate profits will surprise the street to the upside. Post-tax corporate profits reached 12.1% of N-GDP in the second quarter of 2022, their highest in 80 years, according to the Bureau of Economic Analysis. This kind of profit performance is expected to continue because businesses have a lot of pricing power and oligopolistic rent. They are capable of raising prices, skinning services or shrinking standards, including automation and robotization, to withstand higher wage rates and dearer cost of supplies. In other words, they are able to ride the current cost push wave without as much trouble than they have in the past.

The S&P 500 ended the week at 3925, down 134 points or 3.3%. That's 18.1% off the January high and 7.0% above the June low. Selling pressure could continue, given the panicky sentiment of investors. However, the turmoil is creating another investment opportunity for investors who missed the last rally. Many companies have envious business models, strong balance sheets, free cash flows and attractive dividend yields.

"Barron's recently canvassed 8 Wall Street strategists to get a read on the investment outlook for the rest of the year. While the average target among the group puts the S&P 500 at 4185 at year end, up 6.6% from Friday's close, individual estimates range from 3600 to 4800" (JPMorgan). In this connection, there is a lot more upside than downside.

Quant-and smart-beta funds are about to rebalance their portfolios. JPMorgan believes that this could potentially bring monthly inflows of $20 billion. Plus, there are buy-backs. Outside of inflation, the underlying fundamentals of the economy, be they corporations or households, are quite good. A lot of bad news is already priced in, which is why smart money is betting on a year-end bounce.

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