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Weekly Commentary

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Macro View

By Hubert Marleau

Good News Is No Longer Bad News

Submitted September 10, 2022

Calling tops and bottoms in the stock market is an impossible task. The economy is incredibly complex and constantly bombarded by external shocks and behavioral changes. In this regard, mere mortals cannot know for sure what lies ahead. I try to alleviate this problem by keeping abreast of where we are and forecasting as often as I can, hoping to see where we might be going. This is why I write a weekly letter.

This week the S&P 500 gained 143 points, up 3.6%. The idea that a too strong economy would encourage the Fed to increase interest rates more than it should has lost some momentum. It explains why a support floor seems to exist at 3900. Although there is a resistant ceiling at 4300, the march toward higher North American equity prices will likely be maintained, albeit in a volatile manner. There is nowhere better to shelter from the turbulence which is afflicting global economies. According to Refinitiv Lipper, investors from all over the world are adding money to the U.S. equity and bond markets in record amounts, yanking capital from international funds for weeks. Indeed, the U.S. is the least challenged in a challenging world, but there are also other reasons for the lure.

First, the expected 0.75% rate hike due on September 21 will bring the Fed's policy rate to 3.125%, only 25 bps below the neutral rate calculated to be 3.375%. The Reserve Bank of Australia (RBA) and the Bank of Canada (BoC) have already set their policy rate at neutral. In this regard, the monetary authorities will likely stop talking about a front-loading policy outlook. Moreover, the US dollar, being the world's reserve currency, is up 20% from a year ago, and it's so turbo-charged that it is creating havoc in the international market. The Fed will need to take this into account if it wishes to avoid creating grave financial risks to peripheral countries and even major trading partners. In the end, it must justify its actions. It's going to be harder and harder to do so because most of the current macroeconomic problems are due to a food and energy crisis that is outside its control.

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Second, the Fed appears to be navigating the U.S. economy towards a soft landing. Weekly economic indices are holding up pretty well, giving assurance that real economic activity is still in an expansionary phase. There are less negative macro surprises, and U.S. rail transport intermodal transport is rising. As a matter of fact, the Atlanta Fed GDPNow model estimate for real GDP growth in the third quarter of 2022 is 1.3%.

Third, this week brought more conclusive evidence that inflation is in decline. Global supply chain pressures (GSPCPI) decreased in August, continuing the easing observed over the past three months. Macro Strategy Partnership pointed out that China's producer prices rose 2.3% y/y in August, down from 4.2% in July and a 6- and 12-month average of 5.9% and 8.4% respectively. Prices were down 1.2% m/m, with the 3-month annualized decline now -9.7%. The NY Fed's GSCPI remains at a historically high level, but the index is down from a high of 4.51 to 1.47. It's usually around zero. I expect some price pressure relief with this week's upcoming inflation report.

Four, the probabilities are good that third quarter corporate profits could surprise market participants once again to the upside. Here is why.

The Levy-Kalecki Profit Equation:

When it's all said and done, corporate earnings are what determine stock market performance, it is important to know where profits come from. The economy is made up of four entities: corporations, households, governments and the rest of the world. In this context, Robert Armstrong, a wonderful US financial commentator for the FT, wrote last week about the Levy-Kalecki Profit Equation, an accounting identity. This truism, by virtue of how all of the factors are defined, precisely describes how much each of the four entities actually affect corporate profits. The bottom line is: Profits = Investment + Dividends + Buybacks - Personal Savings + Current International Trade Balance of Goods and Services (Current Account Balance) + Government Deficit.

Knowing this axiom gives investors a leg up in predicting earnings. While I recognize that smaller government deficits will burden profits, on the other hand I believe that personal savings will fall adequately, dividend and buy-backs will rise sufficiently and the current account deficits decline enough to compensate for the aforementioned drag.

Macro View cont.

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P.S. Here is what was going on with this equation in the second quarter of 2022 on a seasonally adjusted annual rate in trillions of dollars:

Corporate Profit (2.6204) = Investments (3.3498) + Dividends (1.4737) + Buy-Backs (0.4747) - Government deficits (0.6500) - Personal Savings (0.9450) - Current Account deficits (1.0828). The numbers add up.

Disclaimer:

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