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PALOS

Weekly Commentary

Issue No. 29 | OCTOBER 1, 2022

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Macro View

By Hubert Marleau

Are We in the Final Inning?

Submitted October 1, 2022

Central banks are no longer in a position to ignore the liquidity drawdown caused by the strength of the U.S. dollar, the sharp decline in reserve balances and the shrinking of the Fed's balance sheet. In the past week, the Bank of Japan, the Bank of England and the People's Bank of China intervened, selling dollars, buying bonds or easing their monetary stance.

It now seems possible, perhaps probable, that the dollar will take a reprieve from its parabolic rally, if more central banks start to imitate in a cooperative manner what the aforementioned ones have recently done. With the money supply falling and the 2-year breakeven yield broaching 2.00%, the mission to check inflation is nearing completion. The tightening has been going on for a while. A very big chunk of the excess liquidity that was produced during the pandemic has been removed. There is empirical evidence and theoretical validity that withdrawal of monetary liquidity usually has a cumulative impact on inflation after a lag.

The cracks are starting to show. Atlanta Fed President Raphael Bostic now says that monetary policy needs to be only moderately restrictive. A small but growing number of Fed's watchers believe the overzealous path is under reconsideration. Federal Reserve Vice-Chair Lael Brainard admitted that consideration must be given to what is going on abroad. If there is any truth to all of this, some relief may come our way.

History shows that the worst month for stock market performance is September. We just had the worst one since 2008. On Friday, the CBOE Volatility Index (VIX) stood at 31.62, the CNN Fear and Greed Index at 15 and the Skew Index at 124 causing market sentiment to crescendo to panic level as market instability replaced inflation as the biggest risk. Just about every investment presentation and editorial comment was bearish, without much explanation other than what had been said. On the contrary, the panic was provoked by the new UK government's expansionary "mini budget". The noise level rose as the British pound tumbled and the country's interest rates surged. As a result, UK pension funds found themselves in a very awkward position,

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being forced to raise cash to fund their liability-driven investment (LDI) and other derivative positions. They sold stocks. The market did take that well. Unsurprisingly, last week's Investor Sentiment Survey showed only 20% of the participants were bullish.

The bear market may not be over, but history is clear that when sentiment is at its worst point, future market returns are usually exceptional. As a matter of fact, corporate insiders are acting as though they were. The insider transaction ratio is very bullish and it has been for several weeks. Those in the know buy when everyone sells. Financial officers value their stocks on expected earnings over the long term. In a discounted cash-flow calculation, a few bad quarters -even years - have little consequence on final values. Interestingly, corporate profits are 50% higher today than they were in the last quarter of 2019, while the S&P 500 is up only 12% for the comparable period. Morgan Stanley's Mike Wilson, one of Wall Street's best known stock sceptics and strategists, said US equities are in the final stage of a bear market.

Currently, the S&P 500 earns 6.98%, 317 bps above 10-year Treasuries. The best predictor of superior market returns is starting valuations.

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