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Weekly Commentary

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Macro View

By Hubert Marleau

Macroeconomic Forces Explain Stock Market Returns

Submitted August 11, 2023

Basically it's not daily noises found in the media that matters, it's the big things like employment, inflation and productivity, which are surreptitiously expressed in the bond market. Inflation expectations, term premium and the outlook for growth are the broad factors behind bond yields. Ten months ago the specter of recession haunted investors because conventional economic thinking dictates that rampant inflation, combined with tight monetary policy, usually brings an economic downturn, and in turn lower earnings. This did not happen. Instead, inflation moderated, the job market remained strong, and earnings fared much better than was generally assumed. These were the forces that brought about the unloved stock market rally. In point of fact, stock prices have risen sharply since the 2022 selloff. The S&P 500 is now roughly 25% higher than its October low, reflecting gains across all sectors, while the CBOE Volatility Index - Wall Street’s favorite fear gauge - fell well below the historical average.

Intriguingly, the fall in inflation and the rise in employment were predicted by the bond market, where the true economic brains are located. I cannot overstate the significance of the US Treasury market, being the most important one on the planet: there is simply no better place to look for direction.

Over the comparable period under review, yields on 10-year Treasury notes, which are currently at 4.00% and narrowly fluctuating, are about the same today as they were back then. What is particularly interesting is that inflation expectations are also about the same at 2.40%. Thus the important question is whether the 1.60% differential between nominal yields and inflation expectations are attributable to the prospect of higher growth or the compensation that investors require for bearing the risk that inflation may change over the later life of the bond.

Herein lies what are prospective stock market returns. On the one hand, if the differential is caused by higher term premium, the stock market is going to be in trouble. On the other hand, if the differential is the result of higher real rates, it’s likely to run higher.

Macro View cont.

By Hubert Marleau

I'm in the camp of higher real rates, meaning positive growth and lower inflation. Why? Presently, the Treasury term premium, according to the Federal Reserve Bank of New York, is negative 0.64% compared to -0.75% last October and -0.73% in December 2019, just before the pandemic hit. Given that inflation expectations are around 2.40%, the growth prospect has not changed, still running around the annual rate of 2.25%. How can this be, bearing in mind that employment growth is clearly moderating fast?

As a rule, an economy can only grow as quickly as its workforce expands, plus any gains in how productive the workforce is. Given that current demographics are not promising, the burden of growth will fall on productivity. Thankfully, there is growing confidence that productivity is not only back on track but that a new era of productivity may have emerged. First, last Thursday, the Labour Department reported a huge step up in productivity, as measured by what a typical worker produces in a typical hour, to a 3.7% annual rate in Q2, registering a year-over-year increase of 1.3%, a trend that looks like it was just before the pandemic. Secondly, Goldman Sachs' senior global economist Joseph Briggs, in a recent study showed that comprehensive technological advances and adoption of generative AI have already begun to translate into reality. Indeed the Atlanta Fed's GDPNow model estimates GDP growth in the 3rd quarter of 2023 to be 4.1% - and this is without a meaningful increase in employment.

Not to be left behind, Wells Fargo's team, led by Jay Bryson, also came up with its own version on how these rapidly advancing technologies are impacting capital expenditures, ushering in a mini-productivity boom. Using the deviation from trend in hardware and software spending from 1995 to 1999, and projecting it out over the next 4 years, he noted: "Total real spending on hardware and software would rise north of 50% above the existing trend with clear implications for GDP growth." Such a contribution to GDP growth would triple over the next 4 years. Moreover, he argued persuasively that this transformative potential could raise annual labour productivity growth by around 1.5% per year, persisting for a 10-year period. He is not the only one pushing the idea that tech-efficiencies will fuel future growth, either: The Brookings Institution, Stanford Digital Economy Laboratory, MIT Sloan School of Management, University of Pennsylvania, and McKinsey Global Institute basically agree.

A productivity boost of this magnitude would have far-reaching macro consequences, and could easily overcome the dragging effect of overvaluations, solving the wage rate inflation, and being the catalyst that would fuel the next leg of this rally to my S&P 500 forecast of 4800 by year-end. The current level of the 10-year yield, (or even if it were higher than it is now), does not automatically suggest much lower PEs if the inflation expectations and term premia remain steady and if indeed productivity were to replace employment as the new engine of growth. Nonetheless, August is usually a tough month for stocks and something could always go wrong. A 5% pullback could occur. Don't let this fool you. The market is healthy. Thus, it would offer an opportunity for those who are bulls to re-engage in growth stocks and high income names at a more reasonable price. The S&P 500 closed at 4464 on Friday, 2.7% lower than the very recent high of 4589.

Macro View cont.

By Hubert Marleau

Disinflation Marches On:

Despite a tick up in overall inflation to 3.2% year-over-year from 3.0% in June, the underlying details point to further cooling. First, the 3-month annualized rate was 2.0%. Second, more than 90% of this increase came from shelter. According to private sector indicators, including Zillow's Home Value Index, the Apartment List Vacancy Index and the S&P/Case-Shiller Home Price Index, shelter costs are heading down big time. Third, China has tipped into deflation with producer prices 4.4% lower than a year ago. Given that China sells a very big chunk of what it makes abroad, the global spillovers could lead to export deflation. Lower Chinese demand would also keep a lid on commodity prices and lessen the strain on the global supply chain. Lastly, unit labour cost will likely be tamed by the ongoing mini-boom in productivity. The NY Fed's underlying inflation gauge for July is closing in on the inflation target. The "price only" measure for July is estimated at 2.3%. Meanwhile, the downshift in producer prices stalled to a year-over-year increase of 0.8%. This may prove to be temporary as there is still scope for compression of margins and downward pressure on the global supply chain from excess capacity in China.

All told, the case for skipping a hike in September has significantly strengthened. The odds are near zero. What is even more intriguing is that CME FedWatch gives a 33% chance that the policy rate will be lowered in January.

However I'm getting a bit concerned about the recent rally in oil prices, which have risen by as much as 15% in the last 2 months. Unfortunately there is a fitting correlation between changes in oil prices and inflation expectations. In this connection, oil stocks could be a good hedge.

Huber Marleau's 'Macro View'

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