To subscribe to our Newsletters www.palos.ca/register

PALOS

Macro View

Issue No. 35 | OCTOBER 10, 2023

CONTENTS

The Time is Now Ripe to Buy Dividends 1

Disclaimer & Contacts 4

By Hubert Marleau

The Time is Now Ripe to Buy Dividends

In the 4 months ended October 6, 2023, yields on 10-year Treasury notes rose 100 bps to 4.80%. Remarkably, this huge and rapid increase did not result from higher inflation expectations, better economic prospects or tighter monetary conditions than those which prevailed back then: credit spreads have hardly changed.

So what caused it? Bond vigilantes who have risen from the dead. The last time they were on their rampage was in the late 1970s and early 1980s. Today, not unlike back then, they still have it in for politicians in Washington, who are unwilling to take action to reduce federal budget deficits. In their view, the continuation of senseless government spending could eventually break something, so it's better to stop them now before it's too late. The catalyst may have been Fitch's sounding a clarion call when they downgraded the credit rating of the U.S. government 2 months ago.

We are not, however, at breaking point, otherwise the auction market for U.S. Treasuries wouldn't be running as smoothly as it is. Nonetheless, rational investors are becoming aware that the supply-demand balance has changed for the worse. Supply is expected to rise relentlessly, while foreign officials are losing their appetite for dollars as reserve, and the Fed will need years to deplete its holdings of Treasuries.

Removal of these two large buyers has created a lot of anxiety about who will be the next players. Unlike central banks and official reserves, private buyers will only purchase bonds for profit. In this regard, demanding compensation over and above what they would earn if they kept money at the Fed overnight for the next 10 years is quite reasonable. That is why private investors want to be paid to accept all the ambiguities around the long-term path of interest rates. This so-called term premium is a foundational, but esoteric concept modelled by economists at the New York Fed. And guess what? In the past 4 months, the NY Fed has established that the estimated term premium rose exactly 100 bps, the same as the aforementioned increase in nominal yield on 10-year treasuries.

The big question now is whether the new term premium, which is currently in positive territory, has risen enough to overcome investors' fear of uncertainties erupting, and that it would reward them sufficiently to take the shot.

Macro View cont.

By Hubert Marleau

I think so. Enough is enough. Thus the momentum toward higher bond yields should fade because they are close to the level considered to be historically normal. The average 10-year bond yield since 1926 is 4.80%, while the average inflation rate was around 3.00%. Yes, we are right now either at, or near, the long-term average - on both counts.

Accordingly, the bond market's beef is neither with inflation nor employment. Except for August job openings and September non-farm payrolls which have been surprisingly strong, the latest batch of inflation prints has been moderate. The overall picture is rather goldilocks-like. Indeed, the swap market sees only 33% odds of a November rate hike.

On the inflation front, the risk that it is about to take off is slim: the Truflation measure, which is updated daily on 10 million items, dropped to 2.4% y/y, while the NY Fed's Multivariate Core trend inflation is 2.5%, with a 68% probability band of 2.0% to 2.9%. A large part of its persistence is housing inflation, which is fully expected to fall precipitously over the coming months. Oil prices plunged more than $10.00 a barrel in the last 5 days, subjectively guaranteeing that Brent crude, the international benchmark, should trade around its $82.50 sweet spot. That is a $7.50 premium above September 2024 contracts and about $10 more than its marginal production cost.

On the employment front, the chance that growth will slack off is good. The Atlanta Fed's GDPNow monitor is estimating GDP growth at 4.9% for Q3, but Q4 looks less rosy. The Citi Macro Surprise Index is still in positive territory, but has slipped from 82 to 50 in 2 months. The laundry list of problems - student loan repayments, credit card and loan delinquencies and high mortgage rates - is putting pressure on spending plans, but jobs are plentiful, without any evidence of any breakdown in labour conditions. September payrolls actually accelerated to 336K, and without undue inflation pressure, either. The modest 0.2% Average Hourly Earnings (AHE) print for September followed a 0.2% August increase, correcting some of the damage from the late spring/summer run of much bigger increases and giving proof to the Fed that wage gains are slowing. The reality is that union workers might look demanding, but they represent only 10% of the workforce and their gains are basically catch-ups. Year-over-year AHE growth dipped to 4.2%. With productivity running at the annual rate of 2.0% right now, its contribution to overall inflation is 2.2%. That target is also 2.0%.

Plus, gold is not buying into the idea of a second inflation wave, which explains why its price is relatively stable; and by the same token it's refusing to follow the lead set by real yields because prices are falling. The relative stability of gold tells me players are subscribing to the narrative that the 10-year Treasury bond yield should settle around 4.75%. Money market funds are taking in massive amounts of money: $64 billion just last week.

Macro View cont.

By Hubert Marleau

Given that 10-year Government of Canada bond yields are around 4.20%, my preference is for high-quality dividend stocks that provide cash returns in excess of 5.00%, such as Utilities, Telcos, Staples, and pehaps Reits and Financials, as long as they have acceptable pay-out ratios, strong balance sheets, free cash flows, operating efficiencies and reasonable pricing power. On an after-tax basis, a 6.00% dividend yield is equivalent to a 9.00% bond yield. Of course, there is no magic formula to incite investors to buy dividend bearing stocks, but a 300 bps advantage is definitely alluring, especially when BAA bond yields are only 170 bps more than the 10-year U.S.bond yield of 4.80%.

Moreover, we are currently experiencing a rarity: the yield curve is flattening not because short-term rates are falling, but because long-term rates are rising, a phenomenon called bear-steepening that has always been followed by significant falls in 10-year government bond yields. This could happen sooner than expected because the Fed may decide on any given day to postpone its QT operation and/or stop paying interest on excess reserves, forcing banks to buy bonds.

The stability of the bond market is a less known responsibility of the Fed. The rout in the market cannot go on in perpetuity because it would imperil the balance sheet of too many banks. Moreover, the current level of bond volatility is creating havoc in the financial system and is unsustainable, according to Harley Bassman, the creator of MOVE, a widely cited bond volatility index. In this regard, I strongly suspect that the relative performance of cyclicals versus defensives will soon change as money flows start to favour yields over growth.

Meanwhile, as expected, the S&P 500 has closed in on its 200-day moving average of 4200 because the stock market is in a state of extreme fear, according to CNN's “Fear and Greed” index. Inspired by unruly bond yields, Charlie McElligot at Nomura has calculated that mechanical selling by systematics - to the tune of $50 billion - accounted for the vast majority of the outflow from stocks. From a contrarian point of view, that could be ground zero for a runup to 4600, since better-than expected Q3 earnings should give the bulls better news to work with, as many executives seem more comfortable in guiding the street. At the close on Friday, the S&P 500 closed at 4308, up 24 points from last week.

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., "Palos"). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos' written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. "S&P" is a registered trademark of The McGraw-Hill Companies, Inc. "TSX" is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market value weighted index engineered to measure publicly issued noninvestment grade USD fixed rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM. Palos Funds are not available for non-Canadian residents.

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

4711 Yonge St, 10th Floor
Toronto, Ontario M2N 6K8

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca