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The Palos Perspective

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A Macro Market View by Hubert Marleau

The Vociferous Debate

The Stock market is set to experience a record-breaking year. So far, $450 billion has flowed into US equity funds on a net basis, explaining why the S&P 500 has hit no less than 50 record highs. Investors have also injected a massive amount ($1.1 trillion) of their savings into money market funds, pushing the overall amount to $6.7 trillion. The big question investors are asking is: should they let the good times roll or should they be worried? There is clamorous controversy about whether some of the hoard parked on the proverbial sidelines will now find its way into the stock market and other risky assets, like higher-yielding ones such as credit notes and corporate bonds. There was actually a $22 billion outflow last week: the first one since June.

The bearish crowd is focused on towering valuations and the potential of an inflation shock whereas the bullish one is concentrated on the easing path of monetary policy and the probable blossoming of productivity.

The bears maintain a plausible case that valuations could fall. Since the S&P 500 reached the all-time high of 6001 two weeks ago, the market has struggled for direction. Regardless of the method used, valuation measures such as the 12-month trailing P/E multiple, forward 12-month P/E multiple or Cyclically Adjusted Price/Earnings ratio (CAPE) are very lofty - about 22.5% higher than historical norms - because the bulk of the increase in these metrics has been mood-driven confidence that growth will last. As a result, the Oracle of Omaha has bulked up his cash position because present circumstances show his favourite valuation gauge - the ratio of the stock market's value relative to the size of the US economy - to be at a record high. The bearish argument is fear that the market would not be able to withstand an inflation shock that an across-the-board tariff increase, tax cuts, higher fiscal deficit and deportation of immigrants could maybe bring about. In their regard, the Trump stock euphoria could fizzle.

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The bulls, on the other hand, hold a very different perspective. They have allied with the Fed's monetary authorities (Austen Goolsbee, Michelle Bowman, Lisa Cook, Susan Collins, Tom Barkin, Jeffrey Schmid, et al) in believing that the disinflationary trajectory is still in place to attain the 2% target, allowing additional interest rate adjustments to close in on the neutral rate (4.30%). In this regard, a 25 bps interest cut would bring the lower end of the policy rate to the neutral level and, in turn, eliminate what remains of monetary tightness, thanks to faster productivity growth and restoration of dynamism. AI is in the process of changing everything and will likely be the source of a lot of new technologies. John Williams, who heads the Federal Reserve Bank of New York, thinks that AI satisfies the requirements of becoming a general-purpose technology. That is the kind of stuff that can generate an array of broad applications that automate white-collar work, change how businesses do things, revolutionise the financial-services industry, and efficiently organise the economy. Thus, if the Trump administration does deliver corporate tax cuts and reduce regulatory red tape as promised, barriers to construction of data centres, energy production facilities, and electricity transmission systems to back AI infrastructure – power, chips, software – would facilitate the transformation.

Here is how I look at it. Given that S&P 500 Index's dividend yield is 1.3% and its prospective buyback yield is 2.0%; and assuming that corporate revenue will closely match the expected growth in nominal GDP - 2.5% for inflation, 2.0% for productivity and 0.5% for employment - the benchmark would increase 8.3% without any consideration of higher profit margins - albeit almost every market strategist believe they will. Understanding that it took 5 years for forward P/E multiples to increase from 16.5 X to 22.5X, by shaving 1.2% off the P/E multiple, I end up at a minimum of 6450 for the S&P 500 in 2025. The street, meanwhile, is generally much more bullish than I am. The percentage of S&P 500 companies with positive 12-month percent changes in forward earnings is almost 80%. What is intriguing, is that Morgan Stanley has jumped on board the U.S. train with an overweight rating on U.S. stocks, targeting 6500 by 2024 and 7400 next year.

As it is, in the week ended 11/22, the S&P 500 rose 99 points or 1.7%.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$9.10	18.61%
Palos Equity Income Fund - RRSP	PAL101	$7.75	16.30%
Palos WP Growth Fund - RRSP	PAL213	$11.18	18.81%
Palos Global Small-Cap Equity Fund[2]	PAL251	$9.81	-1.44%
Palos-Mitchell Alpha Fund[3]	PAL300	$11.56	14.39%
S&P TSX Composite (Total Return with dividends reinvested)			22.52%
S&P 500 (Total Return with dividends reinvested)			25.55%
S&P TSX Venture (Total Return with dividends reinvested)			8.82%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.40%
Canadian Government 10-Year			3.33%
Crude Oil Spot			US $69.39
Gold Spot			US $2,631.00
US Gov't10-Year/Moody BAA Corp. Spread			143 bps
USD/CAD Exchange Rate Spot			US $0.7165

[1] *Period ending November 19th, 2024. Data extracted from Bloomberg*
[2] *Fund is priced montly*
[3] *Fund is priced weekly on Tuesdays*

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