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The Stock Market Took a Breather

I ended last week's commentary with two notes:

1. The Stock Market Dodges Bullets: *"The stock market has not flinched in the face of such outrage, because it has kept firmly focused on business profitability. In fact, corporate earnings growth has kept on humming, only a few specific parts of the economy - like the auto and construction industries - being hit by higher interest rates. With 70% of the S&P 500 quarterly reports now in, Q4 earnings growth is estimated to have risen 15.1% y/y, up from an estimate of 9.6% at the start of January. This is on track to be the highest since the end of 2021, because personal expenditure on goods and services, plus capital spending on AI infrastructure sectors remain strong. On Friday the S&P 500 closed at 6112, marking a weekly gain of 1.5%. However, if Trump's policies on taxes, deportations and tariffs were pursued to their fullest, the inflationary impulse would be inescapable. I can already smell the rat. In this regard, a bearish equity trade would likely occur if an overcast of fragility events burst. Investors should therefore take note that even if inflation refuses to die, the best hedge over time is dividend-paying stocks: from Q1/1989 to Q4/2024, dividends rose 648%, almost 500% more than the CPI. This tells me that dips caused by algorithm-run quant traders should be bought by those seeking returns."*

Although 57.4% of investors, according to the AAII survey, expect that the mere talk of new trade policies may be sufficient to slow growth and increase prices, investors have not yet turned their back on the stock market. The uncertainty about where US trade policy is headed, however, is troublesome. A serious escalation in the Skew index, which measures the tail risk of significant deviations from average returns, has now occurred, perhaps because the cash levels among professional money managers are near 15-year lows. The S&P 500 took a breather last week, declining 1.6%.

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However, the market is not ready to cry wolf just yet over the threat of tariffs. While there is some evidence to support the argument of a muted fallout, these may be nothing more than negotiating tactics. Indeed, implementations have been delayed and, therefore, u-turns are possible. They have actually helped to lift stock prices and contain volatility because they might come to nothing or not much. The VIX, dubbed the market's "fear gauge," is 15.0 versus the 19.5 historical average, even though bears are seemingly outpacing bulls by a considerable margin.

The fact of the matter is that the present stock market may not be as overpriced as many overpaid market strategists proclaim. Research Affiliates has conducted a study entitled "Current Constituents Cape" (CC-CAPE), which shows that Robert Shiller's 10-year CAPE ratio, used popularly as a valuation metric, is flawed. By keeping deleted stocks earnings, which are always down on their luck, in the Shiller's CAPE traditional calculation, the P/E ratio is both biassed and wrong. By contrast, if replacement stocks, which are invariably riding high, are included for a full 10 years, the predictive power of the CC-CAPE is significantly superior. And, when the traditional CAPE is combined with the spread between CAPE minus CC-CAPE, the composite's conjecturing power is awesome.

The message here is that the stock market is far less overvalued than many believe; and instead of facing a red light, investors may just be facing a flashing yellow one. Nonetheless, while optimism is not in a crisis, the uptrend is slowing, as both 6- and 12-months moving averages have declined with the profit cycle turning lower, thereby explaining directionless trading. The thing is that we may have entered the last leg of the bull market (which should, however, still last between 3 to 5 years based on previous experience).

Contrary to consensus belief, big tech companies (GOOGL, AMZN, NVDA, MSFT, AAPL, AVGO, IBM) continue to be under owned by active managers. In this connection, the latter will likely be tempted to ride these stocks to rebalance their portfolio. Moreover, according to the BofA, upcoming de-regulations for consumer goods, large banks, the commodities sector, transport, and capital goods, are not priced in, because they are trading at deep discounts to regulation-light groups like technology, media, telecoms, and professional services. Thus, we are still in a bull market until proven otherwise. Interestingly, 71% of the time the S&P 500 goes up a median of about 8.0%.

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Correlations between the risk effect of widespread tariffs and financial markets will occur when everything is expected to go down, especially inflation and growth. This message will be broadcast by the bond market, where everything is taken under consideration. In this connection, watch credit spreads. If these were to start to widen meaningfully, watch out. Presently, yield spreads between corporate bonds rated Baa (5.90%) and 10-year Treasury notes (4.55%) is 135 bps. They are historically very low, normally around 275 bps. For example, 6% of U.S. government spending is funded with borrowed money, compared to only 1% for Canada. While I agree with the Brookings Institute that the US debt will not likely become a crisis, it nonetheless explains the narrowness of credit spreads. The fiscal deficit has transferred wealth and growth to the corporate world, where stability appears to be much better.

The issue here is the undeniable fact that trade relations are purely transactional and pragmatic: just business. There are no friends in trade deals between nations, and trust comes from mutual interest. This lonely point makes me confident that the USMCA will stand because rationality tells me the beautiful combination of cheap labour (Mexico), mineral abundance (Canada), and technology (U.S.) brings comparative advantages that no other areas in the world possess. I cannot believe that MAGA can afford to let all hell break loose on USMCA.

2. New Gold Dream: Again from last week's Commentary, *"Although many opine that Trump is more interested in securing political victories and public attention, one should not be without some protection. This is why Palos, for example, has upped its exposure in gold to 7% when rising odds of a Trump win looked unstoppable. Gold, whether physical or digital, offers insurance against a possible dawn of a new world monetary order based on commodities, triggered by the uncertainties of cost and chaos that global tariffs could bring (Think of the Scramble for Africa and the desire for natural resources). It follows that gold has made gaudy gains without the help of either lower interest rates or the exchange value of the dollar."*

Donald Trump has sparked a gold rush with his threatened trade war. The fear of imposing tariffs on imported gold has ignited financial institutions to get their hands on it physically, viewing it as a geopolitical hedge, dollar hedge and inflation hedge. This phenomenon has upset the usual

international functioning of this highly free market. For one, the price of gold in London has dropped as the price of gold futures in NY has risen, creating a rare opportunity for arbitrageurs to make money off the difference by importing gold to the vaults of the Comex commodity exchange, JPMorgan and HSBC in NY. So far, no less than 393 metric tonnes of gold have been moved. I suspect, however, that the price premium that NY currently commands would likely evaporate should Trump opt for no tariffs, bringing about a knee-jerk reaction. While this may be true, the long-term outlook remains bullish, because China, Iran and Russia and others are scooping up more gold to diversify their international reserves away from the dollar. China gold reserves as a percent of total foreign reserves are 6.5%, for example, compared to 3.5% at the end of 2022. In this latter regard, given that bullion is in short supply vis-a-vis paper gold, and rumours that Bessent may decide to reevaluate the Treasury's considerable pot of gold, gold bugs continue to favour the metal, with ambitious price targets of $4000 per ounce this year and $5000 in 2026. With gold loitering around $3000 an ounce, the value of the US gold reserves in either scenario would create on paper a windfall exceeding $750 billion, presaging a write-up of America's balance sheet.

On the Economic Front:

It was a slow week for macro watchers. The shortened week was sparse for economic prints, too. Yet, New York and Philadelphia regional business surveys suggested that a rolling recovery in the manufacturing sector may be underway, with both January readings entering expansion territory for the first time since late 2022. Moreover, both initial and continuing unemployment claims are subdued, and solid hiring in the private sector is keeping the unemployment rate low.

The NY Fed's GDPNow model estimate for real GDP in Q1 of 2025 is 2.9% while the swap market is predicting that inflation will average 2.7% over the next 5 years, with the possibility of 4.0% in one year's time. Given the good chance that expected deregulation and tax cuts will keep animal spirits high, coupled with the possible effects of potential changes in trade and immigration policies on inflation, the FOMC participants at the Fed's January meeting were therefore in no mood to cut interest rates. Indeed, according to the CME Group's FedWatch tool, there is a 98% chance of rates staying the same for a while longer. The Fed is on hold until further notice.

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