PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

What a Week: From Peak Uncertainty to High Risk Stocks Liked the Big Rescue Plans But the "Infected Curve" Must Bend

Submitted March 28, 2020

In self-isolation I wrote this letter on the shore of the St-Lawrence River and luckily not in claustrophobic conditions, wondering if the North American stock markets have bottomed.

I'm sure that investors already know that current business activity is very ugly and therefore have appropriately discounted the ugliness. If that is true, then we have gone from peak uncertainty to high risk. Future economic performance from hereon will depend on when, how and what kind of economic recovery we are going to have. Economists love to use letters to express their economic outlook when they are incapable of giving an opinion based on conventional theory backed with facts. They use letters. The question is whether the path of the real economy will look like a V, U, or an I; and will this come with more or less inflation.

Today, we obviously have an I-shaped economy. This week's report on initial jobless claims, a high frequency hard data on the state of the job market, showed the severity of the economic hit from the virus-spurred shutdowns---3.3 million people filed for unemployment insurance. The March unemployment rate will rise to 5.5% and to 10% in April. Be patient, in time the economic path will take one of the other shapes--- it will start to show up in June.

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Eventually, we are going to get a recovery shaped letter with an inflation rate that will run moderately below the Fed's 2.0% target. And that completely depends on whether the efforts of the public health authorities can successfully limit the damage caused by the coronavirus or on whether the government can successfully convince the public that enough has been done to permit a return to normal business. The fiscal rescue plans of governments and the monetary packages of central banks are large enough to fend off a global financial and economic crisis. Why? The measures are organized in a manner to ensure that 1) those who lost their jobs will be taken care off and meet their bills, 2) businesses in the interim do not fail, enabling them to keep their employees and to re-rehire those who lost their jobs and 3) there will enough fiscal and monetary stimulus left to support a recovery.

Consequently, whether we are going to get a V or U-shaped recovery will depend on when the U.S. economy is ready to be opened up.

If one works on the assumption that the fight to contain the virus will have some success in flattening the curve and then bending it, an economic recovery of some sorts will occur. Serious observers of the pandemic have manifested optimism that the disease will be controlled and perhaps disappear in next three to six months. A new disease-modelling study from the University of Oxford suggests that the majority of coronavirus infections are so mild as to have passed unrecorded by the authorities and even unnoticed by the people infected. If this is true, many already have had the virus and probably developed some degree of immunity. While I like the possible idea that herd immunity is within reach, it may be good enough to say peak uncertainty has passed but not good enough to say the risk has gone. Nevertheless, I have my own set of reasons why I think peak uncertainty is behind us.

The reasons are:

1. People are increasingly isolating themselves.
2. Epidemics are usually seasonal, and they don't like warm weather.
3. People are being tested faster and in larger numbers.
4. Facilities are opening up so that infected cases can be separated.
5. Ordinances to assure that people desist from going out are issued.
6. Punishments will be imposed on people who disobey.

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7. Tracking movement of diagnosed people through cell phones.
8. Huge amounts of work, time and money is being spent on finding a preventive vaccine and a therapeutic medication. It won't be in six but probably faster than it usually does.
9. Many factories are rapidly converting their production into a variety of protective equipment. Deep-pocket companies like Apple, Facebook and Salesforce are using their clout to source supplies. Ford, 3M, GM and Tesla are tapping their supply chains to build ventilators and N95 respirators. Apparel companies are retooling to make masks and protective garments. Distillers are making hand sanitizers.
10. Innovations as to how to deal with the pandemic are rising. For example, Kinsa Health is making and selling millions of smart thermometers that act as an early warning system for illness spreading.

The bottom line is that people are coming together on this big one. They are willing to endure unavoidable economic, political and social pain, if they believe that the government and industries are on the case. That is the attitude that the populace must have to win the war. A new model was released at the end of last week by the University of Washington's School of Medicine. It is one of the first to forecast a national peak. I would not put all of my money on that bet. Nevertheless, it projects that the peak in daily deaths will arrive in mid-April, and the tail of that curve, subsiding below 10 daily deaths, will arrive by the first week of June.

The infected curve will bend because it is what humans want--Their Lives. Without life there is no society, no economy, no politics. Westerners are accustomed to their comfort and will accept the installation of any unconventional solutions even if it increases the chances of a lot of inflation down the road. As Yuval Harari puts it, "there are no gods in the universe, no nations, no money, no human rights, no law and no justice outside the common imagination of human beings." We have a lot of the latter.

The curve will someday bend and that will be the day when the general population accepts a very offensive trade-off--sacrifice the elderlies for the sake of the economy. The idea is reprehensible but there is research that shows that recessions tend to lead to more deaths and shorter lives. John Authors pointed out in Bloomberg that Philip Thomas, head of risk management department at the University of Bristol, wrote a paper using the "J-value GDP constraint" mathematical technique developed for measuring the cost-effectiveness of safety measures. He showed that an early 12-month lockdown with widespread vaccination at the end would limit deaths to a number below what might have been expected from flu in a typical year---but at a massive economic cost. His work shows that lives saved by a year-long lockdown would be more than counterbalanced by a later

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fall in life expectancy. John did not question the assumption, but he put it out there. I unequivocally think that the trade-off will become a political debate, probably when the infectious curve starts to turn or when level of physical restrictions on individuals become intolerable.

Does anyone believe the "below 70 years old cohort" will go about without cars, work, homes and smartphones for an endless amount of time? Absolutely not! The U.S. has 11.2% of its population over 70 years and Canada has 12.4%.

In last week's missive, I suggested that the market is going to know if we are coming out of the woods before us. According to my figures, we have had four capitulation episodes since February 19 when the stock prices topped off at 3386. On March 23, the S&P 500 closed at 2237 for a decrease of 35.4%. Since then the index has increased 10.3% to close at 2542 on Friday. In large part the rise in the S&P 500 is due to rebalancing of portfolios away from bonds to equities, deleveraging that occurred over the course of the rout, along with covering and flipping toward long positions by CTA.

Interestingly, it normally takes about 6 months for the stock market to go from a top to a bottom and about 18 months from bottom to the previous top. If this ratio were to hold as well as it has in history, stock prices may gradually recover in three months from the losses registered in the four weeks prior to March 23. I'm not predicting that this will happen. I just want to note that recoveries can be unexpectedly swift when valuations are perceived to be abnormally low.

I also made the point that stock market investors will need confirmation from the bond market, the commodity markets and the foreign exchange markets before they go all in. Thankfully, we are getting two positive signs and one negative one. The yield curve has normalized because the central bank is controlling it and the greenback has fallen 4.2% from last week's peak because the Fed is feeding the swap markets with dollars. The dash for cash may have slowed down or the dollar shortage may have lessened. Unfortunately, we are not getting good vibes from commodity prices. Copper, lumber and oil prices are not rebounding. From February 19, the CRB Commodity Index is down 29%. Since commodities reflect present demand and supply, many consecutive price upticks are compulsory, if we are going to see smooth and steady increases in the forward price of equities. While financial conditions were calmer for three days in a row, the reality is that only better

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health data can bring a sustainable recovery. At some point, the infection curve will flatten and then bend. Unfortunately, we are probably weeks away from getting overall positive signals on the coronavirus front.

What is somewhat encouraging is that in spite of a worldwide fiscal and monetary stimulus of humongous proportion, market measures of global inflation expectations are languishing near record lows, below central banks' inflation target of 2.0%. Inflation expectations--the 10-year "break-even" rate, which is derived from prices of inflation-protected government securities--climbed from the low of 0.56% to 1.01%. It means that the present increase in inflationary expectation has not risen enough to invite criticism from the Committee for a Responsible Federal Budget, an ultra-conservative gallery that campaigns for fiscal probity. As Kenneth Rogoff, Harvard University professor, said: "In war time if you have a lot of aircraft carriers, you don't hold them back." Everybody is going along with this idea because we are facing once in a 100-year event.

Similar Conclusion to Last Week: Sticking with the Same Investment Strategy.

In a few months, the saying will be "I knew that exciting opportunities existed. It was in front of me, but I opted to wait a little longer because I wanted full-proof that I was not about to make a costly mistake."

The problem with confirmation bias is that it is an afterthought and associated with the want of being certain about something when everyone also else is. The problem is that during bear markets, it feels like it's too late to sell and too early to buy. That is why timing right decisions is difficult. Yet, if one's goal is to obtain superior market returns, one must be a contrarian. In this respect, I am still nibbling at every drawdown imitating the behaviour of insiders—slowly adding to our portfolio undervalued securities that offer either safe dividend rates and/or superior capital gain potential.

I strongly suspect that publicly traded investments will overshadow private equity in the future to diminish liquidity concerns. Some say it could become an imposition on public funds. I would be more willing today to own listed stocks that a central bank could legally buy than illiquid investments that can take months to sell. Since the great recession, we've turned the economy into a balance sheet. Think of this one: if businesses had no borrowings other than to finance inventories and receivables, meaning that equity would be the only way to finance long term investments-- would we have a liquidity problem?

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N.B.1--Former Chairman of the Fed

Ben Bernake said: "it's a major snowstorm or a natural disaster". Bernanke professionally studied the depression era and orchestrated the monetary response to the 2007-2008 financial crisis. I prefer to accept his opinion on this matter than the cheap comments on social media. He mentioned on CNBC that what we have now is a very different animal from the Great Depression (GD). He is right. The GD lasted for 12 years and came from monetary and financial shocks that were provoked by humans who had a limited understanding of what was happening and how to handle it. He went on to predict that the current contraction will be sharp, but the the recovery will be quick

N.B.2--Chairman of the Fed:

Jerome Powell made the point on NBC that the U.S. is not having a normal recession because there is nothing fundamentally wrong with the economy. He said: "In situations like the present we do have the ability to use our emergency lending authorities and the only limit on that is how much backstop we get from the Treasury department." The Fed has the guarantees. The bottom line is that the Fed has the capacity to step in and provide credit where capital markets have simply stopped working. The Fed will keep doing that aggressively and forthrightly for as long as needed. In other words, when it comes to this type of lending the system will not run out of ammunition. He reassured market participants that it will not happen.

N.B.3--State Capitalism

As a believer in libertarianism and an admirer of Ayn Rand, I regret to say that Mario Draghi is right that we are heading towards state capitalism. In order to save the capitalist system from itself, large amounts of private debt—corporate and household--will be canceled and replaced with state debt, at the expense of private freedom. It's a new feature of the economy. There are two new priorities. One is to provide money to those who lost or will lose their jobs and protect productive capacity and employment. Fiscal and monetary packages are being put in place to make sure that businesses can cover their operating expenses and the unemployed can pay the rent and buy food. It's all about quickly channeling liquidity to those who need it. This is what is going on right now.

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N.B.4--Inflation on the Rise

The anticipated rise in unemployment combined with the decrease in global commodities like oil will certainly hold down inflation for next few quarters. However, the aftereffects of the worldwide fiscal and monetary effort should bring higher inflation. I have two basic reasons that support this conjecture. Firstly, during WW11, the wartime budget deficits bought material, built plants and employed women, which created income. Moreover, spending was rationed, and savings were promoted, leaving a lot of money to finance the deficits. The current budgetary deficit is about supplementing the loss of income that workers and businesses are incurring--caused by government-mandated shutdowns. This time the shortfall is going to be covered by the Fed or by foreigners who want to park their U.S. dollars. Secondly, globalization is on the run and will be curtailed as supply chains are being relocated to avoid crossing borders and for national security rather than to maximize international comparative advantages. It is therefore very possible that we may face a generational inflection point later in 2021, turning the inflation rate from deceleration to acceleration. Investors should at some point carefully consider buying companies with hard assets because they have embedded inflation protection and avoid bonds.

Looking at the 11 Sectors of the S&P 500 by the Numbers:

Name	Index Weight	10-Yr Annualized Total Return	Current Dividend Yield	P/E	P/B	P/S	Comment	Dependency
S&P 500 INFO TECH INDEX	25.6%	17.59%	1.6%	22.67	6.40	4.38	Growth	Future
S&P 500 HEALTH CARE IDX	15.3%	13.55%	2.1%	18.80	3.73	1.53	Growth	Age
S&P 500 FINANCIALS INDEX	11.0%	10.37%	3.3%	9.36	1.00	1.58	Neutral	Interest Rates
S&P 500 COMM SVC	10.5%	10.10%	1.7%	17.78	2.73	2.49	Growth	Innovation
S&P 500 CONS DISCRET IDX	9.8%	16.03%	1.7%	20.14	6.51	1.40	Growth	Inequality
S&P 500 INDUSTRIALS IDX	8.2%	11.83%	2.5%	14.00	3.59	1.32	Cyclical	Exports
S&P 500 CONS STAPLES IDX	7.9%	11.03%	3.2%	18.65	5.40	1.37	Defensive	Population
S&P 500 ENERGY INDEX	2.5%	0.74%	8.6%	9.93	0.76	0.53	Cyclical	Gas & Oil
S&P 500 UTILITIES INDEX	3.7%	12.06%	3.7%	15.08	1.99	2.43	Defensive	Bond Yields
S&P 500 REAL ESTATE IDX	3.0%	10.62%	4.0%	38.75	3.07	5.70	Defensive	Population
S&P 500 MATERIALS INDEX	2.4%	7.98%	3.0%	15.46	1.85	1.36	Cyclical	Global

Source: Bloomberg

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