Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights bullet points - June 17, 2021

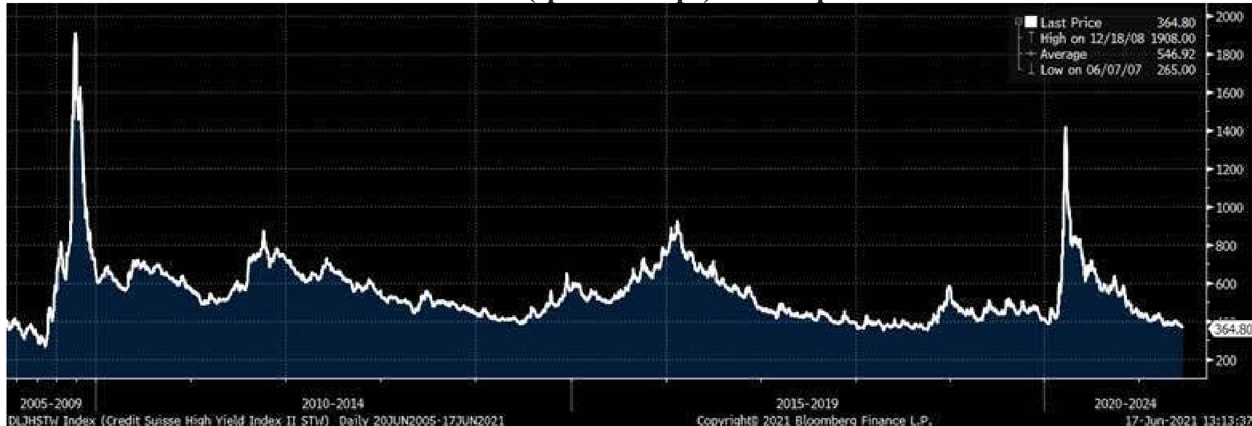
1) There are two prevailing narratives about the FOMC meeting: a) The FOMC effectively tightened policy by bringing the dots forward, and b) As a practical matter the FOMC didn't do much of anything, because simply saying "we are hiking in H2 2023 instead of in 2024" still implies loose monetary policy given where commodities and CPI are today.

For the moment, investors are focused on the pulling-forward of the dots. One could look at today's carnage and call it a correction in a bull market, though objectively speaking some of the charts do look pretty bad. The CPI breakeven chart in particular looks weak, as does copper.

COPPER (purple) vs. 5-YEAR CPI BREAKEVEN (white) -- 5-year chart:

2) Crucially, junk yields didn't budge in the wake of the FOMC meeting -- meaning the Fed's comments were not interpreted as anti-growth. That marks a distinct difference with the last two ill-fated rate-hiking campaigns (2015 and 2018). So by this measure the Fed is certainly not *above* Wicksellian neutral in its positioning (literal and rhetorical). That's good. (H/t Darda.)

CREDIT SUISSE HIGH YIELD INDEX (spread in bps) -- 2005-present:



3) So … what is the Fed's current positioning *vis a vis* the neutral rate? Intuitively one would want to say "below it" (zero rates + hot economy) … but it's not quite that simple because the Fed's own behavior, biases and historical tendencies have a huge impact on where neutral ultimately resides. In theory, one

could argue that the Fed, just by signaling a mild decrease in looseness, is tightening policy more than it realizes. For, absent a relentless commitment to symmetrical 2% PCE inflation, what can investors be left with other than the expectation that the Fed will go back to targeting unemployment, and that demographics and debt dynamics will do their part as well in pulling the neutral rate back to zero in short order?

At the same time, it's hard to construe "We are going to hike in two years" as being tight policy. So, let's see how bonds evolve in coming days and weeks. If junk isn't moving, it suggests the 10-year yield may not need to price in a deflationary error. (But still … the 30-year yield may look further around the corner and see a sign saying "Wicksellian zero: five years ahead.")

4) My base case is still that the Fed will target unemployment. As unemployment falls toward 4% (and U-6 unemployment falls toward 7%), the Fed's desire to run easy policy is likely to fizzle. There is really no constituency for sustained high CPI in the US. The chief sources of new wealth (and power) creation in the US are the technology industries, which of course benefit from low interest rates and cheap commodities. It's the same today as in the 2010s and 1990s (and 1890s for that matter).

The open question is how long it will take for U-6 unemployment to get back to 7-8%. Last time, the trip from 10% to 8% took nearly three years. This time it may happen faster. Or not. It does seem as though it should be at least 18 months based on the historical chart:

US U-6 UNEMPLOYMENT RATE -- 2005-present:

5) It's fascinating to see some less-financialized commodities buck the downward trend, at least for now. These include steel, thermal coal and boxed beef. These commodities offer a helpful reminder that there is a real world in which supply and demand for actual stuff intersect. Of course it still could be that these will "do a lumber" and implode.

I have a client who argues that it's crazy to think that steel, after a 10-year bear market, will have a 6-month bull run and then just go back to the old bear market price. Steel capacity may be maxed out for years. That's a fair point. (Maybe there were bullish global mega-trends afoot before the plandemic was launched, and maybe these will re-assert themselves now?)

6) The IEA is calling for OPEC+ to increase oil production -- at the same time G7/Davos are calling for the end of the fossil fuel industry and the ESG crowd is ramping up pressure against hydrocarbon investment. This is the sort of conflict (megalomania vs. common sense) that could send oil over $100/bbl.

It's sort of interesting to plot copper vs. Brent crude: They diverged sharply in 2014 and again in 2020, both times with copper getting stronger relative to oil. The 2014 divergence may reflect the shale boom, and the 2020 divergence may reflect copper's greater degree of financialization relative to oil. If so (and this is really just thinking out loud) perhaps oil will outperform copper for a while, at least during the current corrective phase.

COPPER (orange) vs. BRENT CRUDE (white) -- 2001-present:

7) Lastly, I took a look at Canadian steelmaker Stelco, which I hadn't thought about in a decade. It's a fairly generic, Ontario-based producer of hot-rolled, cold-rolled and coated steel. Sales are on track for about US$3.2 billion this year, making it about 1/5th the size of US Steel or Cleveland Cliffs.

STLC CN – 33.95

all data in CAD

Sales and earnings

	2020	2021e	2022e	2023e
Sales (mlns.)	**1517**	**4012**	**3753**	**3726**
Sales growth		164%	-6%	-1%
EPS	**-1.89**	**13.78**	**11.48**	**11.19**
Cash flow	-1.15	14.69	12.44	12.21
FCF	-3.70	12.43	9.62	8.83
Cons. EPS		13.80	5.07	3.06

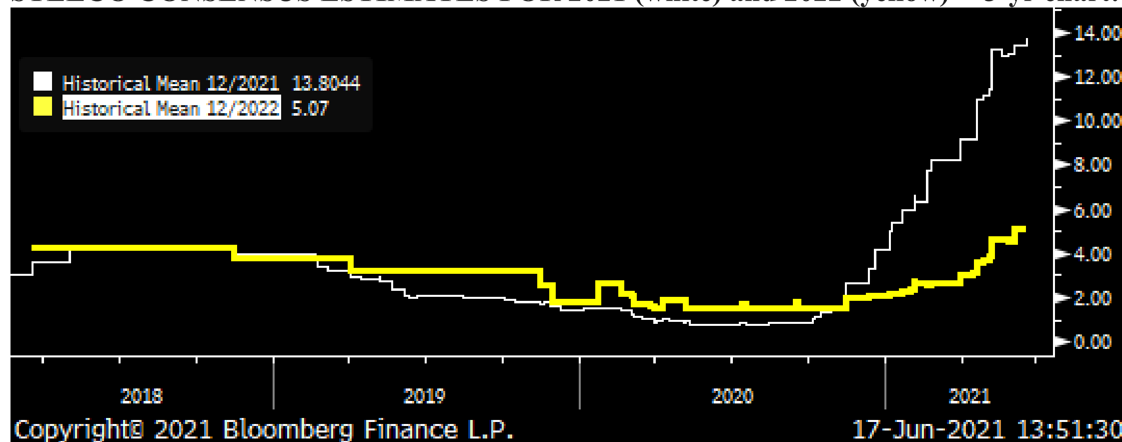
cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

Target price & valuation data

My 12-mo. target	50.37	(based on 4.5x 2023 EPS)	
Upside to target	48%		
		Div yield	1.2%
Mkt cap (mlns.)	3,012	EV (mlns)	2,227
P/sales (2021e)	0.75	EV/sales (2021e)	0.56
P/E (2021e)	2.5	EV/EBITDA (2021e)	1.2
P/E (2022e)	3.0	EV/EBITDA (2022e)	1.4
P/E (2023e)	3.0	EV/EBITDA (2023e)	1.4
		Price/book	7.70

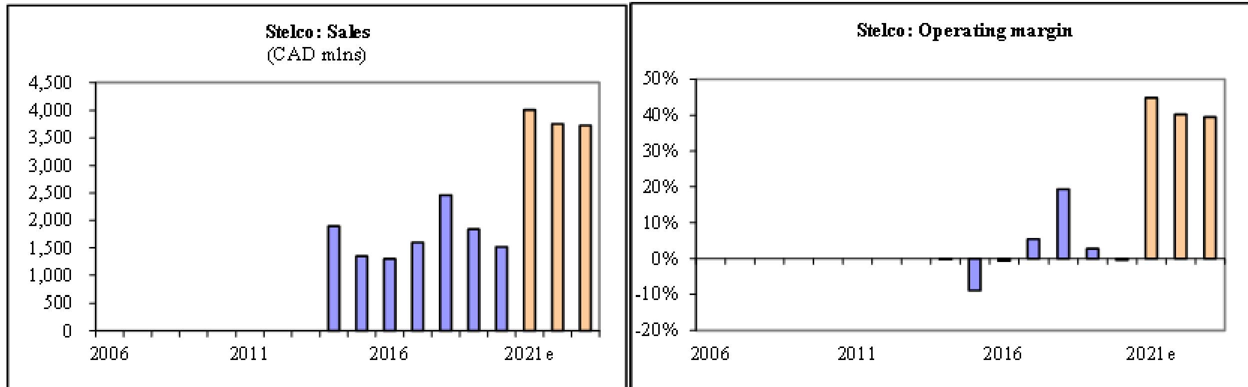
As with Cliffs and US Steel, consensus expects Stelco earnings to implode next year, falling to C$5.07/share, down from C$13.80/share this year.

STELCO CONSENSUS ESTIMATES FOR 2021 (white) and 2022 (yellow) -- 3-yr chart:



The challenge with the Stelco model is that operating margins are on track to run at 40% this year. That's pretty outlandish. Just on that basis I'm sympathetic to the argument they will fall -- perhaps quite a bit.

Still, even my model only assumes US$1,200/ton HRC steel this year, falling to US$1,100 in 2022 and US$1,050 in 2023. Right now 3rd month HRC is US$1,730/ton and 9th month is $1,280/ton. The 12th month future is US$1,124, so my EPS estimate for 2022, at C$11.48/share, is actually a bit below the figure implied by the curve. (Yet it's still twice the sell-side consensus.)



I'm going to add a bit of Stelco to the portfolio.

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