CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

JULY 2021

"**Half-time!**" At the turn of last year, we wrote that we could look forward to a new, more optimistic outlook. This perspective was shaped by factors that included vaccine developments, a brightening macroeconomic outlook, a supportive policy backdrop, inventory rebuilding, pent-up consumer demand, relative political calm, a modest normalization in interest rates, and a softening US dollar that we saw helping exporters and emerging market economies. As we stand at the halfway mark of this year, with the heat reminding us of the shifting seasons, a transition of sorts is coming into focus that suggests we are moving away from a stimulus and normalization fueled growth spurt to something that is more sustainable and enduring.

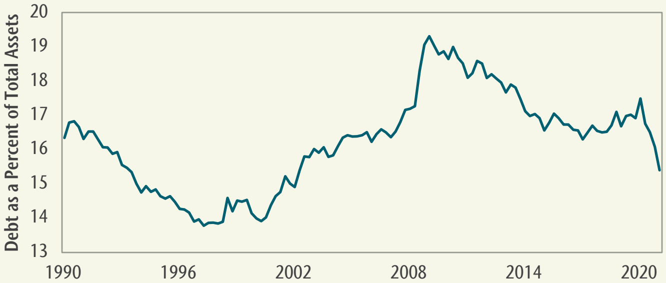
GROWTH DOWNSHIFTING ...

The recovery is becoming more widespread globally, with growth forecasts revised up for regions where vaccination programs are ramping up, such as Europe and emerging markets outside of China. Where vaccinations have already been most successfully deployed including Canada, the United Kingdom and US, the lifting of restrictions is already underway. Indeed, projections for second quarter GDP in the US currently run at around 10% at an annualized pace, powered by a reopening of the economy. However, high frequency economic indicators like industrial production, auto and housing sales, job gains, and retail sales are all showing growth rates decelerating from prior months. Fiscal stimulus is looking to slow as government cheques are replaced by medium term infrastructure investment, and in fact a further tempering may occur via tax increases.

... BUT LIKELY TO BE WELL SUSTAINED

While during the past year, layoffs coupled with school and business shutdowns have undoubtedly been difficult, households' finances, at an aggregate level, are as strong as they have been in years. In both the US and Canada, savings have surged, leaving households accumulating savings of a massive 9% to 10% of GDP. Interestingly, despite all the pent up demand, surveys conducted by the Federal Reserve Bank of New York have suggested families intend to save, invest, and spend in roughly equal proportions. A similar Bank of Canada (BoC) survey suggests Canadian households intend to save even more, nearly half. What has been remarkable, however, is that while Canadian household debt levels have also risen over the past year, the magnitude of the debt accumulation has been dwarfed by the rise in household net worth, according to the latest National Balance Sheet data. In total over the five quarters since the pandemic began, assets have grown by $2.1 trillion, of which $1.39 trillion is physical assets, largely homes. In comparison, mortgage debt has increased $130 billion, about one-tenth the value of homes, leaving total household debt as a percent of assets sharply lower (see Chart 1). Households, it would seem, are in as good shape as they've been over the past two decades.

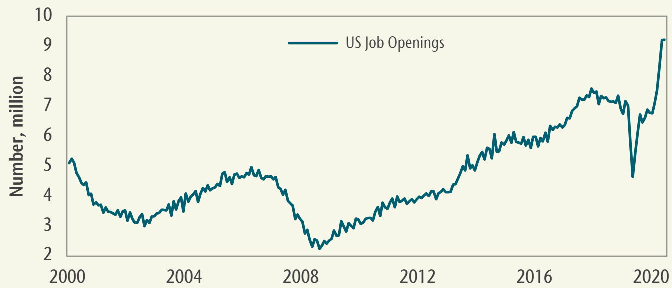
Chart 1: Household Balance Sheets Appear Healthier



Source: Statistics Canada, Macrobond

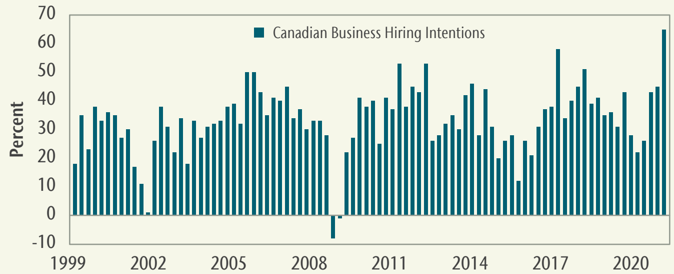
While there is rightful concern over adding to already high household debt levels, the best support for household finances is having a job, and demand for labour has rarely been stronger. In the US, the Job Openings and Labor Turnover Survey (JOLTS) shows nearly 30% more job openings compared to 2019, while the BoC's latest Business Outlook Survey showed hiring intentions at record high levels (see Charts 2 and 3). In the longer term, there is reason to be optimistic about consumer demand and resulting business activity looking to persist for some time.

Chart 2: Help Wanted I



Source: U.S. Bureau of Labor Statistics (BLS), Macrobond

Chart 3: Help Wanted II



Source: Bank of Canada, Macrobond

Note: Percentage of Canadian firms from BoC Business Outlook Survey expecting higher levels of employment minus the percentage expecting lower levels

CAPITAL MARKETS

Even as growth appears to be decelerating from a very high level, we believe the outlook for this business cycle remains bright. Since the extraordinary stimulus measures in the wake of the health crisis began, it was clear that there would be a point in time when central banks and fiscal policymakers would need to wean the economy and markets off extraordinary policy. During this past quarter, these conversations began in earnest. At the latest Fed meeting in mid-June, Federal Open Market Committee (FOMC) members started to reflect a less unified stance behind the notion of allowing inflation to exceed the Fed's target; inflation metrics arguably are already running hot. As a result, the Fed's Summary of Economic Projections ("dot plot") now shows that the Committee believes the first two hikes will begin at the end of 2023. This objectively is a long period of time, a further 24 months from today, allowing economic conditions to simmer further before actual stimulus begins to be pulled back. Similarly, the BoC was among the first in the world to begin to pull back on bond purchases, down now to $3 billion each week, from $5 billion at its peak, while projecting that the output gap will close in about a year's time, signaling a first hike cannot be far behind.

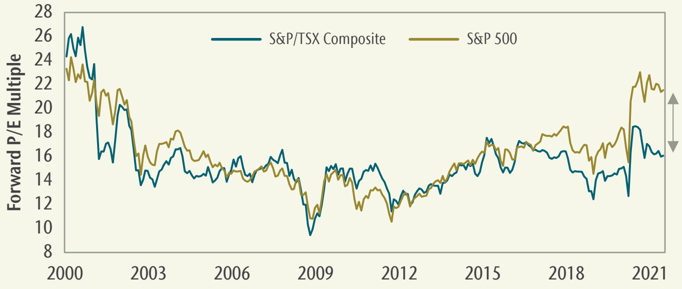
Understandably then, during the month of June, short-term yields surged, rising 16 basis points (bps) in Canada, and 11 bps in the US. However, 10-year yields in the US and Canada each fell around 10-12 bps during the month, extending a trend that began in May and is continuing into the first week of July. While overly bearish sentiment in bond markets signaled a pause was forthcoming, other technical, as well as fundamental factors also played a role. Overseas investors were likely enticed to buy Canadian debt as almost US$14 trillion of global debt continues to have a negative nominal yield, and long duration buyers such as pension funds stepped in as rates backed up. Fundamentally, the downshifting in growth, combined with central banks who have made it clear they will not permit runaway inflation allowed long-term rates to ease.

The pause in the rise in bond yields has served to help bond prices rally; the FTSE Canada Universe Bond Index posted a 0.96% gain in June. Equities, similarly had a good month. The MSCI ACWI rose 2.2% (local currency), the S&P 500 advanced 2.3%, while the S&P/TSX rose 2.5%, hitting 20,000 for the first time ever. Within equities, the lower interest rate environment supported real estate, while the potential lower growth and lower inflation environment gave renewed vigor to growth stocks, as the information technology sector led the index gains in both the US and Canada. The energy sector was bolstered by the 11% rise in oil prices in June. However, the sector leadership from other cyclical sectors paused, with industrials and materials underperforming.

PORTFOLIO STRATEGY

Even as we transition to a more moderate pace of economic growth, and markets and policymakers alike adjust to the new reality, we are clearly in the midst of a robust and, we think, lasting recovery. The variants that are taking hold in some areas of the world remain a key concern, reflected for example in the S&P 500 airlines index, which tumbled 12% in June. Nonetheless, as populations of the fully vaccinated grow, restrictions will ease and mobility should return. At the same time, policy today remains supportive, and any withdrawal of stimulus will be well telegraphed and remains some time away. As a result, corporate earnings are undergoing upward revisions and should support equities as we expect multiples to remain steady. Indeed, according to Factset, early second quarter S&P 500 earnings are estimated to rise 64% year over year over depressed levels last year. Canadian equities, when viewed against US stocks, look to have better value, with a wide gap in price-to-earnings ratios (see Chart 4) and higher weights in sectors that are anticipated to outperform.

Chart 4: Canadian Equities Not Looking Expensive



Source: I/B/E/S, Connor, Clark & Lunn Investment Management

These sectors include financial services that will be helped by higher long-term interest rates over the coming year, as well as industrial metals and oil that will benefit from sustained spending on construction and infrastructure. Our balanced funds continue to remain overweight equities and underweight bonds. Within our fundamental equity portfolios, our positive outlook for growth and modest pricing power for companies can help deliver both strong revenues and help profit margins. In bond portfolios, credit positioning favours companies that will benefit from the economic recovery and normalization of movement, though we have pulled in overall risk somewhat as we navigate this shifting policy environment.