OUTLOOK

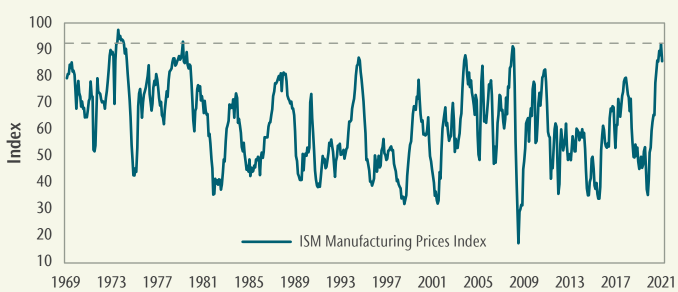
AUGUST 2021

"Reality, in fact, is something you could not have guessed." – C.S. Lewis. It is sometimes the case that looking at the big picture, we can be reasonably clear on the main trends. However, sometimes things do not add up.

Reality: US GDP expanded by 6.5% in the second quarter, following on a 6.3% gain in the first quarter; Canada similarly grew by a hefty 5.5% in the second quarter. US inflation is at a 30-year high. Equity markets have hit successive highs, industrial commodity prices are high, and the US dollar is steady. Would not have guessed: 10-year bond yields in both Canada and the US are around 1.25%, their lowest levels since February. Bond markets appear to be taking cues from the supply shocks around the world that are limiting growth (see June *Outlook*), while fears over the delta variant of Covid-19 around the world have curbed the euphoria around travel and services spending.

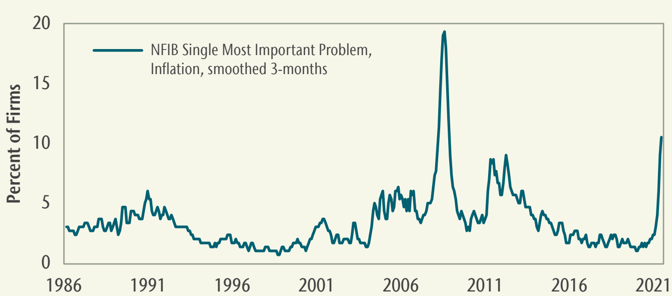
Reality: The core consumer price index (CPI) in the US has risen to 4.5% above last year, the ISM Prices Index hit its highest level since 1979 (see Chart 1), while the proportion of small businesses citing inflation as the single most worrisome concern jumped to an all-time high outside of a brief period in 2008 (see Chart 2). Would not have guessed: The higher actual current inflation gets, the lower long-term inflation expectations go. In June, the US Federal Reserve's Summary of Economic Projections moved its median projection to expect rate hikes to begin in late 2022 and with that took long-term inflation expectations in both Canada and the US down 20 bps in its wake (see Chart 3). The fact that central banks have taken note of inflation is signal enough that they are not going to allow growth and inflation to overheat, and markets promptly adjusted expectations.

Chart 1: Prices at Factory Gates Under Upward Pressure



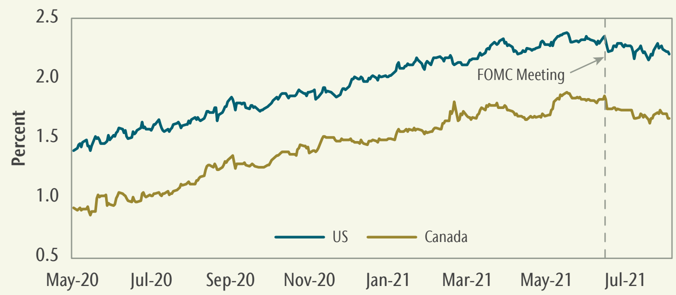
Source: Institute for Supply Management (ISM), Macrobond

Chart 2: Inflation Is An Important Problem for Small Biz



Source: National Federation of Independent Business, Macrobond

Chart 3: 30-Year Breakeven Inflation Expectations Easing Lower



Source: U.S. Department of Treasury, BoC, Macrobond

Reality: The decline in nominal bond yields has been led by real yields pushing lower. Would not have guessed: Gold prices, which typically move inversely to real yields, are not surging. Part of the explanation for the move across all yields is technical and related to the flows both within domestic (quantitative easing, pension and insurance buying, liquidity in the banking system) and international bond markets (relative positive yields in the US and Canada). However, investors also likely believe that current high levels of inflation are related specifically to supply chain shortages (semiconductors, furniture, autos) or reopening of the economy (travel, tourism, restaurants) and that high inflation will resolve over the coming months.

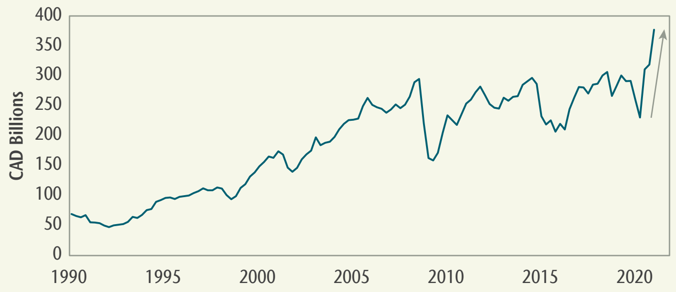
Knowing what has happened, what can we take away?

- As real yields remain negative, inflation is (for now at least) transitory, growth remains strong and policy is still accommodative, this is all supportive for both economic activity and financial markets. This is especially true as this cycle should see strong contributions from sectors like business investment on productivity enhancements and broader household spending.
- There is still a strong capability to keep policy easy, as needed. In recent weeks, support measures have been extended, including the US moratorium on evictions for tenants moved forward three months and in Canada, emergency wage and rent subsidies have been extended by one month. Extending support for tenants further will delay any adjustment to rental costs in CPI, but broader home price appreciation coupled with demand as the economy normalizes will likely be another source of upward price pressure.
- The evolution of wages is rising in importance. A general return to in-person schooling this fall, coupled with a larger proportion of the population that is fully vaccinated should lift some of the hesitancy to return to the labour force. However, many workers have found jobs in different industries, potentially matching their skillset to a more attractive career, while many others opted for early retirement as house and equity values boosted wealth. All this suggests higher wages are likely to be a feature of the coming cycle. As a result, mid-cycle, service sector inflation will come under some upward pressure from labour costs that are not compensated for by higher productivity.

CAPITAL MARKETS

Even though the big picture strong expansion is being clouded by shorter term bumps in the road, markets continue to perform remarkably well. Most notably, global equities have continued to advance. Strong second quarter corporate earnings are consistently surprising to the upside, which are seen through both bottom-up earnings and top down corporate profits (see Chart 4). These are helped by rebounding activity, easy monetary and fiscal policy, and low bond yields. The S&P/TSX Composite rose 0.8% in July, while the S&P 500 gained 2.4%, each posting its 6th straight monthly rise. With about 2/3 of the S&P 500 companies reporting, EPS releases are beating expectations by about 17%. Much of the positive surprise has come in the tech sector, which is doing much of the heavy lifting as the reflation trade is being put to the test. Sector rotation this past month is favouring defensive sectors, such as health care and bond proxies, such as utilities and real estate. The cyclical energy and consumer discretionary sectors lagged the broader index. Similarly, small cap stocks have been flat and emerging markets are down 10%. Equity markets in Asia have weakened, as regulatory action in China soured investor sentiment, property markets softened and weaker growth is causing policy to start loosening. The MSCI China Index contracted sharply, falling 14.2% in July, erasing year- to-date gains. Not all cyclical sectors took a breather, as commodity prices still gained. Base metals, such as copper, still continued to benefit from the pick-up in industrial production.

Chart 4: Canadian Corporate Profits Rebounding Strongly



Source: Statistics Canada, Macrobond

Bond yields globally extended the declines from mid-May. While the US, Australia and the Eurozone led the way with declines in excess of 20 bps, Canadian 10-year yields fell 16 bps, leaving the FTSE Universe Bond Index up 1.03%. The underperformance of Canadian yields reflected the continued pullback in bond buying by the Bank of Canada, and strong commodity price performance. Credit spreads, meanwhile, continued to experience flat to modest widening overall.

PORTFOLIO STRATEGY

Despite the reversal in some sector trends in the recent month, the economic expansion more broadly will continue to be strong and likely extend until central banks are in full tightening mode. We think it will be at least a year before this process even begins. Despite the higher current inflation, the large supply of workers in labour markets today will have to resolve before prompting policymakers to start hiking interest rates. And because inflation acts with a lag, this implies we will see inflation overshoot its target at some point. This is by design. Instead of rising due to today's transitory factors, inflation will be driven by firming wages and higher shelter costs that will come through the more mature part of the cycle. However, until then, markets will continue to benefit from this current early- to mid-cycle period when corporate profit margins are high, and top line sales continues to grow.

We continue to maintain an overweight in equities against an underweight in bonds within balanced portfolios and will look to add to equities on any pullback. Risk has been reduced within bond portfolios as credit spreads have narrowed, while industry positioning favours sectors that will benefit from the reopening in the economy. Similarly, exposures on the interest rates side are also being pulled in, as yields take a breather and move back to levels closer to the start of the year. Equity portfolios maintain their overweight exposures to cyclical companies, such as consumer discretionary, financials, and industrials. Each market continues to benefit from the steadfast accommodative policy direction, as the growth story is tested. Some factors, such as supply bottlenecks, the continued infections and shortage of qualified labour, are all pulling back on growth expectations. But this helps to keep policy accommodative, and that is a positive for markets overall.