Connor, Clark & Lunn

Investment Management

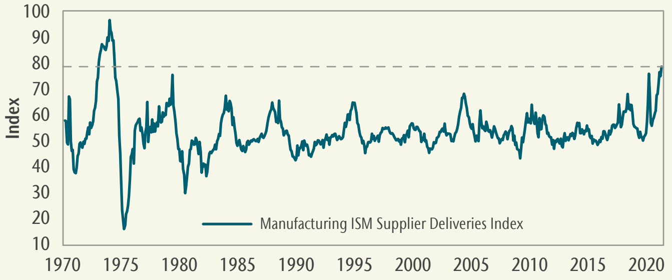
OUTLOOK

JUNE 2021

"Sorry, we are out of stock. Check back later for inventory. The delivery of your purchase may be delayed."

Over the past 30 years, we have witnessed several crises – the 1990 Japan property crisis, 1997 Asian Financial Crisis, 2013 European sovereign debt crisis, 2015 commodity crash and of course the 2008 Global financial crisis – that have all resulted in a collapse in demand. What distinguishes the COVID-19 crisis from all others in recent history is the collapse in supply. Over the past 40 years, manufacturing supply chains were managed lean, with inputs arriving at the factory or retailers right as the last unit was being used or bought. This enabled companies to wring every dollar possible out of cost structures. With the shift in demand as we all stayed home, spending decreased on consumer services and travel, and increased on home renovations and household goods (helped in part by stimulus checks). During this time, businesses have struggled to keep adequate levels of inventory, exacerbated by reduced manufacturing capacity and disruptions in global shipping. It's likely that when trying to make purchases, we have all experienced items that are either out-of-stock or have delayed delivery and indeed, supply chain managers' surveys have been replete with stories that lament the shortages of parts, delays at ports, lack of transportation capacity, surge in container costs and difficulties finding workers. The lengthening delays have pushed the ISM's supplier deliveries index to its highest level since April 1974 (see Chart 1).

Chart 1: Shortages Tightest in Nearly Half a Century



Source: Institute for Supply Management (ISM), Macrobond

TODAY'S PROBLEM

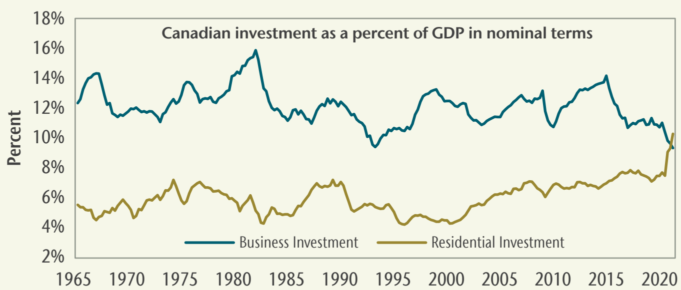
The immediate concern is twofold. First, generally stronger household balance sheets with cash ready to spend combined with the limited inventory supply should permit companies to pass along higher costs, pushing Inflation higher. This is arguably the key risk to the market outlook and is receiving considerable attention. Less discussed is just how much the supply constraint will hurt growth in coming quarters. Already, companies across diverse industry groups like consumer electronics, construction and automobiles have shut down production due to missing parts and the inability to move the products to where they're needed. Similarly, the services sector cannot double the number of flights or hotel rooms overnight. Expectations for global economic growth have been revised higher in recent months – the Organisation for Economic Co-operation and Development (OECD) predicts global growth to be 5.8% this year, a sharp revision from 4.2% in December of last year. However, it looks increasingly difficult to achieve this rate given the pervasive struggle to find inputs.

Thus, as we look ahead into the next phase of the market cycle, we are assessing a few aspects of this. First, how much the supply chain disruption will limit top-line sales simply because there is less to sell. Second, whether margins will be compressed as a result of surging input prices or rising wage pressures, or if operating margins will expand somewhat with top line pricing power. Indeed, through much of the last year, 2021 earnings were able to benefit from upward revisions and even upside surprises; however, the variance between high and low S&P 500 earnings estimates for 2022 has widened relative to previous years, reflecting the uncertainties noted above. Policymakers will need to decide whether this current environment will result in a one-time price adjustment to a new equilibrium, or whether these pressures will result in a pernicious wage-price spiral that in turn demands a policy response, pushing interest rates higher. Our assessment for now, and one that is still evolving, is that strong companies will adapt and work to limit the adverse impact from higher prices. This is because long-term inflation expectations, after decades of low and stable prices, are very strongly anchored. And while there is a labour shortage currently, there is also a large pool of workers; approximately 7 million people in the US and 570,000 in Canada remain out of work compared to February 2020 and are able to pick up some slack once the economy fully normalizes.

TOMORROW'S BENEFIT

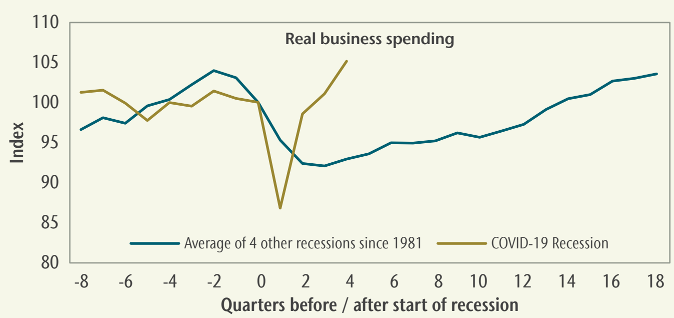
In the long run, however, all this leads us to believe that there could be a positive outcome from this problem. In a world of high debt levels, with governments, businesses and households all piling on debt, it will be critical to keep servicing costs affordable and at the same time creating the conditions for strong growth in both output and incomes. All this is served by productivity enhancements, which helps to keep activity strong, profits solid and the job market robust all without generating inflation. That happens when businesses can allocate resources to investing in creating capacity and there is no better incentive for firms to invest in their businesses than the combination of sustained demand, low financing costs, the prospect for higher selling prices, and in Canada's case, cheaper imported machinery and equipment due to the relatively strong Canadian dollar.

Chart 2: Residential Investment in Canada Now Exceeds Business Investment



Source: Statistics Canada, Macrobond

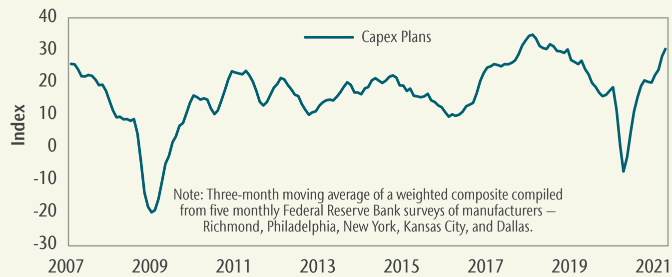
Chart 3: Canadian Business Spending Surge



Note: Indexed at 100 before start of recession. Source: Statistics Canada, Macrobond

This matters, especially in Canada. The housing market's strength has pulled a lot of growth away from other sectors. For the first time in history, investment in the housing stock as a per cent of GDP, has exceeded that of business investment (see Chart 2). This implies a lot of room for companies to invest and raise their capacity and indeed, businesses look well on their way compared to historical recoveries (see Chart 3). This also appears to be occurring outside of Canada. The Economist magazine looked at the biggest 25 non-financial firms in the S&P500 and found that expectations for capex in 2021 have risen by 10% in the past year. The US Federal Reserve's regional manufacturing surveys ask about investment intentions and the composite of these has also hit a 3-year high (see Chart 4). Secular trends are also lining up, including aggressively pursuing de-carbonizing energy sources, securing redundant supply, engaging in cybersecurity, and fiscal infrastructure packages. We are encouraged by all these developments, as we move through this early cycle environment.

Chart 4: Businesses Are Planning to Increase Capex



Source: Reserve Bank of Dallas, Federal Reserve Bank of Philadelphia, Federal Reserve Bank of New York, Federal Reserve Bank of Richmond, Federal Reserve Bank of Kansas City

CAPITAL MARKETS

For the first time since the recovery took hold, economic results this past month have disappointed relative to expectations. The economy is operating at a high level, but data from housing, employment, durable goods orders, industrial production and retail sales all appear to be leveling off. At the same time, inflation metrics have universally surprised to the upside. For the month of May as a whole, the MSCI All Country World Index increased 1.1%, the S&P 500 ended 0.7% higher, while the S&P/TSX Composite rose 3.4%, and did manage to hit a new all-time high near the end of the month. Even as the growth and inflation backdrop became less favourable, equities benefited from a continued strong earnings season. Commodity prices also had another strong month with silver, gold, copper and oil all rising. As a result, materials and energy were the top performing sectors in Canada. Bond yields advanced early in the month, in the aftermath of the surprise jump in the consumer price index (CPI), but slid from peak levels in the latter half of the month. Two-year yields rose 4 bps while 10-year yields fell 5 bps. Corporate spreads tightened though provincial spreads compressed more meaningfully. This left the FTSE Universe Bond Index 0.6% higher in the month.

PORTFOLIO STRATEGY

The last month's disappointing economic releases reflect a moderation, but in the context of a strong economic recovery were in fact more reflective of overly optimistic expectations that are being priced into financial markets. We believe the economic recovery remains robust, particularly as economies ramp up vaccination efforts and move closer toward broader reopening. While inflation prints have surprised to the upside, we believe this is largely due to ongoing supply chain disruptions and the adjustment process as the economy normalizes. Monetary policymakers should continue to look through these data points until the inflation data show persistently higher readings. This will only become evident after the government support programs are dialed back, schools reopen and vaccinations reach a comfortable level. As a result, we continue to believe that we are still at the early stages of a multi-year bull market. The market friendly backdrop of strong economic growth and accommodative policy remains intact. Going forward however, we expect periodic concerns over higher inflation and interest rates should raise volatility and could lead to a short-term market sell-offs. Consequently, balanced portfolios remain overweight stocks and underweight bonds and we would view a short-term market correction as a buying opportunity. Within our fundamental equity portfolios and credit position in bond portfolios, positioning continues to favour companies that are levered to the economic recovery and normalization of traffic patterns. The expected growth in business investment this cycle will only support that outlook, helping to produce strong growth without a sustained spike in inflation.