CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

MARCH 2021

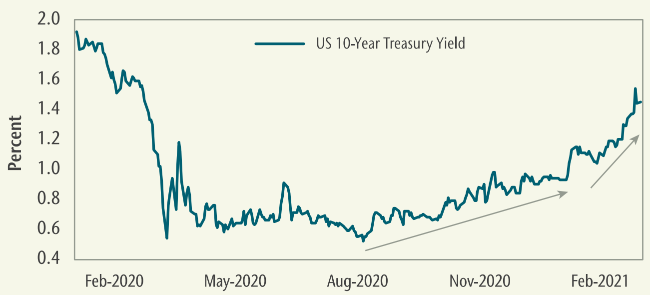
From optimism to pulling away the punch bowl. At the turn of the year, we painted a picture of optimism supported by a long list of positive developments - vaccine progress, a brightening macroeconomic outlook, a supportive policy backdrop, inventory rebuilding, pent-up consumer demand, relative political calm, a modest normalization in interest rates, and a softer US dollar. That calm optimism seems to have lasted about one month. Markets have extrapolated the impact of the continued build up of good news into rising interest rates, as economic activity has held in better than expected (despite lockdowns) and the massive US fiscal stimulus package continues to make progress through Congress. This resulted in a rapid sell-off in bond markets during the last week of February.

INTERPRETING THE RATE MOVES

Ever since hitting a low in August 2020, developed country sovereign bond yields have been rising. February marked the seventh straight month that interest rates rose and bond prices fell. This was all happening at a moderate pace up until the last week of February when the US 10-year Treasury yield spiked to about 1.5%. The result is that the yield increased a full percent from last summer, with half of the gain in just the last month (see Chart 1). To understand whether interest rates will persist on their current path higher, it is worth noting a few features of this latest move:

- Interest rates increased globally, led by Australia and Canada (see Chart 2). These are two economies that benefit from the recent swelling in commodity prices, and have had an extraordinary policy response to date. Policy is likely to be "right sized," and indeed the Bank of Canada (BoC) reduced its weekly purchases of Government of Canada bonds last year. The BoC has also reduced the frequency of provincial and the size of corporate bond buying in the face of little demand. The Provincial Bond Purchase Program is set to expire in May.
- Bond yields for mid-term maturities, the five-year term in particular, increased the most. If abundant bond buying is being reined in, markets are wondering whether policy rate increases are far behind and are thus pushing mid-term rates higher in response.
- The move was led by rising real interest rates and importantly, not inflation expectations.

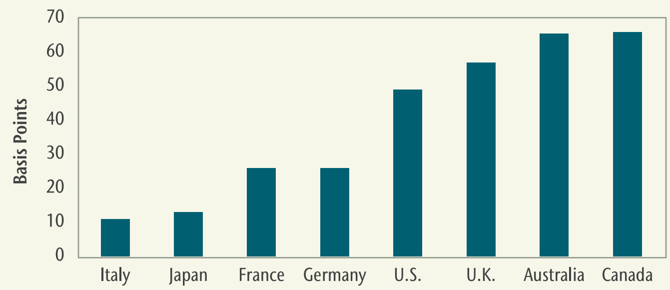
Chart 1: Rise in Yields Accelerated in February



Source: U.S. Department of Treasury, Macrobond

Chart 2: The Rise in Yields Was Seen Globally

Year-to-date change in 10Y government bond yields as of March 1, 2021



Source: Macrobond

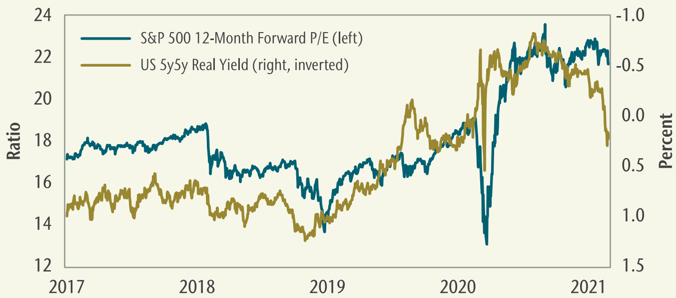
In short, markets are becoming concerned that policymakers will be compelled to begin hiking rates earlier than is currently being signalled. Futures markets see the first rate hike occurring as soon as late-2022, while the US Federal Reserve's (Fed) own projection is at some point in 2024.

COULD HIGHER RATES THREATEN THE RECOVERY OR MARKETS?

Interest rates affect economic growth. The surge in five-year yields, for example, will likely raise mortgage borrowing costs and cool a very seller-friendly real estate market here in Canada. Business borrowing costs are also affected as corporate spread compression has also slowed. Still, borrowing costs remain at very low levels, and we are far away from a pullback in economic activity. Even with the most recent back up in yields, financial conditions overall remain easy. Interest rates are a key building block of asset prices and valuations.

Indeed, real interest rates and price-to-earnings (P/E) ratios have moved together in recent years (see Chart 3). So far, equity markets have been well-behaved and we believe this is because the equity risk premium is still above its long-term average and valuations today are reasonable, even with yields at 1.5%.

Chart 3: Real Rates Have Had a Tight Correlation with Valuations



Source: Bloomberg, IBES

Perhaps most importantly, the fourth feature of the recent surge in rates is that markets are organically pricing in these higher interest rates in response to a positive growth outlook. Despite lockdowns, Canadian GDP closed out 2020 with a banner 9.6% (annualized) gain in the fourth quarter, double the BoC's January projection. In the US, industrial production and business order books are strong, and the latest commentary from the survey conducted by the Institute of Supply Chain Management paints a picture of strong demand and shortages. Optimistic US GDP growth forecasts that incorporate a substantial US fiscal package run as high as 7% for 2021, and earnings per share (EPS) growth at 30% above last year. In other words, the rise in rates is fundamentally driven. Critically, no central bank is talking about tightening, in contrast to periods like the summer of 2013 when then-Fed Chair Ben Bernanke sparked the "Taper Tantrum" by talking about reducing quantitative easing (QE) purchases which caused interest rates to nearly double to 3%. Another example was in December 2018, when Chair Powell said rates needed to "rise to about their neutral levels". Simply, there is confidence in the global growth outlook. Indeed, commentators, not to mention the voting population, have all rejected austerity and embraced the need to prevent policy from being cut off too quickly. Given the risk of too much or too little policy stimulus, the worst outcome is premature policy tightening.

CAPITAL MARKETS

After a calm January, volatility picked up in a number of asset classes in February led by sovereign bonds. Most developed world bond markets saw that optimism in the economic recovery, spurred on by better-than-expected activity data, plus progress on the US stimulus bill would forge a path towards a withdrawal of policy. Canadian 10-year bond yields have surged 66 basis points (bps) year-to-date, almost 50 bps in February alone, to reach 1.4%. The FTSE Canada Universe Bond Index has pulled back 3.6% in the first two months of the year, taking back some of the strong gains from 2020. February alone saw its worst one-month performance since 1994.

The reflation narrative that led to the bond market selloff was positive for equities and commodities overall, and most global equity indices managed to hang on to close the month in positive territory despite the late-February selloff. The S&P 500 rose 2.8% while the S&P/TSX Composite gained 4.4%. The fourth quarter earnings season provided positive momentum for equity markets. Not only did over 80% of the S&P 500 companies post earnings ahead of expectations, but the magnitude of median earnings was a large 9.4% in excess of the consensus forecast for Q4. Similarly, the TSX saw strong earnings leading to materially higher revisions to bottom-up estimates. The rotation towards more cyclical and value oriented sectors benefited the financials, energy and consumer discretionary sectors the most. Optimism also helped small cap stocks outperform their larger cap peers, and commodity prices extended their run higher. A rebound in manufacturing production arising from strong demand and continued supply chain bottlenecks pushed industrial prices broadly higher in February. These include copper (+15.1% to a near-decade high), lumber (hit a new all-time high) and oil prices (+17.8%, up for the 4th straight month to a year-long high). Gold, a safe haven asset, lost some of its lustre, falling 6.1% as interest rates rose.

PORTFOLIO STRATEGY

Despite the rise in bond yields, we believe it remains a positive investing environment. Bond markets are reflecting both the significant improvement in fundamentals, and an expectation that economic activity will rebound. Bonds are also growing concerned about the potential for rising inflation, as well as a disbelief that policymakers will remain as accommodative in the face of higher inflation. Yet patience is precisely what monetary authorities have pledged. They will allow the economy to retest the limits of capacity, and importantly, the lows of the unemployment rate before raising rates. But long before we even arrive at that point, we must contend with the vaccination process, a wide output gap, high debt levels and central banks that are still purchasing bonds in large quantities. This implies that an actual tapering in QE purchases and a liftoff in policy rates will be delayed compared to earlier cycles, and even then, it will be extraordinarily gradual. While financial markets will test that resolve, implying bumpy periods, the environment remains "goldilocks-esque" with strong growth, low inflation and accommodative policy all supportive for risk assets. We continue to hold an overweight to equities in balanced portfolios, while fundamental equity portfolios are biased to companies with discounted valuations that benefit from an improving economy.