CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

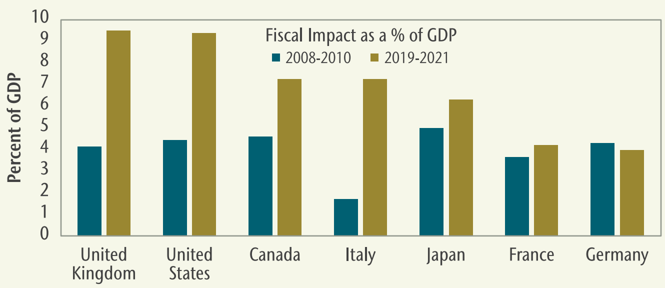
MAY 2021

"History has shown that big Government expands quickest in the immediate aftermath of a crisis." – US Congressman Bob Barr

DAWN OF A NEW ERA

This past month, the governments of the United States (US) and Canada both laid out their visions, committing to vast spending programs over the coming years. In Canada, the Throne Speech extended household and business support programs for the near term to “finish the fight” against the pandemic but also planned ambitiously for a national child care plan, climate change action and some infrastructure investment. Spending over the coming three years will sum to about $100 billion, pushing the deficit to about 6.4% of GDP. While moderating against last year’s peace-time high of 16.1% of GDP, it is nonetheless the second largest deficit over the past 40 years. Having taken the total debt level up to about 50% of GDP, there is no plan to bring it back down.

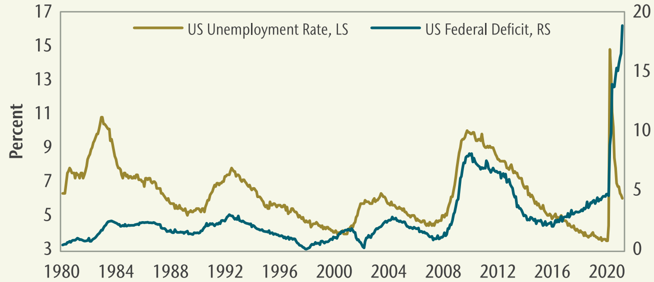
Chart 1: US Government Pushing For the Lead



Note: Calculated as the absolute value of the change in net lending/borrowing as % of GDP.
Source: IMF World Economic Outlook, April 2021, BCA Research

Despite the massive support programs that rank Canada near the most generous around the world (see Chart 1), the US looks to eclipse those levels. In March, the American Rescue Plan Act authorized $1.9 trillion of targeted largely short term income support. At that time, questions were already being raised over its excess. Former Treasury Secretary Lawrence Summers noted that for every dollar of shortfall in the US output gap as measured by the Congressional Budget Office, the government was effectively sending out $3. In the aftermath of the 2008 Global Financial Crisis, that figure was just $0.50. He suggests that it is too much (see Chart 2). Summers worried that there

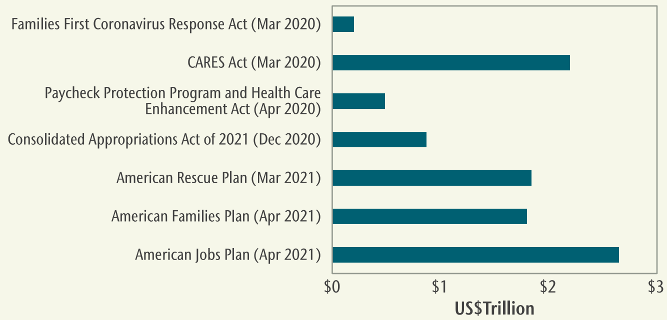
Chart 2: Is the Fiscal Push Too Much With a Recovery in Sight?



Source: U.S. Department of Treasury, U.S. Bureau of Labor Statistics

will not be money left to fund “public investments that should be the nation’s highest priority.” But he need not fret, for before a debate could even begin, in April President Biden proposed another $2.65 trillion American Jobs Plan that lays out infrastructure spending including transportation, water, broadband, clean energy, electrical grid and R&D. Weeks later in a speech to Congress, a new American Families Plan was presented that calls for $1.8 trillion in new family social safety net planning, notably child care, education and paid leave for workers. Together, the three programs should see an excess of $6 trillion in spending over the next few years (see Chart 3). What is remarkable is that even with the dizzying array and speed of announcements, as an early “report card”, President Biden’s first 100 days’ approval rating, the equity market and GDP are all soaring, and the US dollar has broadly stabilized. Even with a 50-50 gridlocked Senate and a tiny majority, Democrats have not been shy about aiming for huge spending bills and are being applauded for doing so.

Chart 3: Ramped Up Fiscal Spending



Source: International Monetary Fund

MAKING THE PLAN AFFORDABLE

Alongside the big US spending and investment plans is an initiative to reshape the tax code, notably including targeted tax increases. Specifically, three areas are targeted: raise the corporate income tax rate from 21% to 28% (about halfway back to the pre-2018 tax rate of 35%); create a global minimum 21% tax on multinational firms (with support voiced now by the finance ministers of France, Germany and Canada); and raise capital gains taxes on US stocks. Though details are still hazy and final percentages still have to be negotiated, if corporate tax rates rise, earnings will be hit. Preliminary estimates suggest a drag of about $10 per share on earnings, on average. At the same time however, upward revisions to S&P 500 earnings these past months have been rapid, rising from under US$190 at the beginning of the year to over US$210 today. Even a pessimistic scenario would take earnings back to forecast levels for 2022 that we saw closer to the beginning of this year.

More broadly, the spending boom should go far in helping to pull out of what has been a series of secular stagnant cycles. Fiscal spending of this magnitude is reflationary not just for the US but globally, and should support both a sustained rotation within equities, as well as towards equities globally. Risks do remain. If tax hikes are enacted, they will take effect immediately, in contrast to infrastructure that sees spending over a decade. Further down the road, we will watch for private sector investment to grow alongside public sector, and both to produce capital investments that lead to productivity gains. Indeed, that is the critical need now – the ability to raise economic power without upward inflation pressures.

CAPITAL MARKETS

Economic indicators remind us daily that the economy is growing strongly. Meanwhile, policy continues to be coordinated and accommodative. April marked a good month across just about all asset classes. The MSCI ACWI rose 3.8% with developed markets marginally outperforming emerging markets. The S&P 500 rose 5.3%, while the TSX gained 2.4%. About halfway through the first quarter earnings season, companies are exceeding expectations by a wide margin. A massive 87% of firms are beating already lofty expectations, with median earnings in excess of 12% relative to expectations. Top line sales are performing well while wage and cost pressures remain muted, leading to healthy profit margins.

Commodity prices are benefiting mightily from the reopening. Coupled with the massive stimulus packages directly funding both infrastructure and clean energy, prices for industrial materials surged, with copper rising 12.1% to its highest level in a decade. Similarly oil prices jumped 7.5% taking the YTD gain to 31%. The stand out commodity is still lumber, which is benefitting from the strong demand for housing, but food prices are also set to rise, given the increase in agricultural commodities as well.

Even with the renewed push towards the reflation and recovery themes, defensive assets still managed to steady after months of weakness. Gold has been on a downtrend since last summer, but appears to have stopped declining. And bond markets that had previously been testing central banks resolve appeared to back down this month, and at least for now are following the Fed's guidance. In the US, 10-year Treasury yields posted their biggest monthly decline since July, falling 11 bps; Canadian 10-year yields were up 1 bp, leaving the FTSE Universe Bond Index return flat for April.

PORTFOLIO STRATEGY

The aggressive fiscal spending is supportive for the corporate sector and broader macro backdrop. As a result, markets will benefit from these optimal conditions. Indeed, investor sentiment is enthusiastic and major equity indices continue to rise to all-time highs. Even though much of the reopening story is being priced in, the pullback in bond yields and the wait-and-see on inflation is likely to allow for an extended period of investor optimism. Our fundamentally managed portfolios, both equity and fixed income, are investing in companies that will benefit from a cyclical upturn. In balanced portfolios, we have maintained an overweight in equities for the past year and continue to believe higher earnings, strong margins and the rotation to early-cycle sector leadership will continue to support outperformance against bonds. Equity portfolios are positioned to benefit from cyclical companies that will see outsized earnings growth offset stable or modestly contracting valuations. The fiscal support for infrastructure spending has also been a theme in our equity portfolios, where we have exposure to engineering and consulting companies for example, as well as equipment dealers. Our fixed income portfolios have pulled in risk marginally, particularly the overweight to corporate bonds. However, similar to equity portfolios, the tilt towards companies that will benefit from the reopening is solidly in place. Both the COVID-19 vaccines and normalization in movement bode well for risk assets. We continue to have a cautiously optimistic outlook that the outcome of this cycle will be higher secular growth.