CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

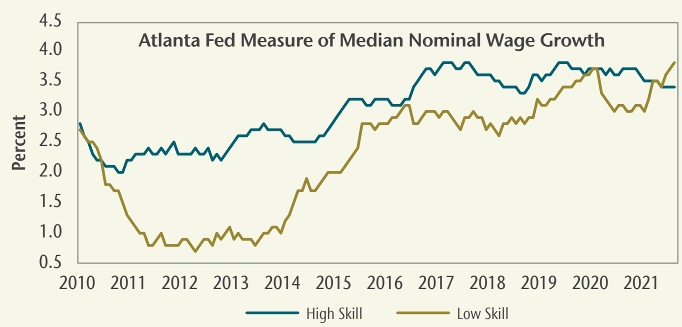
OCTOBER 2021

Lower growth and higher inflation make for a spooky combination. September marked the first down month in risk assets in eight months and the biggest monthly decline since March 2020. Interest rates rose and stocks wobbled as investors warily eyed a long list of concerns in the headlines. Supply chains are being stretched, limiting growth (see June *Outlook*). China's economy, which accounts for about one-fifth of world GDP, will likely decelerate materially as it faces two immediate crises; Evergrande, the country's second largest construction firm piled on excess leverage, and in September the company did not make interest payments on some bonds. While the odds of systemic risk in the financial system are low given the government's ability to manage outcomes, we believe this will slow the pace of construction activity which has contributed about 2.5 percentage points annually to GDP growth over the past few years. Compounding this, the capping of coal-based electricity production is leading to rolling blackouts in the country, and in turn, is limiting manufacturing activity. The energy production problem is not limited to Asia, as natural gas prices are soaring globally, particularly across Europe. In the U.S., the debt ceiling and the lack of progress on the latest infrastructure bill generated concern, while labour shortages have been pushing wages higher (see Chart 1).

To summarize these concerns, they can be broadly sorted into two categories: slower growth and higher inflation. Taking this to an extreme, financial markets have combined the two and have been abuzz with talk of "stagflation". To be clear, this is a serious concern for policymakers, because there's no good solution: tighten to limit inflation and your recovery is gone; or keep policy easy and inflation expectations become entrenched in psychology of households and businesses. The dilemma becomes even more acute when the problem with inflation is not driven by demand but by supply problems, as it is today. Raising rates does nothing to help calm inflation due to energy, other commodities, and goods production and transportation bottlenecks.

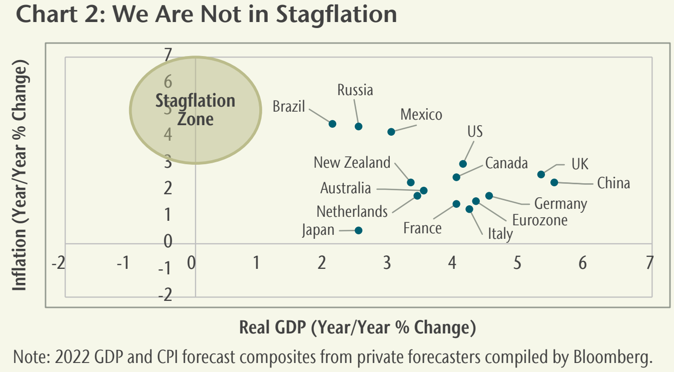
In fact, we are not at the point of stagflation. In order to meet that definition growth must fall within a percentage point of 0% with an elevated unemployment rate, while inflation is concurrently rising. It is clear that the transitory nature of inflation is extending longer than anyone expected. But for now, the components of inflation that are pushing higher are still related to the reopening of the economy and the shortages in component parts. However, from a growth perspective, it is important to recall that we are only decelerating from some of the fastest growth rates over the past two decades. Indeed, it is our view that economic activity today is not derailed, merely delayed, as the full reopening of the economy shifts into early 2022. The world's major economies individually each appear to be a far distance from stagflation (see Chart 2). Despite all the issues concerning markets today, the fundamentals remain solid. Households in both the U.S. and Canada have accumulated excess savings that equates to over 10% of GDP, while benefitting from the wealth effect and low debt servicing costs (see July *Outlook*). Businesses, meanwhile, are seeing the same low borrowing costs, with a need to rebuild inventories and build out capacity to meet the demand surge. Government infrastructure programs are being rolled out, while capital

Chart 1: Low Skilled Workers Seeing Wages Rise



Source: Federal Reserve Bank of Atlanta, Macrobond

Chart 2: We Are Not in Stagflation



Note: 2022 GDP and CPI forecast composites from private forecasters compiled by Bloomberg.
Source: Bloomberg

spending related to improving our environmental footprint is also promising to add a healthy amount to the total. Taken together, the International Monetary Fund's (IMF) global growth projections remain upbeat at 6% in 2021 and 4.9% in 2022, which would be the second fastest pace since 2010.

As a result, the key question facing markets today is what central banks will do as the US Federal Reserve's (Fed) own projection of the core personal consumption expenditures (PCE) deflator this year has been revised up from 3.0% year over year in the June projection to 3.7% year over year in September and is not expected to return back to their 2% year over year target until past 2024. Despite that upward revision, the Fed members still perceived the balance of risks as tilted to the upside as the hiring difficulties and supply bottlenecks persist and push prices upward. This past month saw the Fed take another deliberate step in the direction of less accommodative policy, and will formally announce a taper next month. Globally, a similar move is taking place – the Bank of England (BoE), Bank of Canada (BoC), Reserve Bank of Australia, and Reserve Bank of New Zealand (RBNZ) are all drawing QE to a close. While the Norges Bank was the first developed economy to hike rates, the RBNZ soon followed. Those are not the only ones leaning in the direction, given comments from the BoE. The Swiss National Bank, Bank of Japan, and European Central Bank (ECB) remain at the stimulative end of the spectrum, yet they too have inched forward, with the ECB now halting some pandemic specific asset purchases. Despite these moves, policy rates remain a far distance from even neutral levels, and thus, the expansion still has room to go.

CAPITAL MARKETS

Interest rates were largely unchanged until the last week of September, when they surged. Markets began to absorb expectations of tighter central bank policy, understand the extent of supply chain issues, and gain comfort from data on cases and hospitalizations that did not surge as feared in most regions when schools were back in session. Two-year yields jumped 14 basis points (bps) in Canada and seven bps in the U.S., while 10-year yields spiked 25 bps in Canada and 21 bps in the U.S. Corporate and provincial bond spreads tightened modestly despite a surge in new issuance.

However, the higher yields combined with growth and inflation concerns caused equities to snap a seven month run, the longest string of consecutive monthly gains since 2017 for the S&P/TSX Composite, which fell 2.2% in September. Canadian equities actually outperformed global peers, helped by energy companies that significantly outperformed on the spike in energy commodity prices. While oil prices (WTI) surged 9.5% in September, it was natural gas prices that saw a massive 34% gain in the month. Together they helped the energy sector post the only gain among the S&P/TSX Composite sectors, rising 8.7%. Other equity markets around the world posted steeper declines. The MSCI ACWI fell 3.5% (local currency) in September, while the S&P 500 posted a 4.7% (local currency) drop. Leadership also shifted. Higher interest rates pulled valuations of long duration growth stocks like technology companies lower – the Nasdaq fell 5.7% in the month. Financials outperformed, however, as the yield curve steepened, helping profitability.

PORTFOLIO STRATEGY

Rising bond yields are generally not good news for equities. However, interest rates have been hovering just above their record lows, and real rates in the U.S. are still in negative territory at -0.90%. Some increase in yields can be digested by equity markets, so long as it doesn't jeopardize the economic recovery by becoming restrictive for demand. Two observations in this last backup in interest rates are noteworthy. First, the rise was driven almost entirely by real yields in both Canada and the U.S., while break-even inflation rates have held relatively steady at 1.75% in Canada and 2.2% in the U.S. Therefore, the rise in yields is in response to a stronger economy and a slight normalization of unduly low real yields. Second, the rise in yields was led by the longer-end of the curve despite the more hawkish tone of central banks. This runs counter to what generally happens during a central bank tightening cycle – when policy rates rise, the yield curve typically flattens with higher short rates and prospects for growth slow. Instead, today the overall selloff in bonds with a steeper yield curve is more consistent with a positive economic outlook.

This is important because this part of the economic cycle sees equity markets rise due to strong earnings and not a rise in valuations. Therefore, the overall outlook is still positive, even if the myriad of risks noted above may be injecting more short term volatility than was the case in the earlier phase of the cycle. We continue to believe the underlying fundamental picture remains strong, even if the upside for equities is not quite as positive as the past 12 months. As a result, we will continue to look for companies in our fundamental equity portfolios that are able to deliver earnings and manage through a less accommodative policy environment in this more mature phase of the business cycle. Our balanced portfolios remain overweight equities and underweight bonds, with a slight tilt towards Canadian equities, while our fixed income portfolios are modestly overweight corporate bonds. We will continue to monitor risks closely and look for opportunities through any volatility.