CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

SEPTEMBER 2021

Quantitative easing (QE) is becoming harder to justify. All of the world's major central banks have embarked on large scale asset purchases comprised largely of their own country's government bonds. The purpose of quantitative easing (QE) is two-fold. In times of market stress like we saw in March 2020, QE improves liquidity so markets can normalize; once the markets are functioning, QE's purpose is to lower longer term bond yields and borrowing costs, thereby encouraging aggregate demand in the economy. The challenge is this does not seem to help in today's world where there has been a major supply shock (see June 2021 *Outlook)* while demand has continued to be strong (see July 2021 *Outlook*). Indeed, the persistence of QE is starting to exacerbate the demand problem and is not helping to solve the supply problem[1].

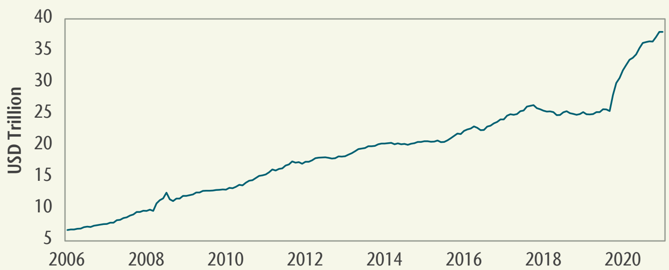
By the end of 2020, central banks in countries that had managed the pandemic relatively well already had begun the process of tapering QE. Notably the Reserve Bank of New Zealand halted purchases altogether in July this year, and the Bank of Canada who began by buying CAD$5 billion of Government of Canada bonds each week are down to CAD$2 billion a week today. Markets currently expect a halving to CAD$1 billion in October and a complete shutdown by around the end of the year. The Reserve Bank of Australia announced in July it would slow purchases from AUD$5 billion per week to AUD$4 billion beginning in September and they have stuck with the plan. However, it's becoming harder to justify QE even for the largest and hardest hit economies. Both the Bank of England and the European Central Bank (ECB) are facing calls to begin lightening up on purchases as headline CPI in the Eurozone reaches 3% year-over-year, a rate not seen since 2011. The Pandemic Emergency Purchase Program (EUR80 billion/month), the Asset Purchase Plan (ongoing at EUR20 billion/month) and the EU Recovery Fund are likely to see some adjustments to both the sizes and flexibility of these programs, that may allow the ECB to own more than one third of any country's outstanding bonds (Germany and Netherlands are getting close at about 30%).

The biggest central bank has now signaled its intentions via US Federal Reserve Chair Powell's speech at the Jackson Hole conference. In the speech he stated that the test of "substantial further progress" on inflation remaining at about 2% for some time has been met, while the prospects for meeting its maximum employment target have improved. So it's likely that a formal announcement will be made at either the November or December Federal Open Market Committee (FOMC) meetings with actions to take place shortly thereafter, aligning nicely with the reduced issuance of bonds by the US Treasury as the fiscal support packages end. Importantly, Chair Powell clearly separated the withdrawal of asset purchases as a completely independent and distinct decision from any quantitative tightening (the selling of bonds off the Fed's balance sheet) or rate hikes. Thus, he took particular care to avoid the 2013 Taper Tantrum episode that saw US interest rates rise from 1.6% to 3% over four months in the wake of Chair Bernanke's suggestion of reducing asset purchases. Indeed, the employment-inflation preconditions must meet a higher threshold for raising rates.

SHOULD WE WORRY?

Excess liquidity arising from the QE programs has been substantial. Central bank balance sheets across developed market economies have grown US$13 trillion over the past 18 months (see Chart 1), far more than in prior periods and roughly double the gain in nominal GDP over the same period. That liquidity has been supportive of all asset prices globally. The reduction of QE will change the global liquidity picture, but we are not concerned in the near term.

Chart 1: Total Assets of 20 Central Banks



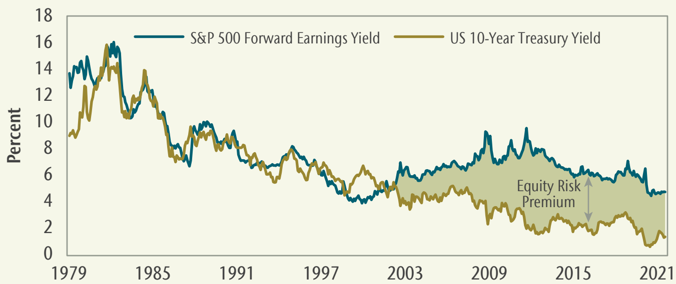
Countries included: US, UK, euro area, Japan, China, Switzerland, Australia, Canada, Denmark, Norway, Sweden, Chile, Taiwan, India, South Korea, Malaysia, Mexico, Poland, Saudi Arabia & Singapore.

Source: Macrobond

[1] What is effective is incentivizing business investment, and indeed we believe this to be a feature of the coming cycle; but it does little to help retailers this holiday season.

Central banks have learned from prior episodes to prepare markets to expect this. Moreover, rate hikes are likely a long time away; we anticipate another year or so. Even with this slowing in purchases, the level of cash remains high and there is little discussion yet of beginning to sell off assets. But critically, the mechanism of influence from QE to markets is actually through interest rates. For now, economies are hitting supply constraints that are limiting their growth and that should in turn keep yields from surging, provided that inflation metrics remain in check. Indeed the May 2013 Taper Tantrum period is instructive. Despite the rise in longer dated yields, the Fed kept policy rates unchanged until December 2015. During that period, the S&P 500 sold off by about 5% following the taper announcement before rebounding to post a 30% increase for the year and did not experience a 10% drawdown until late 2015. Finally, equity markets today, have a fairly strong yield advantage with an equity risk premium that has a large cushion before looking unattractive (see Chart 2).

Chart 2: Equity Risk Premium Supports Tilt Toward Stocks



Note: S&P 500 forward earnings yield minus 10 year Treasury bond yield is a proxy for the equity risk premium.

Source: S&P Dow Jones Indices, U.S. Department of Treasury, Macrobond

CAPITAL MARKETS

While investor risk appetite remained relatively well supported through August, some corners of the market appear to be pricing in an economic slowdown. Canada's economy, which is levered to both global demand and lately the housing market, clearly led the way with Q2 GDP posting a drop of 1.1% along with a weak start to Q3. As a result, 10-year Canada bond yields have settled to about 1.2%, down one-half percentage points from the spring; oil, copper, and lumber prices have tumbled; and within the equity market, some defensive leadership is taking hold with large cap companies and defensive utilities sectors outperforming while cyclical sectors such as industrials and materials are underperforming. Meanwhile, promising news of further fiscal support in the form of the US$550 billion infrastructure bill passing in the US Senate, and a pathway for tapering planned for later this year, rather than imminently as some feared, helped support global equity markets. The MSCI ACWI rose 2.7% and the S&P 500 gained 3.0%, each marking seven straight months of gains, while the S&P/TSX Composite posted a gain of 1.6% closing near all-time highs. Company earnings estimates for 2022 in the US are continuing to advance, despite higher input prices and shipping costs. In fixed income markets, the recent month has been subdued, and the Government of Canada and US Treasury 10-year yields rose just 3 bps and 7 bps, respectively. Credit spreads widened slightly, leaving the FTSE Canada Universe Bond Index largely unchanged at -0.12% in August.

PORTFOLIO STRATEGY

A number of shifts are likely to occur over the coming months: people are transitioning back to their workplaces and schools, there are concerns over the Delta variant and the slowing economy, governments are planning to end their supportive unemployment programs, and of course the gradual pullback in asset purchases by central banks. The coming months could be a bumpy period for financial markets as we work through the tapering announcements and implications. Given how far equities have come and some of the above noted risks, further upside is likely not as large or as clear as it was a year or six months ago. However, we still believe equities will outperform bonds, so we remain overweight equities in balanced portfolios against an underweight in bonds. The fundamental equity portfolios continue to focus on companies who can maintain earnings growth through pricing power, as the markets continue to be driven more by corporate earnings and less by valuations. In fixed income portfolios, we have pulled in risk somewhat, staying modestly overweight corporate bonds. While the pullback from ultra-accommodative policy is on its way, it will be a drawn out process and we will be monitoring the environment closely along the way.