Connor, Clark & Lunn
INVESTMENT MANAGEMENT

OUTLOOK

APRIL 2022

It was the steepest of curves, it was the flattest of curves. If there has been one characteristic of this current, young business cycle, it is that moves that typically progress over months and quarters are instead happening at breakneck speed. The output and employment gaps that expanded during the 2020 recession have largely closed over the past year, in record time. Coming out of the 2020 recession, we were in the early part of the Expansion – Peak – Recession – Trough phase of the business cycle. Today, just a few quarters later, we are already debating if we've seen the peak and are entering into a contraction period. An important driver of this sudden shift in the conversation is that a key metric captured the market's attention in early April: the US yield curve. More specifically, the difference between the 10-year US Treasury yield and the 2-year Treasury yield became negative. In other words, 2-year yields, which had been ripping higher since October of last year, caught up to, and surpassed the rising 10-year yields during the first week of April. The inversion of the yield curve is a well-known predictor of a coming recession (see August 2018 *Outlook*). Consistent with the way things have been going, this inversion also happened within a record short period from the US Federal Reserve's (Fed) first rate hike on March 16th (see Chart 1).

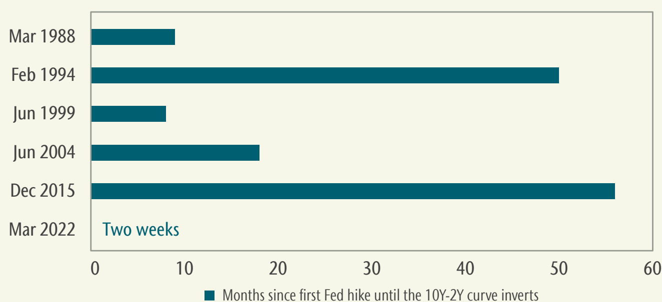
HOW WORRIED SHOULD WE BE?

Probably the most commonly followed yield curve inversion signal is in fact the 2-year, 10-year curve. This is because each recession since the late 1960s has been preceded by an inversion there. However, it is worth noting that the converse is not true - not every inversion has implied a recession. Nonetheless, this certainly raises the risk of recession and the historical experience suggests it takes between 8-24 months for a recession to occur.

Research at the Fed[1] has found that a better predictor of recession is actually the spread between the 10-year and 3-month terms. These are the terms that go into some of the leading indicators at the Conference Board and the NY Fed's recession model. That makes sense – central banks must actually tighten policy and not just talk about it. Another way to put it is that the 2-year less the 3-month part of the curve is still extremely steep at about 1.8% (see Chart 2). This is a reflection of the Fed only nudging rates higher so far, but signaling to markets its intention to move at every meeting from now till mid-2023, and perhaps even in occasional 50 bps increments. The result is a record divergence in the direction between the 3-month to 2-year curve and the 2-year through to 10 year curve (see Chart 3). Persistence and depth of the inversion matters, because it is not just a signal or a predictor. A flatter curve can discourage banks who borrow at short term rates and lend at longer term rates, thereby slowing credit expansion.

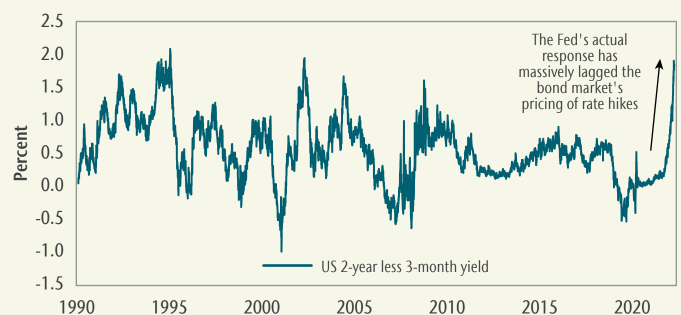
It's difficult to lay out a clear path of scenarios, because more so than in any prior cycle since the late 1970s, the unusually high inflation rate demands that policy rates exceed the central banks' estimated neutral rate (around 2-2.25%), in order to slow demand. Short term (3-month) rates are going higher. And yet, at the long end of the curve, the massive store of bonds totaling

Chart 1: Yield Curve Inversion Following Start of Fed Hiking Cycle Happened More Quickly in 2022



Source: Deutsche Bank

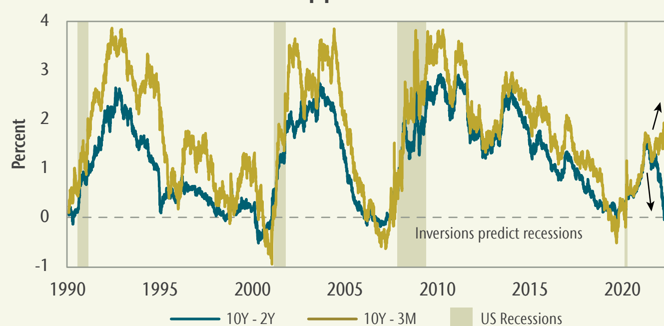
Chart 2: Behind the Curve



Source: U.S. Department of Treasury, Macrobond

[1]Bauer, Michael D., Mertens, Thomas M., "Information in the Yield Curve about Future Recessions", FRBSF Economic Letter, August 27, 2018 and Estrella, Arturo, Mishkin, Frederic S., "The Yield Curve as a Predictor of U.S. Recessions." Federal Reserve Bank of New York, June 1996

Chart 3: Yield Curves in Opposite Directions



Source: U.S. Department of Treasury, Macrobond

about US $8.9 trillion, accumulated over four major rounds of quantitative easing since the GFC, will now start to shrink quite rapidly. That could pressure longer term yields higher; which end of the curve moves faster is not yet clear.

The Fed is also far behind the curve in relation to its developed market peers. Indeed, Canada's yield curve, as measured by the spread between the 10-year yield and the 2-year yield, is still not inverted. With strong immigration to fill job openings, a higher employment rate (74.7% of Canadians in the labour force are employed compared to 70.5% in the US), demand for Canadian commodities supporting national incomes, and fiscal policy remaining accommodative, in contrast to the US, a recession appears further away.

Summing it all up, it is worth recalling that recessions occur when falling demand compresses profit margins and prompts corporate restructuring. This is not quite on the horizon yet – corporate sector profitability remains near cycle highs and demand has held in, as consumers draw on their vast pool of savings. The debate over the timing of a recession is part of what we are monitoring today, but we believe we are not there yet, especially in Canada. But we remain watchful, especially given how fast markets have been repricing everything.

CAPITAL MARKETS

Asset class performance was mixed in March. This is in contrast to the broad-based sell-off in risk assets experienced in the first two months of the quarter. The biggest reaction was seen in bond markets, with yields spiking across the yield curve. Two-year yields jumped 79 bps in Canada, and 10-year yields rose 49 bps. Corporate and provincial bond spreads extended their widening from earlier in the quarter into the first two weeks of March but eased partway through the month. Still, for the quarter, bond markets posted one of their worst quarters in nearly 40 years, with the FTSE Canada Universe Bond Index falling 7% and Bloomberg US Aggregate bond index returning -6%.

Equity markets managed to bounce mid-month and recoup some of the earlier declines. The MSCI ACWI recouped 2.5% and the S&P 500 rebounded 3.7% (and gained 8% off its mid-month lows). Developed equity markets outperformed emerging markets which continued to see challenges from Covid-19, war, supply shocks and inflation. Canadian equities outperformed, with the S&P/TSX Composite rising 4.0% in March, helped by gains in the consumer staples, industrials, energy and utilities sectors. Indeed, commodity prices continued to advance broadly. WTI crude surged another 4.8% in March, its fourth straight monthly rise.

PORTFOLIO STRATEGY

There is little doubt that all central banks have found themselves in response mode to the resilience of inflation, none more than the Fed. While central banks typically aim to achieve a soft landing, the high rate of inflation implies policymakers are now willing to sacrifice growth to restore price stability. Our base case has moved to a slowing in growth, a rising recession risk and thus we expect we are moving into the later stages of the economic cycle. Therefore, we are shifting some exposures in Canadian equity portfolios to stable businesses with strong free cash flow, resilient profit margins and well managed balance sheets. Nonetheless, neither a first rate hike nor an inverted yield curve means a near term end to equity bull markets. Over the past seven hiking cycles, the S&P 500 continued to rally an average of over 6% in the six months after the first rate hike.

Given our view of a slowdown this year, but not yet a recession, balanced portfolios remain overweight equities and underweight bonds. In response to the growing uncertain macro environment, we pulled in the risk twice during March, trimming global equities and reducing the underweight to fixed income slightly. Positioning within bond portfolios has been adjusted such that the yield curve position is structured with a flattening bias (underweight shorter-term bonds, overweight longer-term bonds) and duration modestly longer than the benchmark to account for heightened risks and a slowing economic growth outlook, particularly in the context of the sharp move higher in interest rates so far. Corporate and provincial bond allocations have also been reduced. Over the past couple of years, it felt a bit like we've been through the best and the worst of times. Through each shock, economic event and market reaction, we will continue to assess incoming information, manage risk and look for opportunities.

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