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Investment Management

OUTLOOK

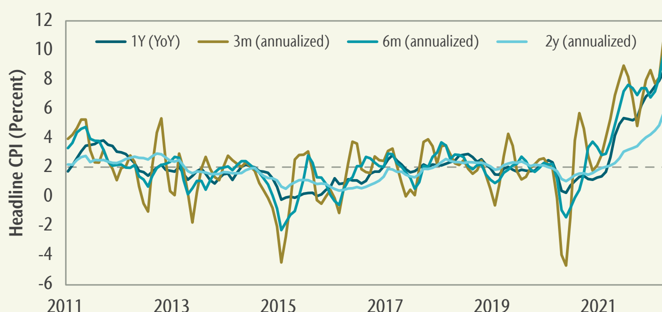
MAY 2022

Is the glass half full or is it half empty? From the end of the last recession, we are inevitably moving towards the next one. The only question is when it will occur. What has happened in the past few months is a remarkably fast shift from an early cycle to late cycle economic environment, and we are now in limbo, waiting for the indicators to signal that we are embarking on another economic contraction.

US economic strength was seen in the details of the droopy Q1 GDP reading that showed the US economy contracted 1.4% quarter over quarter at an annualized rate. The underlying dynamics were actually fairly strong with domestic demand rising 2.6%. In fact, aggregate GDP only contracted by drawing down inventories and importing more, both to satisfy some of that demand. Inflation also generally peaks with the economic cycle and so far, the Consumer Price Index (CPI) has continued to accelerate with 3-month measures faster than 6-month and 1-year changes (see Chart 1). Along with the higher inflation, we are seeing expectations for higher wages. While work stoppages as reported by the US Bureau of Labor Statistics (BLS) remain low and the degree of unionization has declined over the past three decades, it is true that the bargaining power of workers is as high as it has been in decades. This has been reflected in numerous labour market indicators, such as the high pace of voluntary departures from employment. In fact, employers are hiring at a rapid clip, with the economy-wide monthly addition at an astounding average of 600,000 new jobs in each of the past 6 months (in a late-cycle environment no less), taking the unemployment rate down to 3.6%. Perhaps most importantly, the outlook for the labour market is strong. There are currently twice as many job vacancies for every unemployed person, a record high (see Chart 2). So, we are not near the point of recession yet.

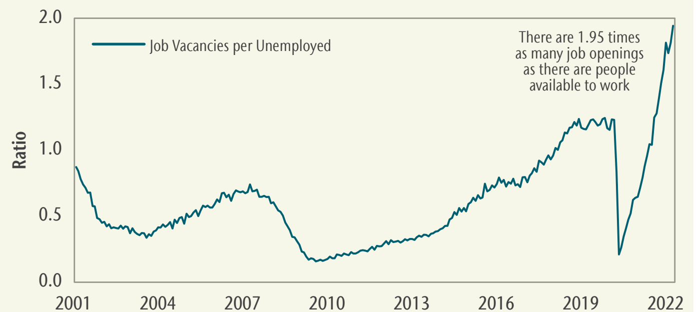
However, the prevailing high rate of inflation is really the main source of discomfort today. For the populace, *The Atlantic* publication noted last month, “[high] inflation is an everyone problem and unemployment is a some people problem”. Thus, the Fed’s only job today is to keep actual inflation and peoples’ expectations of inflation in line. The Fed does closely monitor inflation expectations, which appear to have become unanchored more recently. There is no clear and definitive red line of what defines “unanchored” inflation expectations, but we can infer it from Fed actions. Notably, the drumbeat of Fed speakers appears to communicate more concern – and hawkish policy intentions – when 10-year break-even inflation rate in Treasuries crosses 2.5%. At the end of April, that measure of inflation expectations stood at 2.9%, while another metric, the 5y5y forward rate climbed to an 8-year high of 2.7% (see Chart 3). As a result, even though today’s inflation is high, it is the fact the Fed is seeing inflation expectations rise that the Fed is clearly demonstrating a willingness to forego growth in order to achieve price stability. Indeed, the current economic signals that we are seeing today have given the Fed no real reason to give up monetary tightening.

Chart 1: US Inflation Still Accelerating



Source: U.S. Bureau of Labor Statistics (BLS), Macrobond

Chart 2: Take Your Pick



Source: U.S. Bureau of Labor Statistics (BLS), Macrobond

LESSONS LEARNED

At the Federal Open Market Committee (FOMC) meeting in early May, Fed Chair Powell gave markets a bit of a reprieve stating he believed a soft-ish landing was within the Fed's capabilities, and importantly downplayed the need for more aggressive 75 bps rate hikes (though put forward explicit guidance that 50 bps hikes were likely for at least a couple of upcoming meetings). Equity markets rallied 3% on the day (though it was short lived).

Indeed, the Fed and other central banks have now learned a lesson from the recent successive cycles of injecting ever more liquidity, more quantitative easing (QE), and lower rates (see September 2019 *Outlook*). There is indeed a price to be paid for all the generous supportive policy – inflation – and we are now paying it. The consequence is that the prevailing assumption that the Fed will come to the rescue when financial markets tumble, is likely gone, at least for now. Indeed, the Fed will distinguish between routine volatility in markets and intervention-worthy financial stability threats. It was earlier on the same day as the May FOMC meeting that former New York Fed President Bill Dudley suggested that equity declines are "...exactly what the Federal Reserve wants to happen." Such a deterioration in asset prices would bring some of the excess demand back in line with the longer-term trend rate by reducing some of the positive wealth effect (see Chart 4). But it does imply that despite the strong growth today, market risks lie ahead, a sentiment to which we remain attuned.

CAPITAL MARKETS

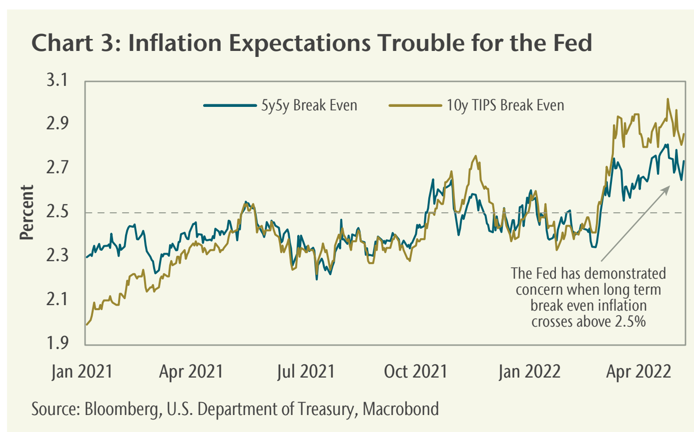
It has been hard to find a place to hide from the sell-off in financial markets as April extended another difficult month in markets, with both equity and bond markets down during the month. Investor sentiment across both retail and institutional investors is getting bearish; equity exchange-traded funds posted their largest outflow in three years. This led to the S&P 500 falling 8.7% in April, while the Nasdaq dropped 13.3% as growth sectors like technology saw valuations hit by rising interest rates. The S&P 500 has now fallen by 13% over the first four months of the year, the worst start to a year since 1939. Stocks globally were also hard hit, with the MSCI ACWI posting a 6.5% drop in local currency terms. In Canada, the S&P/TSX Composite saw a more modest 5% decline in April, outperforming many equity indices globally because of its heavy weighting in energy stocks and comparatively light weight in the tech and health care sectors. On a year to date basis as of the end of April, Canada's outperformance has been notable with the market posting just a 1.3% decline.

The acceleration in monetary policy tightening was reflected in government bond yields globally. Among the most notable moves, the US 10-year Treasury yield touched 3% for the first time since November 2018, effectively doubling in level from just 1.5% 4 months ago. Similarly, the German 10-year bund yield touched 1% for the first time since 2015. While the Eurozone economy is set to weaken due to the war, inflation overshadowed, with the preliminary April estimate for headline inflation in the Eurozone at 7.5% year-over-year, a new record since the formation of the euro. Canadian yields moved higher alongside other developed economies, and at the end of April, the 10-year yield sat just shy of 3%.

PORTFOLIO STRATEGY

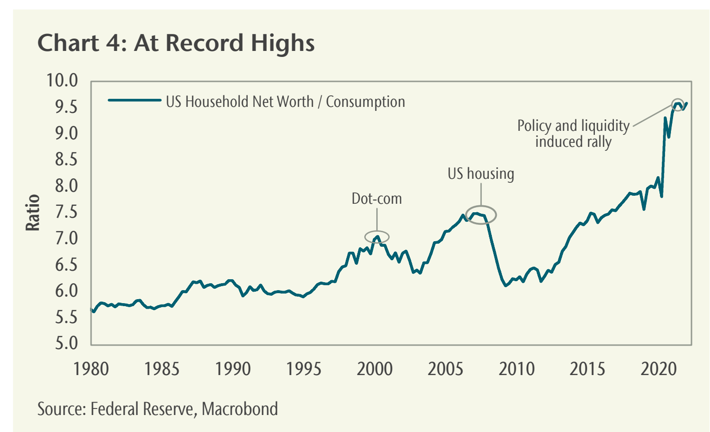
We remain mindful of the new environment for many market participants of high inflation and rising rates. Paramount among these market dynamics is that the Fed is of a single mind today, tightening policy sufficiently to slow inflation. We expect swift

Chart 3: Inflation Expectations Trouble for the Fed



Source: Bloomberg, U.S. Department of Treasury, Macrobond

Chart 4: At Record Highs



Source: Federal Reserve, Macrobond

policy actions to lift rates toward a terminal rate that is likely to exceed the longer-run neutral rate in some cases, which in those economies, moves rates clearly into restrictive monetary policy.

We continue to take solace in the fact that consumer and business balance sheets remain generally healthier than in past late-cycle periods, partly due to the fact this cycle has moved so rapidly. Additionally, despite the equity volatility, underlying corporate earnings continue to be solid. With nearly one-fifth of companies in the S&P 500 having reported Q1 earnings, revenues continue to beat expectations and earnings forecasts are still being (modestly) revised higher.

In our balanced portfolios, we maintain an overweight in Canadian equities and cash, and an underweight in bonds. The late cycle environment should remain positive for equities up until signals for the end of cycle become more apparent. However, we have reduced the tilt towards equities as the downside risks build, especially as markets must now contend with higher risk free rates. In three separate asset mix shifts over the month, we sold Canadian equities (trimming the overweight roughly in half), reduced global equities from neutral to a modest underweight and reduced the underweight position in fixed income.

Our fundamental equity portfolios have continued to position for the later stages of the economic cycle, adding to commodities and defensives, while selling cyclical industries. We remain focused on companies demonstrating the ability to maintain earnings with inflation a key risk. Fixed income portfolios have been structured for an upward move in short term yields relative to longer term yields, and thereby a flattening yield curve. The combination of a withdrawal of liquidity, higher rates, higher inflation and costs do not bode well for credit where we maintain an underweight exposure. Duration has been raised to modestly longer than the benchmark as yields have climbed. We continue to analyze the evolution of the cycle and attendant risks as we navigate these fast moving markets.

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