CONNOR, CLARK LUNN
INVESTMENT MANAGEMENT

OUTLOOK

AUGUST 2022

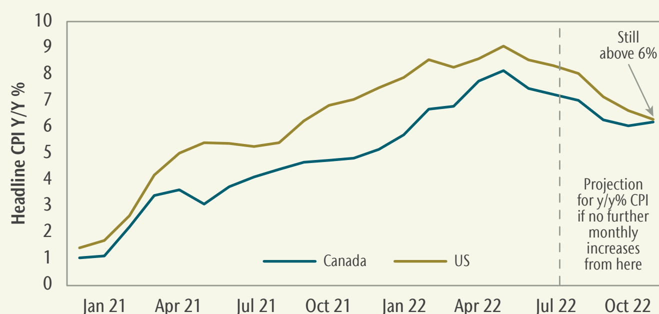
Roaring back, but for how long? As we noted in our July *Outlook*, mid-June marked a bit of a short-term turning point for markets, on the anticipation that slower growth would lead to a shift in central bank priorities. Some of the proposed implications seem somewhat farfetched to us. First is that the long and variable lags of monetary policy have effectively been eliminated. Typically, a late cycle-to-recession period lasts years, and markets have built in the expectation that for this cycle the timeline has shortened to about 16 months in total. This is reflected through rate cuts starting in mid-2023 after they just began hiking in March of this year. Higher rates will no doubt jolt spending and cause investment to contract, but the time period required to bring inflation down is unusually rapid. Moreover, the Federal Open Market Committee (FOMC) meeting projection for the neutral policy rate is about 2.5%, with inflation projected to come down to 2%, implicitly suggesting that a real policy rate of 0.50% will be enough to recreate an environment of 2% inflation and the modest growth scenario of the past decade. Indeed, this level for real policy rates was where the Fed ended its last hiking campaign in December 2018. That low level of real rates seems rather optimistic, when through the entire 2016-18 hiking cycle, CPI stayed between 1.4% and 2.9%, far below today's headline CPI at 9.1%. How plausible is this?

WHAT WILL IT TAKE FOR INFLATION TO MEET OPTIMISTIC MARKET EXPECTATIONS?

Taking a step back to review historical periods of high inflation, it is worth noting that for CPI to hit the market expectation of about 2% by the end of 2023, it will effectively need to fall by about 7 percentage points in just over a year. That has only ever happened once in the last half century, and to accomplish that, the US endured the Great Financial Crisis while oil prices concurrently plunged from US$150/bbl to $40/bbl.

Taking a closer look at current trends, we noted last month that the comparable monthly changes over the next four months will be a challenge to bring the annual change in headline CPI down (see July *Outlook*). Taking it a step further, if we were to see no monthly increases in inflation for the rest of the year, a simple calculation shows that headline CPI in both Canada and the US will end the year at a still elevated pace of about 6% (see Chart 1).

Chart 1: Headline Inflation to Remain Elevated



Source: Statistics Canada, Bureau of Labor Statistics, Macrobond

Decomposing inflation, recent readings show that the number of components experiencing high inflation is broad based. The trimmed mean measures of core CPI, which exclude those components whose rates of change in any given month are at the tail ends of the distribution (i.e. the most volatile factors), are high in both Canada and the US. For inflation to reverse to a more well-behaved level, it will take a broad reversal of all prices for CPI to ease. The good news is that commodity prices have already pulled back, with the S&P Commodity Price Index down 17% from its peak in early June to the end of July. Moreover, goods prices could very well see material discounting, as spending patterns shift and high inventory levels prompt sales.

The other two broad categories, however, represent material risks to the upside. The first is services prices that face a continued demand surge, while wages – a main component of the cost structure – push higher with continued labour shortages. The San Francisco Fed's latest research[1] suggests that the US level of Non-Accelerating Inflation Rate of Unemployment (NARIU) is now at 6%, having seen a large number of disruptions in the labour force, including exits and job changes. Indeed, today's unemployment rate of 3.5% in July, helped by over 500k jobs being created that month, implies labour markets are extraordinarily tight. Likewise, a working paper published by the Bank of Canada (BoC)[2] applied statistical filters to dozens of labour market indicators and found that overall we are above the range of tightness for labour markets and, for some indicators, near our historical best levels. It seems it will take more work to limit upside wage pressures.

[1] *Bok, Brandyn and Petrosky-Nadeau, Nicolas, "Estimating Natural Rates of Unemployment", FRBSF Economic Letter, May 31, 2022*

[2] *Ens, Erik, Luu, Corinne, See, Kurt, Wee, Shu Lin, "Benchmarks for assessing labour market health", Staff Analytical Note 2022-2, April 2022*

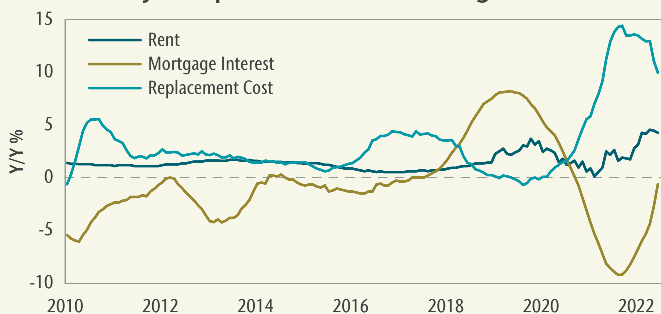
The second is shelter costs, which in both Canada and the US comprise just under one-third of the CPI basket. Despite the ongoing housing market correction that has both sales and prices turning lower, shelter costs in the CPI appear to be headed broadly higher. The main components account for shelter costs for renters as well as homeowners. The former is captured by rental costs. These typically act on CPI with a lag given how CPI is calculated, where rents are often fixed for a full year and renegotiated upon lease renewal. Even with this lag, the rental cost increases are at their highest since 1990 (see Chart 2). Moreover, these prices are typically persistent as it takes time for prices to adjust with contracts. For homeowners, the CPI is assessed via the ongoing cost of owning a home, including maintenance and replacement costs as well as mortgage interest costs. The last component has notably been as flat as a board since 1990, despite the three decade rise in property values (see Chart 3), and has been a longstanding moderating influence on CPI. However, this is now likely to flip from seeing year-to-year declines to increases, in direct response to the largest increase in the posted 5-year bank mortgage rate since April 2000. Pricing in rate cuts and a mild recession in 2023 seems like an optimistic scenario. We believe a better way to characterize CPI is that it will plateau and remain at a high level, at least above target, and for some time.

CAPITAL MARKETS

The first half of the year was a historically rough period that saw investor sentiment turn sour and risk assets decline significantly. US 10-year treasury yields peaked at 3.5% on June 15th and have since fallen to 2.65%. The S&P 500 bottomed at 3,637 around then, and soared 9.7% in the six weeks hence, led by growth-oriented, long-duration stocks. The USD stopped appreciating and stabilized. High yield credit default swaps peaked and have fallen materially. All of this optimism came about despite the US economy delivering its second straight negative quarterly GDP print, and a concerted global tightening in policy. The anticipation of slower spending on the back of higher rates that would limit Fed and other central bank tightening have led to the best month for equities since November 2020 (when vaccine efficacy rates were first made public) and March 2020 for bonds (when the world shut down). July saw broad gains for equities – the S&P/TSX Composite rose 4.7%, the S&P 500 surged 9.2% and MSCI ACWI jumped 7.1%, led by gains in developed market economies. Broadly, cyclical sectors outperformed defensive sectors, with industrials, technology and consumer discretionary all performing well.

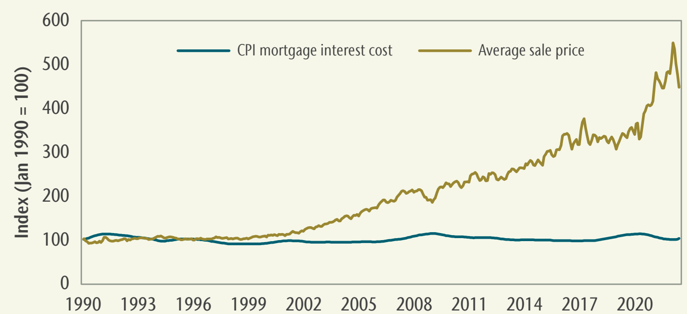
Even with the optimism, July saw central banks persisting with outsized rate hikes. The BoC raised its overnight rate by 100 basis points (bps) to 2.50%, the largest increase since 1998, with Governor Macklem emphasizing front-loading interest rate increases. The Fed raised its target rate another 75 bps and noted that, while the policy rate has reached its neutral level and it will need to move toward moderately restrictive territory, these moves will be guided by incoming data. Markets are indeed expecting the cycle to progress rapidly, now pricing in about 50 bps of rate cuts in the middle quarters of 2023. As a result, bond yields declined significantly, with two-year yields down 16 bps and ten-year yields dropping a significant 59 bps. Yield curves flattened materially and inverted. In the closely watched 2-year to 10-year spread, the Canadian yield curve has inverted by more than 40 bps to the deepest levels since 1990. Credit spreads tightened as volatility moderated and risk assets rebounded in anticipation of less aggressive policy going forward. The decline in yields and tighter spreads helped the FTSE Canada Universe Bond Index rebound 3.90% in July, the first positive return in seven months.

Chart 2: Shelter Costs Take Time To Pass Through, but Key Components Are Headed Higher



Source: Statistics Canada, Macrobond

Chart 3: Value of Homes Surged Yet Cost of Borrowing Has Been Flat



Source: Statistics Canada, MLS, Macrobond

PORTFOLIO STRATEGY

Inflation is clearly high today. We agree with markets that longer term, inflation should ease naturally as the full effects of policy actions are felt. Where we differ from market consensus today is that in the short and medium term, markets are underestimating inflation's stickiness to the upside. Furthermore, we expect that the slowing of economic activity will unfold over a longer period of time. While markets expect a more accommodative policy stance will benefit valuations, the near-term outlook for equity markets depends on the earnings outlook, which will be challenged through both higher costs and the slowing in topline growth. We believe earnings estimates are still too high and expect earnings to be revised down. While many are contemplating the possibility that we have seen the bottom in equity markets already, we are more cautious and believe financial market volatility will remain high. In our fundamental Canadian equity portfolios, we have been adding stable and more defensive companies while reducing companies whose earnings are tied to the economic cycle. Markets have shifted their focus to slowing growth, anticipating central banks are going to ease off tightening. We believe inflation will remain the paramount concern until it shows significant progress back to the central banks' target ranges. We expect further rate hikes, and that rate cuts in 2023 are unlikely. In our fixed income portfolios, we continue to position for the yield curve to flatten, a negative environment for credit, and expect Canadian bonds are likely to outperform US Treasuries. Balanced portfolios have steadily reined in risk through the first half of this year. We remain underweight fixed income as we anticipate continued tightening, while staying neutral equities overall with a modest tilt towards Canadian equities versus global equities.

Last month, we explored the greatest risk to our near-term view, which is a sustained upside surprise in inflation. This month, we assessed what is needed to bring inflation down by the end of the year, and in our eyes, it looks unlikely. Markets may feel sanguine about the outlook for policy, but our concern is elevated. We are looking for opportunities to reduce risk further as we navigate the second half of this year, and will look to add risk when we see more decisive evidence of victory in the inflation battle.

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