CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

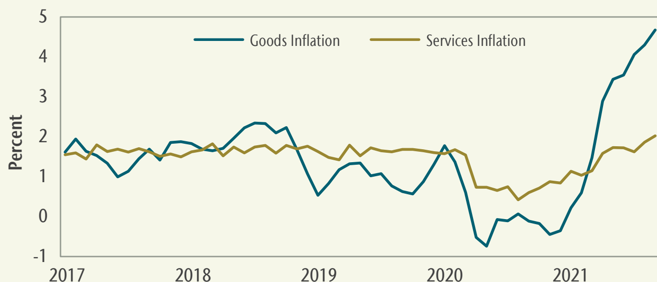
NOVEMBER 2021

The central banks have spoken. Inflation readings have overtaken COVID case counts as metrics to monitor daily. Consumer Price Index (CPI) readings across the world have risen, driven almost entirely by goods prices (see Chart 1). Meanwhile, economic growth has shifted to a slower pace, at least temporarily, as supply constraints are limiting what's available to buy. But high prices are also meeting resistance (see Chart 2), and this in turn may act as a further check against growth. Canada's GDP contracted in the second quarter, and early readings for the third quarter imply activity will also fall short of the 5.5% growth projected in the Bank of Canada's (BoC) October Monetary Policy Report. While likely still a high rate of growth, the level of economic activity is some 1.5% below its pre-pandemic peak. This is a larger gap than what exists in other major economies including the Eurozone (after a 9% surge in Q3, GDP is now just -0.5% below the prior peak) and US (which is actually 1.4% above its prior peak), and in line with the UK.

The concerning scenario circling the world now is whether services prices will also turn higher and this depends on two important factors: shelter costs and wages. The former is expected to rise gradually over time, while the latter has now given its strongest signal yet. At the end of the month, the quarterly reading of the US Employment Cost Index showed that the wages and salaries component grew 4.2% year over year, the highest pace in over three decades. Wages are important to support individual incomes. However, rising wages also drive services inflation and act as a sign of labour market tightness. For aggregate inflation to return to more benign levels, without a policy induced slowdown, we need some combination of a compression in corporate margins with rising wages not passed through to consumer prices, a bump in productivity to reduce costs, or a return of the labour force from those who previously exited. While we see the potential for all three to occur, it is the latter two factors that would support risk assets. From our lens, the coming capital spending cycle will help with the productivity growth part of the equation. Moreover, job seekers also look likely to return to the labour market, as vaccinations for kids and booster shots for seniors will help alleviate health and home caregiving concerns. Meanwhile, federal income support programs are drawing to a close, pushing real disposable income levels below trend. To be sure, total savings – some US$2.2 trillion, or some 9% of GDP in the US – are a healthy cushion, but these factors in aggregate should also lift workforce participation.

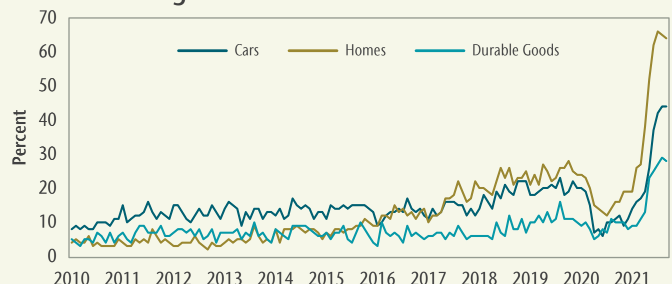
Against this backdrop of wage and price inflation rising against weaker-than-expected growth, this past month policymakers sent a clear message on which of the two is the greater concern. Almost in unison, policymakers globally have pulled back on quantitative easing and the management of longer term yields. The Fed has formally announced the tapering of its asset purchase program this past week; the BoC stopped it altogether; and the Reserve Bank of Australia dispensed with

Chart 1: Inflation Is All In Goods Prices Right Now



Note: Developed market goods and services CPI based on average of Australia, Canada, France, Germany, UK, Italy, Japan, US.
Source: ABS, StatCan, DESTATIS, ONS, Istat, BLS, INSEE, Macrobond

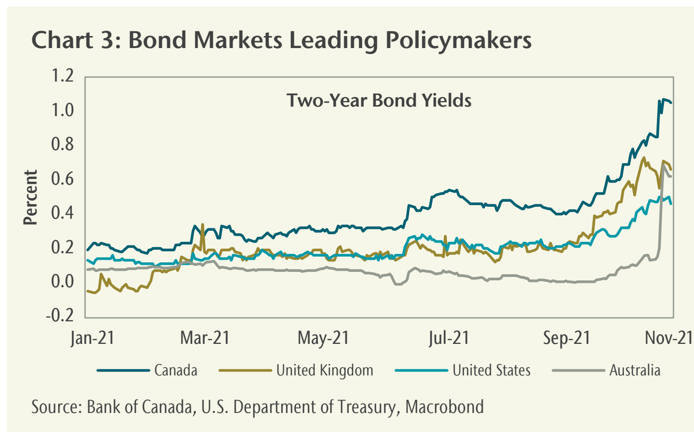
Chart 2: Consumers May Delay Purchases Because of Rising Prices



Note: Survey of consumers showing proportion indicating it is a bad time to buy due to high prices.
Source: University of Michigan, Macrobond

its yield curve control program. The European Central Bank and Bank of Japan are notable exceptions. Still, through this period, bond markets have been a step ahead of central banks and have priced in a considerable amount of tightening. Two-year yields have surged (see Chart 3), and in Canada have priced in nearly six rate hikes for next year. Notably, there was a much more benign reaction in longer term rates, a contrast to last month when longer term rates led the increase in yields. So, even as wages and inflation are high today, it seems that bond markets are worried that either central banks are overreacting to a price surge that will ultimately prove temporary, or alternatively, that the secular forces – decline in global working age population, automation, debt supercycle – are still not over. In the near term, it's apparent that a tightening of policy is coming. While tightening financial conditions will not repair supply chains or factories sidelined by COVID, or unblock transportation bottlenecks, the pullback in policy support will serve to slow the strong demand for goods by consumers. Central bank focus has decidedly turned to battling inflation, even if it means that winning that battle will sacrifice some growth along the way.

Chart 3: Bond Markets Leading Policymakers

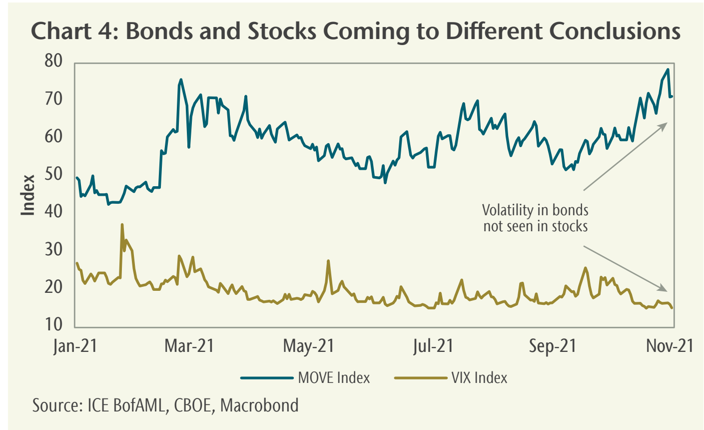


Source: Bank of Canada, U.S. Department of Treasury, Macrobond

CAPITAL MARKETS

Stocks and bonds appear to be sending inconsistent signals in response to central bank messages this month. Volatility in bonds has picked up, while equity market volatility remains steady (see Chart 4). Stocks rebounded after a rocky September posting their strongest monthly rise this year. The S&P 500 rose 7.0%, the MSCI ACWI rose 5.0%, which matched the gain from the S&P/TSX Composite, also 5.0%. The fundamental

Chart 4: Bonds and Stocks Coming to Different Conclusions



Source: ICE BofAML, CBOE, Macrobond

picture for equities still looks strong through Q3 earnings. With roughly half of the S&P 500 companies having reported, revenues are strong and beating expectations, demonstrating the ability for companies to navigate the current high cost and high demand period. Moreover, earnings growth is beating expectations by about 7%, which while positive, is the lowest earnings beat rate since the pandemic, but comfortably ahead of the long-term average. Companies are demonstrating an ability to maintain or expand operating margins with some price pass through. The market continues to see strong leadership from the pro-cyclical sectors of the market, notably automobiles, semiconductors, transportation and financials, reflecting continued optimism in a reacceleration after growth moderated in the middle of this year.

Commodity prices have also been consistently strong this year. WTI oil prices surged 11.4% last month, extending the YTD gain to 72% while natural gas prices were not far behind, before easing near the end of the month. Indeed, some regions saw relief from record high prices heading into the winter, notably in Europe, as Russia began refilling storage facilities. Coal prices, which had surged in China on the shutdown in supply, have eased as production resumed. Prices for industrial metals also advanced, led by copper, as did agricultural prices. In aggregate, rising commodity prices are feeding fears of inflationary pressures. Interest rates in Canada have surged recently, with 10 year yields rising 21 bps in October to 1.76% and two year yields posting the largest one month gain since March 2010, rising 49 bps. The FTSE Canada Universe Bond Index fell 1.05% for the month.

PORTFOLIO STRATEGY

Despite the diverging signals provided by stocks and bonds, the underlying economic conditions are indeed fairly strong. If the stock and bond markets are disagreeing on something today, it is policy. Perhaps central banks will prematurely move to tamp down on high short-term price signals or perhaps over tighten on more sustained supply driven inflation, resulting ultimately in slower growth. However, even as short-term futures markets predict rate hikes, we believe that the BoC will stick to its spring-summer guidance for its first rate hike, and move at a slower pace. This is especially true in Canada, as all sectors of the economy are highly sensitive to interest rates given the high debt levels. Thus, a measured pace of tightening combined with strong commodity prices are supportive for our outlook that equities will outperform bonds. Our balanced portfolios remain overweight stocks, particularly Canadian stocks where the sector composition should benefit from reflation. Fundamental equity portfolios are positioned with a barbell approach - maintaining a bias towards cyclical stocks, such as financials, industrials and technology with the above trend economic growth supporting companies leveraged to strong demand but we also remain overweight higher quality and more stable growth companies. Fixed income portfolios should benefit from added yield with a modest corporate credit overweight, but in aggregate we pulled in risk even before the October volatility. We have added to positions that favour the short-term area of the curve. The message from central banks is clear – inflation will be contained. A resolution to supply chain issues and a return to normal demand should go far in limiting the need for an aggressive tightening cycle, but we will be assessing the developments closely and look for opportunities through the market swings.

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