CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

DECEMBER 2021

We have had a few setbacks on the path to normal. Concerns earlier in the year surrounding stagflation have diminished as the growth scare in the summer in Canada, the US and China have given way to inflation being sustained. Inflation is clearly the topic du jour, and confidence in even calling what direction it will move next year is under considerable debate, yet it will be the driver of policy and markets over the coming year. Much of today's 30-year high inflation readings are attributable to core goods prices, in particular durable goods such as the auto sector that have had to deal with an inability to source parts in order to meet hot consumer demand. Unfortunately, this month, just as supply chains looked like they couldn't get any worse, they did.

Throughout the month, news of renewed lockdowns in Europe came alongside rising Covid-19 caseloads, and that news was followed closely by the arrival of the Omicron variant. Weeks later and there is still little we really know about this new variant – there is no solid data on its transmissibility, hospitalization, and mortality rates, nor, critically, the lasting effectiveness of vaccines. The implications, however, are familiar. Supply chains in Asia, where zero-Covid-19 policies are more widespread, are still bottlenecked along with transportation lines; new travel restrictions are contributing to second thoughts about travel plans; and return to work in high touch areas remains tenuous. This suggests it will be a prolonged period of time before normalization, meanwhile the cost of living is rising.

Unrelenting storms here in British Columbia presented yet another supply side challenge. Heavy rains came after this summer's wildfires, and drought conditions made the ground unable to cope. The province's highway system, rail transportation, and oil lines that connect the main population centres to the rest of Canada, and property and farms in the area experienced catastrophic damage due to flooding and mudslides and were shut down. Inbound supply constrictions resulted in shortages for gasoline and groceries, and airlines stepped up with all-cargo flights. Outbound goods present an even greater problem. The Port of Vancouver is the country's largest port based on volume of goods (more than 3.5x the next largest port), and accounts for just over one-third of port tonnage in the country.

The full economic impact of the flooding could pull Canadian GDP modestly negative in November, though strong momentum leading into the fourth quarter should be sufficient to keep overall GDP growth for Canada still near a trend pace. Encouragingly, next year should see some investment from governments and businesses to rebuild and improve the resiliency of the infrastructure. That should provide a small positive boost for fiscal spending next year. However, despite the magnitude of the shock, this is unlikely to move the Bank of Canada (BoC) off its path towards tightening policy.

On the surface, shocks such as these lead to slower economic growth and perhaps some caution from policymakers. However, in the days after these shocks, US Federal Reserve (Fed) Chair Powell suggested in his Senate testimony that the Fed might be considering "wrapping up the taper of our asset purchases ... perhaps a few months sooner" than previously thought, shrugging off concern over the virus as well as a related market selloff. As we discussed in our November Outlook, policymakers are recognizing the repercussions of prolonged and excessive stimulus. The implication is that a new fiscal stimulus (if the economy locks down again) is unlikely and the desire to keep monetary policy stimulative is clearly waning.

CAPITAL MARKETS

Following a bumpy September and a recovery in October, the volatility in equity markets persisted into November. The first half of the month saw positive investor sentiment supported by strong economic data as well as surprisingly soothing outcomes from both the Bank of England and the Fed. Moreover, a strong Q3 earnings season, where margins among many companies were preserved even with higher costs, helped equities hit fresh record-highs mid-month. However, the sequence of news and events that followed soured sentiment around risk assets. The S&P 500 ended the month 0.7% lower, while the MSCI ACWI (local currency) and the S&P/TSX Composite each fell 1.6%.

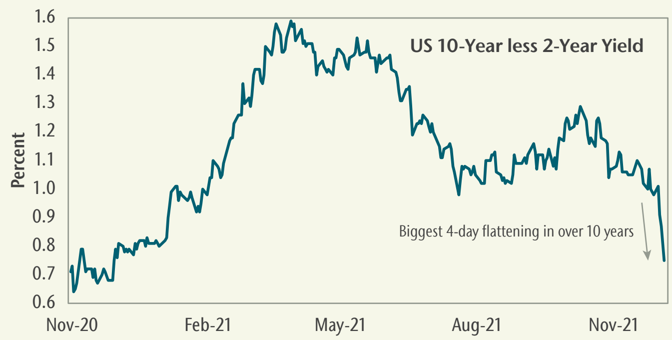
Underlying the moves in the indices overall have been a large number of index constituents that have traded sharply lower, stemming from a rotation away from cyclical stocks and some growth sectors. Industrial stocks like airlines were hit hard, expecting yet another setback in the return to normal travel, while the retail segment of the consumer discretionary sector warned that factory closures and port delays may see further lost sales combined with higher airfreight costs. Commodities saw some of the biggest selloffs, led by oil prices. WTI plunged 20.8%, the worst month since the pandemic began, and energy was one of the largest drags on the index, though it remains strongly positive year-to-date.

In bond markets, short term interest rates backed up significantly, pricing in the likelihood of Fed rate hikes earlier in 2022. This has led to a notably flatter than normal yield curve prior to the onset of a hiking cycle. In the aftermath of Powell's comments, the yield curve posted its largest four-days of curve flattening in over 10 years (see Chart 1). Typically, interest rates move in the same direction, but this move in the curve was the combination of two-year yields rising and 10-year yields dropping. Our interpretation of these market moves is that patience with today's high inflation readings has now diminished and we can expect higher policy rates. At the same time, long rates are under downward pressure precisely because today's high inflation rates aren't going to be tolerated. For the month as a whole, the rush into safe haven assets pushed government bond yields generally lower, resulting in sovereign bonds posting one of the only positive returns across asset classes for the month. Two-year yields rose 7 basis points (bps) in the US as markets repriced Fed expectations while ten-year yields declined 13 bps. In contrast, two-year yields eased slightly in Canada while 10-year yields fell 14 bps. Alongside the deterioration in risk assets, credit markets also saw spread widening for the first time in a year. High yield bonds led the selloff though the widening was felt across investment grade and provincial bonds too. The FTSE Canada Universe Bond Index posted a 0.87% gain in November.

PORTFOLIO STRATEGY

Although there is little that is known about the new Omicron variant, we know supply chain disruptions are going to persist, extending inflationary pressures overall. Economic conditions should broadly improve, and despite the debate surrounding inflation and range of possible inflation outcomes, policy is likely to tighten. Volatility is almost certainly going to rise into the New Year. Within our fundamental equity and fixed income strategies, we have pulled risk in on the margin. Equity portfolios have maintained a bias towards higher quality cyclical and growth stocks, and have begun to look for opportunities to increase exposures during the sell off. Fixed income portfolios continue to be managed with a more neutral outlook for the direction of the yield curve, given the recent flattening, particularly in Canada. Indeed, already more than five rate hikes are expected by the BoC in 2022. However, this could reverse as we see a fuller picture of economic activity across Canada, and we maintain a steepening bias for now. Balanced portfolios remain overweight stocks, overweighting Canada and underweighting global stocks, to benefit from more favourable valuations and sector exposures. Oftentimes, setbacks and new challenges present new possibilities. We will continue to look for these as we turn the page to the New Year.

Chart 1: Flattening in US Yield Curve



Source: U.S. Department of Treasury

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