

# OUTLOOK

JULY 2022

**“I don’t think we are going to go back to that environment of low inflation... there are forces that have been unleashed... that we are facing now that are going to change the picture and the landscape within which we operate.”**  
– ECB President Christine Lagarde. There is no way to spin it – market returns through the first half of the year were dismal, reflecting the dawning realization of a genuine honest-to-goodness tightening cycle taking policy firmly into restrictive territory. Yet, as we began the third quarter, interestingly there was a fairly big counter-trend at play, as markets rallied on the expectation that a recession would curtail central bank tightening. Oil prices plunged, yields fell, equities inched upward led by growth stocks. This looks to us like a classic bear market rally.

Reading into the moves, it appears that investors are interpreting a recession as the “good news” scenario. It implies that investors believe central banks, with policy rates peaking somewhere around 3.5% to 4%, will successfully break the uptrend of inflation, and interrupt a possible wage-price spiral. We can breathe a collective sigh of relief and return to the low growth, low rates environment to which we have grown accustomed. Even better, this cycle can begin with equities more fairly valued, and bonds generating some nominal yield that may even appreciate if central banks cut rates next year.

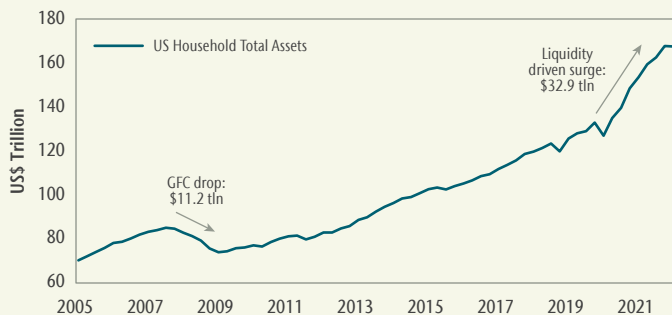
But, what if ECB President Lagarde is on to something. What if, despite the enormous levels of indebtedness across the developed world economies, and interest rates at around 4% (last seen more than a decade ago), are not enough to quell

inflation? Indeed, despite how terrible consumers are reporting they are feeling (US consumer sentiment levels hitting record lows dating back to 1953), they actually have fairly strong tailwinds. First, household cash balances at banks remain strongly above their norms, thanks to COVID-era fiscal stimulus. Moreover, despite the retreat in equities and bonds this year, there has been an accumulation of wealth that has been 3 times larger in magnitude than the total losses in household asset values through the GFC (see Chart 1). While lower income groups do not benefit much from either of these effects, it is worth noting this demographic is gaining from both strong job gains and the highest wage increases out of all income quartiles (see Chart 2).

Over the coming months, the stubbornly high inflation scenario is not far fetched. Base effects will work to temper headline inflation in coming months in both Canada and the US (see Chart 3). However, increases in some stickier prices like rents and services prices could persist, especially with continued strong wage demands and high turnover.

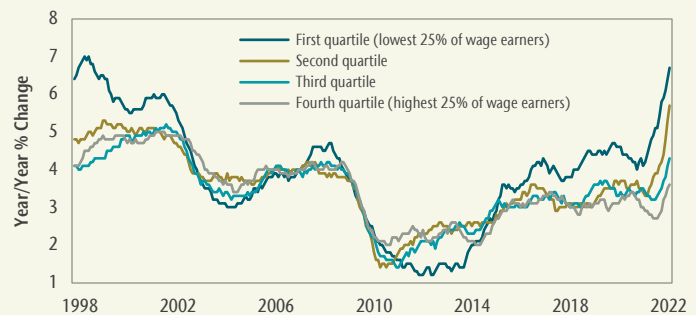
This scenario is probably the greatest risk to our outlook overall because policymakers will be stuck between two downright terrible alternatives. The first, is compromising by explicitly permitting sustained above-target inflation. It would run counter to stated inflation targeting objectives and implies central banks will be sacrificing hard-fought inflation fighting credibility. The second, is forcing interest rates considerably higher than markets currently anticipate, producing a deep, protracted recession.

Chart 1: US Household Asset Values Surged



Source: Federal Reserve, Macrobond

Chart 2: Lowest Wage Earners are Seeing Biggest Jumps in Pay



Source: Federal Reserve Bank of Atlanta, Macrobond

In the first case, volatility reigns as markets parse the intent and moves of a central bank that has given up inflation targeting. Markets may rapidly alternate between pricing in rate cuts and hikes, much like in the early 1980s. The experience could stretch over years. In the second case, the end point for rate hikes will be higher than markets envision today. Historically, policy rates have ended tightening cycles above inflation rates (see Chart 4), as financial conditions turn restrictive. However, the more tightening we get, the greater the possibility of an unforeseen financial tail event after the last prolonged period of ultra loose and highly liquid conditions.

In our view, neither one of these cases is likely. But, neither are they implausible. Under such scenarios, a defensive stance would be warranted. Importantly, high quality companies with strong balance sheets, stable cash flow and protected operating margins would best hold value. Globally, regions that do not command superior valuations today but who are fighting inflation aggressively should do well, which interestingly today includes emerging markets. Real assets would likely perform well, including commodities and some segments of real estate. Cash itself would also be a decent hedge. So, as we head into the second half of the year, we are closely watching all incoming data on inflation, and remain on alert for any underlying shifts in central bank tenor.

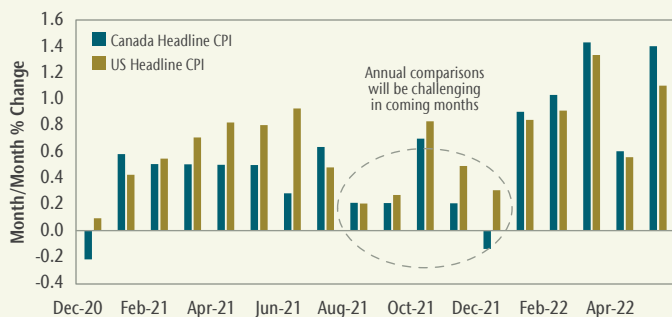
## CAPITAL MARKETS

Despite a mid-June rally, weakness persisted across markets last month with nearly all asset classes posting fairly uniform declines. Global equities fell, with the MSCI ACWI declining 8.6%, its largest monthly drop since the pandemic. Declines were seen in emerging markets (MSCI EM down 7.2%), the US (S&P 500 falling 8.4%) and Canada (S&P/TSX Composite dropping 9%). The weakness was widespread outside of the energy sector which was the lone industry to post a positive

return. This was odd given commodity prices reversed the steady gains achieved earlier this year. The WTI oil price fell 7.8%, posting its first monthly decline on recession fears. The jump in headline CPI mid-month caused a realization of yet larger rate hikes to come and bond yields surged, with two-year yields rising 45 bps and 10-year yields up 30 bps in Canada. In combination with widening corporate and especially provincial spreads, the FTSE Canada Universe Bond Index declined 2.2% in June.

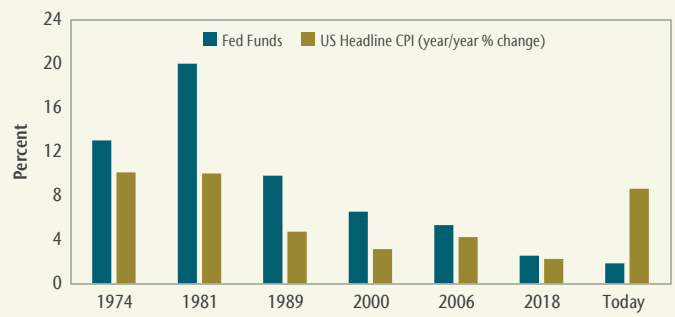
However, the real story has been the longer term context of how poorly markets have fared over the first six months of the year. In the first two quarters, Canadian bond returns posted the worst and third worst returns on record, since the Universe Bond Index began tracking. This theme was global; in the US, bond returns were reported to be the weakest since 1788! Meanwhile, even with an end-of-May and then mid-June rally, stocks posted their worst first half of a year since 1962. The S&P500 fell 21% with every sector down, except for energy as equity valuations repriced how high rates may need to rise. Expectations for short term rates rose with the Fed Funds futures for the end of 2022 rising from 0.8% at the start of the year to 2.4% at the end of Q1 to 3.4% at the end of Q2 (the latter easing off from a peak of 3.8%.) Because the repricing is global, this only has the effect of compounding the collective downturn. Across the world's three largest economies economic growth is flatlining – self-imposed in China, war-induced in Europe and the US GDP moribund though largely due to imported goods supplying still decently strong domestic demand. Still, with Eurozone and US PMIs now scarcely above 50 and the 2-year to 10-year yield curve flattening to close to inversion, the outlook is tenuous. Where this has not yet been seen is in earnings. Guidance remains strong, and bottom-up forward earnings estimates are still, almost incredulously, calling for a near 10% increase in 2023. We will be monitoring this closely as we go through Q2 earnings season.

Chart 3: High CPI to Remain



Source: Statistics Canada, U.S. Bureau of Labor Statistics, Macrobond

Chart 4: In Tightening Cycles, Policy Rates Peak Above CPI



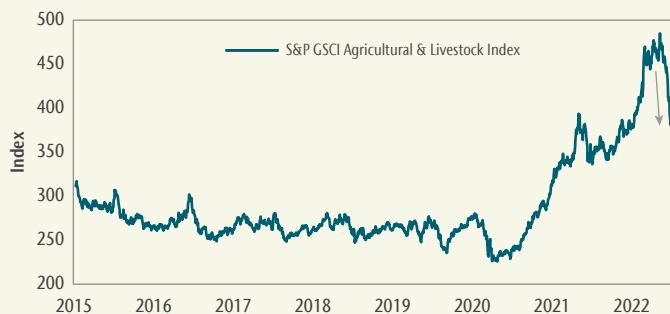
Source: Strategas

Note: Fed Funds target rate and US CPI at the end of prior tightening cycles

## PORTFOLIO STRATEGY

To be clear, our expectation is that the high inflation rates will ease. There is already evidence that is happening: commodity prices have rolled over, with oil below US\$100/bbl and food prices down since May (see Chart 5). Moreover, inventories for goods have been reported to have surged among key retailers. Anecdotal easing in shortages among key inputs, like semiconductors, also signal that we are perhaps past the worst of the supply chain bottlenecks. Finally, China and their manufacturing industry is reopening slowly and cautiously. Taken together, the supply side should contribute meaningfully to an easing in inflation.

Chart 5: Food Prices Rolling Over



Source: S&P Dow Jones Indices, Macrobond

Yet inflation is coming off a startlingly high pace. Monetary policymakers assert these high levels necessitate a move toward restrictive policy. While slowing economic growth has historically led monetary policymakers to ease off tightening in the past, we believe the bar to do so is very high this cycle so long as inflation is vastly in excess of stated targets. In June, we continued down the same path of pulling in risk. Within our balanced portfolios the overall equity overweight was sold down to benchmark weight but we maintain a tilt towards Canadian stocks against global equities, reflecting greater risks in the still more expensive US market. We have also reduced the underweight to fixed income further with a corresponding overweight to cash. Fundamental equity portfolios continue to favour high quality companies with solid business models and strong pricing power that can maintain profit margins. Fixed income portfolios are positioned in anticipation of flatter curves, led by further central bank rate hikes. For now, the key data releases will be the range of inflation and wage metrics to confirm if they indeed ease over the second half. However, the dominant (but still low probability) risk in our view is that we end the year with sustained upside surprises in inflation. That would lead us into a different and even more difficult environment in the new year.