CI GLOBAL ASSET MANAGEMENT

BLOGS

2021 Q3 Outlook: Pausing at the Peaks

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The peak of everything

This year's second quarter represented the peak of just about everything. A year ago, we were in the epicenter of pandemic-driven lockdowns. This year, Q2 encompassed the reopening and relaxation of restrictions across most developed economies. As a result, economic data comparisons will be lapping the weakest data with rapid improvements. For example, in the U.S. we're already seeing:

- Inflation at decades high levels
- Q2 GDP tracking close to 10% by some estimates; and
- Expected Q2 earnings estimates close to 70% year-over-year.

Those are some punchy numbers!

However, that's likely as good as it will get. Data is massively inflated due to low-base comparisons and the transition from lockdown to reopening. But this does not mean an end to the recovery. Rather, we are shifting from accelerated to gradual growth – albeit still well above the economic, inflation and earnings growth estimates going into 2022. The recovery will continue, just at a slower pace. By the same token, returns on risk assets, such as equities, will also slow compared to the past year.

Reaching the end of recovery

Transition periods are often bumpy for markets and that has been evident in recent weeks as:

- Interest rates have declined
- The U.S. dollar has rallied; and
- There's been aggressive rotations between sectors in equity markets.

From my perspective, this is mostly a constructive pause for markets following a strong rally in risk assets over the past year, particularly since the vaccine announcements last November. Keep in mind, a healthy market unfolds in a two-step forward, one-step back fashion. From that perspective, the peaking of U.S. 10-year Treasury yields at 1.75% before rallying toward 1.2% in early July, should ease fears of interest rates rising to the point of curtailing growth and/or valuations.

While we may be transitioning to a later stage of recovery, we are still closer to the beginning of the cycle than the end. Consider that:

- Economies are in various stages of reopening, so robust employment gains will continue as businesses rehire
- Supportive fiscal and monetary policy persists
- Financial and credit conditions remain attractive
- Excess savings are in the US$2 trillion range; and
- Record net worth for U.S. households will support pent up demand spending, particularly in the services sectors.

This is not a bearish backdrop.

The vaccine factor

Against this, the main risk remains vaccine-resistant COVID-19 cases sufficient to overwhelm health care systems. While the current Delta variant is driving a fourth wave in many countries, it appears the severe risk is within unvaccinated populations. This will have global implications, particularly on growth rates in emerging countries without sufficient access to vaccines. This in turn implies some areas of the global economy, including international travel and supply chain logistics, will continue to be affected well into next year.

For developed economies with higher vaccine rates, we may see a slower pace of reopening and some targeted restrictions. But it’s unlikely we’ll return to broad-based lockdowns. As the rise in COVID-19 cases in unvaccinated populations continues to illustrate vaccines’ effectiveness, and to the extent vaccine passport-type policies are implemented, it may encourage vaccine acceptance amongst those who are hesitant. We shall see.

Inflationary angst and Powell policy

Arguably the biggest driver for markets recently has been inflation. In the U.S., June Consumer Price Index (CPI) and core CPI numbers came in at 5.4% and 4.5% respectively, some of the highest levels in decades. Is this elevated inflation merely transitory, or is it structural in nature, indicating we are moving into a more inflationary environment? The issue involves both what the unfolding inflation trends could be, and how policymakers (particularly the U.S. Federal Reserve (Fed)) might react to higher than expected inflation.

Interestingly, the Fed had been far more confident than bond markets. This indicates the inflation is transitory and policymakers are still a way from reaching their criteria to remove accommodative monetary policies. But just as they appeared to have won the battle at the June meeting when U.S. interest rates drifted from the 1.75% peak to the 1.5% range, they blinked. The ‘dot plot’ and commentary gave the impression they were moving up the expected timeline to remove accommodations through earlier tapering of quantitative easing (monetary policy designed to increase money supply in the markets) and liftoff for interest rates.

The Fed's path forward

While I believe there has been some misinterpretation of the Fed's path forward, there is no doubt that the June meeting was a hawkish turn versus its prior stance. Ironically, just as markets became more optimistic around longer-term inflation concerns, the tilt raised concerns that the Fed might tighten too soon and curtail both the recovery and expected inflation outcomes.

The outcome of all this has been a stronger bond rally and an unwinding of reflation trades within equities and across asset classes. This feels overdone. But the pause in the pace of market growth along with concerns about the impact of the Delta variant will give the Fed the room they need to extend accommodations. It's likely any tapering could be pushed into January 2022, while the earliest potential interest rate increase is back to late 2023. Regardless, monetary policy remains supportive and will stay so. Further, the ability to keep interest rates negative for longer is also intact with the real U.S. 10-year Treasury yield back toward a negative 1%! This will be the biggest challenge to savers in the coming decade – there is no positive rate of return on risk-free assets!

Fund positioning

Within CI Global Income and Growth Fund, we're currently positioned as follows:

- Overweight equites with a tilt toward cyclical recovery themes
- Underweight government bonds
- Overweight investment-grade credit
- Maintaining an allocation to gold.

While the reflationary positioning has come under pressure recently, we don't feel that fundamental drivers of recovery are done. As mentioned, we anticipate decelerating but above-trend economic growth in developed economies through 2022.

We foresee a similar dynamic for inflation, but are mindful that longer-term risks of both higher and lower inflation are more elevated today than in recent decades. While the current low-rate environment is leaning us toward the disinflationary outcome, incorporating inflation protection into the portfolio, such as allocations to gold and real assets, remains prudent.

Above average GDP growth and inflation will in turn support stronger corporate earnings. This should allow markets to 'grow' into their current valuations. Even with interest rates increasing at a slower pace, it should continue to support the ongoing economic recovery and above-average valuations on risky assets.

Entering the back half of the year, we are holding the course with our positioning for an ongoing reflationary cycle. We see the recent market turmoil as a mid-cycle pause, not the end. We expect risky assets to resume their outperformance, but we also anticipate the path forward will remain bumpy with modest, yet still positive returns for equity markets.

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