ECONOMIC RESEARCH AND STRATEGY

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Spring 2021 Economic and Financial Outlook – Now is the Time to Rebalance

Very Fast Materialization of our December 2020 Market Calls

With vaccination solidifying the global outlook, adaptation of consumers and businesses to lockdown measures and the alignment of fiscal and monetary policies have led equity markets to all-time highs. Now is time to revisit our strategic asset allocation for the next 12-18 months.

Let us begin by reviewing our previous calls. Several of our predictions from December 2020 including an overweight strategic allocation to equities relative to bonds have already materialized. The recovery has been brought forward and we now expect global real GDP growth in 2021 to surpass slightly the 6% figure projected by the IMF in April. Vaccination has kept hospitalisations at bay in several developed countries despite the stubbornly elevated number of confirmed global COVID-19 cases, particularly in emerging markets.

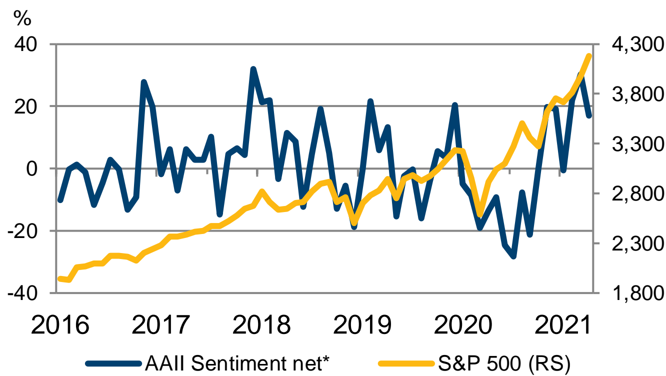
The U.S leads the global recovery. The US$1.9T American Rescue Plan (ARP) notably including a third round of checks was particularly larger than anticipated. The control of the Senate by the Democratic Party reinforces the odds that Congress will pass the US$2.3T Build Back Better plan later this year, which should increase potential GDP in the long run. Thanks to the rapid vaccine rollout, the reopening in 2021Q1 contributed to the highest percentage of S&P 500 companies, at 86%, reporting positive earnings surprises, the most since 2008 at least according to FactSet. The S&P 500 index already surpassed our previous 2021 year-end target. The majority of subsectors registered double digit price returns. In contrast to our December expectations, the U.S. equity market did not underperform relative to Canada and other developed markets. However, Canadian investors unhedged in the U.S. equity market saw their gains cut by almost half due to the robust appreciation of the Canadian dollar. The loonie's appreciation was propelled by the other big player of this multi-polar world: China. The Chinese central government spending spree, the build-up of inventories and pent-up demand were firing on all cylinders in recent quarters.

In Canada, supply disruptions that had slowed the immunization campaign earlier this year are mostly resolved at this point. The vaccination campaign will soon eliminate short-term noise in high-frequency data created by multiple lockdown measures, increasing our conviction that a broader and sustainable reopening is about to happen. As for the S&P TSX, the reflation trade led to above-par gains in the financials, industrials and consumer discretionary subsectors, privileged in our December outlook. OPEC+ reluctance to ease the deep output cuts in place since last year surprised global markets. The International Energy Agency (IEA) estimates the most of the excess oil inventories have been exhausted. The IEA forecasts a steady increase in global demand going forward. The combination of these factors contributed to push WTI prices close to US$10 above our previous forecast of US$55/bbl.

Finally, the beginning of 2021 was particularly challenging for the bond market. Our call for a steeper Canadian yield curve occurred faster than we thought. Our previous Canadian interest rates targets for year-end 2021 have been reached due a turnaround in the term premium, short-term inflation concerns, the beginning of QE tapering by the BoC and a marked preference from the federal government to issue longer term bonds going forward.

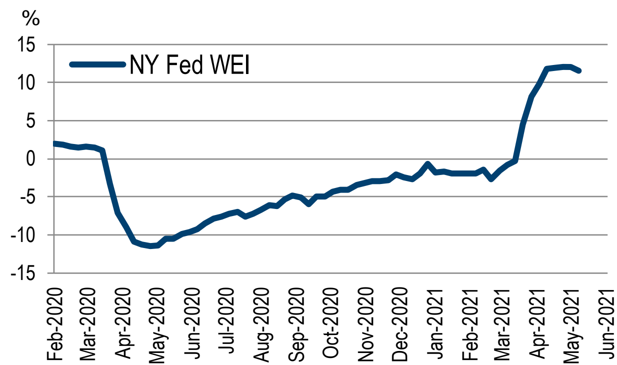
Signs of Peaking U.S. Momentum and Market Sentiment: Downgrading Equities Allocation to Neutral
The accelerating economic momentum and fading COVID-19 risk in developed markets fueled the global chase for yield. Saying market sentiment has been high so far in 2021 would be an understatement. The American Association of Individual Investors (AAII) Sentiment Survey suggests extreme bullishness (chart 1). Similarly, 61% of Americans think the U.S. stock market will gain ground within the next year according to the April University of Michigan consumer confidence survey, close to previous all-time highs. The FOMC Financial Stability Report released in early May also underscores warning signals in terms of risk appetite. Bullish market sentiment led to record ETFs inflows over the first three months of 2021 according to FactSet. American households held a record-high 41% share of their assets in equities. Some of these invested dollars are subject to outflows as the reopening ignites consumer spending. Signs of irrational exuberance showed up in February during the *meme* stocks frenzy. Financial populism took a step further when many investors increased their exposure to cryptocurrencies in April and May. We agree with Federal Reserve Chair Powell and Bank of England Governor Bailey warning investors that they should be prepared to lose all their money given the absence of intrinsic value in decentralized peer-to-peer currencies.

Chart 1: Very optimistic market sentiment in 2021



*Net percentage of investors who feel the stock market will be higher in the next six months.
Source: AAII/Bloomberg Finance L.P. and LBS Econ. Res. and Strategy.

Chart 2: U.S. economic activity is peaking



Note: The weekly economic indicator (WEI) estimates U.S. GDP growth using 10 high-frequency economic indicators.
Source: Federal Reserve of New York, ISM Institute, LBS Economic Research & Strategy.

The recommendation to move from an overweight to a neutral equity allocation is not merely mechanical. Our call is tied to an inflexion point in both economic momentum and global QE. First, equities rarely outperform when peak momentum is past, something suggested by the New York Fed Weekly Economic Indicator (chart 2). Slowing ISM manufacturing and non-manufacturing PMI indices, above 60 in April, is also in the cards. However, the solid medium-term economic outlook prevents us from suggesting an underweight allocation to stocks. For instance, the IMF and the OECD peg global real GDP growth to moderate from 6% in 2021 to a still-robust 4% pace in 2022. Projected GDP growth in both the U.S. and Canada is also around 4%. Such growth is unambiguously above-trend, but also lowers the bar for earnings disappointments.

Central bankers won't be able to avoid tapering talk for too long. The Federal Reserve, currently buying US$80B in Treasuries every month, is moving closer to a QE tapering announcement. The Fed's goal to promote inclusive labour market outcomes across age cohorts means monthly asset purchases will not be entirely phased out during the first half of 2022. Nonetheless, the economic situation will have embellished enough to convince markets that the Fed's QE will eventually end. In Europe, the ECB's pandemic emergency purchase program will not end at least until March 2022 but officials are likely to start discussing paring down stimulus relatively soon. All in all, even if QE remains open-ended in some countries, we think global exit strategies will substitute global QE as a dominant market theme.

Excessive Public Debt and the Future of Taxation

Fiscal packages introduced by governments to mitigate the adverse impacts of the pandemic stand out from the dominant Reagonomics neoliberalism policies of the 1980s. Japan announced in late March a record spending budget of ¥107T in 2021 but investors start to question the BoJ's willingness to put a floor on equities with its ETF purchases. In Europe, the EU recovery fund is meant to promote the green transition, less supportive of real GDP growth over the next 12-18 months. Accordingly, we prefer to move from an overweight to a neutral equity allocation to developed countries excluding U.S. and Canada.

In Canada, the federal government proposed $100B over the next three years to promote economic growth and inclusiveness. In the U.S., spending for transportation infrastructure, affordable housing and better access to high-speed broadband are the main pieces of the Build Back Better program. While markets have priced in the positive news, economists continue to debate the short- and long-term impact of these policies on economic and social outcomes. Inclusive social policies could partly reverse past real GDP drag generated by inequalities.

This being said, aggressive pandemic fiscal responses left public finance more vulnerable than ever to higher interest rates. Debt servicing costs remain very low relative to history but could rise further in the coming years. The April 2021 IMF Fiscal Monitor reveals a record high public debt-to-GDP ratio of 120% in advanced economies, limiting the ability of governments to counter future financial and economic downturns. Large debt burdens increase the odds that future deficits will be financed by new tax levies, particularly since governments seem unwilling to implement austerity measures. Secretary Yellen's push for a global minimum tax rate on corporations, the proposed U.S. corporate tax rate increase from 21% to 28%, and higher capital gain taxes for ultra-wealthy Americans are insufficient to erase post-COVID structural deficits. Consequently, we cannot rule out additional tax increases in the future. History suggests that tax hikes have not been immediately punitive on equity markets after their implementation due to the positive fiscal multiplier effect. This being said, market concerns over after-tax corporate earnings are likely to gain ground this time.

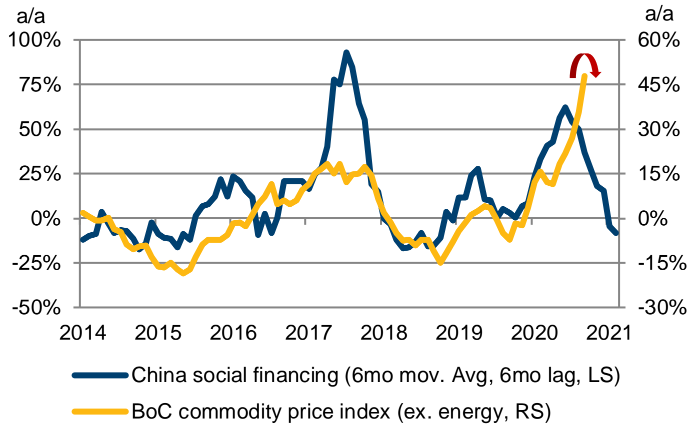
The lower 60% public debt-to-GDP ratio in emerging markets make them less subject to higher taxes but does not make them more attractive from an asset allocation perspective. Indeed, several EM remain vulnerable to capital outflows, currency volatility and higher all-in financing rates, in addition to having relatively poor vaccination rollouts and insufficient health care capacities. Thus, we prefer to maintain a neutral equity allocation to EM.

Most of CPI Inflation Pressures Appear Transitory

The drivers behind inflation concerns are materially different relative to previous inflationary eras. First, the late-2020 positive vaccine results brightened the outlook. Second, shifting consumer preferences and lockdown measures still limit consumption of services in several countries, excluding the U.S. Both contribute to unusually strong spending on goods products. Third, decades of underinvestment in mining, agriculture and domestic electronic capacities, streamlined global supply chains, tight forestry management practices and consolidation in the maritime freight business also contribute to supply bottlenecks. For instance, manufacturing backlogs in the U.S. have continuously increased over the past 10 months according to the latest ISM report. New orders particularly outpaced production for fabricated metal products, computer and electronic products, transportation equipment, chemical products and food, beverage & tobacco. Meanwhile, strong demand for the transportation of merchandise goods led to soaring shipping costs worldwide. All in all, cost-push inflation is suddenly a short-term threat to corporate margins, an element not our radar last December.

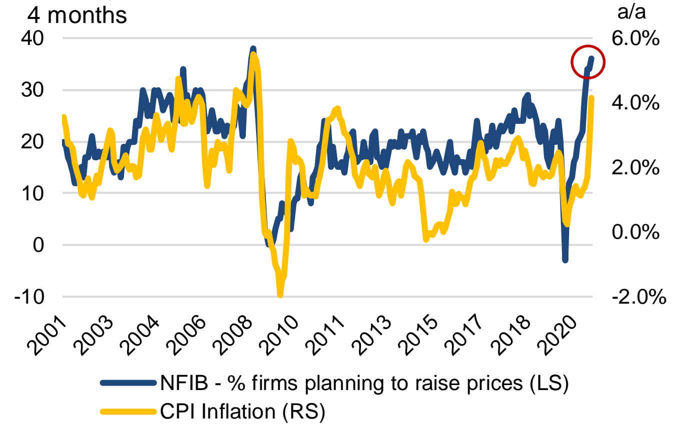
However, in contrast to taxation and QE tapering, we are confident to witness lesser inflationary concerns 12-to-18 months from now. The sources behind the current run-up in CPI inflation should ease during the second half 2021 and in 2022. First, the base effect currently boosting inflation and resulting from negative CPI growth in the early stages of the pandemic will start to dissipate in May. Second, sectors reopening in developed countries including Canada should restore some equilibrium in the consumer spending mix between goods and services (chart 6). In turn, this should alleviate pressure on specific supply chains currently stretched such as motor vehicles. Third, the slowdown of Chinese governmental stimulus suggests the end of the commodity price rally (chart 3).

Chart 3: The chinese stimulus rolled over



Source: Refinitiv, LBS Econ. Res. and Strategy.

Chart 4: U.S. businesses raised prices this spring and they intend to continue to do so in the next 3-4 months

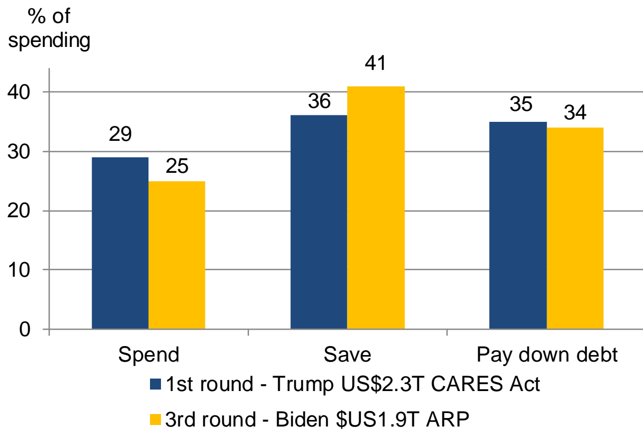


Source: NFIB, BLS / Refinitiv.

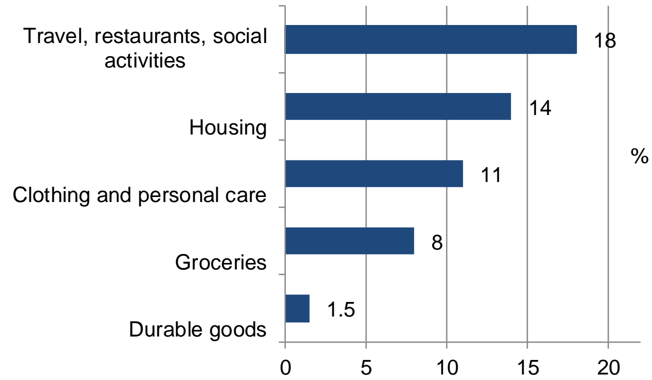
Until transitory inflation subsides, the ability of companies to pass on to consumers rising input prices will influence sectoral equity performance. The latest reading from the U.S. NFIB survey shows the highest net percentage of small businesses looking to increase prices over the next three months since 2008 (chart 4). The story is similar in Canada. The balance of opinion relative to higher output prices for businesses reached a record high in the latest BoC Business Outlook Survey. Also, respondents to the CFIB business survey plan to increase consumer prices by 3.1%, also a record high. Overall, Canadian CPI inflation is likely to briefly surpass the upper bound of the 1%-3% inflation range in the near-term and average 2.5% in 2021. It should then moderate closer to 2.2%-2.3% in 2022 and 2.0% in 2023.

Consumers Deleveraging to Ease Inflation, Shifting Preferences still Favour Uneven Discretionary Spending

Most households' financial situation unusually improved during the pandemic, contrasting with other recessions. Statistics Canada reported that Canadian homeowners' net worth jumped by $66K on average in 2020, approximately a 10% gain driven by soaring housing and equity prices. Savings also soared through the roof and led some households to deleverage at a faster pace. It is too early to tell if the pandemic has been a "wake-up call" for individuals to build resiliency, marking the beginning of a long deleveraging cycle. In any case, the ongoing preference to pay down debt is disinflationary in nature. Recent surveys provide valuable colours on this shifting habit. The latest New York Fed Survey of Consumer Expectations indicates that about one-third of the money sent by the U.S. government to households will be used to pay down debt (chart 5). The BoC Canadian Survey of Consumer Expectations (SCE) stipulates that 15% of accumulated savings will be used to pay down debt, a slightly lower ratio. Deleveraging slightly tempers our expectations relative to the length and intensity of a "roaring moment" for consumers. Spending and savings intentions also vary by age groups. In the U.S., the Conference Board confidence index level for baby boomers remains relatively low compared to younger people even if a majority of them have already been vaccinated. Similarly, the BoC SCE shows that Canadians aged 55+ look forward to engage in fewer social and economic activities relative to before the pandemic after vaccination. Older generations seem to prefer avoiding mass gatherings and socialize in a "safer" way, leading us to remain upbeat about the sales outlook for recreational vehicles. Also, housing demand in non-urban areas is poised to stay strong. New surveys continue to show a strong preference for work-from-home post-pandemic in both the U.S. and Canada.



Source: New York Federal Reserve Consumer Survey.



Note: Net percentage of consumers reporting higher spending.
Source: Bank of Canada Survey of consumer Expectations Spring 2021.

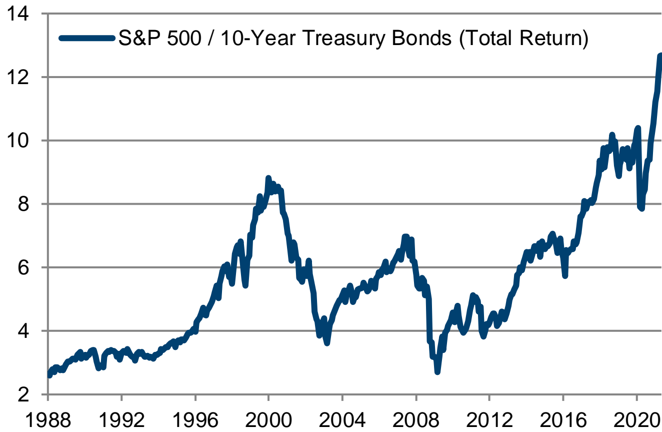
All in all, it appears to be an appropriate time to shift from an overweight equity allocation to a neutral stance. On the positive side, the reflation trade still has some legs: global real GDP growth in 2022 should stay above potential and contribute to closing the global output gap further. Furthermore, the Federal Reserve's new policy framework increases tolerance relative to above-target inflation, leaving U.S. monetary policy accommodative for longer. We continue to favour the TSX financial sector, attractively valued relative to other sectors such as consumer discretionary. While the U.S. equity market did not underperform as expected due to a strong performance from communication services, information technology and consumer discretionary, these sectors are vulnerable to our concerns about taxation, consumer deleveraging, and an inflexion points in economic momentum and monetary policy easing. As such, our recommendation to modestly underweight the U.S. stocks remains intact. For the time being, Canadian investors should also hedge their position in U.S. dollar equity markets (see section below).

Upgrading Bonds Allocation to Neutral

Government sovereign bonds have provided a negative total return so far this year, driven by both inflation uncertainty and the turnaround in the term premium associated to the improved economic outlook. Nominal yields have reached pre-pandemic levels across many segments of the yield curve during the first quarter of 2021, earlier than what we had anticipated in our December 2020 outlook. North American bond yields have been fairly stable since the beginning of April. The steepening of the Canadian yield curve in early 2021 was triggered by the shift in the federal government's debt management strategy that will rely more heavily on 10-year and 30-year bonds from now on. We are at a point where bonds are excessively cheap relative to equities (chart 7). The very rapid deterioration in the pricing of bonds relative to equities is in our view driven by the short-term global chase for yields discussed above rather than credit risk repricing.

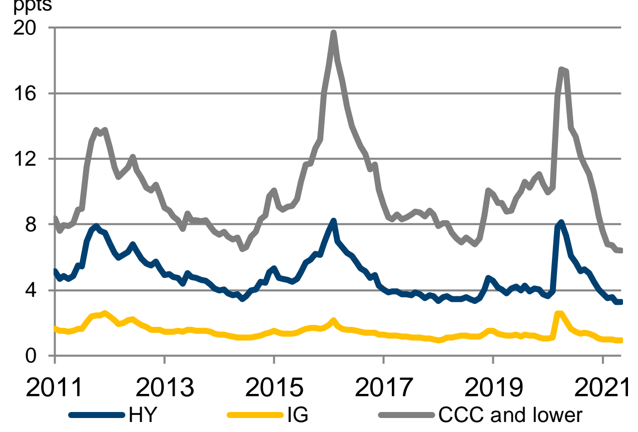
Meanwhile, there is not a lot of room for further positive returns in the corporate bond universe. Both investment grade and high yield corporate bond spreads hover around historically tight levels (chart 8). Government emergency measures drove down business bankruptcies below pre-pandemic levels last year, particularly helping small and medium-sized firms. Larger companies with capital access took advantage of low financing costs. Investors have climbed down the quality ladder in their search for yield and drove up the valuation of the "junk" market (bonds rated CCC and lower) to an all-time high. That being said, the corporate bond market is more heterogeneous than before, and thus more vulnerable. The April IMF Global Financial Monitor stipulates that additional corporate debt reflects 1) higher balance sheet liquidity assets and 2) borrowings to cover for stress events such as short-term financial payments at troubled firms. Overall, we also recommend a neutral allocation to the corporate bond universe.

Chart 7 : Equities have neven been this expensive relative to bonds



Source: Refinitiv, LBS Econ. Res. and Strategy.

Chart 8 - U.S. Corporate spreads are at or close to record lows

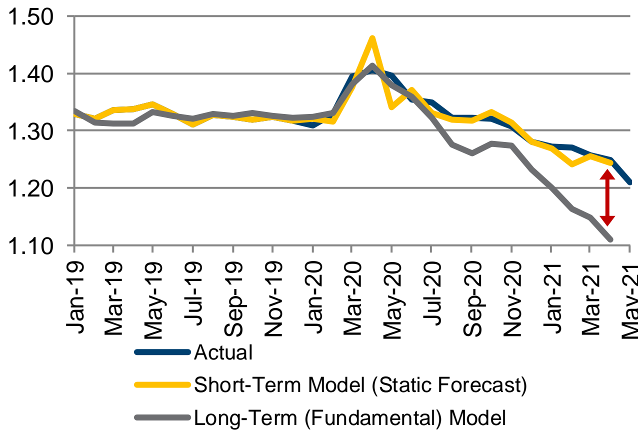


Source: FRED.

Loonie – Most of the Appreciation behind Us

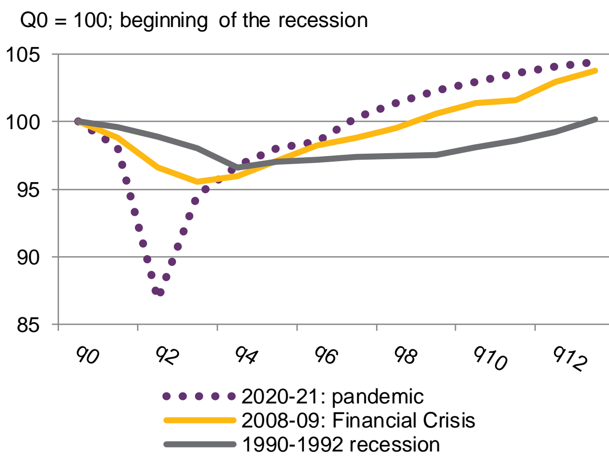
The Canadian dollar already received a large dose of positivism. The USDCAD went from 1.30 before the initial vaccine results were released last November to below 1.21 mid-May, lower than our December forecast deemed optimistic relative to consensus at the time. The rally in commodities explains most of the Canadian dollar strength. Canada-U.S. interest rates differentials play a lesser role. With the U.S. ahead in terms of vaccination and fiscal support, the net short position of investors on the U.S. dollar recently subsided and restored some stability to the Greenback. Our model-based USDCAD fundamental (long-term) value, driven by energy and non-energy prices, stood at 1.11 in April, its highest mark since 2014. The fundamental value does not imply that the Canadian dollar spot pricing will converge to this level in the near future. Instead, it suggests, all else equal, additional strengthening for the loonie (chart 9). Accordingly, we revise our year-end target to 1.20, from 1.22 last February.

Chart 9: The Canadian dollar remains undervalued



Source: LBS Econ. Res. and Strategy.

Chart 10: Canada Real GDP



Source: Statistics Canada, LBS Econ. Res. and Strategy.

Closing Remarks – Multiple post-pandemic Risks

Our last words go to the stronger-than-expected acceleration in economic momentum in early 2021. Several economies are currently experiencing a V-shaped recovery including Canada (chart 10). Permanent damage to households' financial situation is particularly small relative to the 1990s and the 2008-09 recessions. The flip side of the coin is that the world does not begin this new expansion cycle on a "clean" sheet. Indeed, beside the risk associated to future COVID-19 variants, risks and vulnerabilities cited at the beginning of our December 2020 outlook report are still intact: cybersecurity threats, inequalities that could trigger social unrest; an increasingly multi-polar world creating geopolitical tensions; and the adoption of new policies to accelerate the global reduction of carbon footprint. Many of those are included in the World Economic Forum (WEF) 2021 Global Risks Report. Respondents to the WEF survey put the highest weights to environmental risks, an argument supporting increasing capital flows in the ESG market. In a similar way, the cryptocurrency market, if left unchecked and unregulated, could become a vulnerability to global financial stability.

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Strategic Asset Allocation Recommendation	Overweight (Underweight)
Fixed Income	=
Government	=
Corporation	=
Equities	=
Canada	+
United States	-
Other Developed Markets	=
Emerging Markets	=

Financial Forecasts

	19Q4	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q4
Canada											
Overnight Rate Target	1.75	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.00
3-Month Treasury Bills	1.65	0.07	0.08	0.10	0.10	0.10	0.15	0.15	0.25	0.50	1.00
2-Year Bond	1.70	0.19	0.23	0.35	0.40	0.50	0.60	0.80	0.80	0.90	1.25
5-Year Bond	1.68	0.39	1.00	1.00	1.10	1.20	1.25	1.40	1.50	1.60	1.85
10-Year Bond	1.70	0.67	1.56	1.65	1.70	1.75	1.80	1.85	1.90	1.90	2.25
30-Year Bond	1.76	1.21	1.98	2.25	2.30	2.30	2.30	2.30	2.30	2.35	2.50
United States											
Federal Funds Rate Target*	1.75	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
10-Year Bond	1.92	0.91	1.75	1.80	1.90	2.00	2.10	2.15	2.20	2.25	2.70
Canadian Dollar (US$/C$)	0.77	0.79	0.80	0.85	0.83	0.83	0.82	0.82	0.81	0.80	0.80
S&P 500 Index	3,231	3,756	3,973	4,250	4,400	4,500	4,600	4,650	4,700	4,800	5,050
TSX Index	17,063	17,433	18,701	19,500	20,000	21,000	21,500	21,750	22,000	22,500	23,500
Oil WTI (US$/barrel)	61	48	59	65	65	65	60	60	55	55	55

Quarter-end data
* Upper bound of the Fed's target range

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