ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

Sébastien Lavoie,
Chief Economist
LavoieS@vmbl.ca
514 350-2931

Dominique Lapointe, CFA,
Senior Economist
LapointeD@vmbl.ca
514 350-2924

October 20, 2021

Fall Economic and Financial Outlook: Inflation Challenges the Solid Economic Outlook

The COVID-19 transition from pandemic to endemic continues. Economic bumps associated to each wave of infections have been smaller every time. There are plenty of reasons to keep a constructive base case scenario from a strategic asset allocation perspective: vaccination progress in most countries points toward the reach of global immunity in the first half of 2022, most countries are easing restrictions according to the stringency index, progress in labour market conditions continue, consumers gradually spend a portion of their excess savings and businesses' intentions regarding CAPEX are solid. Global fiscal stimulus will fade in 2022-2023, even with the possible passage of the Build Back Better 10-year plan in Washington. Most central bankers plan to gently withdraw monetary policy easing, keeping in the closet the taper tantrum of 2013.

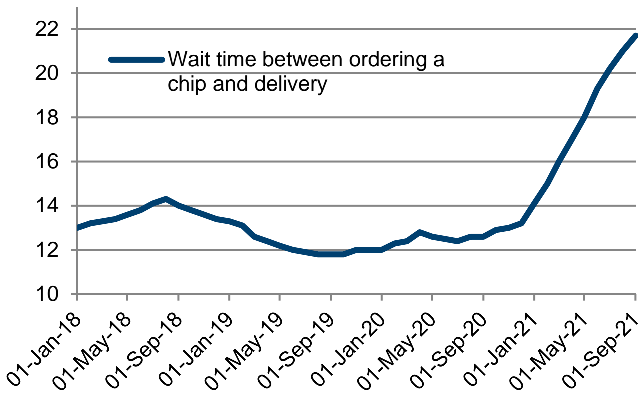
Market Sentiment Deteriorating, Global Supply Disruptions Continue Unabated

Our 2022-2023 economic and financial outlook remains solid. However, the foggier short-term outlook calls for caution from a tactical asset allocation standpoint. This Fall has been marked by the return of market bearish, although the majority of the following metrics have not deteriorated enough to clearly signal a contrarian signal: consumer expectations for higher stock prices has declined lately according to the New York Federal Reserve; the share of Americans who think the stock market will increase in the next year fell to its lowest since early 2021 according to the Michigan Survey; the CNN fear and greed index stands in greed territory after a brief dip in fear and neutral a few weeks ago; the AAII sentiment survey show a marginally higher-than-historical percentage of bearish investors. Junk bonds (high yields) underperformed the investment-grade universe. The MSCI all country world index, a global large cap equity index, turned negative for the first time in 11 months in September.

One trigger for the downward shift in global market sentiment comes from the international exposure to highly leveraged Chinese real estate companies and the possibility of U.S. stock exchange delisting, both tied to China's regulatory crackdown. Since regulators pulled the plug on Jack Ma's Ant Corporation IPO in late-2020, restrictions have hit several neuralgic sectors of the Chinese economy including technology, education, health care and construction.

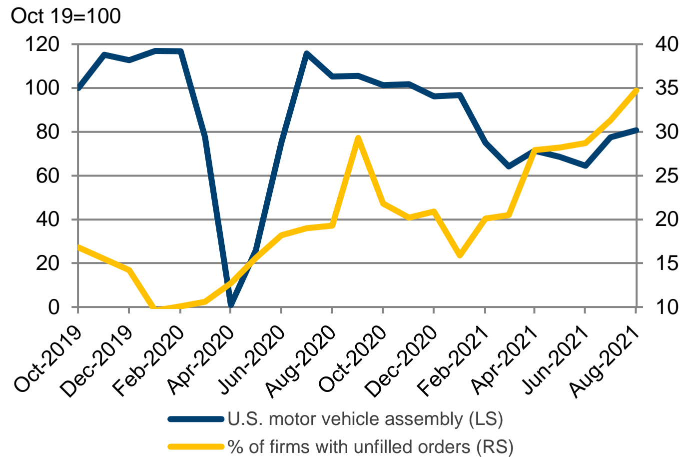
But the most preoccupying factors relate to second-order effects of the pandemic, namely the worsening in supply chain disruptions and commodity shortages. The world still deals with an uneven recovery due to an heterogenous response of governments to the contagious delta variant and insufficient vaccines in selected emerging markets. The closure of critical ports in Asia and truck driver shortages in several countries prevent goods from moving efficiently. The intensifying global microprocessor shortage hampers motor vehicle production and begins to hit large scale consumer electronics (charts 1 and 2). Reflecting these lasting supply constraints, the International Monetary Fund (IMF) recently revised down its 2021 real GDP growth forecast for advanced economies by 0.4 percentage point, to 5.2%. The 2022 forecast was revised up by 0.1pp to a solid 4.5% figure. The 2021 and 2022 IMF projections for emerging markets were virtually unchanged at 6.4% at 5.1%, respectively. But the mid-October release of softening real GDP momentum in China due to the energy crunch and manufacturing shutdowns led a few private forecasters to revise down by a few ticks their emerging markets real GDP growth estimates.

Chart 1: Global microprocessor shortage worsening



Source: Susquehanna Financial Group / Bloomberg News.

Chart 2: Production declines, unfilled orders climb



Source: Federal Reserve, CFIB.

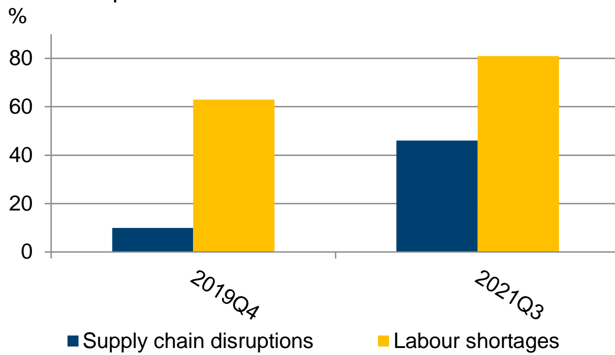
Corporate Profit Margin Squeeze, CPI Inflation to Cool but will Remain Above 2% in 2022

COVID-related supply dislocations and labour shortages limit sales for companies already struggling with low inventories and extremely elevated unfilled orders (charts 2 and 3). Substitution becomes more difficult and the cost of doing business increases. Wage growth accelerates in many countries including the U.S.. This being said, the most striking regime shift in the making relates to climate change: more frequent extreme weather events, including droughts, wildfires and hurricanes feed through higher commodity prices, including lumber, potash and cotton. In addition, strong demand coupled to shrinking inventories led to an acute natural gas scarcity in Europe and Asia. The practice of substituting coal for natural gas to lower GHG emissions also contributes to the first energy crunch in the low-carbon transitioning world.

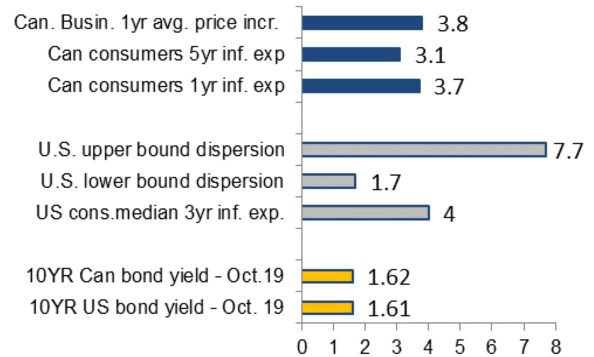
Altogether, some erosion in corporate profit margin emerges. A large net 15% of small U.S. businesses say that higher costs reduced their profitability according to the September NFIB survey, compared to 4% a year ago. In Canada, the share of businesses expecting a significant increase in input prices growth (48%) surpass those expected to significantly increase output prices (38%). The surge in a variety of input costs cannot be fully passed on to consumers even if the latest CFIB survey says that small businesses intend to increase consumer prices by a record high of 3.8%, on average over the next year.

Without surprise, consumers feel the same way. According to the latest NY Fed consumer survey, 1-year and 3-year median inflation expectation stands at a record high of 5.2% and 4.0%, respectively, surrounded by larger-than-usual dispersion (chart 4). For the moment, consumer inflation expectations remain anchored around 3% over the 5-to-10 years horizon, according to the University of Michigan survey. The story is the same in Canada: consumer 1-year inflation expectations hit a record high, but medium-term expectations have not soared.

In our base case scenario, we peg the peak in Canadian CPI inflation at 5.0% in late 2021, followed by an average figure of 2.5% in 2022. Consumers will further re-orient spending from goods to services, easing upward pressures on selected CPI items such as materials. Also, some CPI components that have surged cannot keep rising such as used motor vehicles. Furthermore, reaching global immunity during the first half of 2022 will reduce the number of abrupt shutdowns at manufacturing and port facilities.



Note: Number of mentions by Canadian businesses: Main reason cited by firms preventing them to meet an unexpected increase in demand.
Source: Bank of Canada.



Sources: Fed. Reserve, BoC, CFIB, Bloomberg

Strategic View: Underweight Government Bonds

The lack of market-based inflation expectations, relative to the consumers and business price expectations cited above, calls for further upside adjustments to nominal bond yields over the next 3-4 quarters. Investors should seek refuge in inflation-linked bonds while the strategic allocation to government bonds should remain underweight.

This strategic recommendation is also based on structurally elevated gross debt levels highlighted in the new October IMF Fiscal Monitor, in addition to the global QE tapering process underway setting the stage for eventual policy rate liftoffs. In the U.S., stars are aligned for the beginning of a reduction in Treasury and MBS purchases in November, by $10B and $5B per month, respectively. Guidance provided by Chair Powell led markets to anticipate the pace of QE to fall from the $120B today to zero in mid-2022, implying an eventual net reduction of Treasuries on the Fed balance sheet. Bond markets should not have a problem digesting Treasuries rolling off the Fed balance sheet during 2022 as long as to the compensation coming from a shrinking cyclical fiscal deficit in Washington occurs. Of course, Canada's bond market has started to import the upcoming change in U.S. rates dynamics. At least, the increase in GoCs yields vs. US Treasuries should be restrained by the gentler BoC QE tapering path proposed. The BoC plans to reinvest proceeds for its maturing bond assets for some time in 2022, thereby keeping steady the amount of GoCs held on its balance sheet for a longer time period than the FOMC.

As for policy rate liftoffs, Norway led the way with a 25bps hike in September. The Bank of England leans in favour of preserving stable inflation expectations by increasing its policy rate before the end of 2021. In North America, we do not think the narrative has changed to the same extent. In both the U.S. and Canada, we see the policy rate liftoff to occur during the second half of 2022 once the pandemic is clearly in the rear-view mirror. We now project two 25bps increase in the BoC overnight rate target in 2022Q4 instead of one, starting with the MPR of October 2022. Accordingly, our 2022 year-end target moves up from 0.50% to 0.75% but we do not revise up our peak projection of 1.00% in 2023Q1. Consistent with the latest FOMC dot plots, we still see policy rates ending 2023 below pre-COVID levels in our base case scenario.

Short-Term Pressure - Tactical Overweight Cash Position and Overweight Canadian Stocks

Even if our forecast for moderate increases in North American yields materializes, higher rates will not significantly surpass the average dividend yield offered by equity markets. Over the past decade, there has been several episodes over which equity markets have performed well in a rising yields environment. In today's case, robust real GDP growth should compensate higher - but high relative to recent history - discount rates used in equity valuations. Thus, we remain tactically neutral on stocks, with a preference toward Canadian and US equity markets at the expense of emerging and European stock markets. Cyclicals and value stocks are more prevalent in the TSX index and should provide a better hedge against higher inflation uncertainty going forward. For

instance, financials usually perform well in a strong growth and rising yield environment. While energy stocks have greatly outperformed this year and remain attractive from a tactical standpoint as investors debate the durability of the new global energy shortage, we believe the global oil market will eventually balance itself out during the first half of 2022. Furthermore, OPEC+ could normalize production at a faster pace in the coming months. Gold is not the safe heaven it once was during the 1970s stagflation era, reflecting the cryptocurrencies alternative to gold for younger investors. Nonetheless, the TSX materials sector looks particularly attractive based on the recent drop of the gold-oil price ratio.

A tactical overweight position to cash is warranted. Possible signs of CPI inflation peaking in late 2021 and early 2022 should provide a better entry point to return strategically overweight in equities and corporate bonds. Until then, patience is required as heightened global supply dislocations and inflation uncertainty could feed through financial markets in multiple ways. First, inflation could peak at a higher level than anticipated. The upcoming Holiday shopping season will be affected by recent factory closures in China reducing production and challenging the build-up of retail inventories this fall. Companies could increase prices further, leading to a surge in bond yields and choking the recovery. Our second worry relates to inflation persistency. CPI inflation could run in the current fast lane for a few additional quarters during 2022, particularly if supply disruptions caused by adverse climate events persist. Our third concern relates to central banks' reactions to above-target inflation. Talks of earlier -rather than later- policy rate hikes during 2022 are intensifying. Patience has its limits for central bankers dealing with higher inflation uncertainty. In mid-October, a few FOMC officials have expressed support for a faster withdrawal in monetary stimulus to keep inflation and inflation expectations in check. In addition, the rotation in voting FOMC members will bring four additional hawks in 2022. Hawks could abruptly take over consensus at the Fed and point towards a more aggressive policy rate path, even if labour market conditions are not back to where they stood before the pandemic.

Households Start to Spend Excess Savings, Quit Retail Trading

Unprecedented restrictions in economic activities due to lockdowns and government income support programs have led to a substantial increase in households' exposure to stocks during the pandemic. Retail trading exploded and led selected stocks favoured by social media to skyrocket. Furthermore, the buy-the-dip mentality supported stock prices and rendered episodes of equity market drawdown very shallow. As a result of the large inflows into equity funds and the rally in prices, most of the improvement in U.S. households' net worth has recently been driven by equities according to Federal Reserve data.

But a major turnaround in the making shape our expectations of smaller investment returns from equity markets in 2022 relative to 2021. Extended unemployed benefits ended late summer in about half of U.S. States and some federal income support programs are about to expire in Canada. Accordingly, households started to spend a portion of their savings accumulated since the Spring of 2020, implying a reduction in equity inflows. For instance, the 2021Q3 BoC survey of consumer expectations reveals Canadians spent 10% of extra savings in 2021, and plan to spend about one-third in 2022. Some individuals will return to the job market as the economy continues to reopen. Socialization activities will also improve further as the world approaches the endemic phase of COVID-19. Altogether, retail equity inflows and retail trading activity will not be as market supportive as they were for the last 18 months, weighing down on valuation extension. Research by JP Morgan Chase reveals downloads of the popular brokerage app Robinhood plunged by 78% in 2021Q3 relative to the previous quarter. Daily active users dropped by 40% over the same period. Other popular platforms such as Charles Schwab Corp's and the crypto trading platform Coinbase have also seen slower activity.

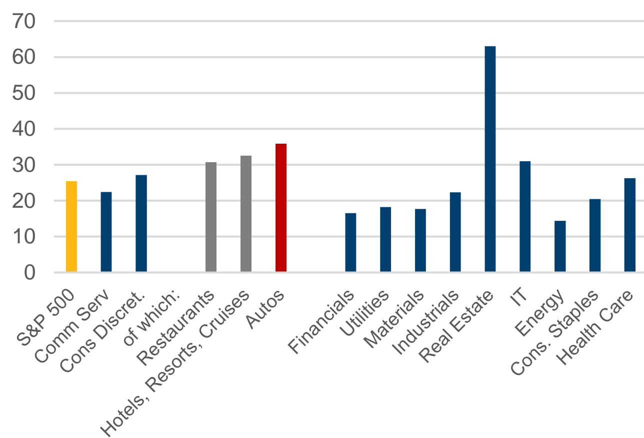
As for how and where consumers will spend, it matters more than usual due to the profound shifts in preferences caused by the pandemic. Accordingly, it would be misleading for investors to bluntly expose themselves to **consumer discretionary** and **consumer staples** subsectors. For consumer discretionary, the prevalence of large **internet retailers** in the S&P500 index makes it a riskier play in light of rising long-term interest rates and the shift in consumers' spending toward "real-life" services. However, consumer discretionary sub-industries such as, **hotels resorts and cruise lines** and **restaurants** continue to present an interesting opportunity. The 2021Q3 BoC survey of consumer expectations indicate a higher share of Canadians looking to spend in social events and restaurants, followed by shelter, groceries and tourism activities. High-frequency data from OpenTable also

indicates progress in restaurant traffic despite the delta wave. Moreover, after a momentary catch-up to the S&P 500 index with the announcement of vaccine trial results in November 2020, hotels and airlines have severely underperformed the S&P500 index last summer as the delta variant delayed expectations relative to a strong recovery in international travel activities (chart 5). At the other end of the spectrum, there are more Canadians planning to reduce purchases of cars, appliances, and furniture over the next 12 months. Similarly, Americans think it is a very bad time to buy a motor vehicle or other big-ticket items according to the University of Michigan consumer survey. Despite facing renewed production shutdowns this fall and more persistent chips shortages, **automobile and components** have overperformed the S&P500 index recently, leaving them less attractive from a valuation perspective. The 12-month forward P/E ratio of the auto subsector is significantly higher than the corresponding ratio for the commercial services and consumer discretionary subsectors (chart 6). Surveys also indicate a strong preference among households to continue teleworking post-pandemic. This will continue to support residential and warehousing real estate markets, although 12-month forward P/E ratio of the entire real estate sector has already reached stratosphere. Conversely, real estate office companies are unlikely to fully recover their pandemic-related losses anytime soon.

Chart 5: Airlines and hotels continue to represent a buying opportunity

Note: Price return relative to the S&P 500. Last data point is October 11.
Source: Refinitiv.

Chart 6: S&P 500 GICS Sectors - 12m f-PE



Note: As of October 11.
Source: Refinitiv.

Sébastien Lavoie | Chief Economist
514 350-2931 | lavoies@vmbl.ca

Dominique Lapointe, CFA | Senior Economist
514 350-2924 | lapointed@vmbl.ca

Asset Allocation Recommendation	Tactical (1-3 months)	Strategic (12-18 months)
Fixed Income	-	=
Government	-	-
Corporation	-	+
Equities	=	+
Canada	+	+
United States	+	=
Other Developed Markets	-	+
Emerging Markets	-	=
Cash	+	-

Financial Forecasts

	19Q4	20Q1	20Q2	20Q3	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	0.25	0.25	0.25	0.75	1.00
3-Month Treasury Bills	1.65	0.22	0.20	0.12	0.07	0.08	0.14	0.12	0.12	0.15	0.15	0.15	0.65	1.00
2-Year Bond	1.70	0.42	0.28	0.24	0.19	0.23	0.45	0.53	1.00	1.20	1.35	1.40	1.50	1.50
5-Year Bond	1.68	0.58	0.37	0.35	0.39	1.00	0.98	1.11	1.35	1.65	1.75	1.80	1.90	2.20
10-Year Bond	1.70	0.69	0.53	0.56	0.67	1.56	1.39	1.51	1.70	1.75	1.85	1.95	2.00	2.40
30-Year Bond	1.76	1.30	0.99	1.11	1.21	1.98	1.84	1.99	2.10	2.20	2.25	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	0.25	0.25	0.50	1.00
10-Year Bond	1.92	0.67	0.65	0.68	0.91	1.75	1.44	1.53	1.75	1.85	1.95	2.00	2.25	2.60
Canadian Dollar (US$/C$)	0.77	0.70	0.73	0.75	0.79	0.80	0.81	0.78	0.82	0.80	0.78	0.80	0.80	0.80
S&P 500 Index	3,231	2,585	3100	3363	3,756	3,973	4,298	4,308	4,600	4,700	4,750	4,800	4,825	5,150
TSX Index	17,063	13,379	15,515	16,121	17,433	18,701	20,166	20,070	21,000	21,400	21,500	21,800	22,100	23,400
Oil WTI (US$/barrel)	61	20	39	40	48	59	74	75	80.00	78.00	75.00	70.00	65.00	60.00

Quarter-end data

* Upper bound of the Fed's target range

Last Update: October 2021

This document is intended only to convey information. It is not to be construed as an investment guide or as an offer or solicitation of an offer to buy or sell any of the securities mentioned in it. The author is an employee of Laurentian Bank Securities (LBS), a wholly owned subsidiary of the Laurentian Bank of Canada. The author has taken all usual and reasonable precautions to determine that the information contained in this document has been obtained from sources believed to be reliable and that the procedures used to summarize and analyze it are based on accepted practices and principles. However, the market forces underlying investment value are subject to evolve suddenly and dramatically. Consequently, neither the author nor LBS can make any warranty as to the accuracy or completeness of information, analysis or views contained in this document or their usefulness or suitability in any particular circumstance. You should not make any investment or undertake any portfolio assessment or other transaction on the basis of this document, but should first consult your Investment Advisor, who can assess the relevant factors of any proposed investment or transaction. LBS and the author accept no liability of whatsoever kind for any damages incurred as a result of the use of this document or of its contents in contravention of this notice. This report, the information, opinions or conclusions, in whole or in part, may not be reproduced, distributed, published or referred to in any manner whatsoever without in each case the prior express written consent of Laurentian Bank Securities.