Quarterly Commentary

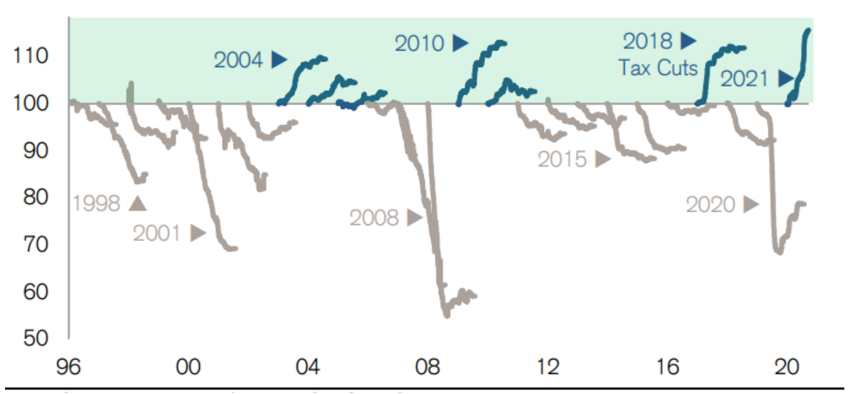
July | 2021

Strong growth, easy Fed

As we head into the second half of the year, our viewpoint remains unchanged; positive towards equities and cautious on bonds. While the valuations for both stocks and bonds are at the higher end of their historical ranges, valuation as a standalone measure is a poor timing indicator. What high valuations imply is that longer term returns (average over the next decade) are likely lower than in most ten year periods, however this has very little bearing on the outlook for shorter time periods such as the coming year. High valuations do mean that asset prices are more vulnerable to negative surprises. The various branches of government have successfully steered the economy through the pandemic, and created an environment that has supported these higher asset prices. The pace of vaccinations in each region has dictated the pace of economic recovery. The U.S. has had the most robust vaccination program out of the gate, and as a result they're also seeing the strongest economic growth. Canada is now not far behind.

We've often discussed how asset prices have risen as a result of easy money policy (low cost of money). From an investment perspective, monies continue to flow into stocks on every dip. A 1.5% yield on a ten year Treasury bond simply isn't compelling enough for most to sell stocks en masse and buy bonds. In fact, we don't see a 2.0% or even a 2.5% ten year Treasury yield to be a big problem for stocks, so long as a move towards those yields occur in waves, and not up in a straight line. Also, it's not a good idea to bet against stocks when earnings are improving and earnings estimates are rising. Earnings in turn are driven by economic activity, which benefits from this easy money policy. Earnings have in fact been so strong in recent quarters. The stock market's valuation is actually cheaper now than it was back in the fall, even though the markets have continued to rise. Earnings for companies within the S&P 500 have risen faster during this period the index itself. Whereas, in most years, earnings expectations are usually revised lower through the course of the year (most enthusiasm shows at the beginning of the year), analysts are having to significantly revise their estimates higher through 2021 as companies are simply doing much better than what was expected (Chart 1). Investors' biggest concerns at the current time are factors that could lead to the end of this easy money era.

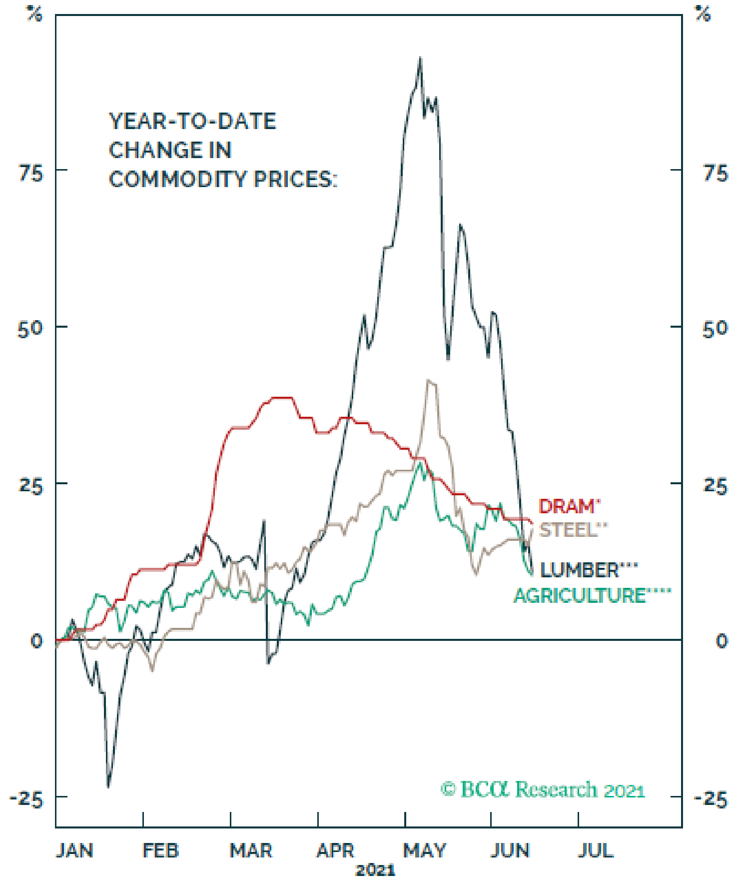
Chart 1: Annual S&P 500 earnings revisions



Source: Credit Suisse

The main purpose of the Fed (and the Bank of Canada) is to support the goals of maximum employment, stable prices, and moderate long-term interest rates. We are in the most inflationary period we've seen at any point in the past decade. The inflation rate in Canada rose to 3.6% in May, the largest yearly increase since 2011. Similar data in the U.S. could justify rate hikes by the FED, but we are not close to maximum employment (there are 8 million fewer people employed in the U.S. versus pre-pandemic, and 500,000 fewer in Canada). There's also evidence that some input prices are beginning to roll over, supporting the point of view that some of the inflation pressures are transitory (chart 2). An interest rate hike too early, and the Fed risks slowing down the economy at a time when there are still too many who are jobless. While the pandemic has improved the financial health of those who have investment assets, it has made worse the financial health of those who do not. Extraordinarily low mortgage rates have also led to a surge in housing prices, further worsening this inequality gap. It is those who do not have wealth that the Fed is mindful of, and so keeping rates lower for longer.

Chart 2: Input prices have rolled over

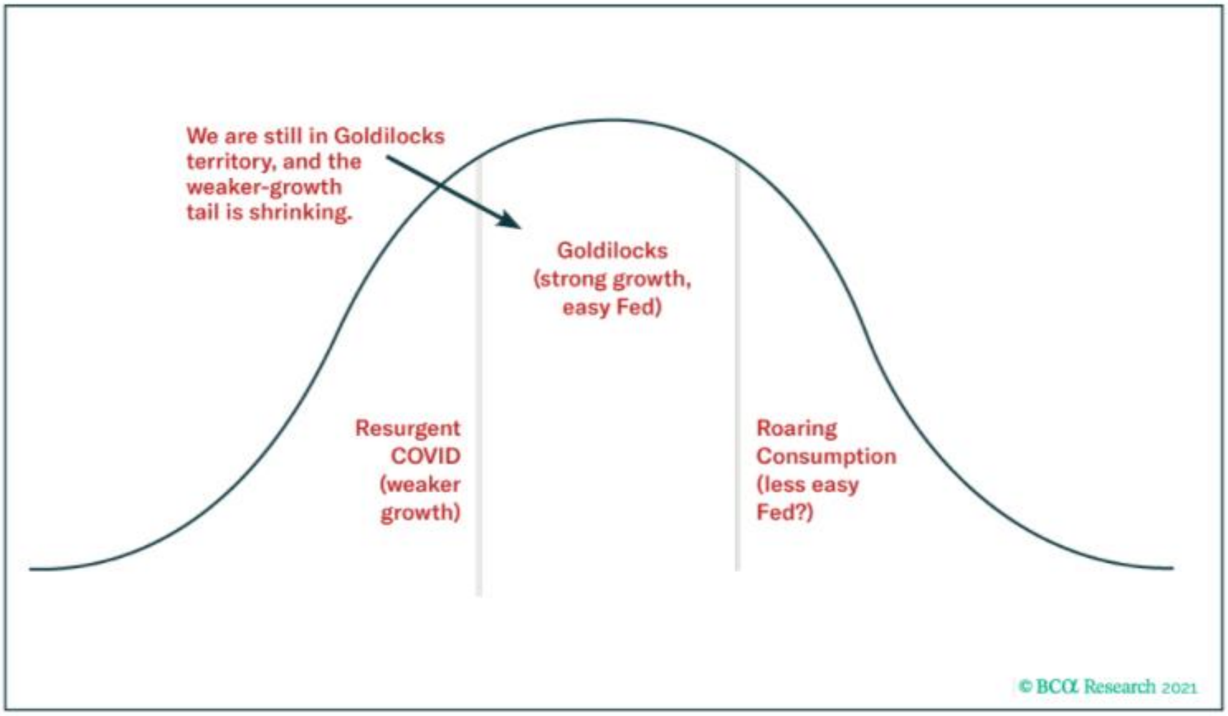


* DRAMX DDR3 1GB 128Mx8 CHIP PRICE. SOURCE: DRAMEXCHANGE.
** STEEL REBAR FUTURES PRICE. SOURCE: SHANGHAI FUTURES EXCHANGE.
*** SOURCE: CME.
**** GOLDMAN SACHS COMMODITY PRICE INDEX. INCLUDES WHEAT, CORN, SOYBEANS, COTTON, SUGAR, COFFEE, AND COCOA.
NOTE: DATA SHOWN AS PERCENT CHANGE SINCE BEGINNING OF 2021.

Source: BCA Research

This Goldilocks scenario of strong growth and easy Fed (monetary) policy (Chart 3) is likely to remain with us through the next year, possibly even longer. Our portfolios are at near maximum equity exposure allowed by investment policy statements, as the return prospects in equities are much higher than the alternatives in bonds and cash. Nevertheless, it is important not to be complacent at a time when valuations are elevated. Within the equities component, greater diversification is absolutely essential, from a style (value versus growth), sector, and geographic positioning perspective. The emergence of alternate scenarios is possible, given that this pandemic and its impact on the economy and policies is truly unique. After a strong first half of the year for stocks, we anticipate further upside for the balance of 2021. Strong economic growth should be positive for broadening stock market strength into the more economically sensitive international markets. We are underweight bonds at this time given that yields are poised to drift higher through the remainder of the year and beyond.

Chart 3: Goldilocks – an ideal environment for stocks



Source: BCA Research

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