The Stan Clark Financial Team's

PERSPECTIVES

Mid-Year REVIEW

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Welcome to our 2021 mid-year review issue

Michael Chu and I have collaborated on a mid-year review of how Canadian, U.S. and international markets performed in the first half of 2021 – and what the major influences were over the last six months.

We hope you find this review both informative and useful in understanding the current economic context – and how we're keeping your portfolio firmly on course.

Enjoy your summer!

Stan

CIBC Wood Gundy

Mid-Year Review: The robust recovery keeps on going

By Stan Clark - Senior Investment Advisor and Michael Chu - Investment Advisor

We trust you are enjoying the summer, especially with restrictions being eased! As all of us continue to stay careful and safe, the midpoint of the year seems a good time to review 2021 so far. And, to discuss what we might expect ahead.

The positive performance of stock markets around the world continued into the second quarter of 2021 as economic growth expectations picked up. That growth has translated into good corporate earnings across many industries. Low interest rates have also been a primary driver for stock markets.

Inflation remained top of mind with investors and central banks. While indications of inflation rose over the quarter, pundits disagreed about whether this would be temporary or sustained.

Long-term interest rates eased lower after moving up earlier this year. Given the economic recovery and signs of rising inflation, many central banks are in the early stages of planning to normalize monetary policy, such as tapering bond purchase programs and eventually increasing short-term interest rates.

Most major stock markets around the world ended the first half of the year in positive territory. The World Equity Index, a gauge of stocks around the world, was up 10.1% (in C$). At home, the TSX was up 17.3%. The chart below shows the returns of major markets around the world. Note these returns are in Canadian dollars, so the effects of currency changes are included.

	Q1 2021	Q2 2021	H1 2021
Canada (S&P/TSX)	8.1%	8.5%	17.3%
U.S. (S&P 500)	4.8%	7.1%	12.3%
Europe	3.1%	6.7%	10.1%
Japan	-1.5%	-2.8%	-4.2%
EAFE (Europe, Australia, Far East)	2.2%	3.8%	6.0%
Emerging Markets	1.0%	3.7%	4.7%
World	3.6%	6.3%	10.1%

Source: Bloomberg

Valuations

	Trailing P/E	Trailing Earnings Yield	Dividend Yield	10-Year Bonds*
Canada (S&P/TSX)	20.0	5.0%	2.6%	1.4%
U.S.	29.7	3.4%	1.3%	1.5%
Europe	24.4	4.1%	2.4%	0.0%
Japan	21.0	4.8%	2.0%	0.0%
EAFE (Europe, Australasia, Far East)	24.1	4.2%	2.3%	0.0%
Emerging Markets	18.7	5.4%	1.9%	3.1%
World	27.4	3.7%	1.7%	1.0%

Source: Bloomberg
*Weighted average for regions

As you can see, dividends from stocks in Canada are much higher than 10-year bonds. Although the difference is not as much as it was earlier, it's still significant – and a good indication there is still value in stocks when compared to bonds. In the U.S., stocks are still decent value when comparing dividends or earnings yield to bonds, but not as good as in Canada. When we calculate the average 10-year rate for the regions such as Europe, EAFE and World, you can also see that they are very low or even zero (as negative rates exist in some countries such as France and Germany).

The earnings yield in the table above uses reported earnings over the past 12 months. It's also useful to look at estimates of future (or forward) earnings. According to data from Ed Yardeni, the S&P 500 price-to-earnings (P/E) ratio is 21.5 times forward earnings, which equates to 4.6% earnings yield. This is not cheap vs. historical averages, but still very attractive relative to interest rates. At the peak of the dot.com boom the forward earnings yield was 3.9% and 10-year bond yields were over 6%. So bonds yielded 150% more then, but only 32% as much now: a five-fold improvement today when comparing stock earnings yield to bond yields. Current expected earnings are almost three times higher than at the dot.com peak.

U.S. jobs

The U.S. Labour department announced 850,000 jobs were added in June, more than the consensus expectation. The May report was also revised upwards to 583,000 jobs.

Despite the largest payroll growth in about a year, the unemployment rate counterintuitively rose to 5.9% from 5.8% in May as more people rejoined the labour force to look for work. The labour force participation rate is still at a depressed 61.6%, which is 2% below pre-pandemic levels. A whopping 6.8 million jobs have disappeared since the pandemic began. This gives the Fed more room to be accommodative, as increasing employment is one of its two major mandates.

Labour shortages

It's a strange situation when you see both high unemployment and a high level of job openings. Businesses can't find workers and workers can't find businesses. For a while, we could explain at least part of this situation. Enhanced unemployment insurance meant that some people were just reluctant to enter the workforce; or perhaps feared being infected; or faced a lack of daycare. Whatever the reason, such issues are largely fading, so we should see more of these reluctant people going back to work.

New frictions exist, though. Since many businesses are restarting at the same time, everyone is hiring. But it can't be done that quickly. It takes time to hire. Maybe that's why there's a mismatch. Also, wage gains have caused workers to jump ship to a higher-paying jobs, creating more turnover. Some workers are even quitting to start their own businesses – good for the economy, but maybe not so much for existing businesses seeking workers. Regardless, there is still significant room to grow in employment as we keep progressing past the pandemic.

Inflation

Inflation has emerged as perhaps the biggest concern over the past quarter and will likely have a huge influence on markets going forward. The pace of economic growth has been much greater than expected – even when considering the tremendous fiscal and monetary stimulus – and that has led to increased demand for goods and services. Many industries are having a challenge meeting this demand. This has led to shortages and increased prices. The big question is whether these inflationary pressures are long-lasting or just transitory.

The market doesn't seem able to decide whether inflation will take off or is approaching its peak. According to the Fed, inflation has indeed peaked and should cool off in the months ahead. But notable pundits like Ray Dalio say that the Fed is wrong and inflation is growing. To its credit, the Fed raised inflation expectations for 2021 to 3.4% from 2.5%. Currently the market has bought into the "transitory inflation" narrative of the Fed and other forecasters. However, this might change as more data comes out. If such data contradicts the Fed's narrative, it could cause a panic in the markets.

The recent leap in inflation is due in a large part to several temporary factors. These include higher commodity and energy prices, and shortages of shipping containers and computer chips. Stimulus cheques have also prompted a splurge on big-ticket items, driving prices higher. Interestingly, another driver was a shift in consumer preference during the pandemic. Services normally make up about 65% of consumer spending. However, with many services temporarily shut down, people purchased more goods. As the impact of the pandemic fades, demand preferences should revert at least partially toward the historical norm. Also, as stimulus cheques come to an end, the inflationary pressure resulting from those cheques should fade.

But upward inflation pressure, although milder, continues from large-scale money printing by central banks. The Fed's new mandate, seeking more than 2% inflation over the next few years, is in itself an inflation driver.

So, while inflation fears have currently subsided, there are other fears from within companies about input costs and wage pressures. Executives expect the cost of labour to rise, as their companies are growing faster than the labour market can supply skilled workers.

This wage push could change the Fed's narrative. The Fed may have to raise rates or tighten monetary policy sooner than it would like.

In the long term, big deflationary forces are still in effect. Older populations with lower fertility rates are deflationary. As well, new technologies, higher productivity, declining unionization and maturing emerging market economies all impose downward pressure on inflation.

Why are yields drifting down as inflation heats up?

Normally, if there are signs of higher inflation, interest rates will also move up. But U.S. treasury bond yields are doing the opposite, heading down as inflation numbers rise. There are several theories about why. The most obvious is that the bond market doesn't believe the higher inflation numbers will last, and remains concerned with longer-term deflationary risks. Another theory is that near-zero or negative interest rates in Europe and Japan (as discussed earlier) make the positive yields in the U.S. look attractive, even if they are lower than anticipated inflation. A third theory is that the Fed is engineering low yields so that the cost of servicing U.S. debt will start to shrink.

If and when the Fed raises key short-term rates, it probably won't be able to raise them too much, since the federal debt has now risen to $30 trillion. Even with today's low rates, the cost of paying interest exceeds the U.S. Defense Department's annual budget! This doesn't bode well for those invested in government-guaranteed fixed income, but could provide good support for stocks.

Market getting ahead of itself?

The S&P 500 is at record highs. There hasn't been even a 5% correction since the U.S. November 2020 election. Second-quarter earnings will be out as this article is published and they should be quite positive.

The broadest measure of U.S. corporate profits is the National Income and Product Accounts (NIPA). This includes all public and private companies. According to the Fed, year-over-year growth in NIPA after tax profits is 28% higher from the first quarter of 2020 to the first quarter of 2021. This also represents a 7% increase from the previous quarter. Some might point out that companies inflate their earnings, but this is taxable income and nobody inflates that! Company earnings tend to track NIPA.

For companies in the S&P 500, analysts expect second-quarter profits to come in at 64% higher than a year ago. Admittedly, profits at that time were badly handicapped by the COVID lockdown. But second-quarter 2021 earnings are also expected to be 8% above the boom-time second-quarter 2019 earnings. This means corporations have grown at a net 4% per year in earnings through the pandemic!

There's also plenty of cash on the sidelines that should be available if there are small corrections in the market coming up. Maybe that's why we haven't seen any significant drawdowns lately. In addition, investors are increasingly taking the view that *there is no alternative* (TINA) to stocks, because cash, bonds and most other income-producing investments offer such low yields.

Feeling good – for now, anyway

According to Ben Carlson of Ritholtz Wealth Management, corrections and bear markets outnumber bull markets by over two to one. There have been 23 bull markets (24 including the current one) and 53 corrections and bear markets (32 corrections and 21 bear markets). At first, that doesn't sound like a good deal for investors. But while downturns occur more often, bull markets make up for a lack of quantity with magnitude and duration. Downturns have lasted an average of 207 days, while upturns have lasted 1,121 days. The average loss in a downturn is 23%; the average gain in an upturn, 122%. Obviously, the ranges around averages vary widely, but over time up-markets more than make up for down-markets. This also doesn't include dividends, which matter a lot – especially today when interest rates are so low.

While we'd all like to avoid downturns, they are a natural extension of bull markets. One problem of bull markets is that during them you start to feel invincible. Things feel pretty good right now. The economy is back on track and humming along nicely and the stock market is at record highs. This will change eventually, but no one knows when the market will take a breather. And when a drop comes, no one can predict when it will turn around and go back up. It could be a minor correction or a bigger bear market. Unfortunately, you don't get the big gains without incurring the occasional losses. On average since 1928, double-digit losses occur every 21 months.

But this is just an average. In the market things don't occur at set times as on a train schedule. Either way it's important to keep expectations in check and be prepared for a range of outcomes.

Fast and furious

Top economist Ed Yardeni calls the current business cycle unprecedented. Last year's recession was among the worst in U.S. history, but it only lasted two months. The V-shaped recovery in real gross domestic product (GDP) was one of the fastest on record. A full recovery took only five quarters, and the economy is now in the expansion phase. This remarkable performance has been reflected in record high corporate earnings and stock prices.

Meanwhile, policymakers continue to step on their growth accelerators to boost employment and support businesses still recovering from the pandemic. Policymakers' hope is that inflation and financial stability will remain under control. The Fed is still purchasing $120 billion bonds per month and the Biden administration is pushing for more spending. This is all good for investors…until it isn't.

To stimulate or not to stimulate?

As the global economy emerges from the COVID-19 shock, central banks face the unenviable task of deciding when and how quickly to phase out the extraordinary stimulus measures. There's no easy answer, as judgement calls will be necessary to account for all the uncertainties, and policy changes will have far-reaching implications.

Mohamed A. El-Erian, Chief Economic Advisor at Allianz, uses the analogy of a car trip with two groups of passengers. The two groups agree on three things. The destination is to achieve durable and sustainable economic growth; the route to get there is far from straight; and the car has good forward momentum. Beyond that the two groups disagree. One group believes much of the remaining journey will be uphill and therefore they're not too worried about the curves. They prefer to keep the foot on the accelerator, lest the car decelerates or even stalls. The other group anticipates a downhill journey with many treacherous curves. With the car gaining speed, they would prefer to ease off the gas now, to avoid sudden braking.

Whether you are an uphiller or downhiller depends on your assessment of three current issues: the labour market; the surge in inflation; and the risk of not recovering quickly should policy mistakes occur.

How transitory is today's inflation? The keep-the-foot-on-the-gas group thinks that the uptick in inflation will reverse itself as pent-up demand is spent and as manufacturers catch up with increased supply. But others argue that many supply chains have been more permanently damaged, suggesting that the price increases might be more long-lasting. This could be made much worse when combined with a continued ramp-up in government spending.

Policymakers have a tough job ahead of them. Central bankers still have many tools available to overcome inflation, but some argue these tools have become increasingly ineffective and difficult to calibrate. Perhaps the solution for now would be to operate around the edges where there is more clarity. Given that the economic growth is buoyant, fiscal policy is expansionary and savings are high, perhaps now would be a good time to start gradually and carefully reducing the bond-buying program. We need not keep the foot completely on the gas, nor need we take it off completely, either – but maybe a little less gas would be prudent.

Canada's recovery

Canada experienced a more intense COVID third wave than the U.S. because of our sluggish start to vaccination. Accordingly, our economy underperformed that of the U.S. in April and May, much as it did during the second wave. But today Canada's infection rate is in free fall due to stringent restrictions and accelerating vaccinations. Despite the third-wave setback, Canada's economy has staged a significant recovery. The stronger Canadian dollar has been a headwind, but has been more than offset by government stimulus, spillover from the U.S. and a rebound in commodity prices. Toward the end of this year, Canada's economy should recover to pre-pandemic levels.

Productivity growth

We haven't heard about productivity growth as a significant contributor to the economy for some time. Productivity gains during the 2010s were unusually paltry. But lately there are some good arguments for expecting more productivity growth going forward, which should increase both standards of living and corporate profits.

Arguments in favour of more productivity growth include a pandemic-induced productivity leap due to advances in remote working, online commerce and automation. The advances are also due to a surge in capital expenditures, scientific progress and developments in China on the technology front.

Looking ahead

As stock markets continue to be pulled forward by investor optimism, we become more aware of the ongoing threats of setbacks. Potential risks include: COVID-19 variants; geopolitical risks such as rising U.S.-China tensions; and uncertainty about the persistence of inflation.

Things seem relatively calmer these days compared to a year and a half ago. At the start of 2020 we were facing the start of the pandemic, as well as then-president Donald Trump's second impeachment, followed by protests and urban riots across the U.S. Maybe the current positivity is just feeling relief from reduced pandemic restrictions. Perhaps events are just averaging out, but we hope it's not the calm before the storm. It always helps to be prepared for a range of outcomes. That's why it's important to have a financial plan coupled with a personalized investment plan that will help you navigate *your* future, no matter what the economic future may bring. ■

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