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Investments

Avoiding unforced errors in the mid-cycle transition

Todd Mattina, PhD
Senior Vice President, Chief Economist,
Portfolio Manager, Team Co-Lead
Mackenzie Multi-Asset Strategies Team

Jules Boudreau, MA
Economist
Mackenzie Multi-Asset Strategies Team

Highlights

- With the worst of the economic downturn hopefully behind us, policymakers in developed economies face a heightened risk of "unforced errors". Policymakers need to avoid providing excessive stimulus for too long, stoking inflationary pressures and financial instability. At the same time, they must avoid withdrawing stimulus too aggressively, slowing job creation and the recovery.
- As central banks begin gradually tightening liquidity in coming quarters, fiscal policy can help sustain economic momentum with growth-friendly fiscal adjustments.
- We expect a mid-cycle transition to a more sustainable pace of growth with stable long-term inflation, supporting our overweight in equity. Consistent with our asset allocation views over recent months, we also remain overweight in sovereign long-term bonds.

With the peak rate of expansion and policy accommodation already behind us, the economic cycle is transitioning to a new phase. In the emerging mid-cycle phase, we expect growth in coming quarters to moderate from its unsustainable double-digit pace while long-term inflation expectations stabilize. Strong growth with inflation expectations under control would be a constructive environment for risk assets, such as global stocks. However, the outlook hinges on policymakers avoiding "unforced errors" in withdrawing pandemic-era support. A key risk is that providing excessive policy stimulus for too long can stoke inflation and higher interest rates, while conversely the removal of stimulus too quickly can slow job creation and the recovery. As policy blunders would have negative impacts on asset prices, investors need to keep an eye on shifting macro policies in the mid-cycle transition.

Gradual monetary tightening is expected in coming quarters by major central banks. Several central banks have already announced or begun tapering asset purchases (i.e., "quantitative easing"), including the Bank of Canada, Bank of England, Reserve Bank of Australia, and the Reserve Bank of New Zealand. We also expect the US Federal Reserve to start tapering its US $120 billion in monthly asset purchases in the fourth quarter. With policy interest rates still at around zero in most major economies, the rebound in inflation implies that *real* yields have declined even further, despite economic growth accelerating at a double-digit pace. In this context, tapering sets the stage for policy rate hikes beginning in 2022-23, barring a sharp economic slowdown due to the Delta variant. However, investors expect this hiking cycle to be limited based on Eurodollar futures with US policy rates rising to about 1.5% over 5 years, supporting the recent decline in long-term bond yields.[1]

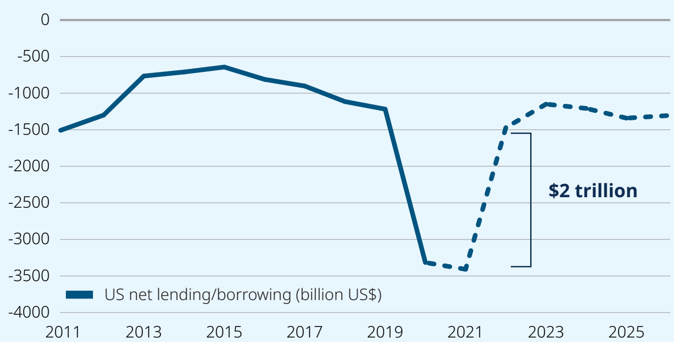
Fiscal support has also moved beyond its peak pace of accommodation and may start subtracting from demand growth in coming quarters. Several "cliff effects" will impact the economy in the second half of 2021 as emergency measures imposed during the pandemic expire.[2] In the US, close to half of states have already phased out supplemental unemployment insurance benefits before they expire nationally in September. In Canada and the UK, job retention programs will expire early in the Fall.

1 See our commentary, High Inflation, Low Inflation Risk, July 2021.
2 See Peering down the cliff-edge, The Economist, July 18th, 2021.

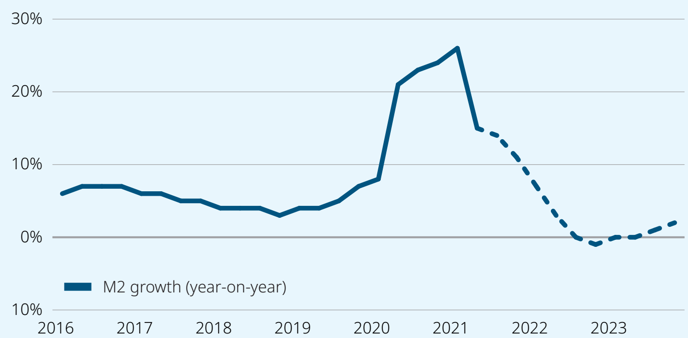
Deferred tax and interest payments as well as moratoriums on evictions are also set to expire in some markets, setting the stage for increased pressure on cash flows and balance sheets. Offsetting these expected drags on growth is over US$2.5 trillion in excess savings accumulated over multiple lockdowns, allowing for a smooth hand-off from declining fiscal support to higher consumer and business spending. Figure 1 illustrates the expected fiscal drag on economic growth and projected decline in the money supply as central banks begin tapering.

Figure 1 | Moving beyond the peak pace of expansion and policy accommodation

As the US deficit is reduced next year, $2 trillion in net stimulus will be removed from the economy



Money growth is expected to turn negative after the Fed begins tapering at the end of this year



Notes: Left chart: IMF projection for US general government net lending/borrowing, See the April 2021 WEO. Right chart: US M2 annual growth rate projection via Oxford Economics assuming a taper in asset purchases beginning in Q4 2021.

A gradual withdrawal of fiscal support is important to support near-term growth and risk assets given uncertainty about the impact of cliff effects and tighter monetary conditions. Maintaining strong economic growth will be important not just to recover from the pandemic but also to ensure long-term debt sustainability. However, with the worst of the economic crisis likely behind us, fiscal policymakers may shift their focus toward reigning in unsustainable budget deficits. A key downside risk is a sharp decline in budget deficits without a full hand-off to sustainable private sector-led growth. We will be looking for growth-friendly fiscal adjustments that credibly delay deficit and debt reduction, supporting current demand conditions. Avoiding unforced errors is important and we would be looking for several key characteristics in a growth-friendly fiscal adjustment:

- Implementing a medium-term policy framework specified over 5 years that anchors reductions in the budget deficit (or government spending) to a sustainable debt level.
- Avoiding cuts in public investment, especially in infrastructure, to support productivity growth.
- Targeting program spending and tax deductions to achieve long-term efficiencies.
- Reforming tax policies to focus on consumption and environmental impacts rather than income and savings.

For investors, the mid-cycle transition with an expected gradual withdrawal of macro policy support provides a constructive backdrop for risk assets. Consistent with the asset allocation views of the Multi-Asset Strategy Team, we remain overweight in equities as stock markets are expected to continue outperforming in conditions of strong growth and stable long-term expected inflation. An overweight in sovereign bonds this year has helped to balance total risk in multi-asset portfolios. A continuing overweight in sovereign bonds also provides some sensitivity to downside risk scenarios, such as an unexpected decline in growth momentum due to new variants, policy blunders or other unexpected events. We are also underweight in corporate debt given increased corporate leverage after the pandemic and low credit spreads. We believe equities provide a better risk-reward opportunity at this stage of the cycle.

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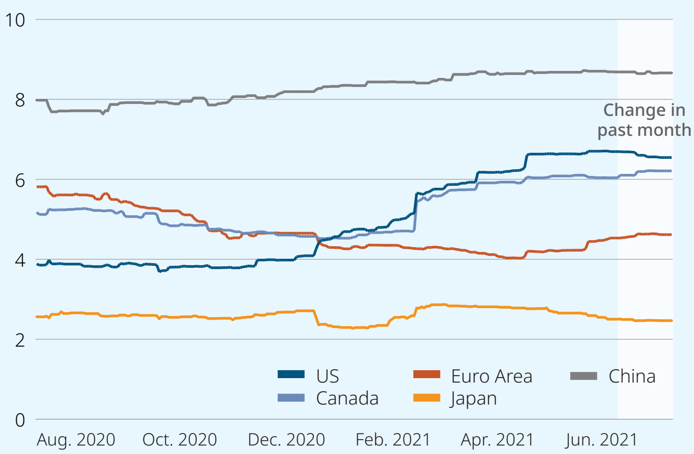
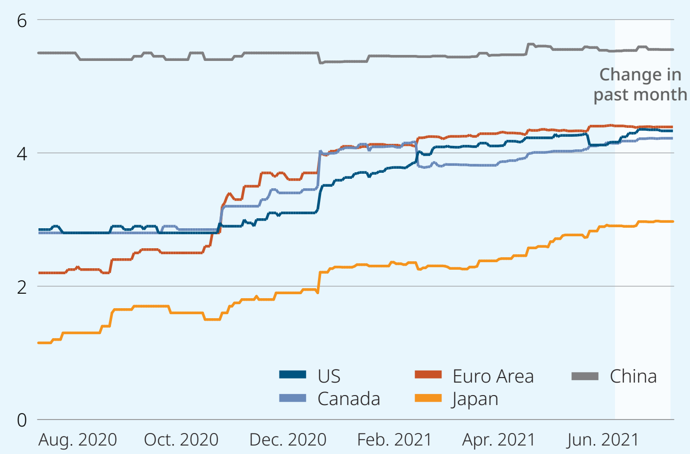
Global macro update

- Another month, another rise in short-term **inflation** forecasts in the US, Canada and Europe. Economists now foresee 3.8% annual inflation in the US this year and 2.8% in Canada. However, as we explained last month, hawkish turns by central banks, a pullback in fiscal support and an unwillingness by governments to engage in further deficit-financed spending mean that the risk of a persistent inflation spiral is low. But inflation will likely stay above target for a few more quarters. While some sources of temporary price pressures have begun to moderate – used auto prices have plateaued, most commodity prices are pulling back – others, like chip shortages, will take longer to normalize.
- Economists still expect **Eurozone inflation** to fall short of the European Central Bank's (ECB) target. On July 8, the ECB unveiled its revamped monetary policy framework. The 2% inflation objective is changed from a ceiling to a symmetric benchmark, and the ECB will allow some short-term deviation around its target. The new framework does increase the ECB's policy flexibility and could help it hit its target more consistently, but is still more conservative than the Federal Reserve's official average inflation targeting framework. The ECB framework change was broadly expected by markets and does not change our view on the undervalued euro.

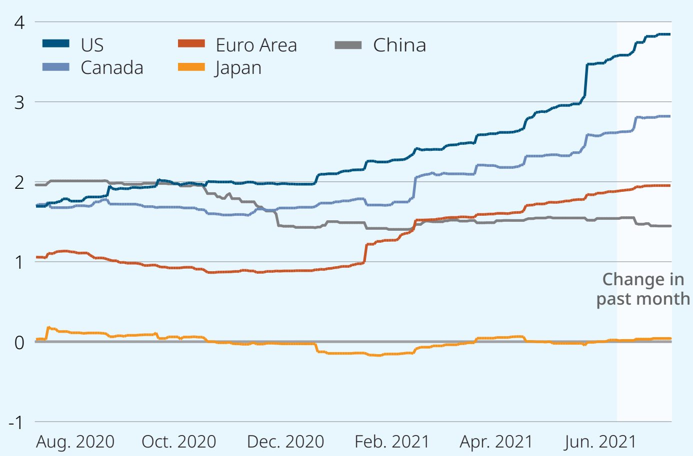
2021 real GDP growth forecast (%, consensus)



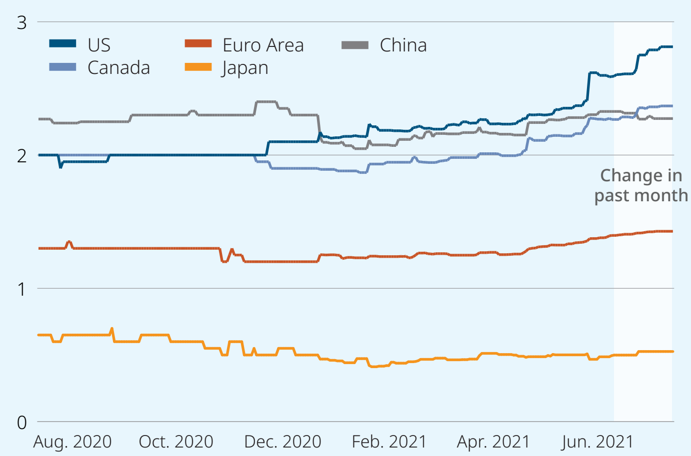
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)



Source: Forecast surveys from Consensus Economics as of July 31, 2021.

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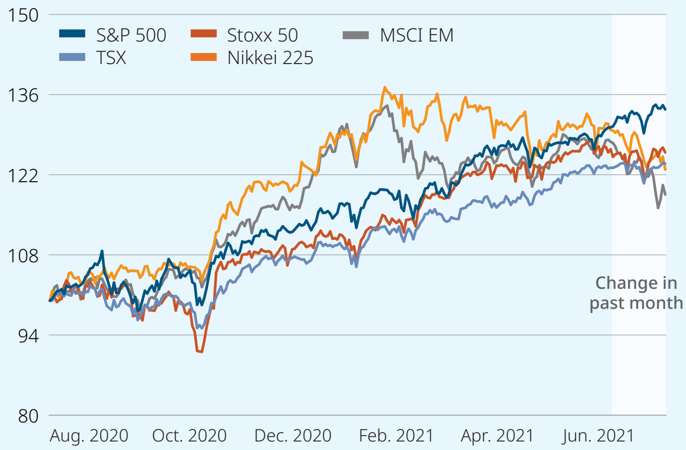
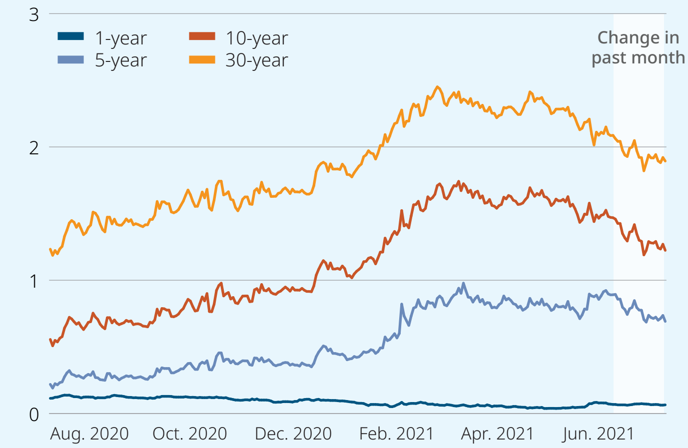
Capital markets update

- The **long bond rally** which began in the second half of June picked up steam in July. On July 20, the yield on 10-year US Treasuries dipped below 1.2% for the first time since February. Potential explanations for the rally include a risk-off impulse from the global Delta variant flare-up, lower expected growth and inflation after the Federal Reserve's hawkish turn at its June 16 meeting, and the potential unwinding of short bond positions accumulated by institutional investors in the lead-up to June 16.
- Declining yields contributed to an overperformance of growth stocks in July, with the growth-heavy **S&P 500** outpacing other equity markets. US equities were also supported by strong Q2 earnings, reminding markets that even as the delta variant and the Fed's hawkish turn cloud the outlook for growth, the US economy is still growing at a high single-digit annual rate and consumer demand has shown few signs of weakening.
- **Oil prices** fell in mid-July as the price-setting OPEC+ agreed on a plan to increase oil supply in coming quarters. Last year, the largest oil-producing countries cut 25% of their supply as lockdowns sharply constrained oil demand. With the new deal, OPEC+ production should be back to pre-pandemic levels around September 2022.

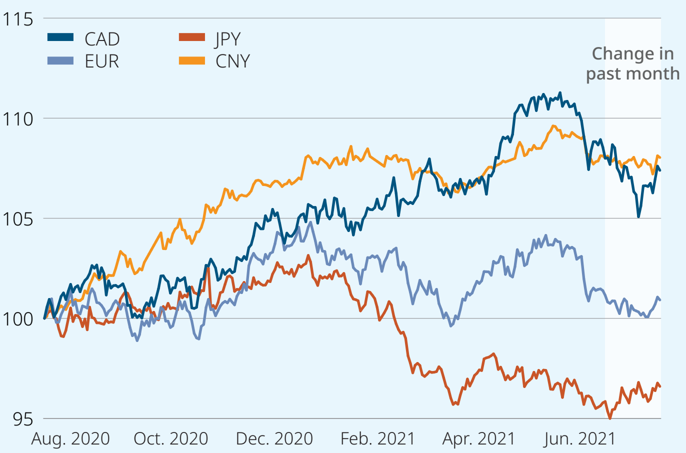
Equity indices (one year ago=100)



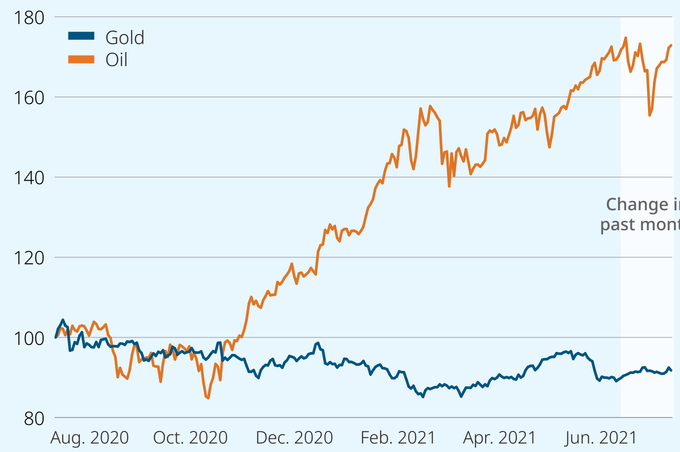
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD, one year ago=100)



Source: Financial data from Bloomberg as of July 31, 2021.

What we'll be watching in August

August 11: US July employment data

- Job creation data slightly beat expectations (+850k jobs vs. +720k expected) in June. But the overall job growth in recent months has been disappointing, especially compared to the bullish expectations economists had earlier in the year. JOLTS data for May show that job openings have likely peaked, suggesting some easing of wage pressures.
- At the solid June pace of +850k jobs per month, we estimate that the US unemployment rate would decline to around 4.5% at the end of 2021. That would still be somewhat above the level at which employment can generate persistent inflation, which the Congressional Budget Office believes is around 4%.

August 19: Canada July house price index (Teranet)

- Even after a few months of cooling housing markets (see Emerging theme section below), we have not yet seen the moderation in demand translate into lower house price growth.
- Since June of last year, house prices have climbed 16% on average in Canada's eleven largest cities per the Teranet-NB index. Halifax (+30.8%) and Hamilton (+28.0%) have experienced the fastest melt-ups, highlighting the pandemic's acute effect on demand for housing in periphery cities.

August 26-28: US Federal Reserve's Jackson Hole retreat

- This year's edition of the Jackson Hole retreat, the Fed's flagship conference, comes at a pivotal moment for monetary policy. After taking a slightly hawkish turn at its June meeting, the Fed could use the event to either (1) retract some of its recent macro optimism in the face of rising Covid cases or (2) give further detail on the eventual tapering of its asset purchases.

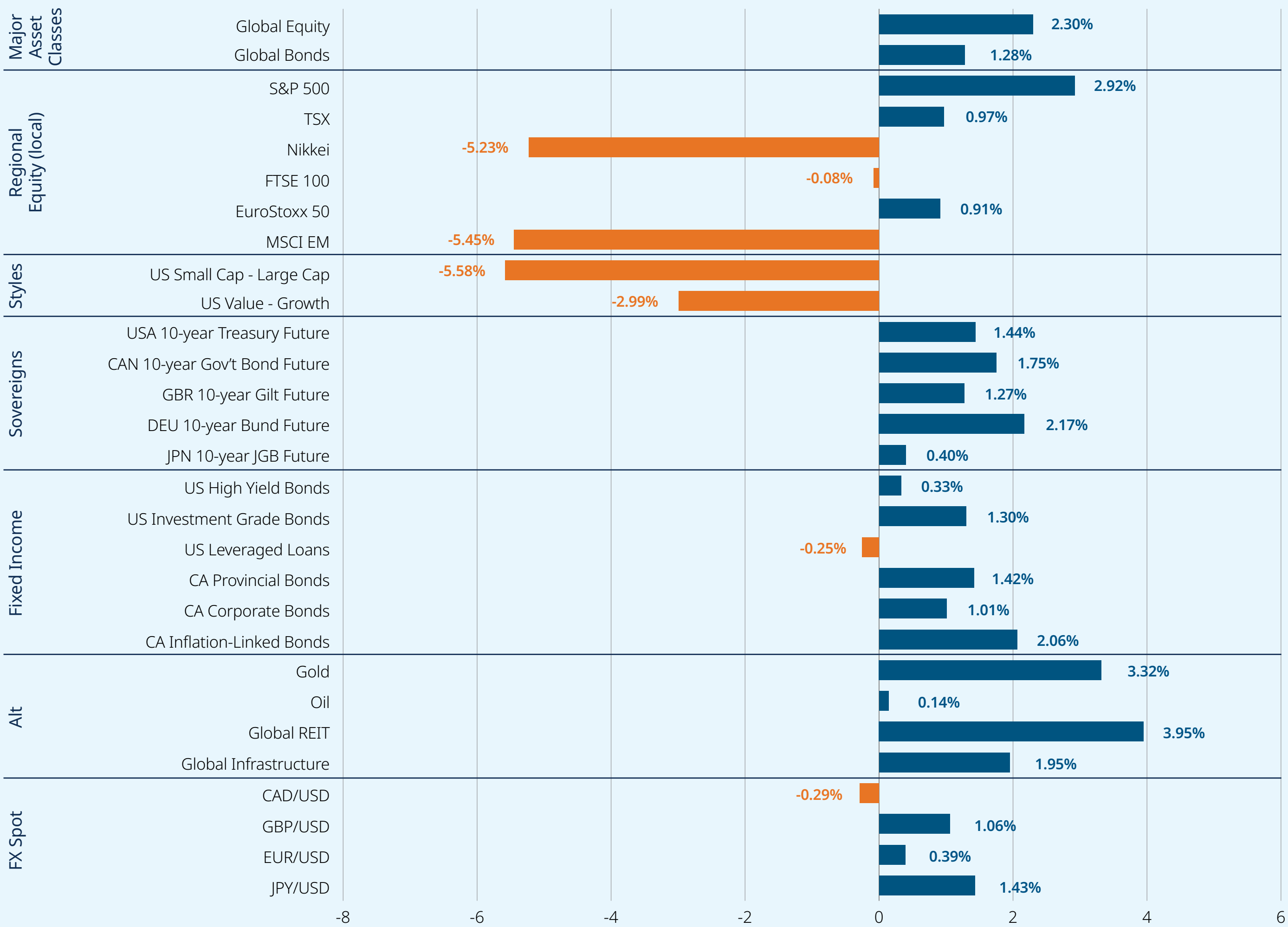
Emerging theme

- The **Canadian housing market is showing signs of cooling** after a few months of unprecedented tightness. Home sales as a percentage of new listings, a measure of excess housing demand, is now back down to summer 2020 levels.
- The **housing market matters for macro dynamics** in Canada. Residential investment makes up 9% of GDP in Canada, compared to 5% in the US. Plus, the pricy housing market is a constant source of concern for regulators in Canada, as the household sector leverage it generates can be a risk for financial stability.
- Hot housing markets could **force the Bank of Canada to tighten monetary policy** to quell prices, hurting the recovery in the process. A deceleration of housing activity mitigates this risk. The Bank of Canada can then focus solely on maintaining a policy stance consistent with supporting the recovery.
- **Will a housing slowdown hurt Canadian growth?** Certainly, given the sector's important share of the economy. But a housing boom implies a leveraging up of the household sector, which can weigh on growth in the long-term. A moderation in housing demand slows this leverage build-up. And with the rest of the Canadian economy primed to bounce back in coming months, other industries will be ready to pick up the slack left by a pullback in residential investment.

Housing market cooling after a tight stretch

Notes: From CREA as of July 26, 2021.

Appendix:
Capital market returns in July



Notes: Market data from Bloomberg as of July 31. Index returns are for the period: 2021-07-01 to 2021-07-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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