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Macro and asset allocation update

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Highlights

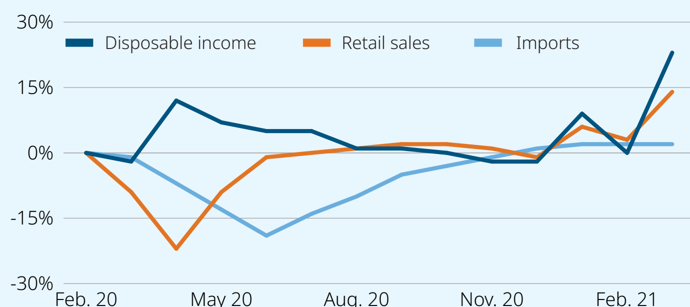
- Fiscal and monetary stimulus have propelled the US bounce back from the Covid crisis but have also generated macro imbalances which could become new sources of risk.
- These risks include an inflation run-up, a more hawkish Fed and a weaker US dollar. While these risks are real, our base case remains for US macro imbalances to smooth themselves out.
- In this environment, we believe equities remain attractive relative to low-yielding fixed income and corporate debt and we remain slightly bearish on the US dollar.
- However, given the currently wide range of macro risks, maintaining a well-balanced portfolio across geographies, asset classes and currencies is as critical as ever.

In our February commentary, we discussed Biden's "growth gambit": a high-risk, high-reward fiscal stimulus plan. The massive US $1.9 trillion American Rescue Plan (ARP), combined with over US $3 trillion in prior fiscal support and exceptionally easy monetary policy, gave the US economy the potential to emerge from the pandemic much faster than it did from the 2008 Great Financial Crisis. But the stimulus has also generated macro imbalances. These imbalances could result in downside risks for financial markets, including an inflation run-up, higher interest rates and a credit crunch for over-leveraged firms.

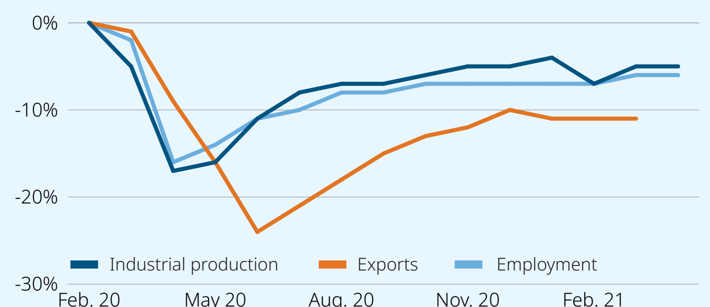
Concerns about US imbalances, especially higher inflation from an overheating economy, have recently become more acute. Figure 1 shows the deviation of select economic indicators from their pre-pandemic trend. Indicators of domestic demand have already rebounded beyond the pre-pandemic trend, while supply remains well below trend. This supply-demand mismatch opens the door to risks of overheating.

Figure 1 | Imbalances in the US economy are a clear source of macro risks

"Demand-side" indicators are back... (percent above trend)



..."supply-side" indicators are lagging (percent above trend)



Notes: Data provided via Bloomberg as of May 20, 2021. "Trend" is interpolated based on Feb. 2016-Feb. 2020 data.

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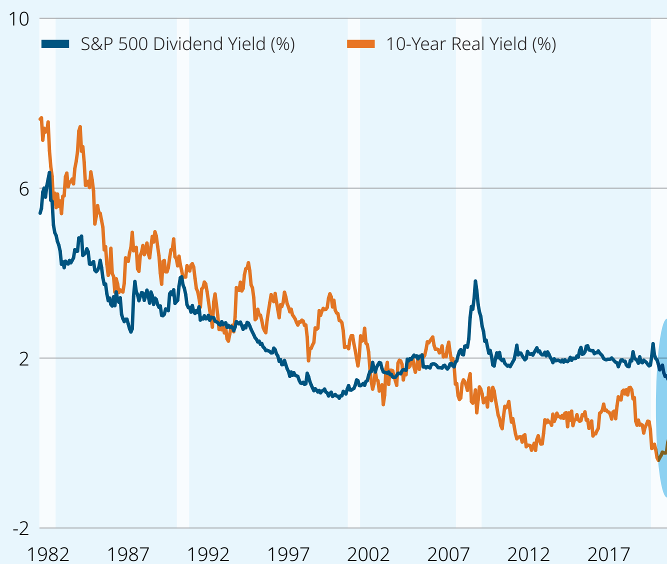
While the risk of overheating is real, our base case is for underlying macro imbalances to resolve smoothly in the next few quarters. US inflation may stay well above target for more than a year but should subside in the medium term. Supply chains, rattled by lockdowns, should build up capacity over the next year, tempering input cost inflation. Unemployed workers, hesitant to return to work, will rejoin the labour force as virus fears abate and unemployment benefits are withdrawn, limiting excess wage growth. With inflationary pressures subsiding, the Federal Reserve can stick to its plan of keeping rates low for an extended period. This should help highly leveraged firms avoid a destabilizing credit crunch. Finally, on the external side, net exports should recover somewhat. The gradual rollout of vaccinations should allow more economies to reopen, bringing back demand for US exports while imports moderate as consumers start shifting consumption from goods back to services.

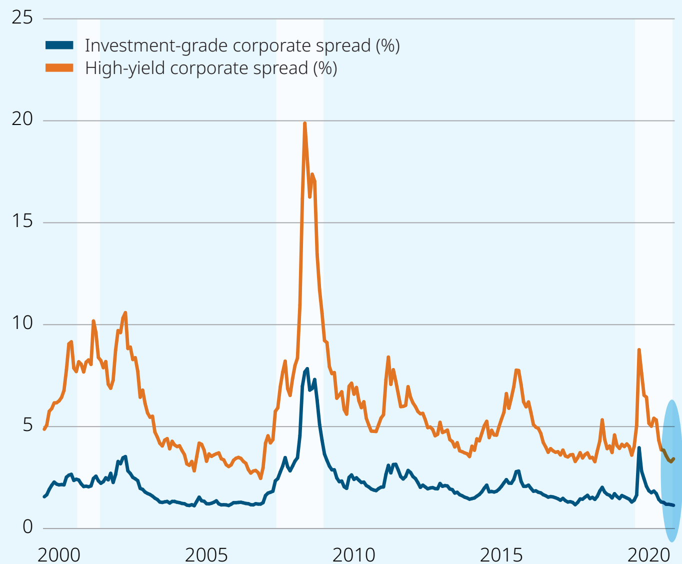
Given this base case, we remain overweight in equities. While volatility may remain elevated, strong growth in the US and a catch-up in global growth should support company sales. Margin pressures due to commodity price inflation and higher labour costs can also be partially passed on to consumers in the short term while subsiding in the longer term. Rich stock market valuations are supported by still-low real bond yields. And equities offer an attractive long-term earnings yield compared to low-yielding sovereign bonds and tight credit spreads for corporate debt at this early stage of the economic recovery (Figure 2).

Figure 2 | Equities are attractive on a relative basis

Low real bond yields support high equity fair values



Credit spreads are tight given the macro risks



Notes: Real rates from the Cleveland Fed. S&P 500 yield via Bloomberg. Spreads are ICE-BAML IG and HY indices. As of May 21 2021.

We are slightly bearish on the still-overvalued US dollar. The vaccination-driven reopening of global economies could weigh on the US dollar as other economies catch up. In addition, US real yields have stabilized in recent months near record lows as the Fed has stuck to its dovish messaging. At the same time, other countries with more hawkish central banks could start normalizing policy earlier than the Fed, driving their local currencies to appreciate vs. the USD. Canada is one of these countries, as we explained in last month's commentary. Finally, while economists expect the current account deficit to close somewhat, it will likely remain negative even as foreign portfolio inflows could be weaker, putting downward pressure on the US dollar.

In the face of greater macro uncertainty, holding a well-balanced portfolio is more important than ever. In the event of serious overheating, the Fed could be forced to raise policy interest rates above the neutral rate to quell inflationary pressures. This could also drive the US dollar higher while putting pressure on other asset classes. We always stress the importance of maintaining a well-balanced and diversified portfolio across different geographies, asset classes and currencies. But diversification takes on added importance when the range of macro risks is this wide.

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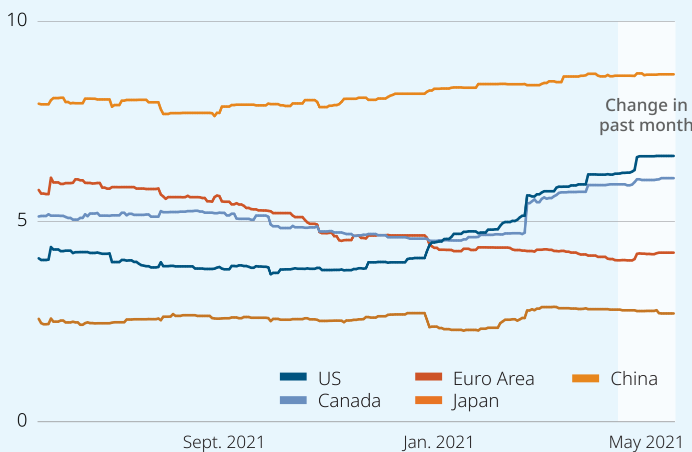
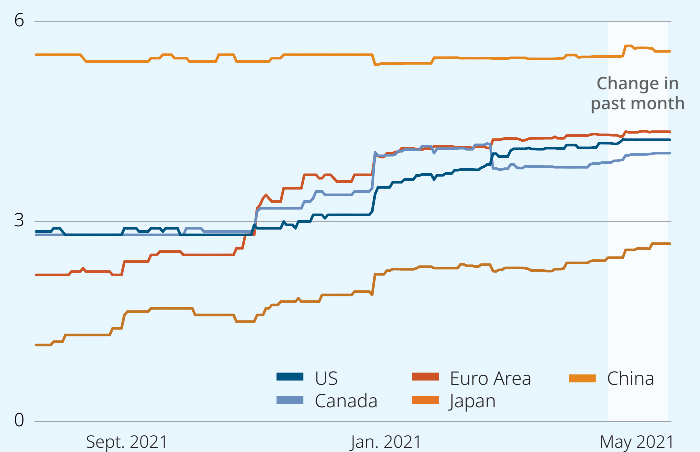
Global macro update

- The month of May started with a macro surprise in the US: employment figures for April showed 266,000 jobs created on net, well below economists' average forecast of 1 million. We see this as a temporary snag explained in part by generous unemployment benefits and childcare constraints limiting labour supply. The big picture is still one of strong **US growth** in 2021, albeit one that could already be priced in by markets.
- Another surprise followed in mid-May, with **US CPI inflation** coming in well above expectations. Looking at the underlying drivers, two-thirds of the monthly inflation spike are caused by (1) used cars and (2) "reopening" categories, including airfare, restaurants and hotels. Forecasters now see annual CPI inflation of 2.9% in 2021, a figure not seen since 2011.
- In **Canada**, CPI inflation for April also came in strong at 3.4% year-on-year, although the Bank of Canada's core employment measures are still around the BoC's 2% target.
- **Global growth** expectations for the next two years inched up in May, as vaccination campaigns picked up speed.

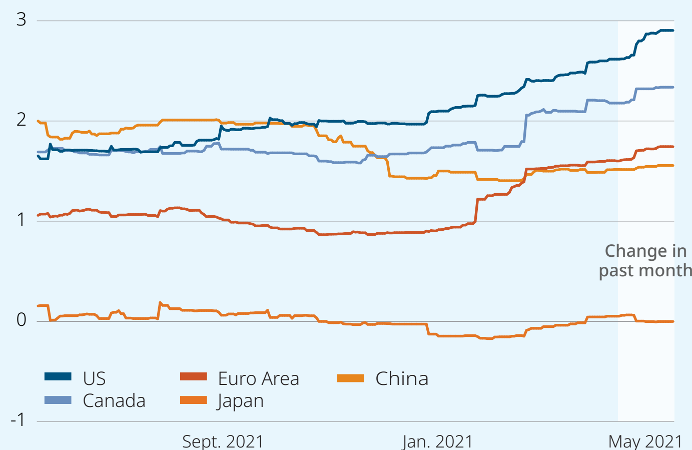
2021 real GDP growth forecast (%, consensus)



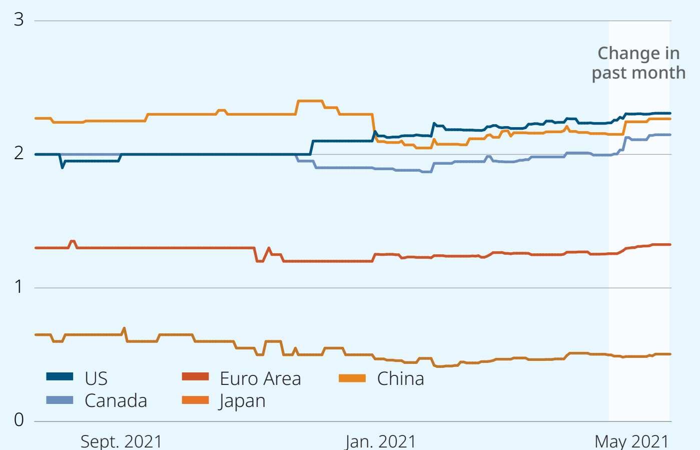
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)



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

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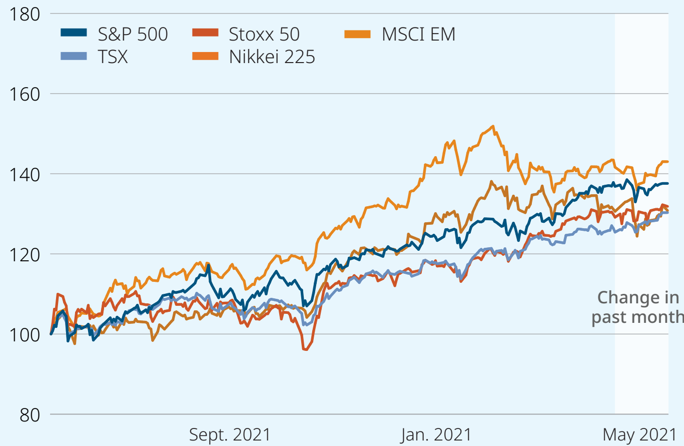
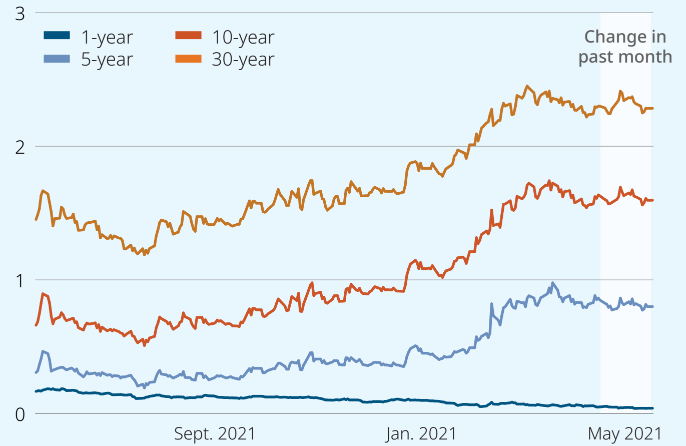
Capital markets update

- **US bonds** sold off upon the mid-May CPI inflation release, before rallying slightly as markets assessed the transient nature of the inflation surprise and Federal Reserve officials reiterated their dovish stance.
- The **yen** once again underperformed the G5 currency basket. As we highlighted last month, Japan is severely behind in its vaccination efforts, which could partly explain the recent weakness in its currency. Red tape, medical conservatism and vaccine hesitancy partly explain its slow vaccination campaign. In May, Canada vaccinated a larger proportion of its population every week than Japan has since the beginning of its campaign in January.
- **Gold** rallied in May as yields on inflation-protected Treasuries slumped. Lower real rates decrease the opportunity cost of holding a cash-flow-less asset like gold, thus supporting a higher fair value for the metal.

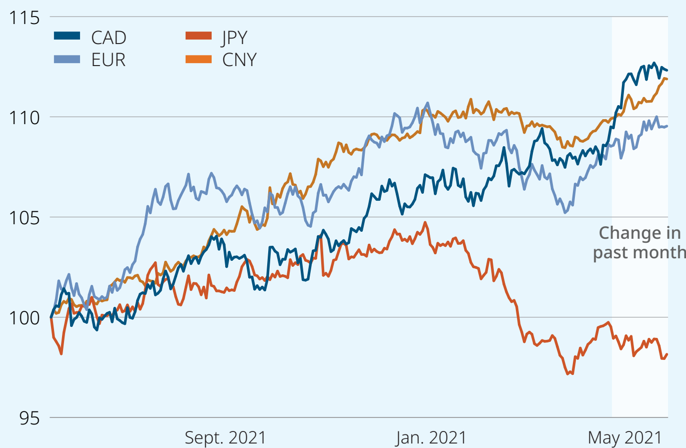
Equity indices (one year ago=100)



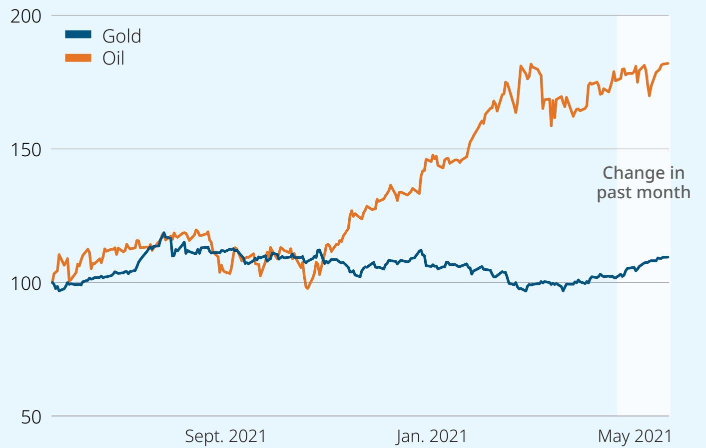
US Treasury yields (%)



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



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



Source: Financial data from Bloomberg as of May 31 2021.

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What we'll be watching in June

June 9: Bank of Canada rate decision

- We learned last month that the Canadian economy shed 207k jobs in April amid a tightening in lockdowns The BoC has recently highlighted how far Canada is from a full recovery in employment. Against this backdrop, we expect the BoC to stay put at its June meeting, waiting at least until July to taper further its bond purchases.

June 10: US CPI release

- For the nth month in a row, our focus will be on US CPI data. Last month's release saw inflation jump to 4.2% year-on-year (0.8% month-on-month), surprising both economists and markets.
- While most of the upside surprise can be attributed to potentially transitory components, including "reopening" categories like airfare and hotels recovering to their pre-crisis price levels, inflation could keep grinding higher for the next few months. The Fed has been clear it would look through any short-term inflation, so we don't expect a policy reaction in the near term.

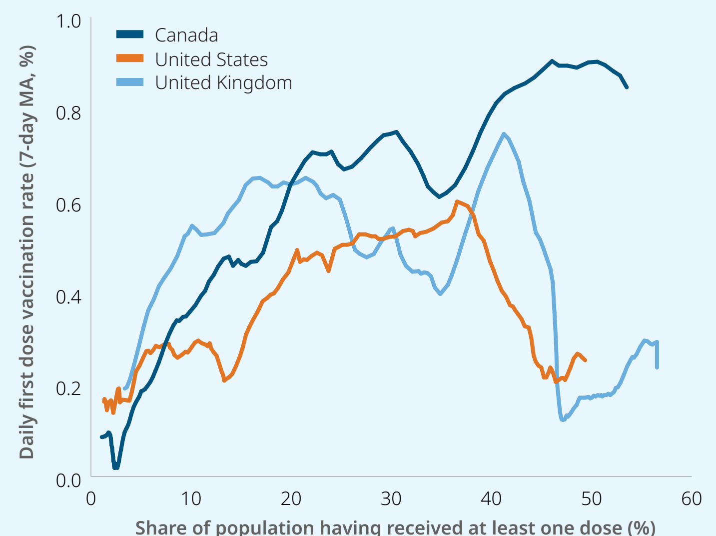
June 10: European Central Bank (ECB) policy meeting

- The ECB must decide whether to maintain the current pace of its emergency securities buying program. Rising inflation is Germany could warrant a taper, but at the deteriorating financial conditions in Southern European countries.
- A taper would further support the Euro's recent appreciation driven by a catch-up in vaccination, a firming up of economic indicators and the prospect for a new euro-wide fiscal package.

Emerging theme

- Vaccination in rich countries has shifted to a higher gear in Q2. Every G7 country has now vaccinated **35% of more of their population**, save for Japan.
- With vaccine supply becoming less of a constraint, the challenge for rich countries' vaccination efforts will become one of **breadth rather than speed**. For a country's economy to fully and permanently reopen, it likely needs to vaccinate at least two-thirds of its population.
- We've seen the growth in newly vaccinated individuals slow down as countries cross a certain vaccination threshold. While a part of the slowdown is due to governments employing a rising share of its vaccine supply as second doses, **vaccine hesitancy is an important factor** as well.
- In the US, new first doses dropped sharply once around 40% of Americans had received their first dose. We see a similar pattern in the UK. On the other hand, **Canada stands out by the resiliency of its vaccination campaign**, which has shown no signs of losing steam even with 50% of its population having received a dose. This bodes well for a permanent reopening… and for the strength of the Canadian dollar.

Daily vaccination rate given share of vaccinated people



Notes: Via Our World in Data as of May 26 2021.

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Appendix:
Capital market returns in May

Category	Index	Return
Major Asset Classes	Global Equity	1.03%
	Global Bonds	0.97%
Regional Equity (local)	S&P 500	0.70%
	TSX	3.82%
	Nikkei	0.16%
	FTSE 100	1.08%
	EuroStoxx 50	2.30%
	MSCI EM	2.32%
Styles	US Small Cap - Large Cap	-0.13%
	US Value - Growth	3.60%
Sovereigns	USA 10-year Treasury Future	0.62%
	CAN 10-year Gov't Bond Future	0.56%
	GBR 10-year Gilt Future	0.47%
	DEU 10-year Bund Future	-0.04%
	JPN 10-year JGB Future	0.08%
Fixed Income	US High Yield Bonds	0.29%
	US Investment Grade Bonds	0.98%
	US Leveraged Loans	0.54%
	CA Provincial Bonds	1.02%
	CA Corporate Bonds	0.49%
	CA Inflation-Linked Bonds	4.01%
Alt	Gold	7.79%
	Oil	4.49%
	Global REIT	1.02%
	Global Infrastructure	-1.11%
FX Spot	CAD/USD	1.86%
	GBP/USD	2.82%
	EUR/USD	1.72%
	JPY/USD	-0.23%

Axis: -3, 0, 3, 6, 9

Source: Market data from Bloomberg as of May 31 2021. Index returns are for the period: 2021-05-01 to 2021-05-31. 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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Index performance does not include the impact of fees, commissions, and expenses that would be payable by investors in the investment products that seek to track an index.

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