Putting the Pieces Together

The Comeback

In this newsletter we will examine the effects of the economic recovery and its consequences on interest rates, investment themes and real estate.

This year's first quarter may have lacked the historic moves of a year ago, but it packed plenty of intrigue into 90 days. Arguably, the watershed event occurred in the very first week, when the Democrats won control of the U.S. Senate. This led to President Biden's massive $1.9 trillion fiscal package which, in turn, fired up U.S. growth forecasts output to levels rarely seen, and put the reflation trade on steroids. This revised growth outlook sparked a materially higher inflation forecast, than what had been expected just in the previous quarter. Consequently, long-term rates increased causing a decline in bond values and by setting off a momentum trade from growth-oriented securities to more value-like equities. Further, oil was supported by Saudi Arabia's unilateral oil production cuts, and copper by the stronger than expected world growth outlook. Henceforth, companies that benefit from a re-opening of the retail economy such as airlines and the hotel industry, increased in share price. In certain cases, the latter two industries have reached valuations that don't support their fundamentals. We are witnessing the same exuberance, which we had last year in certain technology names. However, in today's markets, the more retail-oriented names are benefitting from this momentum.

For our portfolios, as we did last year, we will remain disciplined in our strategy and focus on secular criteria that have long lasting benefits instead of chasing the herd in the current momentum trade. Consequently, in the first quarter of 2021, our portfolios slightly underperformed their benchmarks. However, since the beginning of the second quarter, this latter momentum trade has lost steam. Since the start of the second quarter, our portfolios have narrowed the performance gap and markets are starting to be driven by earnings multiples. We remain confident that staying disciplined will pay off over the longer run. As a result, we prefer having quality growth, as well as consistent dividend growth securities.

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Strong growth in international GDP

Because of the U.S. fiscal intervention and the shape of the vaccine rollouts, BMO Economics had to revise some of their GDP growth expectations. On balance, they state that 2021 global GDP growth has barely budged in the past three months, remaining at 5.7%. However, the largest upgrade was to the U.S. outlook, due mostly to the aggressive fiscal push, but also due to signs of a faster reopening of the economy alongside a rapid vaccine roll-out. Canada has been pulled along for the ride, and we look for a similar growth rate here. The U.K. has also been bumped up 1 ppt to 6.0%. However, Europe has moved the other way, with the Euro Area now expected to grow just 4.0% this year (down 1.5 ppts). Finally, the view on China's GDP growth is 8.0%. All these revisions articulate to us that we should remain overweight in North American equities for our portfolios.

Some effects of rising interest rates

As mentioned previously, because of the stimulus and the vaccine rollouts, the long-term interest rate increased during the first quarter.

At face value, this is positive for the economy because an increase in rates signals an increase in growth. However, a spike in rates signals inflation which is obviously not good for the consumer and asset values. BMO Economics states, that their view on global growth may not have changed that significantly over the quarter, but apparently the consensus became much more comfortable with the forecast of a robust rebound in activity. Yields leaped the very first week of the year, with 10-year Treasury yields touching a post pandemic high. Further, the Ten-year GoCs (Government of Canada) jumped 88 bps in the quarter, bringing them all the way back to around pre-pandemic levels above 1.5%, similar to the increase in rates globally.

The new consensus for inflation, driven by the increased in demand because of the "re-opening", coupled with supply challenges, has driven rates higher. Hence commodity prices did follow higher as well because they are viewed as a hedge against higher prices.

By now most have heard about the rise in lumber prices during the first quarter. For example, lumber prices stayed above $1000 US per thousand board feet (MBF), 15% higher in the first quarter, and well above its long-term averages. Oil as well, participated in a rebound in the first quarter, up by 22%. We remained underweight in our portfolios in commodity exposure, because these are very cyclical industries, especially oil, with the added geo-political risk. History has shown that when oil prices move higher, it is seen as an opportunity to produce more and increase supply which in turn drives prices lower again. We did take tactical positions into lumber and the resurgence of the American suburb theme in which was highlighted in our previous newsletter.

Above, we've outlined the economic climate and consequently, we've adjusted certain criteria in our investment process to reflect these realities going forward. At the outset of the pandemic there was the rush to the stay-at-home trade. The latter did well up until when rates started to rise. Consequently, valuations had to get adjusted and prices decreased quickly and suddenly. Then, in the first quarter of 2021, the rush to the re-opening trade followed. Both trades resulted in lofty valuations that were not warranted. Basically, we experienced P/E expansion. Market leadership in the last 12 months has been into high beta and speculative names. However, as we go forward and valuations remain elevated with low interest rates, the re-opening of the economy and the positive economic data, we've put an additional emphasis on earnings expansion in our investment process. Stocks must earn their returns. Our research partners at Cornerstone Macro state that when you look back in history at years where P/Es were flat, they found the best performing factors were earnings momentum (i.e eps revisions) and high Free Cash Flow Yield. In other words, this is not the time to be in high beta and highly speculative names.

The big bounce in Canadian commodity prices and an improved growth backdrop helped lift the loonie 1.3%. Furthermore, financial markets remain set on the notion that the Bank of Canada will be a leader in starting to normalize policy—a notion that is not at all obvious to our BMO Economics team.

Perhaps adding a bit of fuel, Governor Macklem expressed some direct concern about the housing market. That topic has already consumed plenty of oxygen, and we doubt that the Bank's concerns on that front will translate into a significant change in monetary policy. The concerns of an overheated real estate market will be covered at length further down in our newsletter because we believe that real estate is a concern for many clients, and it represents a substantial asset for many.

Sectoral consequences of rising interest rates

With economic momentum continuing to rise and more stimulus coming (in particular, the recently rolled out $2.3 trillion infrastructure package in the U.S.), U.S. 10 Year interest rates – the single most important benchmark in the world of finance – have now reached the level of 1.65%. Still low by historical standards but a move up in just a few months.

However, the changing inflation and interest rate landscape provides some interesting geographic allocation opportunities. In Canada specifically, our historical studies clearly indicate that the market has reacted quite differently than the U.S., posting far better average gains when interest rates were rising, likely because these periods coincided with inflationary pressure and associated strong commodity price cycles.

Increasing long-term interest rates are generally a positive for financial stocks, particularly for life insurers whose long-term liabilities decrease and generate higher investment income in this environment. For banks, a steeper yield curve, tends to increase the net interest margin and thus profitability. Our historical work supports this argument and has shown that Financials have performed especially strongly in periods when long term (i.e. 10-Year yields) interest rates are rising. Going back to the 90s, average annualized returns for the financial sector have been close to 20% in the U.S. and Canada respectively when 10-year yields were rising vs. less than 2% when rates were declining. Since we expect rates to continue rising over the next few years, this should be a solid tailwind for bank and insurance stocks.

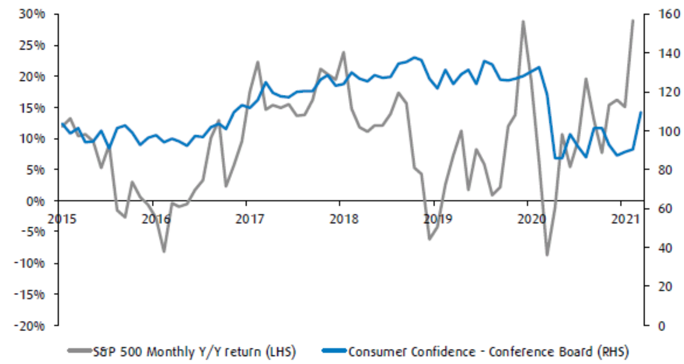
We remind our readers that almost 60% of the S&P/TSX market capitalization is in the Financials, Energy and Materials sectors versus about 15% in the U.S. BMO Capital Markets states that if these trends hold, they are highly supportive of making a call that the Canadian stock market will outperform the U.S. for the first time since 2016.

The shape of the yield curve; Steep and getting steeper.

This is the best way to describe the shape of the yield curve. What does that mean and why does it matter? In a nutshell, the yield curve measures the difference between long term rates (e.g. 10 year+ interest rates) and short-term rates (3 months to 2-year interest rates). When long-term rates rise faster than short term rates – as they are currently doing – this has historically been a bullish sign for stocks (and particularly financial and other cyclical stocks), since it signals a stronger economic upturn and associated inflation fears for which bond investors demand compensation.

In that regard, this crucial leading indicator is very consistent with our models and the view of our Chief Economist Doug Porter who states, "We fully expect the softness to be short-term for U.S. growth, with more current indicators now pointing higher". Just as one example, the New York Fed's weekly economic index reading (which syncs with GDP growth) rose suddenly to more than 4%. As stated above, GDP growth outlook remains positive and that is echoed by the just released U.S. Conference Board's Consumer Confidence Index surging 19.3 points to a one-year high of 109.7 in March. The survey indicates that there is still plenty of interest in buying a home, a car and new appliances. U.S. house prices, as measured by S&P CoreLogic Case-Shiller, were up over 11% from year-earlier levels. In Canada, we are seeing even stronger housing gains. The positive implications for stocks are clear from this data and the chart below.

S&P 500 Monthly Returns vs Consumer Confidence Index



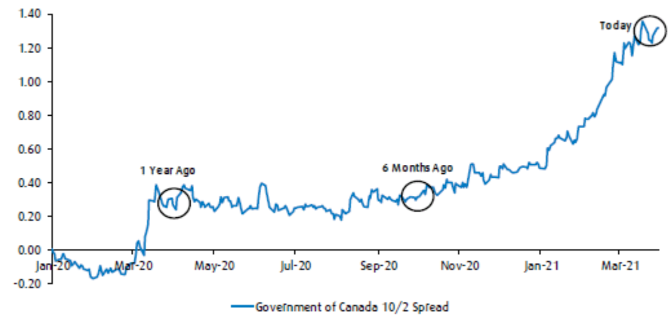
Source: Bloomberg, BMO Economics BMO Private Wealth

The yield curve, an excellent predictor

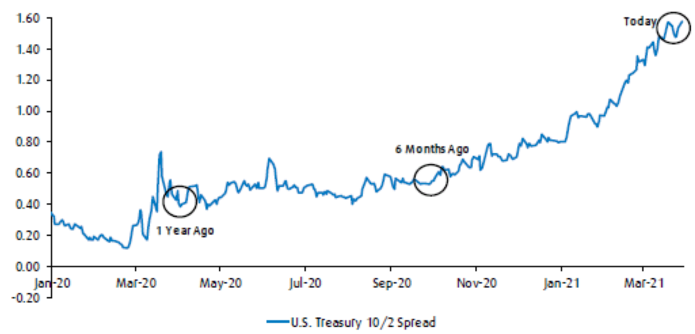
BMO Capital Markets took a close look at the historical impact of the yield curve on the S&P 500. Their analysis going back to the late 1970s clearly shows that investors should pay attention to the shape of the yield curve since it vastly increases the probabilities of getting stocks right over a multi-year time frame. The S&P 500 has done better during cycles when the yield curve was steepening (as it is currently doing) with average annual returns of more than 9% versus under 6% when the yield curve was flattening. Data was more mixed in Canada but in both cases, stock market returns were far superior two years after the curve started steepening. This is what we mean by the yield curve being a great forward indicator.

The charts below show just how much steeper the curves in Canada and the U.S. have gotten over the last year (a positive number on the left axis shows how much higher 10-year rates are versus 2-year rates, in percentage terms).

Gov. of Canada Yield Curve - 10 Year / 2 Year Spread (%)



U.S. Treasury Yield Curve – 10 Year / 2 Year Spread (%)



Investment Themes

In our last quarterly newsletter, we listed certain investment themes that will shape our investment discipline going forward. That said, we would like to take the opportunity to elaborate on those themes.

1. **Low interest rates**

   The FED has consistently stated that short-term rates will remain at current levels until 2023. Consequently;

   - ✓ Bonds represent very little value because the income stream is low and there is very little upside potential (risk of rising rates in the future).
   - ✓ Valuations will remain higher than their historical averages. When discounting dividend or earning flows at this rate, the multiples will remain high.

✓ When rates do rise, and they will because of the economic recovery (admittedly we still believe rates will remain below their historical averages. Mainly due to macro trends such as technology and demographics);

a) Dividend growing companies offer a hedge and outperform (not necessarily names with high payout ratios).

b) Companies that have higher profitability margins will outperform because making money in a rising interest rate environment is difficult due to higher cost of capital. For the most part, higher margin companies are within the technology sector. Ideally, we want to focus on the names that have a diversified revenue stream. The obvious examples are Apple, that offers an ecosystem of products and Microsoft, that are the leaders in an enterprise offering that range from hardware, to software and to cloud business.

2. Infrastructure & 5G

We've heard from the previous two administrations, talks of an infrastructure bill before, but the houses haven't been able to pass any bill yet mainly due to the price tag associated with the spending. The reality is that even if they don't come to some sort of an agreement, the pandemic has highlighted the need to invest in infrastructure by the private sector. This investment will be in the form of information. That's why 5G will reshape how we work, and it will also reshape how we live. The 5G network is one that can process a much larger database of information in comparison to our existing network. For example, some of the workforce will continue working from home even after the pandemic is over. Consequently, a company needs to invest in hardware and in cloud computing, which is basically storage of information. Another example is that a 5G network will improve logistics when ordering online. Further, the accelerated investment in autonomous vehicles is due to the existence of 5G, which at first will probably be used in logistics.

3. Oligopolies

Our investment theme into oligopolies is simple. As Canadian investors, we are lucky in the sense that many parts of our economy are oligopolies; for example, the banks and the rails. As for south of the border, they don't have as many oligopolies as we do but they do have companies that quite frankly, have competitive advantages because of their scale. Usually, this represents high barriers to entry in their respective industries. For example, think Costco… These competitive advantages offer these companies a monopolistic type of industry. The reality is that after a recession, we get consolidation and the biggest get bigger.

4. **The American consumer**

We do believe that the American consumer is still the driver of the global economy. They are well positioned for this recovery. Firstly, the debt levels per household remain low, the price for gas is relatively low and even if this current administration raises taxes on income, it will probably do so on higher earners. Plus, they just received a stimulus package of $1.9T. Henceforth, we like both consumer discretionary and the staple sectors.

5. Alternative or renewable energy

When we say alternative energy, people think electric cars and rightfully so. Every car manufacturer is making a considerable investment in EV (electric vehicles). We don't like to pick a winner in that space, but we can invest indirectly via suppliers. That said, we do believe this will take a long time to manifest itself because the infrastructure is not in place.

In the now, alternative energy as a power source is a rapidly growing industry. And this ties into the infrastructure theme. The private sector is already making huge investments in renewables and the government has incentive to do so as well because that industry is the main driver of labour and income growth, which in turn increases tax revenue.

Canadian Housing

The extreme strength of the Canadian housing market has been well documented. We believe the market has long been smoldering thanks to fundamentally driven pressure from demographic and supply-side factors. Further, record-low interest rates have lowered mortgage costs, and central bank guidance is cementing expectations that there is little to stop prices from moving higher.

At the same time, employment has rebounded swiftly in higher-paying industries, while fiscal policy is providing broad support to the economy. Moreover, the blind-bidding process in extremely tight markets is adding another layer of upward momentum.

Our BMO Economics team believes that policymakers need to act immediately, in some form, to address the home price situation before the market is left exposed to more severe consequences down the road. As it stands now, prices are going parabolic across several markets, and the price strength appears to be feeding on itself.

While development policy has created supply-side issues for a decade or more, and affordability for younger households is always a policy concern, the acute issue today is market psychology. According to the latest Mortgage Professionals Canada survey, expectations for home price gains are the highest in at least a decade; while expectations for mortgage rate changes are the lowest in at least a decade.

The action needed today is one that immediately breaks market psychology and the belief that prices will only rise further. That would dampen the speculation and fear-of-missing-out that those expectations are creating.

BMO Economics has outlined examples of what policy measures could be used to cool the market**.** Without making a definitive recommendation, they outline a few possible measures that are on the table for policymakers, some effective and some not. It's clear that no single measure is perfect.

Breakdown of potential Measures

1. BoC Interest rates/guidance; The Bank of Canada could hike rates, or at least back off from its commitment to hold policy rates at near-zero until 2023.

Interest rates and the Bank of Canada’s commitment to keep them low for years are arguably the key drivers behind the meteoric surge in home sales and prices across large swathes of the country. A move here would have an immediate, clear and notable impact to cool housing. However, interest rates are a blunt tool and impact more than just housing. The economy has yet to return to pre-pandemic levels of activity, and tightening credit conditions will only lengthen the recovery. In addition, higher interest rates would likely strengthen the Canadian dollar, providing yet another drag on growth.

2. Real Estate bidding process; Implement an offer system that eliminates blind bidding in real estate transactions. This could use open bidding among agents and/or standardized escalation clauses for the price component of offers.

This would keep the sale price from settling well above the price of the next willing buyer and keeps the comparable more appropriate for the next property to list in that location. While this won't cool the market on its own, it would limit the ballooning that we're now seeing in a very tight market. This measure would likely have to filter through provincial real estate associations.

3. Speculation Tax; A special capital gains tax on the sale of residential real estate purchased from today forward, with the rate falling to zero over five years of holding the asset.

On non-principal residences, the maximum capital gains tax would become the current rate (e.g., about 26% in Ontario) plus the speculation tax. On principal residences (if applied), the speculation tax would effectively become a capital gains tax that fades through the five-year window. This could easily crowd out speculation and alter market psychology. A similar concept was used in Ontario in the 1970s, and it weakened the market overnight.

4. Increase single-detached supply (major urban areas); Refocus municipal intensification targets to allow more single-detached development within major urban centres.

This is a challenging proposition given that it would turn against roughly 15 years of policy that has (predictably) put us where we are now. That can't be undone quickly. And, in many areas, it could require pushing into environmentally sensitive areas. This is also a long-term fix for a problem that needs a fast response.

The fight against Covid-19 and the return to normalcy is not over, and so your team will remain alert to emerging trends and be active to keep your short and long term plans on track. Hope to talk to you soon.

Team Roux & Associates