Putting the Pieces Together

Price is right?

It has certainly been an eventful year for US stocks thus far. While the market has largely moved higher throughout 2021, underlying price action has experienced ebbs and flows with multiple rotations occurring along the way among value vs growth trade, cyclicals vs defensives sectors, and reopening/stay-at-home trade, developments we expect to continue in the coming months.

Furthermore, never-ending fears and correction worry among investors related to Fed tapering, rising interest rates, peak earnings, and seasonality, to name a few, are also things we expect to continue. We have discussed these areas of concerns in our previous newsletters over the past year but wanted to reiterate them again and remind investors that the positive fundamentals underpinning US stocks remain in place. Hence, the underlying market price movement has been volatile this year, but we remain steadfast in our investment process putting an emphasis on a company's capacity to generate predictable earnings and positive trending margins. As such, our message to investors as we look ahead to the final months of 2021 is to expect more of the same.

In this quarter's newsletter, we will mainly focus on inflation. This topic is top of mind for everyone and not a day goes by without us being aghast by the prices at the pump, the grocery store, real estate prices and list goes on. Furthermore, we'll draw parallels between today's inflationary period and that of the 70's. We will also highlight the impact that inflation has on different sectors within the equity market. We will also discuss the effects of the "taper tantrum" and finally we will reiterate our focus during this type of market environment.

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Inflation

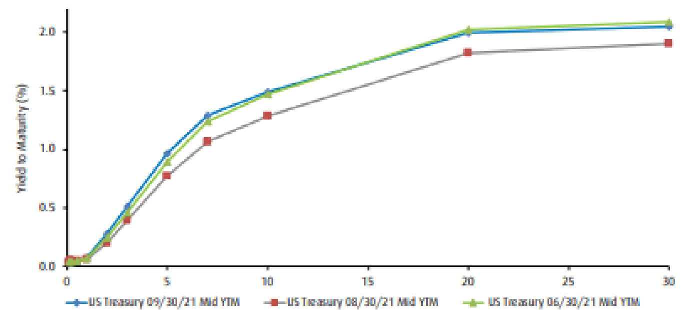
Inflation continues to be a key part of the investment narrative and we do not see this situation changing in the short term. For manufacturers, retailers and transportation companies, supply chain issues including spiking shipping costs continue to hurt production and push up total production costs as noted by several huge companies including FedEx, Costco and Nike. While this trend could be negative for companies that trade with high multiples, the historical impact has been much kinder to sectors such as financials, energy, mining and industrials.

This focus on rising prices is well-founded since inflation trends are among the most important determinants of market returns. The impact on equities is complicated since mild inflation can be positive as it provides additional pricing power to well-positioned companies.

BMOCM's (BMO Capital Markets) data analysis work going back to the 1960s clearly shows that stocks in general do better when inflation is declining. This makes intuitive sense since the value of future corporate cash flows is worth more in today's dollars when inflation and interest rates are low. That said, it is still possible to make money when inflation is rising, but one does have to be more selective. In Canada, the performance has been better when inflation was rising, no doubt because of our market's very high exposure to financials, basic materials and energy which offer good inflation protection.

As expected, the U.S. Federal Reserve (Fed) suggestion of its tapering path likely starting in November applied some pressure on rates. But the Fed's more hawkish tone, with revised forecasts for slower growth and higher inflation, alongside signs of potentially a more aggressive tightening timetable weighed even more in the repricing of the U.S. Treasury yield curve.

U.S. Yield Curves

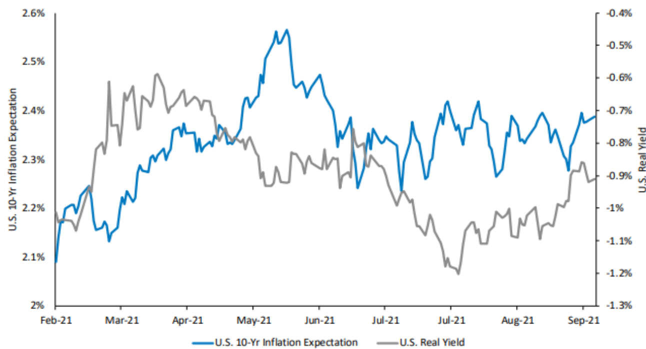


Source: Bloomberg

Furthermore, the Fed Chair, Jerome Powell stated that "it is frustrating to see the bottlenecks and supply chain problems not getting better. We see that continuing into next year, probably, and holding up inflation longer than we had thought." In Europe, the Bank of England noted it could raise rates twice before May to curb inflation and that even before the current bond-buying program expires if necessary. The European Central Bank highlighted risk for higher euro-zone inflation as Germany's Consumer Price Index (CPI) rose to the highest level since 1993. Norway's central bank also became the first of the major banks to raise rates and is expected to move again in December.

Adding to concerns are the severe drought in Brazil that could impact production of coffee, orange juice and sugar, adding to mounting pressures on food prices, as well as the energy supply issues impacting Europe and Asia. The energy crisis has prompted the U.K Prime Minister Johnson to put the army on standby to ease a fuel shortage, while in China, a government worrying about the upcoming winter ordered its top energy companies to secure supplies at all cost. While the prospect of earlier Fed tightening could continue to pressure the short-term part of the curve, longer term yields have yet to reflect the extent of inflationary concerns. With most of the recent move upward in yields being driven by real yields, and not by inflation expectations.

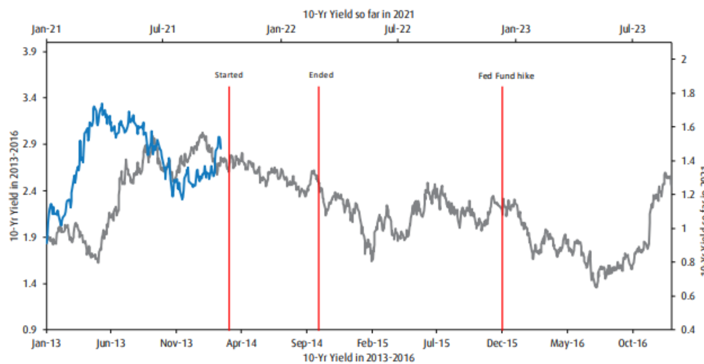
Real yield driving uptick in U.S. 10-year treasury nominal yield



Source: Bloomberg

When compared to the previous cycle, there is a perception that most of the tapering risk was likely reflected in yields already. Unlike today, in 2014, CPI peaked early in the year as the Fed started tapering, before turning negative 12 months later. It is yet too early, but if history repeats itself, any signs of peaking inflation could provide clues as to potential interest rate trends.

Comparing tapering cycles



Source: Bloomberg

Our partners at Cornerstone Macro state that; “they do not believe that the Fed will be raising their policy rates in 2022. That said, the closer we get to those rate hikes, the more likely we’ll see market volatility. Next year’s slowdown in PMIs (Production Manager Index), earnings and inflationary pressures will all complicate the outlook in late 2022, perhaps leading to hikes later, rather than sooner”.

They continue by stating they don’t see the Fed easing with one hand and tightening with the other. Therefore, it’s logical that the Fed would stop QE before raising rates.

Basically, the short end of that yield curve trajectory (i.e., near-term expectations) has been going up since the June FOMC meeting, when the Fed surprised by signaling two rate hikes in 2023 vs. none before. Then the process continued after the September FOMC meeting, when the committee was evenly divided on the idea of hiking in 2022. At the same time, the long end of the expected yield curve trajectory has been coming down, signifying skepticism about the long-term prospects for US growth and/or inflation.

Furthermore, they outline some data points that support their view that rate hikes are not imminent in 2022. For example, evidence is mounting that the supply/demand imbalances which have been pushing goods prices up, are reversing, meaning lower goods prices ahead.

1. Ships: The number of anchored containerships is slipping, as Covid retreats globally, allowing for reopenings. What will happen to prices when all the “stuff” on those boats gets to market?

2. Freight rates: According to China’s Sunday Global Times: “The average cost for shipping a 40-foot container from China to the US West Coast dropped 22% from late September, the fourth consecutive weekly drop, according to Freightos.”

3. Exports: Chinese exports are clearly rising, despite typhoons, floods, Covid, and power shortages -- more stuff is coming to market.

4. Hours worked: The key LA/Long Beach ports are moving to 24-hour operations, and firms including Walmart, UPS and FedEx are also expanding work hours, to clear bottlenecks.

5. Rail: Stocks are outperforming, as goods are now being moved from ports to factories, stores, etc.

6. The core goods CPI rose just 0.25% m/m in September and has been in a weakening trend for 3 months.

7. The “core” PPI rose just 0.08% m/m and has been in a weakening trend for 2 months.

As stated above in our introduction, the market’s price action and fund rotation into different sectors and trading styles since the beginning of the pandemic can be characterized as a momentum driven market. This is due to the short-term and long-term interest rate movements. As the world economy is trying to deal with this pandemic, these latter two rates are constantly being re-priced because of all the factors listed above. The reality is that it is impossible to forecast rates because it is data dependant. And the fact remains that central banks are caught in a conundrum whereby they can’t increase rates if the long-term rates are still low.

Firstly, the short-term rate is set by the central banks. Since the beginning of the pandemic, the obvious remedy for central banks was to decrease the short-term rate substantially in order to offer economic stimulus. From the outset, the Federal Reserve clearly indicated to market participants that they will keep rates low at least into 2023.

Secondly, long-term rates are set by the marketplace, more precisely by the fixed income market and they are a function of long-term growth prospects. That said, since the Financial Crisis, central banks globally started being the biggest fixed income participants and started buying long-term bonds to keep long-term rates low; this was known as Quantitative Easing (QE). Henceforth, since the beginning of the pandemic central banks initiated more QE in order to provide liquidity in the credit markets.

Essentially, this relationship between short-term rates which is an indication of price power (inflation vs deflation) and long-term rates which is an indication of long-term growth, is driving these ebbs and flows within the marketplace. The ideal trend for interest rates should be upward slopping and intuitively, it makes sense. Shorter-term rates should be lower than long-term rates. For example, any company or investor which choses to invest either through capital expenditure or via the credit markets should be rewarded for their longer-term prospects. If not, then there wouldn’t be any reason to invest for the long-term.

And thus, the conundrum… Currently, long-term rates remain historically low because of the factors outlined by Cornerstone Macro and so are the short-term rates. However, price inflation is real, and the only way Central Banks can remedy it is by increasing the rates. However, if they do, then they will flatten the yield curve, or they can involuntarily inverse the yield curve which will probably decrease growth even further and bring us back into some sort of recession. That is why the Federal reserve said they will be slowing down QE in the hope of increasing long-term rates (essentially removing themselves as a market participant in the debt markets in order for institutions to demand more for their longer-term investment). Thus, the only way they can increase short-term rates is when the longer end of the yield curve steepens. We don’t believe that inflation will completely abate after these bottlenecks subside because job growth and wages remain strong for now. Henceforth, some reversion to the mean is a more probable outcome.

Parallels to 1970’s inflation - Stagflation

Stagflation is sustained high inflation, persistent weak demand, and soft employment. Today’s economic environment may suggest thoughts of 1970’s stagflation for some. However, BMO’s Chief Economist Doug Porter says that, while there are parallels between then and today, we are still far from such an environment. He notes that in the early 1980s, U.S. inflation was well into the double digits even as the unemployment rate was well above long-run norms (and eventually rose above 10% in 1982). Currently, even with some disappointment on the growth front, the U.S. jobless rate is 5.2% (and falling) and even the highest measure of inflation is 5.3%.

Today’s sharp inflation will prove transitory according to Cornerstone Macro. Overall demand has remained robust (retail sales just half-a-percent off April’s record high), and the labor market is exceptionally hot (roughly 2.5 million

more job openings than people officially unemployed). Just last week:

1. Retail sales surprised on the high side, even adjusting for inflation, despite a bit less demand for some goods.

2. Unemployment claims (initial and continuing) broke lower.

3. JOLTS; job openings for July were revised up to over 11 million, with August's slight downtick setting them 3 million above their pre-pandemic peak – a powerful leading indicator of job gains.

4. The private quit rate hit a record high of 3.3%, signaling people are confident they can find another job (a precursor to higher wages).

We've seen a big, scary-but-transitory inflation surge before. After the steep 2008-2009 Global recession, China eased massively, prompting a Global V-rebound, and a surge in commodity prices/inflation. But once stimulus was pulled back, the inflation acceleration proved temporary, as the Global economy slowed. We've had many discussions with investors who feared inflation would become engrained, ala the 1970s. But again, as Global growth slowed in 2011, commodity prices peaked, and the U.S. CPI slowed. That's likely to be the path going into and through 2022.

The effects of rising rates in the stock market

Rising rates have benefited, not hurt, US stock market performance. The S&P 500 has posted an average price return of 14.8% during periods of increasing y/y (year over year) rates compared to just a 6.5% gain during periods of falling rates. BMOCM's work also shows that some of the strongest returns for the market tend to occur when the US 10Y Treasury yield rises from below-average levels with the S&P 500 registering a 20.5% price return, on average, during periods in which the yield was below its three-year average and increasing on a y/y basis.

In addition to examining the effects of rising interest rates on the overall market, BMOCM's also outlined performance implications across sectors as well. To do this, they again looked at average one-year price performance based on the level and trajectory of the US 10Y Treasury yield going back to 1990 but separated the pre- and post- Great Financial Crisis ("GFC") periods because some sectors' relationships with rates have changed considerably since then.

1. Since the start of 2009, Financials outpaced the S&P 500 by 6.2% y/y, on average, during periods of rising interest rates, and outperformed by 11% when rates increased from below-average levels - the strongest returns across all sectors. This marked a notable shift from the 1990-2008 trend, in which Financials trailed the market by 2% when the US 10Y Treasury yield moved higher.
2. Relative y/y performance for Consumer Discretionary and Energy also exhibited changes to their relationships with yields between the two periods of time. Discretionary stocks have logged above-market one-year price returns amid rising yields post-GFC, after trailing market returns, on average, during the pre-GFC period, while the opposite holds true for Energy stocks.
3. By contrast, Consumer Staples and Utilities appear to have become much more sensitive to increasing interest rates as their underperformance relative to the broader market has worsened since 2009, especially when the US 10Y Treasury yield has risen from below its three-year average.
4. The relationship in place during 1990-2008 between Industrials and Materials relative performance and interest rates largely remained in place, with slight positive improvements occurring for both groups in the post-GFC era when rates rose from below-average levels.
5. Despite Tech and Communication Services being some of the hardest hit groups amid the current uptick in yields, these sectors have historically logged decent levels of outperformance during rising rate periods since the Financial Crisis.

Overall, rising interest rates have not had a detrimental effect on performance at the sector level as all 11 S&P 500 sectors still logged positive average one-year price returns during these periods both pre- and post- GFC. Since 2009, seven of 11 sectors have eclipsed the one-year price return for the S&P 500, on average, when the US 10Y Treasury yield was rising y/y from below its three-year average, which represents the current rate environment.

The effects of QE tapering on the market

In its September policy statement, the FOMC seemed to move a step closer to the start of tapering by saying that a reduction in its asset purchase program "may soon be warranted". Despite the signaling by the Fed, many investors still believe the market will have a tantrum once the tapering is officially announced. And this is normal because the market did pullback last time the FOMC started tapering. For our part, we do not think tapering will cause any sort of prolonged market havoc. Keep in mind that the Fed has already telegraphed QE reduction on several occasions, unlike Bernanke did back in 2013 when his initial comments sparked a 5.8% selloff. Even so, that peak-to trough decline was erased just 12 trading days later amid an 8.7% recovery rally in the weeks after the taper-induced low. As such, the so-called taper tantrum of 2013 represented a buying opportunity in US stocks.

Portfolio strategy

As stated in our introduction, we have put a bit more weight on earnings growth rather than multiples. That's not to say that we ignore the latter variable. However, in a market whereby rates are rising, it is more difficult for a company to generate earnings because cost of capital is more expensive. Therefore, companies that execute better are rewarded. Earnings growth has become the major driver of market performance in 2021, a trend we expect to persist in the months ahead. Throughout the previous newsletters, we have continued to discuss this transition from a P/E-driven environment to an EPS-driven environment and its implications for the market.

BMOCM's analyzed S&P 500 performance for all rolling monthly one-year periods since 1955 and isolated those periods where performance was being driven by P/E or EPS. The work shows that EPS-driven periods tend to exhibit lower average price returns, more dispersed returns, and a higher frequency of losses vs. P/E-driven periods. However, when diving a bit deeper and looking solely at EPS-driven periods in which S&P 500 EPS growth was 10% or more (the current and anticipated environment), performance results noticeably improved.

Furthermore, because companies have generated strong earnings growth, share buybacks and dividends for S&P 500 companies have ramped up this year after notably shrinking in 2020 amid the pandemic. Elevated cash levels, below-average payout ratios, and an unprecedented recovery in corporate earnings are setting the stage for an extended rebound in shareholder distribution, in our view, which should ultimately be a positive for US stock market performance as we look ahead to 2022.

Despite the already solid rebound in shareholder distributions, BMOCM's still believe there is more to come. Their work shows that the aggregate cash and short-term investments balance for S&P 500 ex-Financials companies totaled $1.9 trillion, a sizeable uptick from the $1.5 trillion in cash at the end of 2019.

The fight against Covid-19 and the return to normalcy is not over, and so your team will remain alert to emerging trends. Hope to talk to you soon.
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