RBC Dominion Securities Inc.

Wealth for Life

Wealth Management
Dominion Securities

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A tale of two stories

I think if one were to ask anyone how they feel about the progress of our recovery from the COVID-19 pandemic, you would probably receive a far-less-exuberant response than that of what was represented by financial markets in the first quarter – and that I believe is a gross understatement! There is clearly a contradiction of terms in the "economic reopening" and "reopening of the economy." Yes, the U.S. and a few other countries have had vaccine success and enjoy more freedom for their citizens, but many countries like Canada are embroiled in doggedly drawn-out lockdowns – with little resemblance to life as we knew it in 2019.

Notwithstanding the heartbreaking number of lives lost to COVID-19, the tragedy of the pandemic is still playing out, with employment levels still 20% and 36% below pre-pandemic levels in Canada and the U.S. respectively. Sectors like travel, entertainment and retail are often referred to as being at the "epicenter" of the COVID recession and have clearly borne the brunt of the COVID unemployment landscape. On the flip side, the economy has recovered in miraculous fashion through the first quarter. Economic data since January has been building consistently in a positive way. Manufacturing, services, new orders, home sales, new home construction and most importantly, consumer confidence have all improved robustly. Not surprisingly, financial markets have responded favourably.

Equity markets in Canada and the U.S. returned 8.1% and 6.2% (US$) respectively in Q1. Interest rates, as measured by the benchmark 10-yr. (US$) bond, increased to almost 1.75% from just below 1% in Q1 – a significant increase by any measure, but still below pre-pandemic levels. The robust financial market conditions were also supported by more than generous stimulus measures by governments worldwide and accommodative measures by central banks globally. Stimulus packages passed in the U.S. now amount to more than 10 times that delivered in the Great Recession. The scarcity of inventory was recently highlighted by the shortages of semi-conductors that has led to the noted slowdowns and halts in auto manufacturing. Similar product shortages – notably lumber and metals for product fabrication have led to pronounced price increases – have led many to believe that product shortages and robust stimulus will deliver future inflation.

After the Great Recession, central banks were weary of inflationary pressures that never materialized. Instead, 2009–2020 was noted for a period where central banks fought persistent deflationary pressures and never faced expected inflation. So today, central banks have communicated a clear bias to keep financial conditions (interest rates low) accommodative until targeted inflation of 2% or more is achieved. The objective is to do everything possible

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to ensure "economic lift-off" after the COVID recession – or "full employment" of those currently left behind in the "epicenter" industries.

In short, the economy is reacting to fundamental drivers. Demand from consumer spending being at greater than pre-pandemic levels keeps lean inventories lean and drives replenishment and more economic activity. As employment and jobs recover, spending levels increase, raising the level of economic activity. The cycle of surging and declining new COVID cases drives relative weakness and strength in select equity sectors. However, the underpinning of economic strength drives all equities higher, even though individual sectors experience mini corrections in the short term. For example, in mid-February through early March we saw "big tech" take a 10% or more haircut, as money moved to epicenter sectors. As the reality of economic strength set in, big tech recovered into April with the rest of equity markets.

Calls for inflation are building and will certainly gain in strength as gigantic stimulus packages gain traction. Burgeoning job growth in the wake of economic expansion will surely build consumer saving and spending power.

The magnitude of stimulus relative to the recovery after the Great Recession is a noteworthy differentiating factor when compared to the recovery of 2009–2020. As a result, inflationary pressures are potentially real, and a factor to be considered. At the time of this writing, U.S. March CPI showed inflation running at 2.6% year-over-year and that number is likely to increase meaningfully, as comparisons to the prior year will be at the depths of the COVID-19 depression.

Just as the COVID depression was like no other, we have never faced an economic recovery scenario like this before. For example, the U.S. provided \$900 billion in stimulus in January, then \$1.9 trillion later in the quarter, and is now looking to pass another "outsized" stimulus package. Coincidently, the U.S. Federal Reserve (central bank) has pledged to keep interest rates accommodative as well – more fuel! Although Canada's numbers are smaller, the stimulus is similar and this is true of most developed economies. Let's keep in mind that this economic "fire power" is occurring at a time when most (but undeniably not all) consumers have jobs, and in general, have more savings, less debt and greater net worth than they did before the pandemic.

With goods and services shortages feeding through the economy, I think there is no place for demand to go but up – so one would also think prices must follow suit, just as they have for things like lumber, aluminum, cardboard, food and gasoline. Not sure about the experience of others, *but trying to book a plumber, painter or contractor has become a job in itself, not to mention an exercise in "patience."*

As we look out into the rest of 2021, inflation will at least be a news item in the short term – longer term is yet to be determined. Valuations are always a watch word in any market and especially in this "Rodney Dangerfield," "V-shaped" COVID recovery. Clearly, if one uses "current" earnings estimates, valuations are in the upper band of expectations. However, with ultra-low interest rates and tame inflation – valuations are framed in an environment that has never existed, even back to the Great Depression. Add in unprecedented stimulus worldwide – maybe financial markets are indeed looking out 6-12 months and telling us something? *Step back 12 months to April 2020 and ask yourself – what was the market telling you then, and would you have ever thought that 12 months out would look like today? I don't think so – I didn't!*

Earnings estimates have consistently missed the mark through this recovery and given the trends in earnings reports and economic momentum, I expect future earnings estimates are still too low. Corporate operating efficiencies have taken a leg up on the backs of accelerated digital service & manufacturing platforms and work-from-home flexibility, all of which have delivered lasting improvements to margins and market penetration.

The economic reopening is happening, albeit at various rates around the world. Vaccine production is still growing and more people are being vaccinated daily.

By the end of May, the U.S. expects to have more vaccine supply than it needs, and expects that most of its population will be vaccinated by July 4, if not earlier. Although new variants are igniting a new wave of COVID-19 in regions, vaccination momentum, better weather and natural outdoor summer distancing and activities should help ease new COVID-19 case development. New COVID-19 cases surged in the fall of 2020, winter 2020/21 and subsided thereafter, illustrating the cycle of surge and decline. With summer representing the next "surge" phase, we now have vaccine ramp-up to promote the "decline" phase.

As we approach May, we can hear the calls for "sell in May & go away," an investing axiom that was derived from market weakness observed in May over the years. However, as with most "rule-of-thumb" investing techniques, it's had a spotted history in general and focuses on short-term trading patterns that are typically overruled by real economic underpinnings. To that end, a correction in technology has already occurred in March, many epicenter sectors remain undervalued and cash balances have now exceeded the peak levels last seen in June 2020. By the end of March, over $4.5 trillion was on the sidelines in cash, with 70% of that institutional and 30% retail investors. With rising interest rates making bond investments less attractive, the current cash hoard looks like more fuel for equity!

As the year progresses, we will keep a close eye on inflation and interest rates. With the unrelenting stimulus and low interest rate backdrop, equity investments are clearly favoured. Earnings seem poised to outstrip estimates, vaccination momentum is continuing to build, and economic reopening is expected to unleash the 30% of the economy in epicenter sectors that have yet to participate. Continuing job recovery, consumer confidence, spending and savings, as well as millennials' household formation will sustain earnings growth and favour equities.

As we endure this next COVID-19 wave, we salute the unwavering commitment of all our healthcare employees and first responders for the sacrifices they and their families are making for all of us!

Steve Lester

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Earning your trust through enhanced risk management

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