

CIO Rob Edel explores the state of the markets; including monetary and fiscal policy, Biden's crashing approval ratings, current inflation and what it tells us about the future.

By Rob Edel, Chief Investment Officer

[View commentary in PDF format](#)

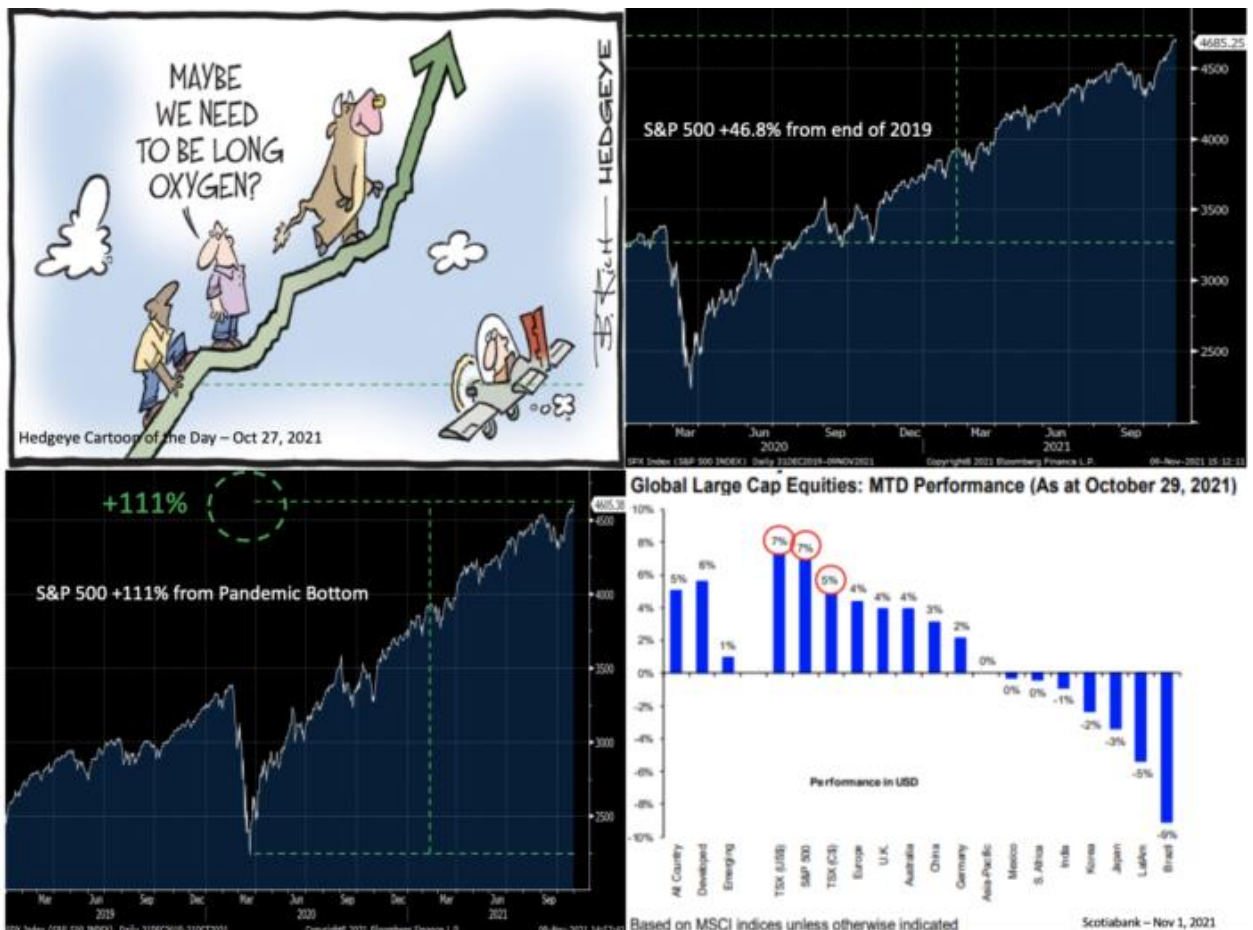
View the [Nicola Wealth Investment Portfolio Returns: October 2021](#)

Highlights this Month

- - [Stuck between a rock and a hard place.](#)
 - [Digging deeper into the curve.](#)
 - [The impact of surging demand and a broken supply chain.](#)
 - [Can Biden build back his approval rating?](#)
 - [How long can inflation remain transitory, before we admit it's persistent?](#)
 - [It all comes down to the consumer.](#)
 - [Ready to wave the white flag.](#)

October in Review

After September's slight misstep, markets continued their march skyward last month, with the S&P 500 up 7.0% (total return in US dollar) and the S&P/TSX up 5.0% (total return in Canadian dollar). When reported in US dollar terms, the S&P/TSX was up 7.5%. From the March 23rd pandemic low of last year to the end of October, the S&P 500 has increased a remarkable 111% (SP/TSX +97%). Even if we assume the bear market last year never happened and measure the market's total return from the beginning of 2020 instead of the pandemic low, the S&P 500 has still gained nearly 47% (S&P/TSX +30.3%), or an annualized 23.4% (S&P/TSX +15.6%).



Clockwise from top left: Hedgeye Cartoon of the Day, Bloomberg Finance L.P., Scotiabank, Bloomberg Finance L.P.

The pandemic rally has been strong and consistent. September's 5.2% drawdown stands out as the largest so far this year, and was well below the market's average 11% maximum intra-year percentage price decline over the past 20 years. In early November, the S&P 500 hit a record high for the 65th time in 2021, its second-highest calendar year total in history. The large-cap US index also managed eight consecutive record daily closings- the most ever. But the year is not over yet, and the last two months of the year have historically been the S&P 500's best returning months of the year. Same for the S&P/TSX. Since 1920, the S&P/TSX has gained an average 1.1% and 1.5% in November and December, with a 63% and 75% positive return probability respectively.



With Max SPX Pullback YTD Only 5.2%, Many Investors Are Still Waiting for a Correction

Market is Heading Into the Strongest Period of the Year in Terms of Performance

S&P 500 Historical Average Daily Price Trajectory



Source: BMO Investment Strategy Group, FactSet BMO – Oct 28, 2021

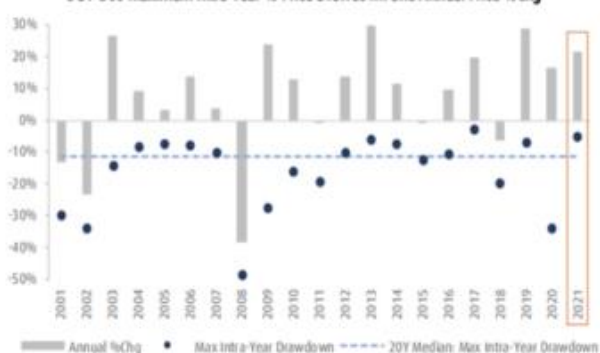
TSX Seasonal Pattern Since 1920

Scotiabank – Nov 3, 2021

Price-only (%)

Period	Average Return	Prob. of Positive Return	Max	Min
Monthly				
Jan	1.6%	64%	16%	-9%
Feb	0.4%	57%	8%	-13%
Mar	0.1%	54%	8%	-20%
Apr	0.6%	57%	13%	-16%
May	0.4%	60%	23%	-25%
Jun	-0.2%	45%	17%	-11%
Jul	1.4%	68%	15%	-11%
Aug	0.7%	56%	19%	-20%
Sep	-0.5%	50%	18%	-16%
Oct	-0.5%	50%	11%	-23%
Nov	1.1%	63%	11%	-17%
Dec	1.5%	75%	12%	-10%

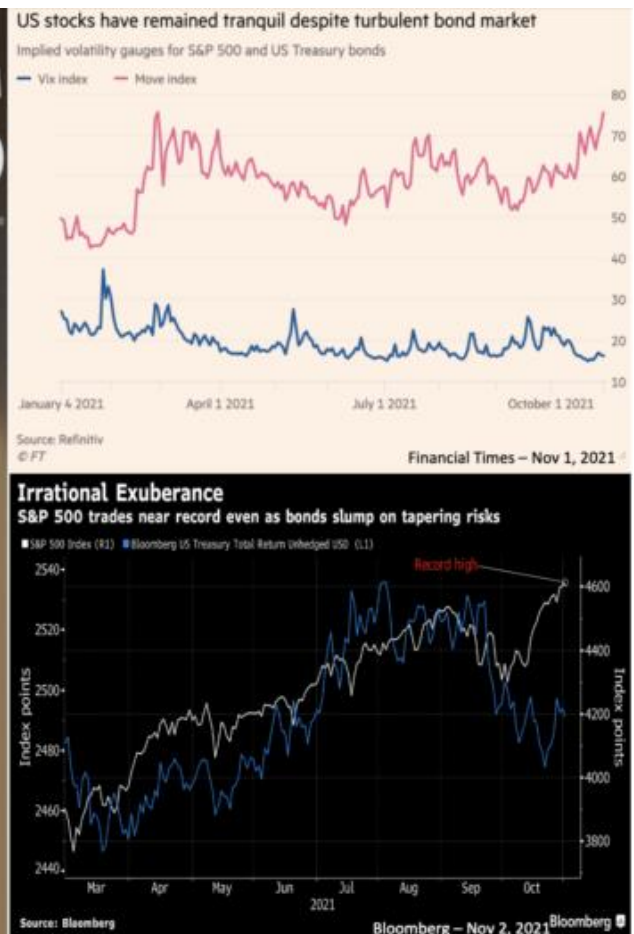
S&P 500 Maximum Intra-Year % Price Drawdown and Annual Price %Chg



Source: BMO Investment Strategy Group, FactSet. BMO – Oct 28, 2021

Clockwise from top left: Hedgeye Cartoon of the Day, BMO Investment Strategy Group, Scotiabank, BMO Investment Strategy Group
Just noise, or signs of a turning point?

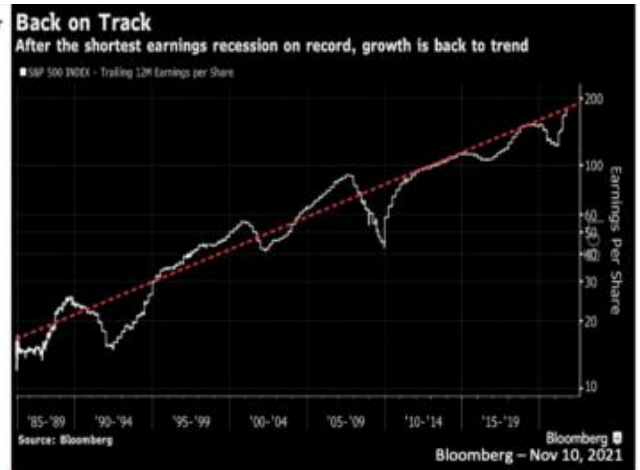
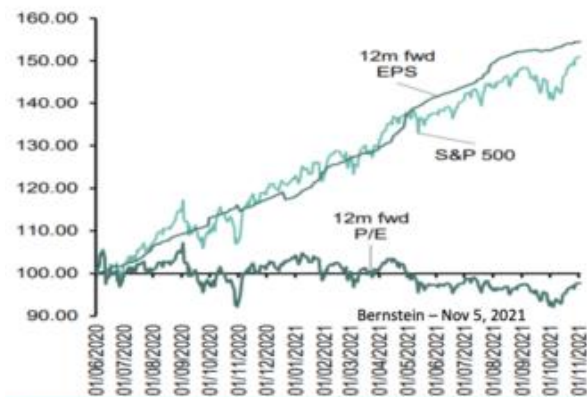
It's been a great time to be an investor, with not only large cap stocks moving higher. Cryptocurrencies, for example, have seen gains of 110% in Bitcoin and 485% in Ethereum. According to Coinmarketcap.com, Ecomi (OMI) is the cryptocurrency with the largest gain in 2021, up over 15,000%! Everyone wants to believe these kinds of returns are sustainable, but as a recent Barron's cover commented, a decade of near-zero percent interest rates have created bubbles in both the real and virtual worlds. It stands to reason that if low interest rates created the bubble, higher rates are likely to be what burst it. If the truth is out there and asset prices return to more terrestrial levels at some point, the bond market may be where investors look first for signs of a change in market sentiment. Interestingly, last month while implied equity volatility remained subdued, bond price volatility moved back up to levels last experienced during the depths of the pandemic as both bond prices and returns slumped. Is it just noise, or signs of a turning point? Such an important question deserves our undivided attention, which we provide in detail below.



Clockwise from left: Barron's, Financial Times (Refinitiv), Bloomberg

From an asset valuation perspective, interest rates are very important as they define the discount rate used to determine the present value of future earnings and cash flows. However, market gains in 2021 have been entirely attributable, and then some, to higher earnings expectations, as made apparent by a recent Bernstein chart showing a near-perfect correlation between an upwardly sloping forward 12-month earnings curve and the S&P 500. According to Bloomberg, earnings per share growth has added 28% to the S&P 500's price return so far this year, while valuation has detracted 4%. For small-cap stocks, the difference is even more dramatic, with earnings adding 52% to returns, while valuation detracted 19%. Looking forward, things start to get a little tougher for investors relying on earnings to lift returns. FactSet projects that S&P 500 earnings growth rates will slow as the recovery matures, and record profit margins are forecast to decline. S&P 500 earnings have already recovered back to their pre-pandemic trend line, and according to RBC, 36% of their institutional clients in September believed profit margins will contract over the next 6 to 12 months. This doesn't mean stocks can't continue to move higher. Earnings growth is forecast to slow, not decline. Just don't become too accustomed to those high returns of the past few years, especially if valuations suffer a more material decline.

EXHIBIT 7: US: Market gains continue to be accounted for by rising earnings expectations.



Clockwise from top left: Bernstein, Bloomberg, Financial Times (RBC Strategy Spotlight), Bloomberg

And what could cause valuations to suffer a material decline? Higher interest rates top the list, followed by a recession and lower earnings. Or perhaps skip the higher interest rate part and go straight to a recession. Boston Consulting Group believes the recovery is entering a risky phase as it transitions away from relying on fiscal and monetary policy and places its fate back into the hands of the consumer. The key will be determining the pace of policy normalization required to ensure enough support remains for the economic recovery to become self-sustaining, but not so much so that a negative output gap develops with the economy overshooting full capacity and accelerating inflation. According to Goldman Sachs, an unusually large gap has developed between the short and long-run output gaps, with the US economy appearing to overshoot in the shorter term, but still working through a sizable shortfall in output over the longer term. To address the short-term overshoot, monetary policy will need to be adjusted, starting with a tapering of the Fed's \$120 billion a month bond and mortgage buying program.

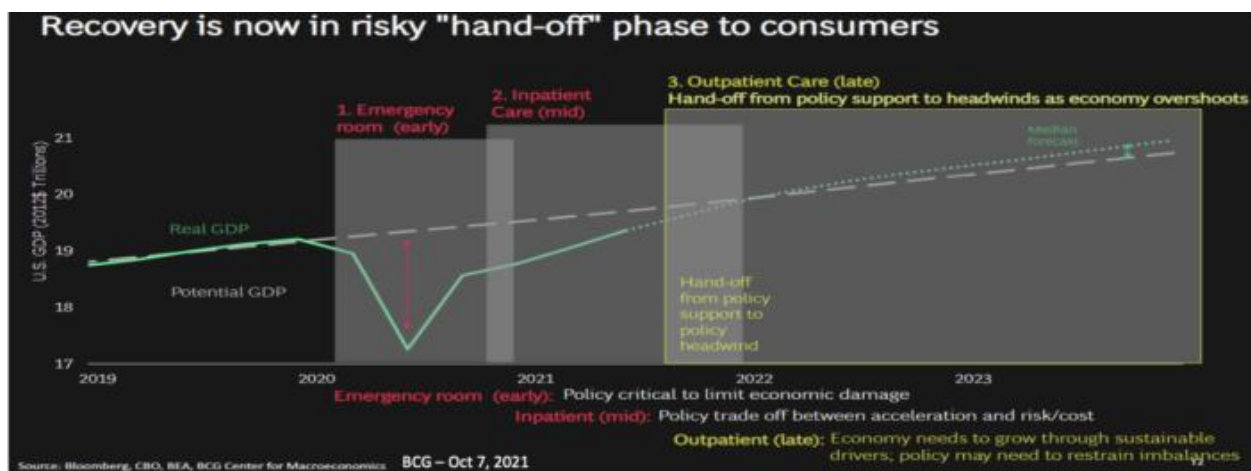
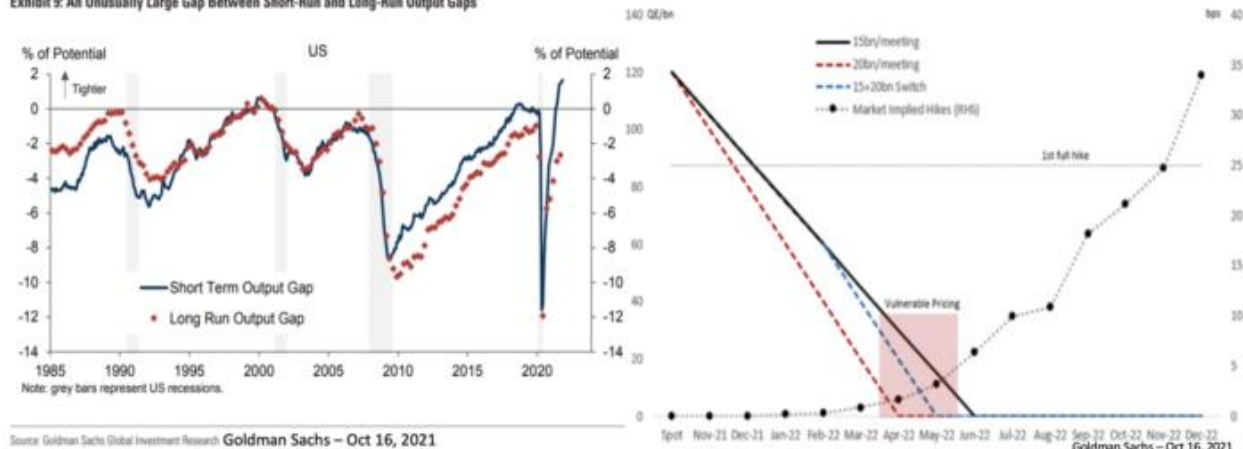
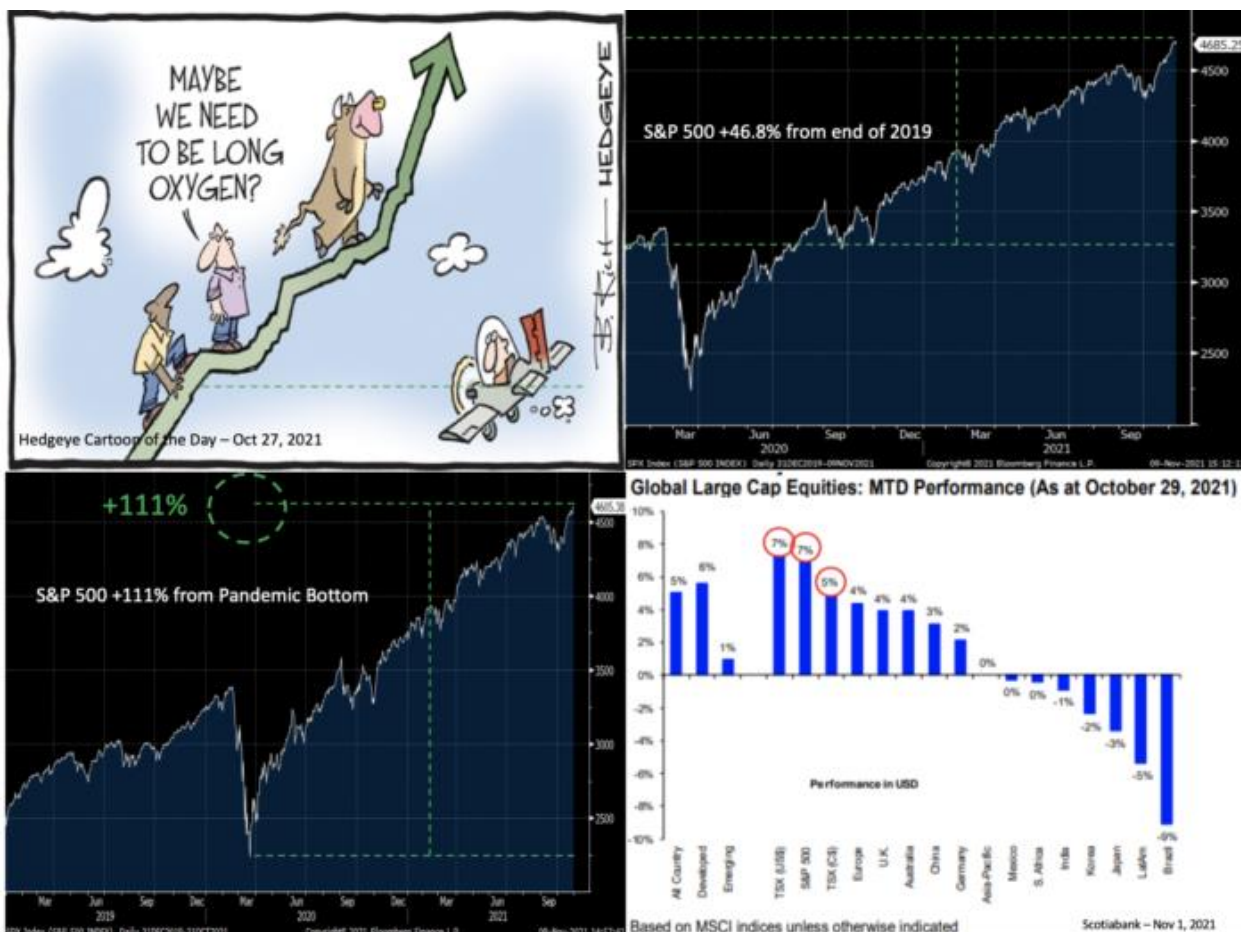


Exhibit 9: An Unusually Large Gap Between Short-Run and Long-Run Output Gaps



Clockwise from top left: Bloomberg (BCG Center for Macroeconomics, Goldman Sachs, Goldman Sachs Global Investment Research

As expected, the Fed announced in early November it would trim its monthly purchases by \$15 billion a month, which would effectively wind the program down by June of next year if they hold to this schedule. Even though Chairman Powell has clearly stated there is no direct link between the end of tapering and liftoff (raising overnight rates), most are convinced there is. Expectations are that the Fed won't start raising rates until they finish tapering, which means June is the earliest the Fed will start, though a gap of at least a few months between the end of tapering and the first-rate hike is more likely. In mid-October, most Fed observers believed liftoff wouldn't happen until November or December of next year.



Clockwise from top left: Hedgeye Cartoon of the Day, Bloomberg, Scotiabank, Bloomberg

Stuck between a rock and a hard place.

Unfortunately, Chairman Powell and his Fed colleagues have put themselves into a bit of a box. Raise rates too soon and they risk hurting the recovery, not to mention the stock market, but wait too long and risk the economy overshooting and unhinging inflation. Last month, it was looking like the Fed was falling behind the curve by waiting too long. Goldman Sachs shows that financial conditions are presently near their loosest level in four decades, a questionable policy given the progress the economy has already made in recovering and the current path of inflation. As of early November, the market had brought forward their expectations of rate hikes, fully pricing in two rate hikes next year and putting an 84% probability of the Fed hiking three times next year. Quite a change from just a couple of weeks earlier, and evidence of the balancing act the Fed is trying to navigate.

Changes in the shape of the yield curve can be a good indicator of how well the market believes the Fed's high-wire act is going. A steepening curve, where long rates are moving higher, is indicative of a strengthening economy where inflationary pressure is starting to build. A flattening yield curve, where short rates

are rising, is typical of a late-cycle environment where the central banks are getting ready to start tightening monetary conditions by raising interest rates. Last month we saw the latter, namely a flattening yield curve with short-term rates moving higher. The increase in yields was fairly systemic across the entire spectrum of the curve, up until the 20-year term. Terms beyond 20-years experienced falling yields, with this section of the yield curve inverting as 30-year yields fell more than 20-year yields. Falling long rates is a bit unusual at the beginning of a tightening cycle.

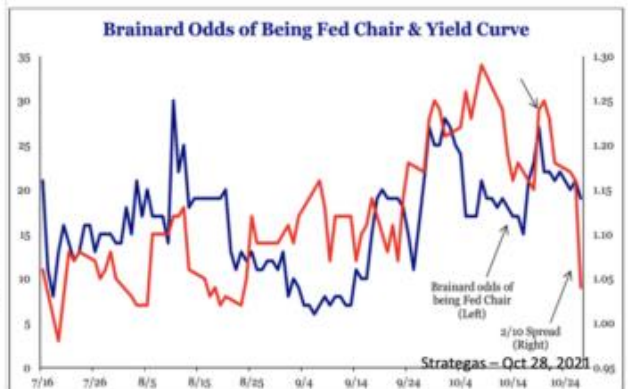
Normally, we would expect longer-term yields to fall later on, once tighter monetary conditions have started to slow the economy and investors shift out of risk assets and into long-term bonds, thus driving their prices lower. Early in the monetary normalization cycle, while strong economic conditions still exist, longer-term yields typically still have an upwards bias as the economy is still expanding. Looking at various potential explanations for last month's action, an expectation of weaker future economic growth is the prime suspect. Strategas points to the strong historical correlation between the yield curve and the change in consumer confidence, specifically expectations less present conditions. When consumer confidence is expected to be higher in the future, economic growth is normally strong, and the yield curve should steepen. Present consumer confidence has been falling, therefore it should not be surprising the yield curve is flattening. A strong correlation between the flattening yield curve and a basket of stocks positively impacted by the re-opening trade, as shown by Strategas, also backs up the thesis that the yield curve flattened due to expectations of slowing future growth, possibly due to the further delays in re-opening the economy. The third correlation Strategas highlighted was the negative association between the yield curve flattening and the odds of Lael Brainard taking over from Jerome Powell as Chairperson of the Federal Reserve. Brainard is considered more dovish and less likely to raise the rate, so a steeper yield curve would become more likely if she were to become Chairperson.



US RE-OPENING TRADE UNDERPERFORMING AGAIN AS THE YIELD CURVE FLATTENS



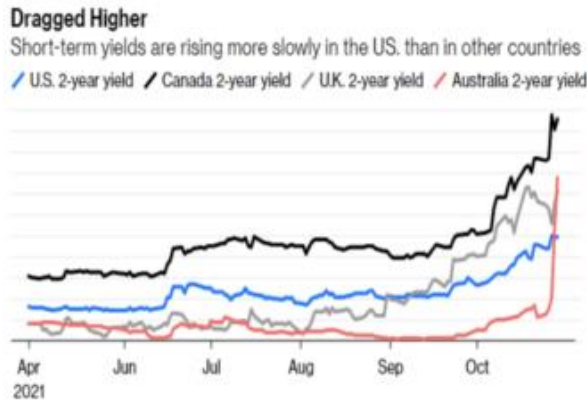
FLATTENING YIELD CURVE COULD BE SIGNALING POWELL'S REAPPOINTMENT



Clockwise from top left: U.S. Department of the Treasury, Strategas, Strategas, Strategas

Digging deeper into the curve.

Digging a little deeper into what caused the curve to flatten, we need to analyze why short rates went up, and long rates declined. The reason short-term yields rose last month is pretty clear cut: expectations for the timing of central bank interest rate increases were being brought forward as global inflation started to increase, thus driving short bond yields higher. Canada, Australia, and the United Kingdom experienced sharp increases in 2-year bond yields and flattening yield curves. While the US 2-year yield also rose, the Bank of England, Bank of Canada, and Reserve Bank of Australia have all been more proactive in starting the tapering process and thus all experienced sharper rises in 2-year yields last month. Also of note, while 2-year nominal US bond yields increased just over 20 basis points in October, real 2-year rates declined to negative 2.5%, as a 50-basis point increase in inflation breakeven rates compensated for the small increase in nominal rates. Stocks don't mind higher yields if real rates stay low or go even lower. Free money is pretty attractive for investors and corporate earnings.



Source: Bloomberg Bloomberg – Nov 1, 2021

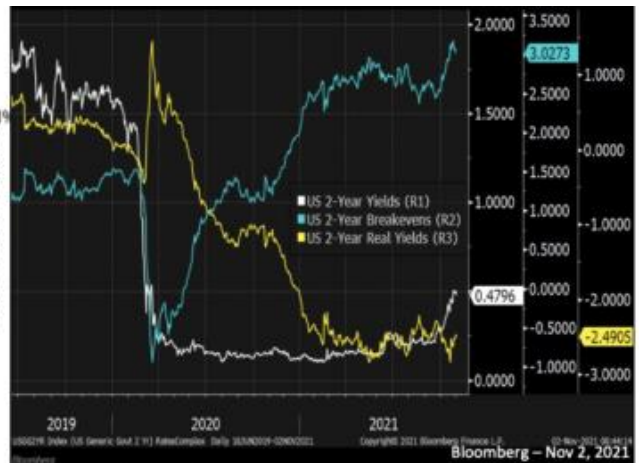
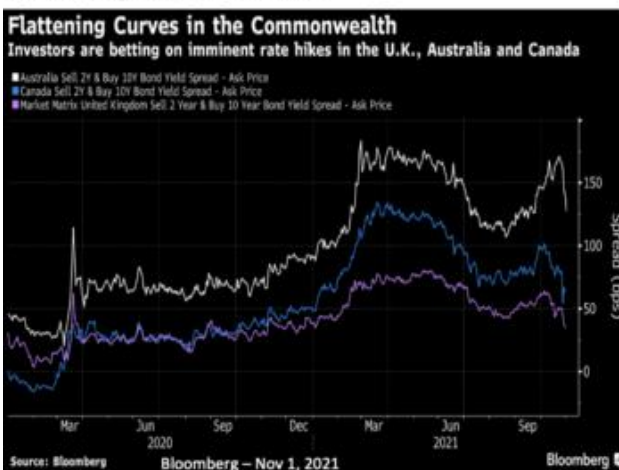


Exhibit 1: Asset Purchases Are Becoming Less of a Constraint on Liftoff in Several G10 Central Banks



Source: Bloomberg Bloomberg – Nov 1, 2021



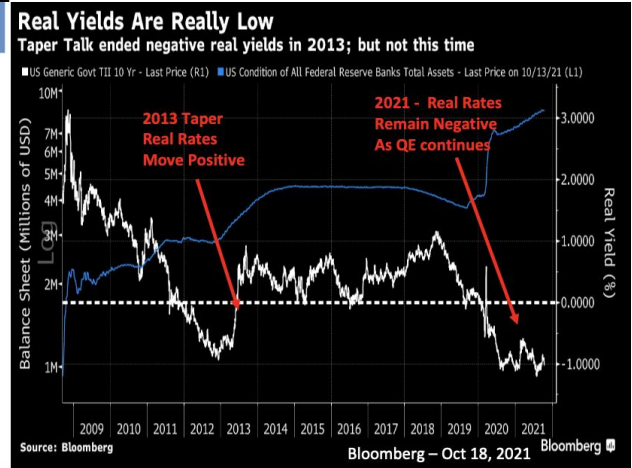
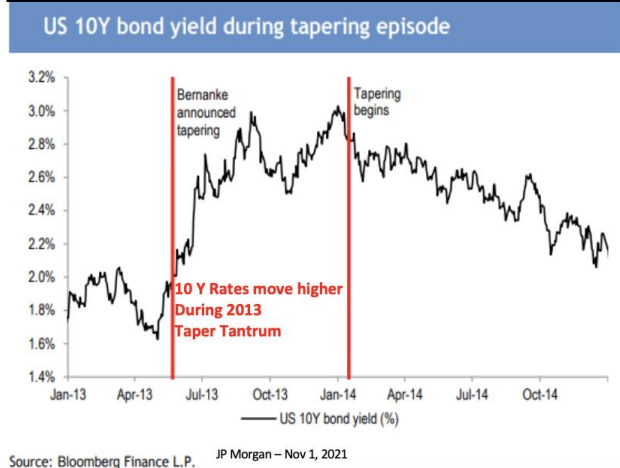
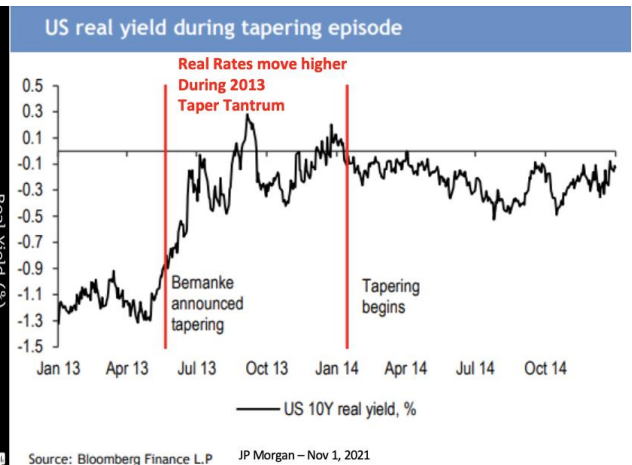
September BoE minutes indicate that liftoff can occur before the end of asset purchases.

Source: BoE, Riksbank, BoC, Fed, ECB, RBA, Goldman Sachs Global Investment Research

Goldman Sachs – Nov 1, 2021

Clockwise from top left: Bloomberg, Bloomberg, Goldman Sachs, Bloomberg

In the short end of the curve, traders were reacting to the increased odds that stronger growth and higher inflation would prompt the Fed to start tightening monetary policy sooner. This wasn't the case at the longer end of the curve. The decline in 20 and 30-year bond yields last month was potentially a powerful but contradictory indicator. Declining long rates are a sign of falling future growth expectations, which if true, would not be an environment the Fed wants to face with a tightening monetary policy. The market appears to be pushing the Fed to tighten in the short term, but it seems to believe this tightening phase could be short-lived as growth is set to slow in the future. Remember the high-wire balancing act? Similar to 2-year rates, real 10-year rates also remained solidly negative. During the 2013 taper tantrum, nominal and real rates began to move higher once Ben Bernanke, Fed Chairman at the time, announced tapering. Taper talk ended the reign of negative rates in 2013, but if anything, real rates have moved even further into the red this time. Why?



While inflation may indeed compel Central Banks to tighten more quickly than previously anticipated, there appears to be less conviction around the durability of the recovery and whether the current inflationary episode will prove more persistent or merely transitory. As fiscal and monetary policy inevitably wind down, growth will become more dependent on the historically steady, but now suspect, consumer. Personal income is projected to decline as stimulus rolls off, but Bloomberg estimates consumers have accumulated over \$2 trillion more in savings than they would have had it not been for the pandemic, and they appear ready to spend it. The US personal savings rate has recently dropped back to pre-pandemic levels, as consumers ride to the rescue and save Christmas, but longer-term trends become more questionable. As Morgan Stanley recently pointed out, personal income has dipped below trendline retail sales such that future retail sales will be challenged to maintain their current lofty pace. How long US consumers will be able to rely on their savings and how quickly they can replenish their pocketbooks will be key to determining the durability of the economic recovery and inflation. Demand is currently strong, but is the strength transitory?

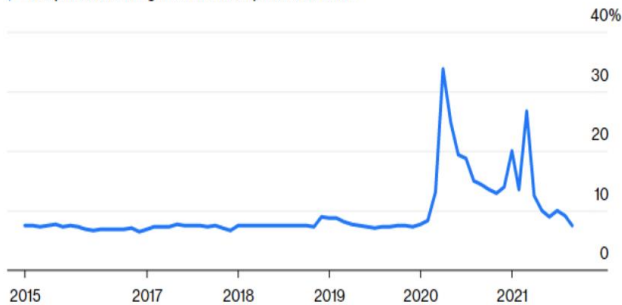


WSJ—Oct 22, 2021

Dipping Into Savings

Consumers' saving rate dropped to pre-pandemic levels as enhanced unemployment benefits expired and prices for goods climbed

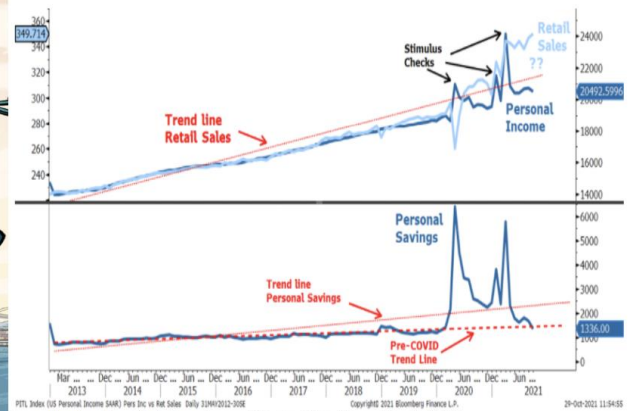
U.S. personal saving as share of disposable income



Source: U.S. Department of Commerce

Bloomberg—Nov 2, 2021

Exhibit 1: Demand looks vulnerable, perhaps just when supply rebounds next year



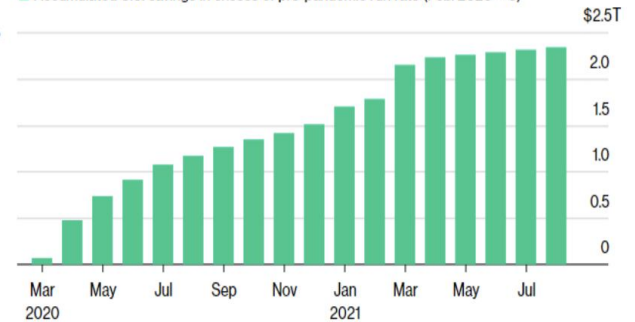
Source: Bloomberg, Morgan Stanley Research

Morgan Stanley—Nov 1, 2021

Pile of Money

The U.S. stock of pandemic savings hasn't shrunk

Accumulated U.S. savings in excess of pre-pandemic run rate (Feb. 2020 = 0)

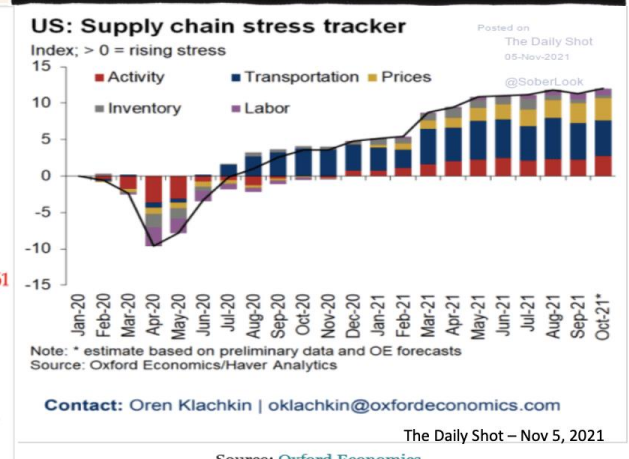
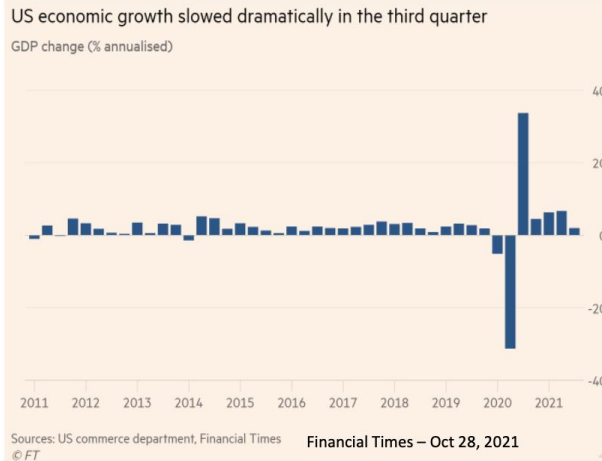


Source: BEA, Bloomberg Economics

Bloomberg—Oct 18, 2021

The impact of surging demand and a broken supply chain.

Along with questioning how transitory demand might be, we also have to consider the supply side of the economy. Stretched and broken supply chains are making it harder to deliver goods at the pace and price consumers want. Stress in the supply chain is broad and continues to be elevated, according to Oxford Economics' tracker. If companies can't get their hands on raw materials and goods, they can't deliver their products to market, which is likely one of the reasons US economic growth has slowed dramatically in the third quarter. Strategas believes CEO confidence in the economy year from now is plummeting, though we are reasonably confident supply chain issues will prove to be temporary. Either demand proves to be transitory and falls, or companies make the necessary adjustments and investments to boost supply. It may take longer than we would hope, but the supply chain should self-correct, eventually.

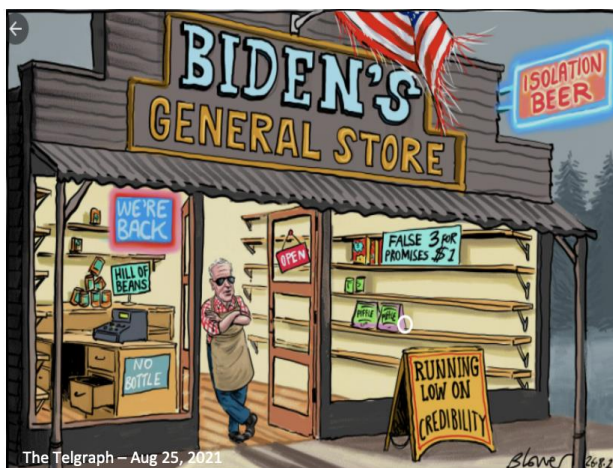


It's the same with demand. Higher prices lead to demand destruction, especially as consumer savings start to deplete. The one caveat is if more government stimulus is forthcoming and consumer pocketbooks are replenished. In early November, President Biden was finally successful in passing his bipartisan infrastructure bill, providing \$550 billion in new spending. Still pending is his Build Back Better social spending package, which is presently earmarked at about \$1.7 trillion over 10 years. According to Moody's Analytics, together the Infrastructure and Social Infrastructure packages would add about 0.3% to inflation over the 2022-to-2024-time frame. In an economy some see as already at or beyond full capacity, this becomes problematic for a President running low on credibility. After getting off to a strong start, Biden has seen his job approval rating plummet.

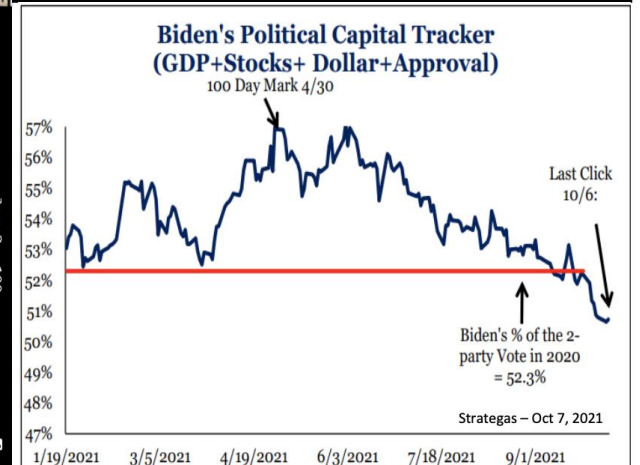
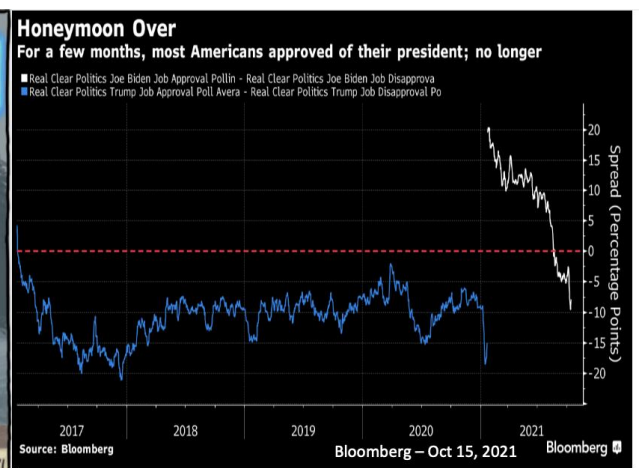
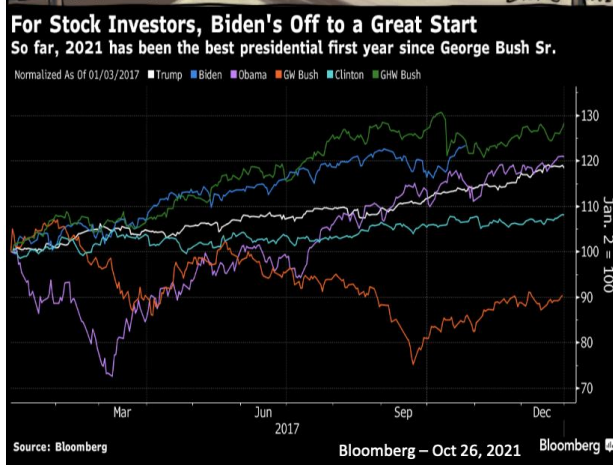
Can Biden build back his approval rating?

According to Strategas' Political Capital Tracker, a combination of GDP, Stocks, US dollar and approval strength, Biden's popularity has sagged well below levels that saw him gain 52.3% of the popular vote in 2020. Only stocks appear to be giving Biden a passing grade, with 2021 proving to be the best first year for a

President since Bush Senior. Wall Street is grateful, but the progressive wing of the Democratic party striving to chip away at the growing wealth gap in America is likely less impressed. While Biden looked almost certain to get his Build Back Better spending package approved a few months ago, his depleted political capital lowers both the odds and the size of the bill. On the one hand, Build Back Better will put more money in the hands of lower-income Americans who need it, but on the other hand, higher inflation makes additional spending an even harder sell. With Democrats looking to lose control of Congress in next year's midterm elections, time is running out for the passage of a transformational social spending bill. The market and the Fed are watching, as fiscal support has the potential to help shift inflation from being transitory to persistent.



The Telegraph – Aug 25, 2021



How long can inflation remain transitory, before we admit it's persistent?

We are reasonably confident that supply and demand imbalances will be self-correcting and transitory. We can make this statement because we have conveniently refrained from discussing how long inflation can remain transitory before it should be considered persistent. Frankly, there are just too many variables to forecast with any conviction. Fiscal policy is one of them, as are the

labour market and energy prices. At some point, Americans need to go back to work. Even though the US added 531,000 new jobs in October and the unemployment rate fell to 4.6%, there are still four million fewer jobs than before the start of the pandemic last February. According to the Dallas Federal Reserve, an additional 1.5 million people retired between February 2020 and April 2021 than the pre-pandemic trends would have predicted, but it's not just the 55+ year-olds that have not returned to the labour force. The participation rate for Americans in the 25–54-year-old bracket remains well below pre-pandemic levels.

Interestingly, the participation rate for the same category of workers in Canada has fully recovered. Rosenberg Research points to higher vaccination rates in Canada as a potential reason why the Canadian workforce appears more interested in getting back to work. How quickly Americans get back to work will be key not only because it will determine how quickly personal income can recover, but more workers will help to mitigate the rising wage growth.



An additional 1.5 million people were retired from February 2020 to April this year than would have been if the 2019 retirement trend had continued.

Share of U.S. population retired

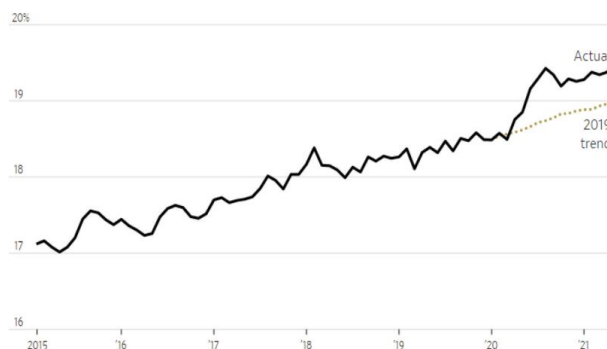


Exhibit 4: Wage Growth Has Surged at the Lower End

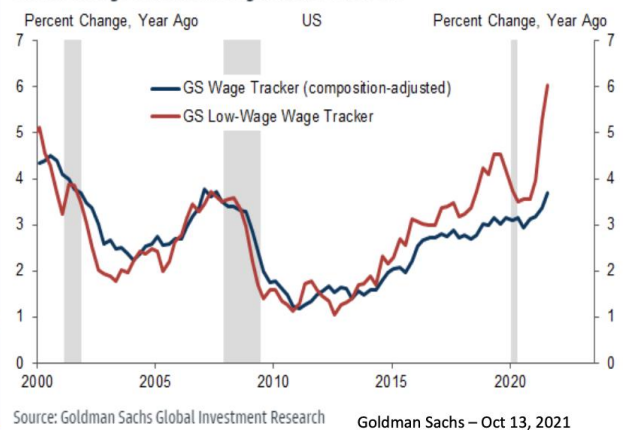


CHART 5: Labor Force Participation Rate: 25-54 Years

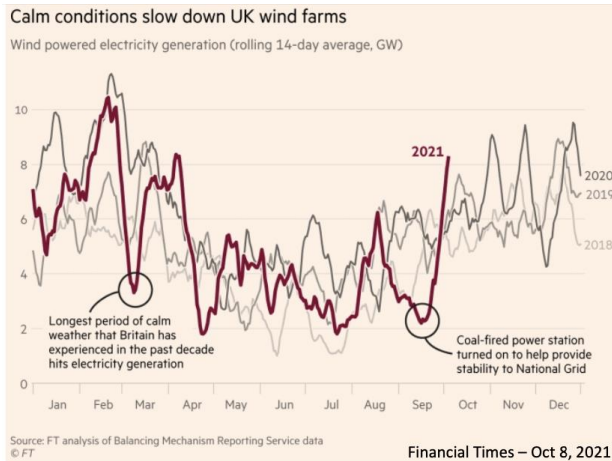
North America
(red line; United States; percent)
(blue line; Canada; percent)



Rosenberg Research – Nov 9, 2021

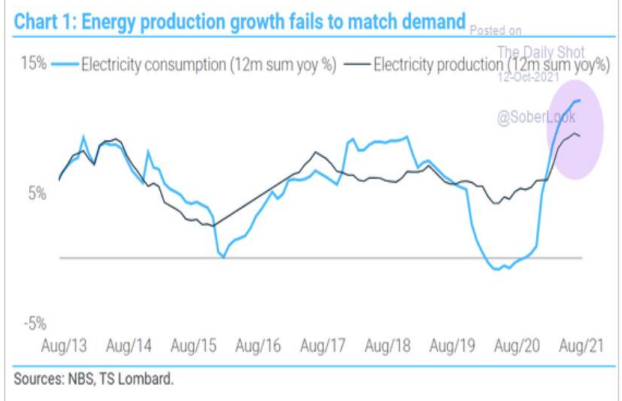
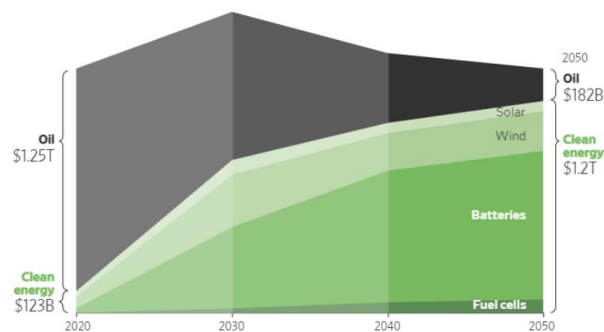
We also have some long-term concerns about energy prices. Some of the recent increases in demand are likely transitory, but what is less clear is how durable

the supply of energy will be in the future. Developed economies are relying more on renewable power, which is proving to be a less stable source of energy than the fossil fuels they are replacing. Wind conditions in the UK, for example, have been calmer than normal, lowering the output of wind farms and increasing the demand for coal-fired power stations. Lower power supply from alternative energy is especially problematic in an environment where electricity demand is growing faster than production, resulting in higher energy prices, particularly for fossil fuels.



Supply Shift
In order to reduce the world's net carbon emissions to zero by 2050, renewable energy sources must quickly displace oil and other fossil fuels.

Projected market size of energy technologies to reach zero emissions



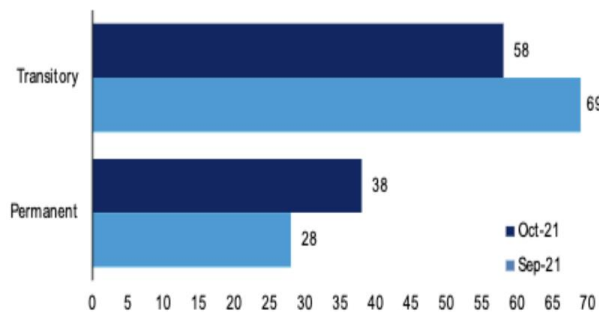
Source: [TS Lombard](#) The Daily Shot – Oct 12, 2021

Wage growth and higher energy prices will be one of the key determinants to whether inflation is transitory or persistent. For Wall Street, it is pretty well a split decision, though the trend has recently favoured the persistent camp. A recent Bank of America poll showed 58% of investors in October believed inflation would prove to be transitory, down from the 69% in September. The Atlanta Fed says that over the past 12 months, goods that have historically experienced flexible prices have indeed seen large price increases, but goods deemed to have sticky prices have indeed stayed sticky. Though this may be in the process of changing. According to the Washington Post, goods with flexible prices like energy and used cars drove most of the price increases earlier in the year, but food and shelter were more of a factor in driving prices higher in September.

While it may be true some price inflation will be transitory, if inflation continues to broaden out into more the more non-cyclical goods sectors, it may prove to be more persistent than the market is presently pricing.



Chart 5: 38% of investors think inflation is permanent
Do you think inflation is transitory or permanent?

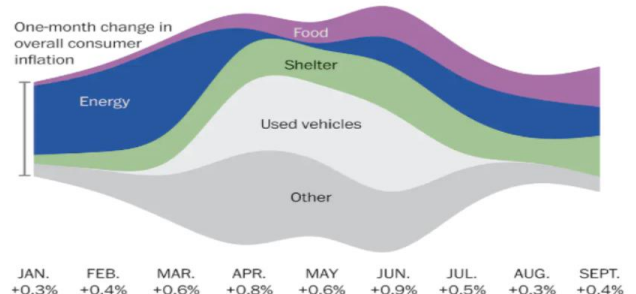


Source: BofA Global Fund Manager Survey
Dave Lutz/Jones Trading – Oct 19, 2021



What drove overall consumer inflation in 2021?

Price increases in food and shelter accounted for a growing share of inflation in Sept., in contrast to energy and used vehicles earlier in the year



Energy costs had a slight negative impact on overall inflation in April and May (-0.0001 and -0.007 percentage points). Seasonally adjusted.
Source: Labor Department
Washington Post – Oct 15, 2021 THE WASHINGTON POST

It all comes down to the consumer.

The final arbiter on the transitory versus persistent debate remains the consumer. Once consumer expectations for inflation start moving meaningfully higher, the battle is over, and the persistent camp can claim victory. Right now, consumers expect prices to remain high in the short term, with consumer inflationary expectations over the next year hitting a 10 year high of 4.8%. Alternatively, expected price increases over the next 5 to 10 years appear more anchored at only 2.9%. Financial markets are similarly split, with two-year breakeven rates at 3.1%, while 10-year breakeven rates were closer to 2.6% at the end of October.



Inflation expectations in market-based gauges have climbed to multiyear highs



Consumers Expect...

Over the next year, consumers inflation expectations hit 10-year high



Consumers Stay Calm....

Longer-term inflation expectations remain anchored

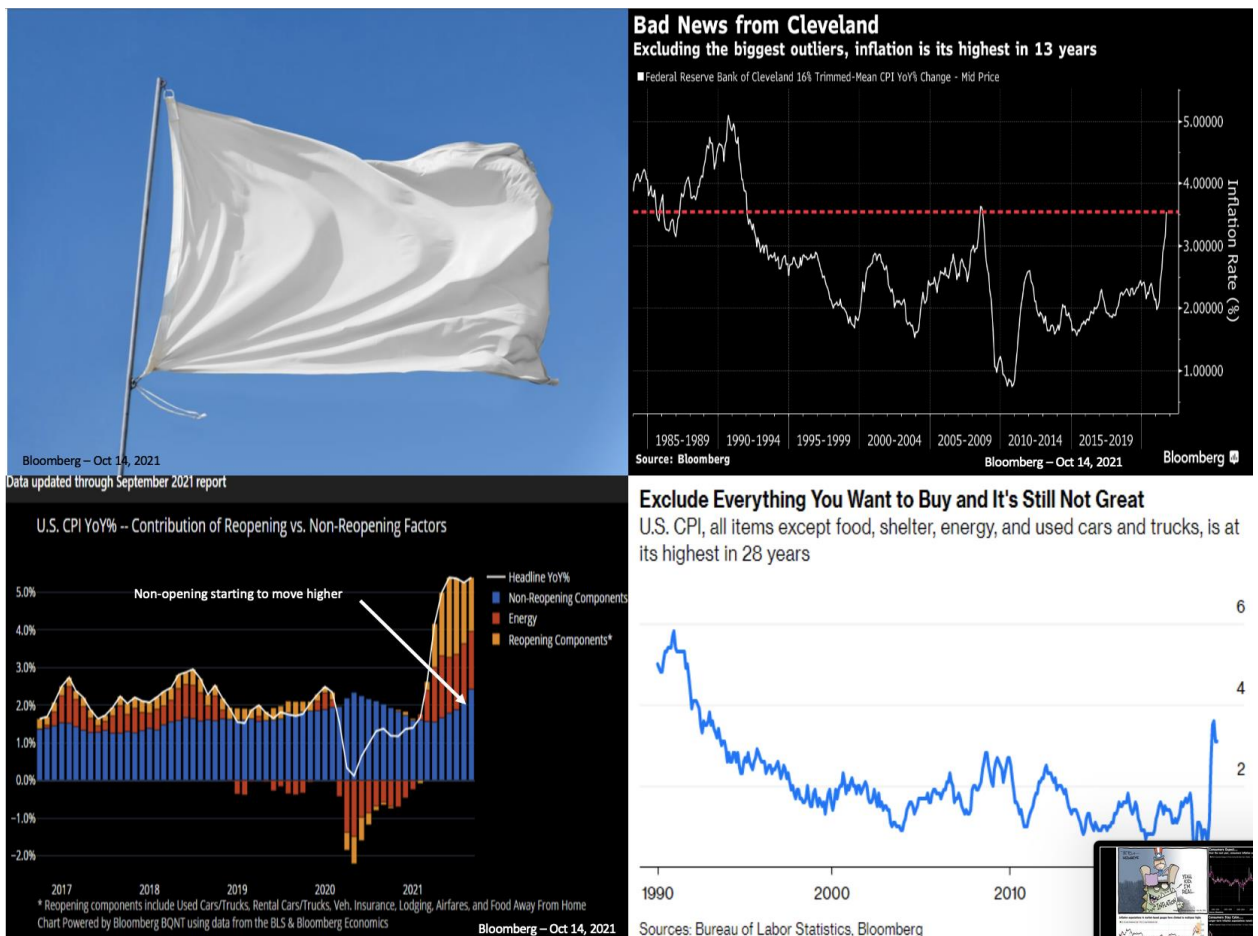


A recent Bloomberg article signalled the author's surrender to the notion that inflation was not transitory by waving the white flag. We still think it's too premature for the persistent camp to claim victory, at least in the longer term. There remain too many unknowns to conclude as to the future direction of prices beyond the next several quarters. Are prices moving higher due to increased demand, or due to a broken supply chain? The answer is likely a bit of both. Regardless, the impact will surely end up being transitory, though we admit to not defining exactly how long that will be. If inflation persists long enough, expectations will eventually increase enough such that inflation will become unhinged. Also, fiscal policy, wage growth, and energy prices all have non-transitory biases to them and could tip the balance in favour of inflation being permanent.

Ready to wave the white flag.

Alternatively, it could be that we get past COVID and life goes back to its pre-pandemic norm, which includes slow economic growth and low inflation. Lower longer-term bond yields suggest this scenario needs to be considered. We'll go more into the numbers next month, but current trends show inflationary pressures are broadening beyond the re-opening factors. Even excluding

outliers, as calculated by the Cleveland Fed's 16% trimmed-mean CPI index, inflation looks to be inflecting higher as it recently hit its highest level in 13 years. All the things we want to buy, like food, shelter, energy, and used cars are getting more expensive and even US CPI excluding those items are at 28-year highs. If there is one thing we have learned about forecasting during the pandemic, it's that it's hard to forecast during the pandemic. Right now, the market believes in the Fed balancing act, and that inflation will be transitory. Patience is running thin, however, and bond market volatility could test investor resolve, especially if real interest rates start to move higher. We have our white flag ready, but we are not ready to start waving it quite yet.



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