

Market Commentary: Great Expectations

CIO [Rob Edel](#) explores the Great Expectations investors have in a market that has largely moved on from the pandemic, in this edition of our Monthly Market Commentary.

By [Rob Edel, Chief Investment Officer](#)

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

August in Review

The S&P 500 increased +3.0% (total return in US \$'s) and the S&P/TSX was up 1.5% (total return C \$'s). Year-to-date, the market has been doing well, with the S&P 500 providing a +21.6% total return, placing 2021 as the sixth-best start to the year since 1950. After reaching its pandemic induced low on March 23rd of last year, the market has exemplified perhaps the optimal definition of how good looks. The S&P 500 had gained over 100% as of August 16th, and by the end of the month, it was at +106.9%. The S&P/TSX ended August +91.5%, but in US dollar terms was +119.9%. Not since late October of last year has the market seen a pullback above 5%, which, as JP Morgan points out, is unusual as at least one correction above 5% has occurred in 93% of calendar years since 1980, with an 11% intra-year drawdown being the median. At over 200 trading days and counting, one would have to search between June 2016 and February 2018 to find a period of such duration absent a 5% plus pullback.



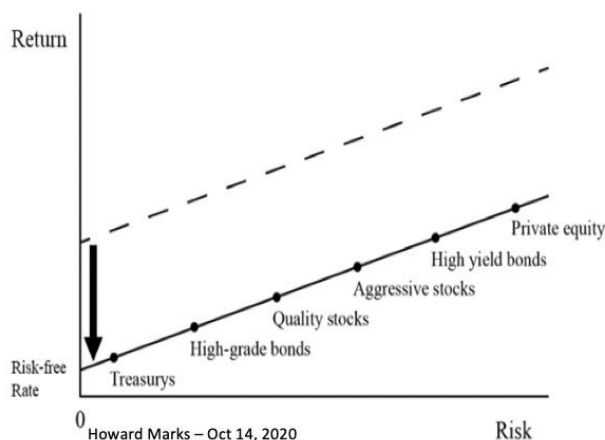
Investors are hoping this fairytale of high returns and low interest will last into the future.

The market is turning into quite the Cinderella story, with investor expectations becoming unhinged from reality. According to Natixis SA, US investors now expect a long-term after-inflation return of 17.5% from their investment portfolios, much higher than the 10.9% they expected in the 2019 Natixis survey. That is also much higher than the +6.7% financial professionals expect, and higher than BlackRock's 30-year annualized mean return forecast for any individual asset class. Only leveraged buyout with a forecast return of just over 16% gets anywhere close, with equity asset classes expected to return less than 10% and fixed income under 5%.

A simple chart from last year by distressed debt manager Howard Marks efficiently frames the issue for investors. High returns and low interest rates have realistically lowered the expected forward returns for all asset classes. Rather than taking this into account, investors appear to be projecting the high returns from the past year and a half and hoping that the fairytale will continue into the foreseeable future. Last month we detailed the current reality for markets and asked whether this was as good as it gets for the market. This month we answer the question by looking at current market action and

what it might or might not be saying about the future direction of returns. The two main drivers helping create and sustain the current bull market have been fiscal and monetary policy. The pandemic's impact cannot be ignored; so we will not ignore it, but the market has largely moved on. Understanding how fiscal and monetary policy impacts markets, now and in the future, will be much more significant in determining what good looks like for investors.

Conditions still favour a risk-on market, but not all asset classes are created equal. Because of this, portfolio construction is becoming even more important as this bull market matures and investors come to grips with the harsh realities of a low-interest rate and high debt world that presents longer-term returns. It may not be as good as it gets, but it is getting close.



The driving force behind economic recovery hasn't been successes or failures of virus control; it's fiscal stimulus.

In the short term, if fiscal and monetary policy remain accommodative, it's hard to see the market running into any obstacles. A 5-10% correction, sure, but not a sustained bear market. Fiscal policy, for example, has been deployed on a scale not seen since

the Second World War, with the American Rescue Plan's \$1.9 trillion of spending expected to add over 9% to the American Debt/GDP tally. Even more stunning is the Bipartisan Infrastructure Plan of \$550 billion in extra spending and the Democrat's \$3.5 trillion Reconciliation Bill, which could add another nearly 18% in debt to GDP, though spread out over multiple years. What has differentiated economic recovery amongst countries, according to Boston Consulting Group, hasn't been how successful or unsuccessful a country has been in fighting the virus; it's how much fiscal stimulus they have been able to deploy to protect their economic growth. A mountain of debt has helped protect the average American and Canadian family.



WILL DEBT & DEFICITS MATTER?

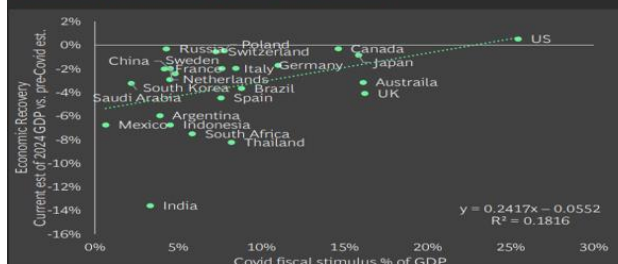
We're All Modern Monetary Theorists Now

Select Stimulus Bills & Tax Cuts	2020 Dollars	% US GDP
American Rescue Plan (2021)	\$1.90T	9.1%
Bipartisan Infrastructure (2021)*	\$550B	2.4%
De' Reconciliation Bill (2021)*	\$3.50T	15.4%
Phase 4 Covid Relief (2020)	\$900B	4.3%
CARES Act (2020)	\$2.02T	10.2%
Tax Cuts & Jobs Act (2017)	\$1.9-\$3.0T	
ARRA (2009)	\$1.03T	5.8%
Marshall Plan (1948)	\$154B	5.2%
New Deal (1930)	\$835B	12.6%

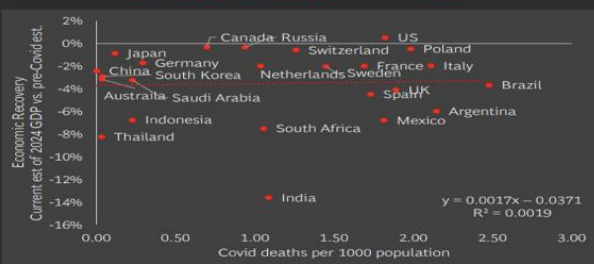
Mauldin OMS/Bruce Melhman – Aug 13, 2021

Why (II): The virus is a poor explainer of recovery—fiscal explains more

Recovery is linked to fiscal stimulus...



...much more than to the severity of the virus



Sources: IMF; John Hopkins University; United Nations; BCG Center for Macroeconomics.
Notes: Sample G20 + Netherlands, Poland, Sweden, Switzerland, Spain; Turkey is left out for data issues/availability ~85% of world GDP.

BCG – July 20, 2021 16

The same story goes for monetary policy, except the beneficiary is not so much American and Canadian families as it is American and Canadian investors. Zero percent interest rates and unheard-of central bank liquidity have helped bid up the price of financial assets. This fact is evident when looking at a chart showing a steep inflection point in the size of the Federal Reserves balance sheet coinciding with the March 23rd lows in markets last year. Once the Fed signalled their willingness to use the near limitless firepower at their disposal to backstop markets, the S&P 500 bottomed and has never looked back. Just how accommodative the Fed has been is evident by the US Fed Funds Rate adjusted for QE purchases, which Societe Generale

SA believes is the easiest it has been in 50 years. As Morgan Stanley discussed, the last time the Fed began tightening monetary policy by tapering their QE program, the U-6 unemployment rate was 12.6%. The rate is currently 9.2%, meaning the Fed is taking a much more accommodative and cautious stance in normalizing monetary policy this time around.

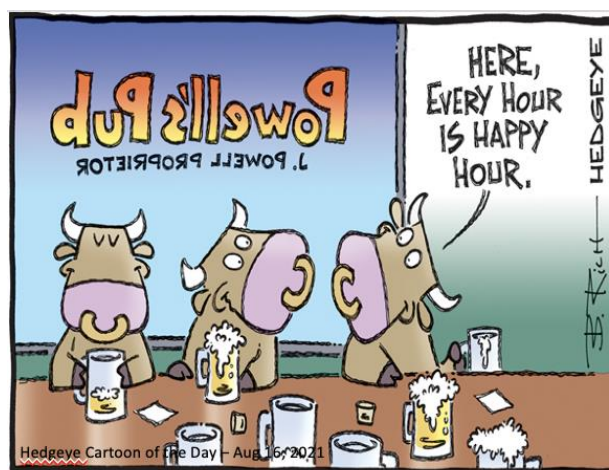
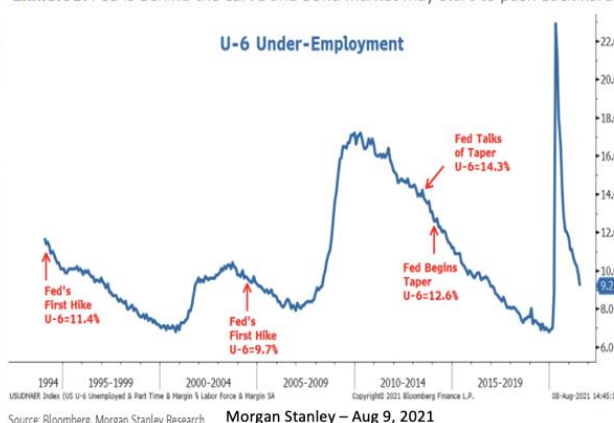
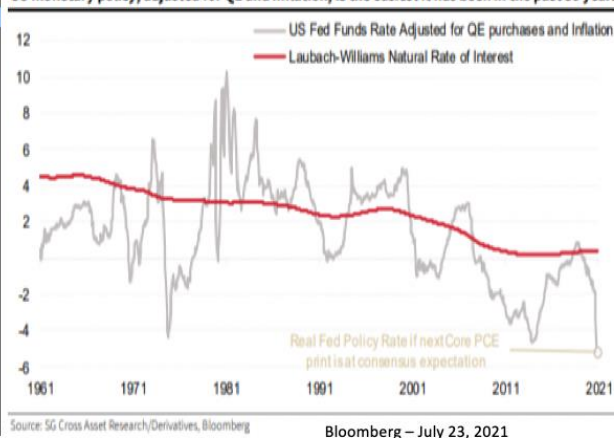


Exhibit 3: Fed is behind the curve and bond market may start to push back hard



US monetary policy, adjusted for QE and inflation, is the easiest it has been in the past 50 years



The number one tail risk for markets is still inflation.

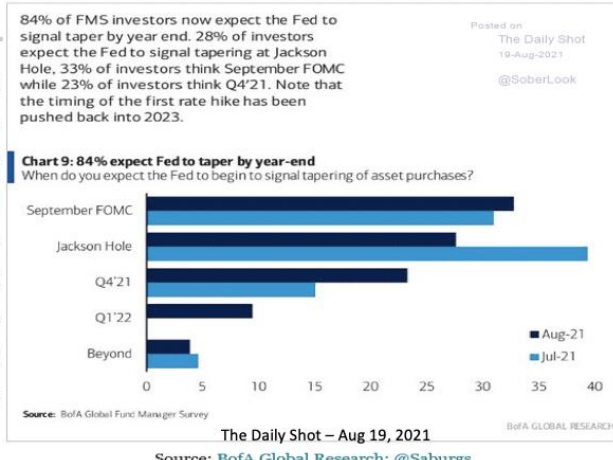
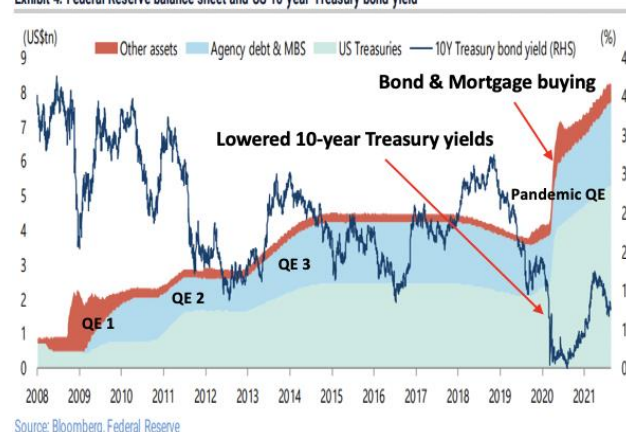
So the US government is spending at an unprecedented rate while the Federal Reserve is keeping interest rates lower for longer. No wonder investors expect the fairytale to never end. However, the end will inevitably arrive and the timing will likely coincide with a material increase in inflation, which is why a recent Bank of America Fund Manager Survey continues to list it as the number one tail risk for markets. As long as inflation remains under control, governments can continue to spend while central banks can keep monetary conditions easy. Nevertheless, once inflation starts to move higher, the Fed will need to begin the tightening process by phasing out their monthly quantitative easing buying program of \$80 billion in Treasuries and \$40 billion in mortgages. This fact is significant given the expansion of the Fed's balance sheet was instrumental in lowering 10-year yields last year and keeping markets liquid. In a survey by Bank of

America, 84% of respondents indicated they believe that the Fed will signal their intentions to taper by year-end. This statistic has become the intention of equity investors, with both the S&P 500, Dow Jones Industrial Average, and Nasdaq 100 trending lower in mid-August due to rumours of Fed tapering. Regardless, a decision to taper is unlikely to be fatal and could buy the Fed a little more time in keeping overnight rates at zero for longer. It is the first step in the tightening process, though, so traders will be keeping a close eye on how the market digests the news when it finally happens. This is a test that the market is likely to pass, but still a test.

Chart 27: Inflation remains the biggest "tail risk"
What do you consider the biggest "tail risk"?



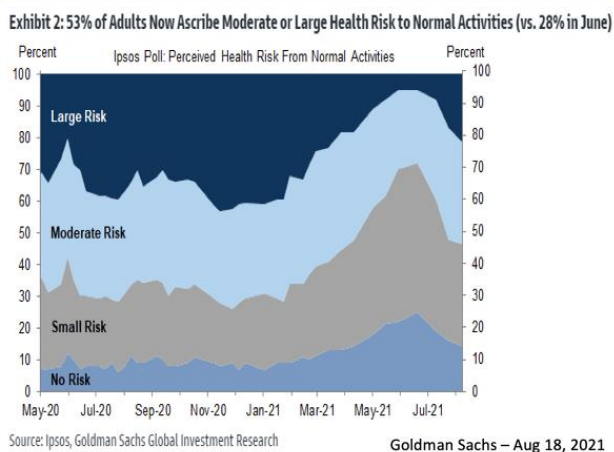
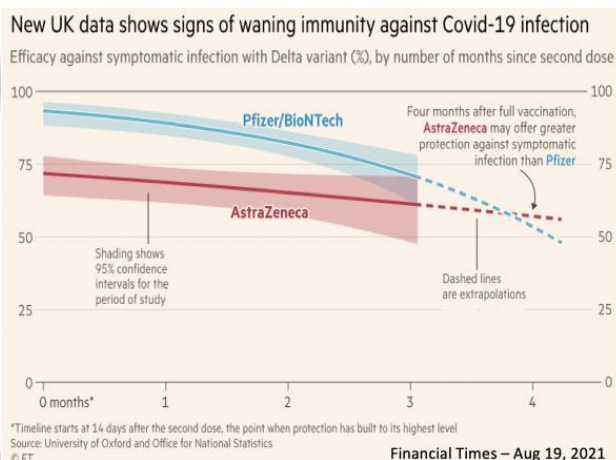
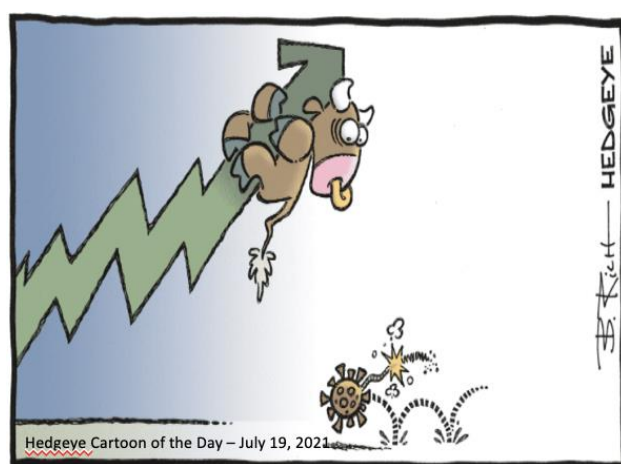
Exhibit 4: Federal Reserve balance sheet and US 10-year Treasury bond yield



Markets have largely moved on from the pandemic, despite rising cases.

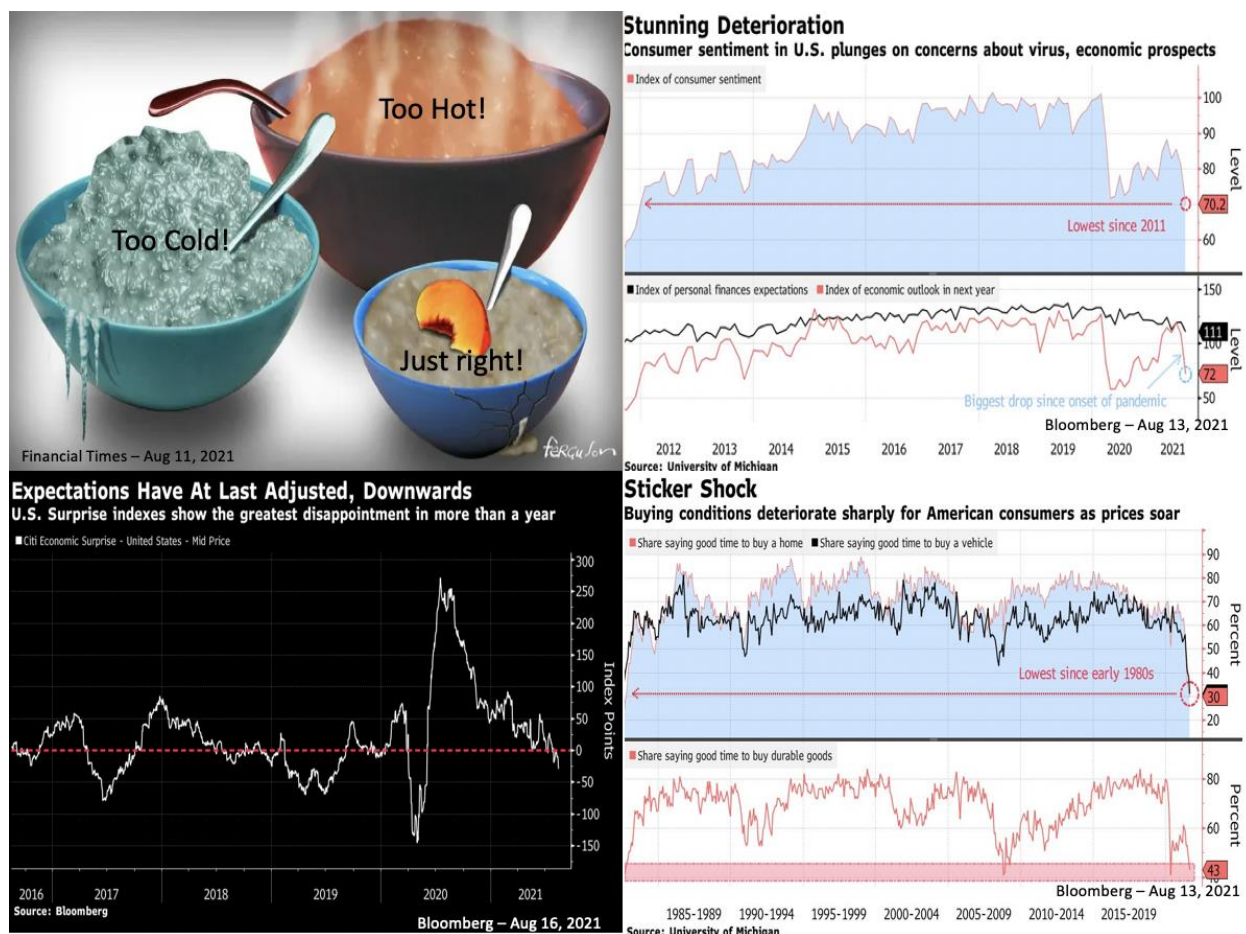
The pandemic also remains a test the market will continue to grapple with. While the COVID-19 Delta variant was only listed as the third largest risk in the Bank of America survey last month, it did gain more attention than the survey from the previous month. We do still believe markets have largely moved on from the pandemic despite rising global infections. As we pointed out in a previous chart, markets bottomed on March 23 when the Fed stepped in and provided much-needed liquidity. Markets recovered and started moving higher, though volatility was still evident. It wasn't until Pfizer released promising vaccine trial data in November 2020, however, that traders removed the left

tail risk of the pandemic such that the market rally could continue without any real threat of a correction. Even when infection rates increased due to the highly infectious delta variant, confidence that the vaccine still offered protection buoyed market confidence. Yet new data from Israel and the United Kingdom showing signs that vaccine immunity may wane over time could weaken the confidence in the market, as Goldman Sachs believes 53% of Adults now ascribe a moderate or significant health risk to normal activity.



Last month, with concern over the Delta variant and a fourth wave of infections hitting headlines, consumer sentiment plunged to its lowest level since 2011. As highlighted by Strategas, the timing of the fall was in line with the share of the population saying Covid is a severe health risk, but this isn't the only thing worrying consumers. Consumer confidence is part of a broader group of economic indicators that looked to have rolled over recently, as evidenced by the Citi Economic Surprise index turning negative for the first time in more than a year. Along with the Delta variant, inflation is also starting to weigh on consumers: buying conditions for homes, vehicles, and durable goods have recently hit their lowest levels since the early 1980s. From the market's perspective, this is a greater threat given concerns over inflation would prompt the Federal Reserve to tighten monetary policy sooner rather than later. While the Delta variant and higher

infection rates may reduce mobility and cause growth to slow, the pandemic could be helping keep the economy to stay in a goldilocks equilibrium by helping keep the economy from getting too hot or too cold. At the very least, only if breakthrough infections from a new variant render the vaccine ineffective do we see the negative left tail pandemic scenario back on the table, with volatility increasing. Without this, the market will likely treat the pandemic as a non-issue.

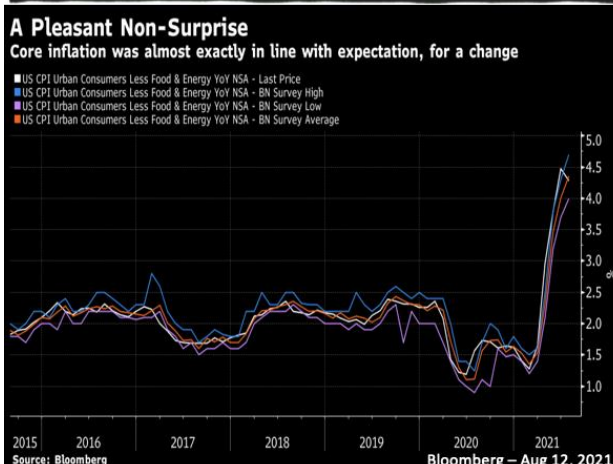


Higher inflation is offsetting gains, causing the average American to continue falling further behind.

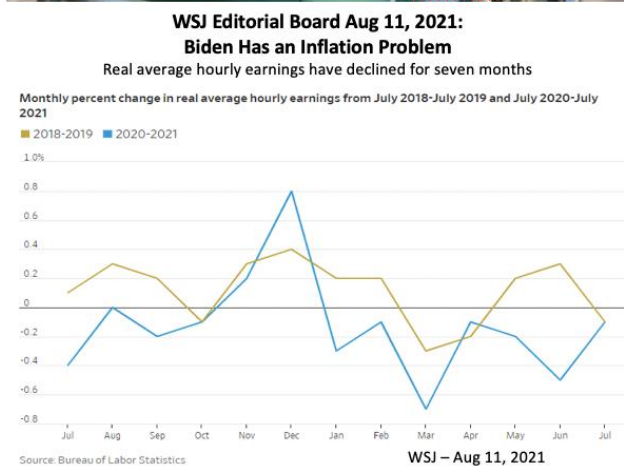
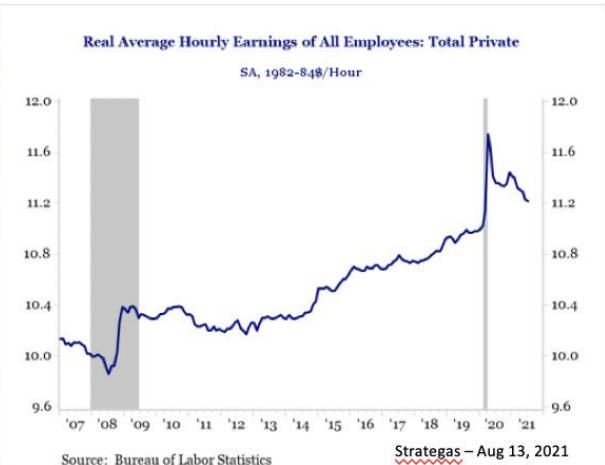
The market does care about inflation, given that it remains vital to securing the wealth of both consumers and investors. According to the University of Michigan, consumer inflation expectations have increased significantly, especially shorter term. Over the next 12 months, consumers see prices increasing around 6%, versus a lower but still elevated 3% over the next 5 to 10 years. Financial markets are a little more sanguine, with 5-year inflation rates five years forward off their pandemic lows but consolidating close to where they were in 2018 at just above the 2% level.



Markets took some solace from July CPI reports that, while still elevated, headline inflationary readings were in line with expectations. The belief that rising prices are a transitory phenomenon has largely been accepted by the market, given the drivers have come from a small group of products impacted by short-term supply and demand imbalances. Even when eliminating the outliers, prices look to be heading higher. Furthermore, while it is true that some price increases will likely prove transitory and will turn lower in the future, others appear set to start increasing and take their place in continuing to push inflation higher. Housing is a notable component in most inflation indices, comprising 18% of Core PCE inflation. According to Fannie Mae, the rate of shelter inflation could increase from around 2% currently to over 4.5% and contribute over 1% alone to inflation in the coming years.



Even more concerning for inflation handwringers, wage growth looks to finally be gaining some traction, especially for lower-skilled workers. According to the Atlanta Fed Low Skill Growth Tracker, salaries have started to move higher in 2021, as have real average earnings of all employees. While this should be good news for workers, unfortunately, inflation has increased even more, such that real average earnings have declined for the past seven months. This presents something of a dilemma for President Biden. Despite showering the average American with free money in hopes of reducing inequality, higher inflation is offsetting much of the gains, causing the average American to continue falling further behind. Monetary policy favours the rich because low-interest rates and increased liquidity bid up the value of financial assets, which makes the rich richer. The advantage of fiscal policy is it can be directed to benefit specific groups or demographics, like lower-income families. Unfortunately, if it also leads to higher inflation, these same groups stand to be negatively impacted the most. It seems Biden cannot win for losing when it comes to inequality.



The key remains inflation. If it is indeed transitory, Biden has room to let fiscal policy build back a better America. If it looks like inflation has moved in and looks to stay, then he doesn't. The sustainability of the recent increase in inflation is an active debate, with valid points on both sides. One of the most compelling arguments on why inflation may keep accelerating revolves around the capacity of the economy. Once the output gap has been eliminated and the economy expands beyond capacity, the laws of supply and demand would dictate prices should rise. If fiscal policy has the power to drive economic growth higher, it's only reasonable to assume growth will exceed the economy's capacity if government spending continues to grow.



IS RISING INFLATION LASTING OR A TEMPORARY SURGE?

Why Inflation May Be Transitory

DRIVING PRICES DOWN

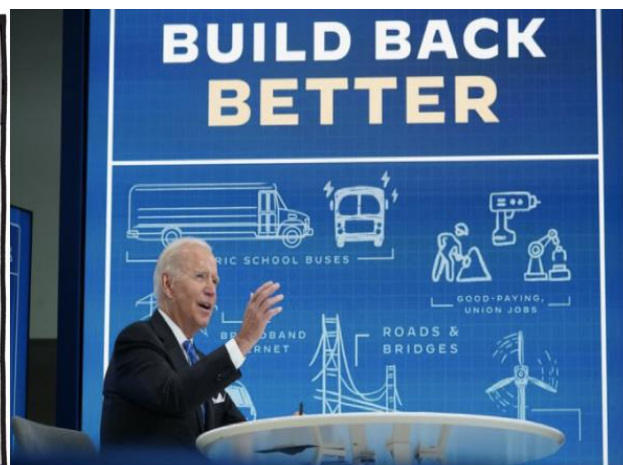
COVID accelerating/Delta slowing global recovery
Stimulus ending (maybe)
Recessionary effects (still 5.7M jobs below last peak)
Technology (digital productivity, automation)
Supply chain corrections (eg lumber)
Massive government debts

Why Inflation May Keep Accelerating

PUSHING PRICES UP

Wage gains sticky & labor markets tight
Epic government stimulus spending
Historic consumer savings
Supply chain issues & rebuilding inventories
Tariffs & deglobalization
Fed's QE =

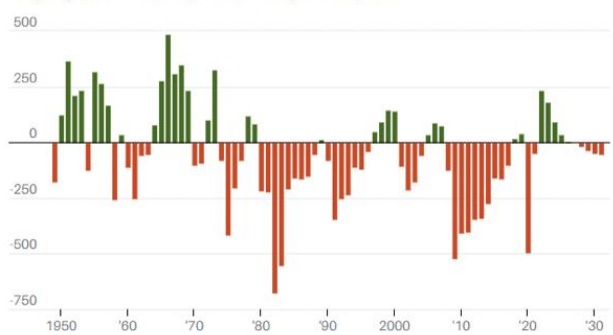
Mauldin OMS/Bruce Melhman - Aug 13, 2021



Minding the Output Gap

The gap between actual and potential GDP in 2022 is expected to be the largest since 1973.

Output gap as a share of potential GDP, in basis points



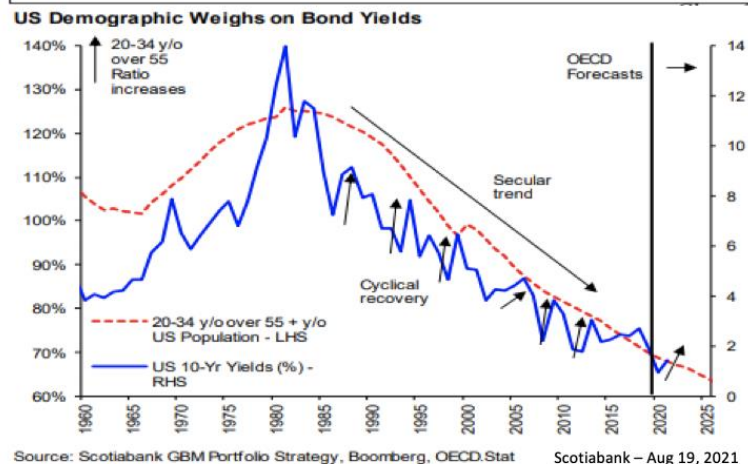
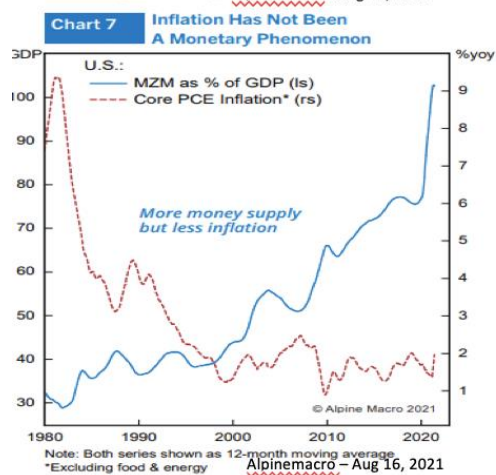
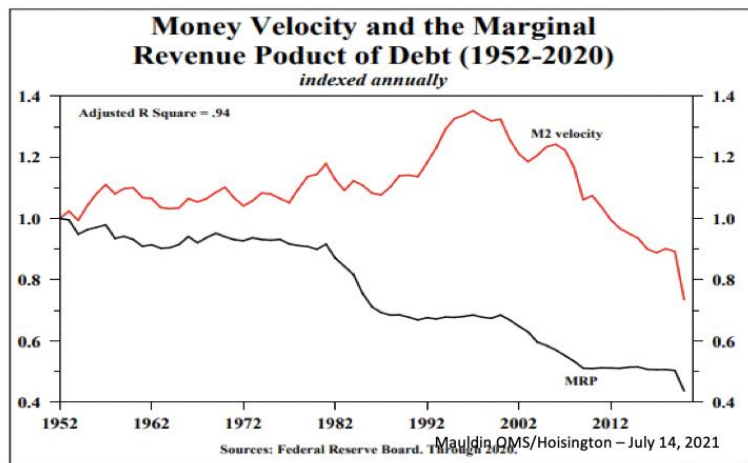
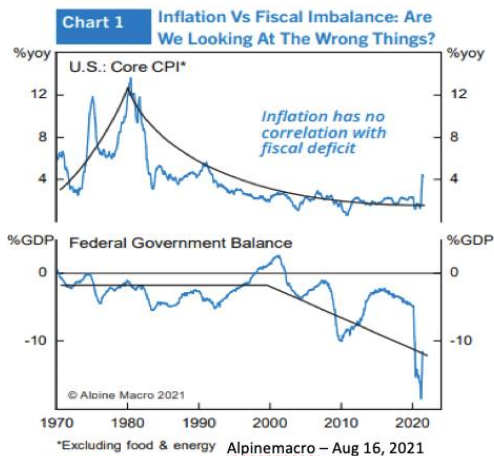
Source: Natixis, CBO

Barron's - Aug 14, 2021

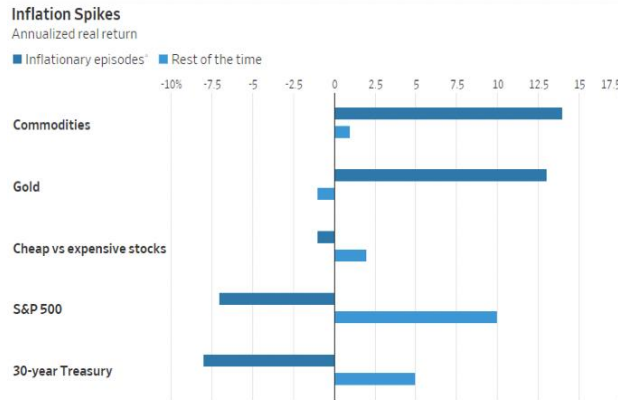
Exploring the counterargument: inflation was low pre-pandemic and will remain so when the economy normalizes.

Nonetheless, it is a heavily debated subject, so before we move on, we feel compelled to spend some time on the counterargument, namely, inflation was low before the pandemic and will remain so once the economy normalizes. First, debt levels have been increasing for years, yet core CPI has trended consistently lower. Based on this, there is an argument to be made that no correlation between inflation and the fiscal deficit exists. Nor does there appear to be any correlation between money supply and inflation.

Money supply has also moved consistently higher without causing an inflationary spiral. While the money supply has increased, the velocity of money has declined, offsetting much of the increase. The theory on why this has occurred revolves around the declining marginal productivity of debt. The higher a country's debt level, the less additional revenue or growth it's able to generate with each additional dollar of debt. Demographics, namely an ageing population with a lower propensity to consume, is also cited as a headwind against higher inflation though one could also make the counterargument on the supply side, particularly an ageing population with a higher dependency ratio, will lead to higher wages and thus higher inflation. Regardless, the decline in the ratio of 20-34 years versus 55+ year-olds lines up nicely with the consistent 40-year decline in 10-year bond yields.



For investors, determining the direction of inflation is crucial as some asset classes fair better than others in an inflationary environment. Commodities and gold tend to do well, while stocks and bonds are less so. Not only is the direction of inflation important, but the magnitude is as well. Commodities, for example, excel when inflation is high and rising. Stocks don't do as well in this environment, but they do great when inflation is low and rising. Bonds don't look too good in either. According to consulting group Investment Metrics, with the exception of high-net-worth investors, big institutional asset managers have been paring back their fixed income allocations and buying equities over the past year. At the same time, according to the Bank of Americas Global Fund Manager Survey, big investors report that they are massively underweight bonds. While we concede there is a valid argument that inflation could remain low, investors see the risk-return proposition as favouring stocks, and thus inflation and higher rates.

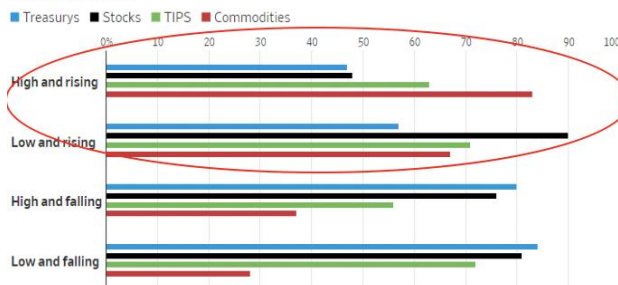


*Eight episodes since 1926 of more than six months when inflation peaked above 5% before falling back; see ssrn.com/abstract=3813202 for details
Source: Man Group **WSJ – May 11, 2021**

Fighting Inflation

Asset classes perform very differently in different inflation environments.

Percentage of rolling 12-month periods in which returns exceeded inflation, 1973-2020, by type of inflation environment



Notes: High and low inflation defined as CPI above or below 3% over the preceding 12-month period. Data for all assets starts March 1973, except TIPS, which starts March 1997.
Sources: Schroders; ICE BAML 7-10 Year US Treasury Index (Treasuries); MSCI USA Index (stocks); Bloomberg Barclays US TIPS Index (TIPS); S&P GSCI Commodity Total Return Index (commodities) **WSJ – May 24, 2021**

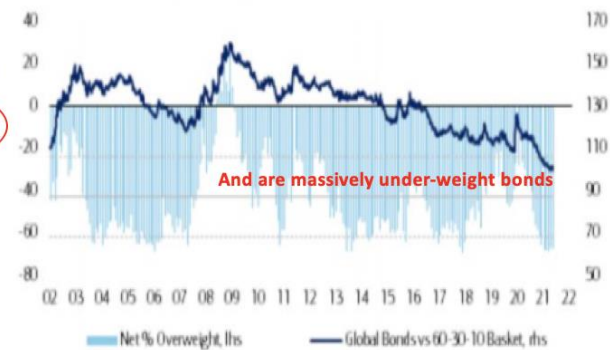


Figure 3: Q2 2021 Median Asset Allocation Changes.

Source: Investment Metrics

Chart 36: Net % AA Say they are overweight Bonds

Net% of FMS investors overweight bonds



Source: BofA Global Fund Manager Survey

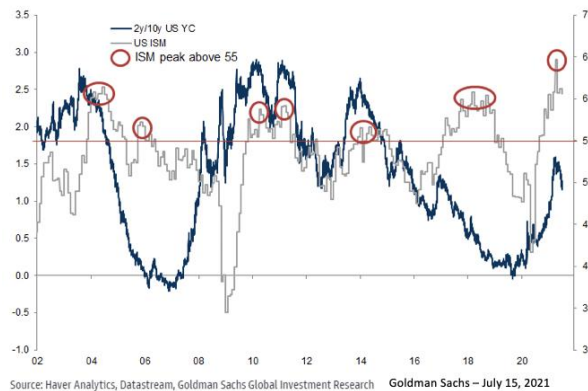
Bloomberg – Aug 20, 2021

But in July investors chose poorly by underweighting bonds as yields ground lower for most of the month, thus increasing bond prices and returns. Equities went up as well, but with inflationary expectations headed higher, the surprise in July was falling bond yields, especially declining real yields.

Why were bond yields falling? Were markets telling us inflation isn't going higher, or even that the direction of inflation doesn't matter? As mentioned earlier, the Delta variant and concerns it would cause a delay in re-opening the economy likely played a role. Even without the impact of the Delta variant, many felt the re-opening trade was close to being played out anyways and economic growth was set to slow regardless. Historically, the steepness of the yield curve has been a good barometer of the economy, and as pointed out recently by Goldman Sachs, tends to flatten in line with peaks in the ISM manufacturing index. With the ISM appearing to peak in July, a flatter yield curve appeared to confirm growth momentum was about to turn lower. Typically, however, the yield curve begins to flatten due to higher 2-year rates anticipating tighter monetary policy, not declining 10-year yields. It makes sense that longer-term rates would eventually rise as tighter monetary conditions cause the economy to slow, but it seemed a little pre-mature for 10-year rates to be declining in July given the Fed remains extremely accommodative.



Exhibit 2: The yield curve tends to flatten in anticipation of, or together with, peaks in the ISM, i.e., when growth momentum is about to slow
US 10Y-2Y yield curve and US Manufacturing ISM



Yield Swoon Spread of delta variant triggers concern about economic growth



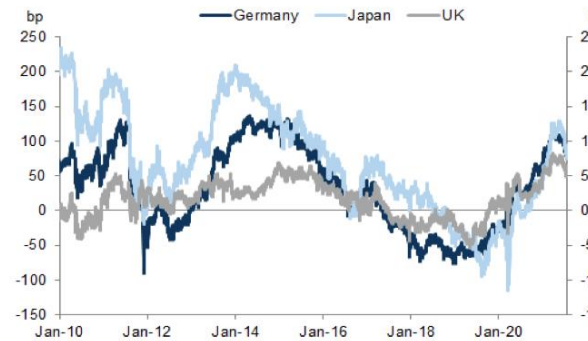
Inflation-adjusted yields on medium-term US debt sink



To be fair one needs to consider global growth, not just US growth when analyzing Treasury yields. Global investors can buy US bonds, hedge the currency risk back into their home currency, and still get better rates than they can in their domestic government bonds. This caps how high US yields can go and can even cause them to fall if foreign yields drop. That said, foreign holdings of US Bonds were flat in July, thus indicating foreign buying wasn't behind July's fall in yields. What likely did contribute to falling yields was short-covering by traders.

Most were speculating yields would trend higher and have sold bonds short in hopes of buying them back at lower prices after yields increased. Given rates did not cooperate, many had to cover their shorts and buy bond futures, thus helping drive yields even lower. It's an important issue, as evidence of higher inflation and a recovering economy would suggest yields should be increasing. However, evidence in July was pointing towards a continuation of the low inflationary environment from before the pandemic where yields might take a run at the zero bound that exists in Europe and Japan.

Exhibit 4: The relatively elevated hedged yield pick-up of USTs provides an incentive to foreign private investors, but evidence of such flows is limited
FX-hedged yield pick-up of 10y UST vs rest of G4 (rolling 6m hedge)



Source: Goldman Sachs Global Investment Research

Exhibit 3: Fed custody holdings data suggest relatively flat foreign official sector demand over the period when yields declined

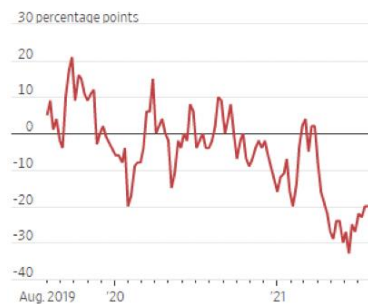
Valuation-adjusted Fed custody holdings



Source: Goldman Sachs Global Investment Research

Goldman Sachs – July 23, 2021

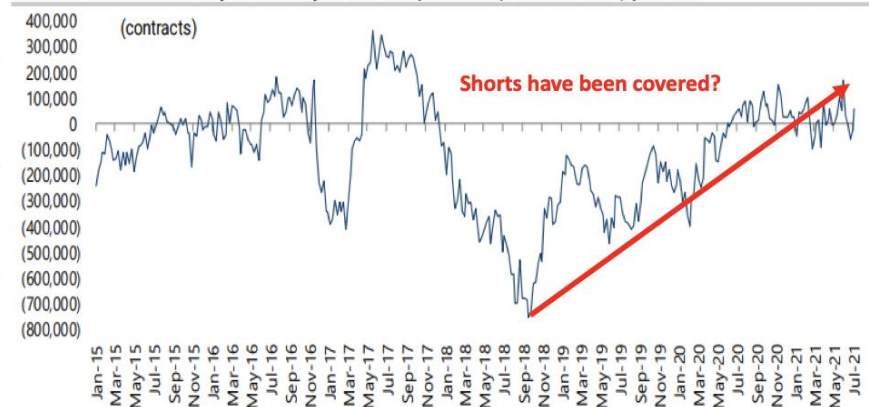
JPMorgan Treasury client survey, net long position



Note: Negative number indicates more survey respondents are betting on higher Treasury yields than are betting on lower Treasury yields.
Source: JPMorgan Chase & Co.

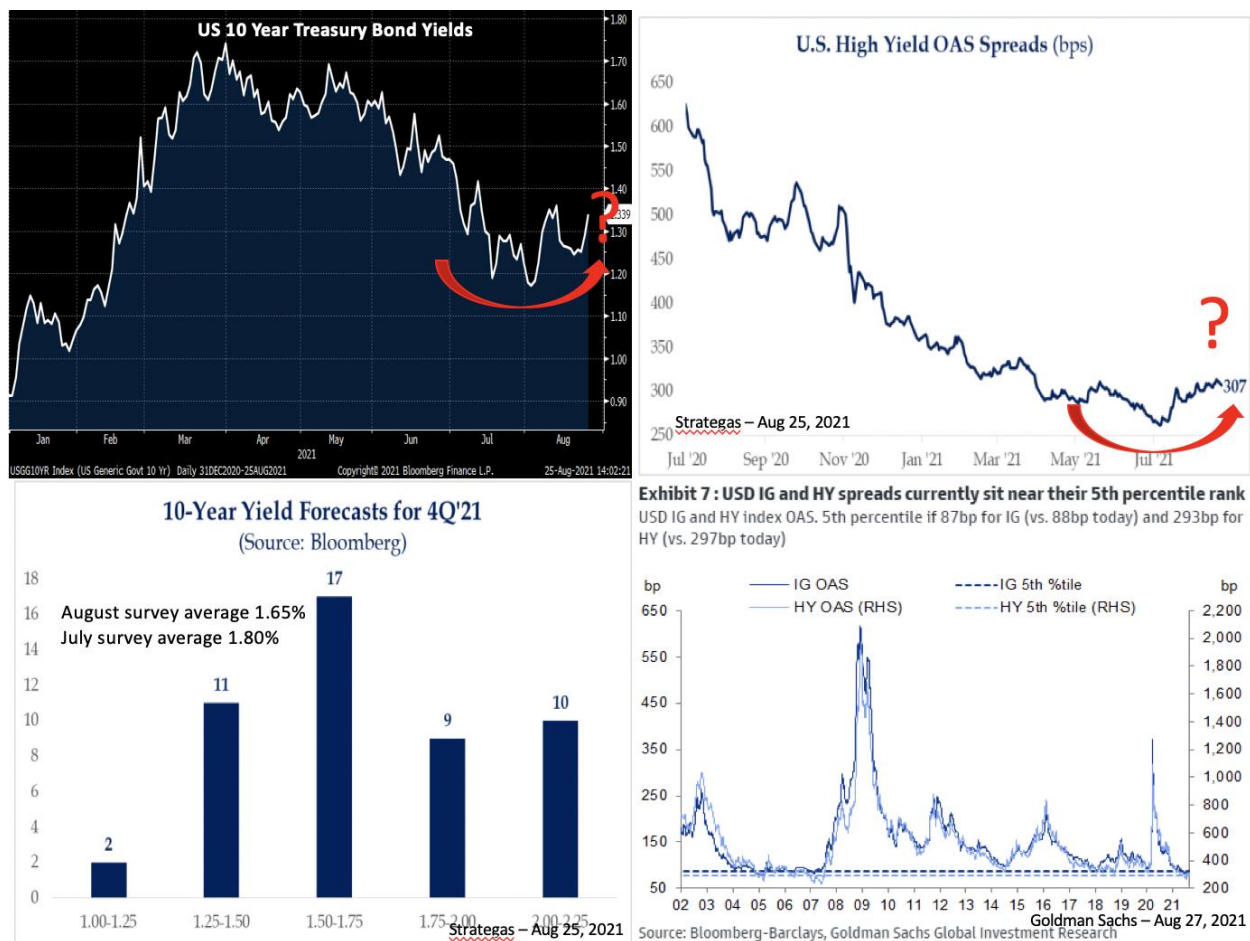
WSJ – Aug 9, 2021

Exhibit 12: CFTC CBT US 10-year Treasury futures net speculative (non-commercial) positions



Source: Bloomberg, Commodity Futures Trading Commission (CFTC)

Nonetheless, yields did turn higher in August, showing signs that rates may have bottomed, and most forecasters still believing yields are headed higher. The average forecast from an August Bloomberg survey of professional forecasters expects rates to end the year at 1.65%, still lower than the July survey's 1.80% forecast but higher than where yields have been since May. Credit (investment grade and high yield bonds) has been more consistent, with US High Yield OAS (option-adjusted spreads) continuing to grind progressively lower, though there are signs recently they also may have bottomed. Currently, investment grade and high yield spreads rank near their 5th percentile, meaning they are very expensive.



While we admit the short-term view and direction of yields are a little muddled, we believe the longer-term trend will become clearer once the future paths of fiscal policy and government debt become more established. Just like quantitative easing and zero interest rates (or even negative rates in Europe and Japan) became mainstream after the Financial Crisis, big deficits could now be the first line of defence in future recessions. Debt exploded during the pandemic and successfully blunted the negative economic fallout on the average American (and Canadian) household.

How much debt is too much?

How can politicians deny their citizens the same protection during the next economic slowdown? There remains the question of how much debt is too much, but as long as a country can grow its nominal GDP faster than its debt over the long term, there is no limit. Inflation can play a role in accomplishing this. High inflation increases nominal growth, and according to McKinsey Global Institute, has historically been one of the most popular means in which countries have decreased their debt/GDP ratios. They cite belt-tightening as the most common deleveraging path, but that's no fun, especially for politicians. Inflating away debt only works if governments can rely on their central banks to keep nominal interest rates under control. Remember, debt needs to grow slower

than the economy, and this can't happen if borrowing rates spike higher. If inflation moves higher but nominal rates are capped, then real rates have only one way to go: down. We don't think the Fed is doing this right now. We think they would like to see longer-term yields move a bit higher so the yield curve steepens. A flat curve makes it hard for banks to lend money, which is vital for a healthy economy. At some point though, if the government keeps spending and inflation accelerates, the bond market vigilantes will start to drive rates even higher, and either the Fed steps in, or the spending will need to stop.

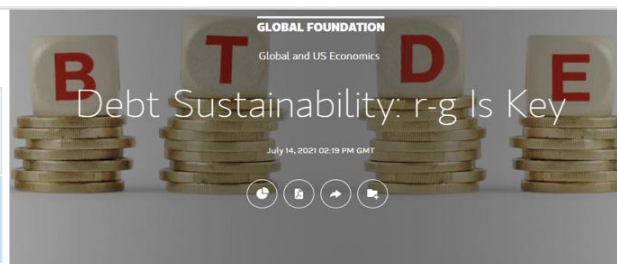
We have observed 4 archetypes of the deleveraging process

Archetype	Number of episodes after a crisis (total ¹)	Description	Examples	Years
1 "Belt-tightening" <i>Most common deleveraging path</i>	16 (23)	Episodes where the rate of debt growth is slower than nominal GDP growth, or the nominal stock of debt declines	Finland Malaysia US S. Korea	91-98 98-08 33-37 98-00
2 "High inflation" <i>Absence of strong central banks, often in emerging markets</i>	8 (12)	Periods of high inflation mechanically increase nominal GDP growth, thus reducing debt/GDP ratios	Spain Italy Chile	76-80 75-87 84-91
3 "Massive default" <i>Often after a currency crisis</i>	7 (7)	Stock of debt decreases due to massive private and public sector defaults	US Argentina Mexico	29-33 02-08 82-92
4 "Growing out of debt" <i>Often after an oil or war boom</i>	1 (3)	Economies experience rapid (and off-trend) real GDP growth and debt/GDP decreases	US Nigeria Egypt	38-43 01-05 75-79

¹ Includes 13 deleveraging episodes that were not preceded by a financial crisis.

SOURCE: McKinsey Global Institute

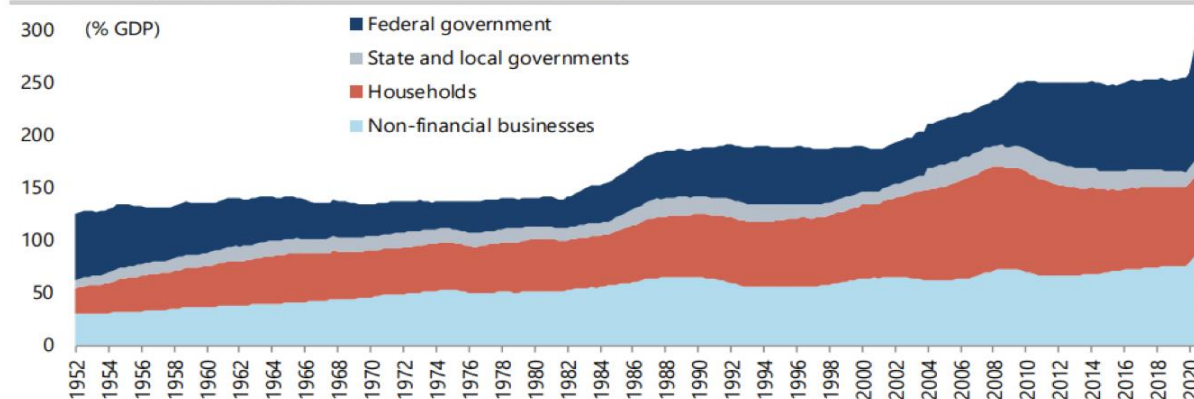
McKinsey – Jan 2010



Morgan Stanley – July 14, 2021

To ensure that public debt is on a sustainable path, history suggests that creating an adequate buffer between real rates and real GDP growth matters more than just relying on fiscal austerity. We apply this lesson to the case of the US to find the debt-stabilising range of real rates.

Exhibit 8: US non-financial sector debt as % of annualised GDP

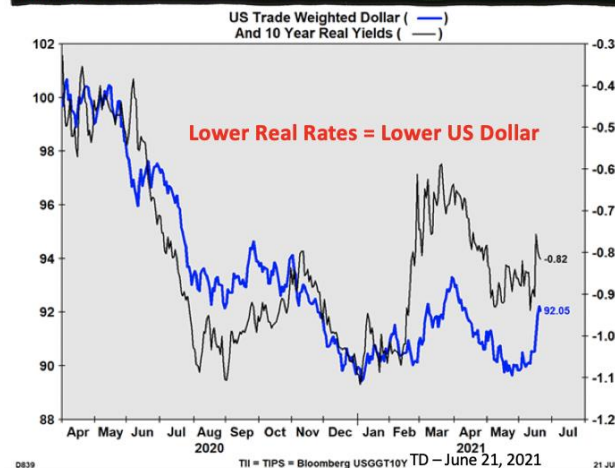
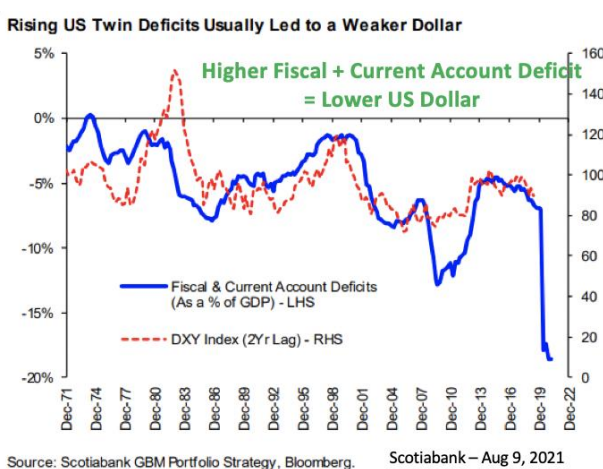


Source: Federal Reserve, Jefferies

Jefferies Fear & Greed – Aug 19, 2021

By capping nominal rates, Central Banks would be effectively diminishing, or even eliminating, the role of the bond market of signaling debt levels are approaching dangerous levels. The market would no longer be responsible for the price discovery of financial assets, that responsibility would fall on the Fed and the Treasury Secretary of the US Government. Put another way, the US government can spend as much money as they want by issuing an unlimited amount of debt, even if it causes inflation to increase if the Federal Reserve buys enough (or all) of the debt such that yields don't move higher. Under this scenario, interest rates would be determined by the Federal Reserve, not the market. If this sounds too good to be true, you're right. While the Fed might be able to stop bond prices from plummeting (yield increasing), they will have a

harder time protecting the US dollar from falling, which is exactly what would happen if real rates move materially lower (meaning higher inflation but capped nominal rates). Not surprisingly, the trade-weighted dollar is highly correlated with real rates, with declining 10-years real yields closely aligned with a falling US dollar. Also negatively impacting the dollar historically has been a rise in the so-called twin deficits. A rising fiscal deficit and deteriorating terms of trade usually result in more sellers than buyers of the greenback, which could result in a screaming descent for the dollar. This is of course only one potential path. The US could choose to tighten their belts and accept a lower growth economy, or increased productivity and innovation could result in higher economic growth without inflation, with both scenarios resulting in interest rates staying lower for longer. Perhaps much longer. How will we know which path we're on? Watch inflation, and then watch how the Fed reacts.



Virtually every asset class is impacted by the direction of both rates and inflation.

The future path of interest rates has a direct impact on fixed income returns in that higher rates mean lower prices and vice versa. There will always be opportunities in credit (both public and private debt) for investors to opportunistically earn a higher return, but if you believe rates are headed higher, fixed income is a challenged asset

class. The influence of interest rates extends beyond fixed income, however. Virtually every asset class is impacted by what direction rates and inflation take, including equities. Stronger than expected economic growth with higher inflation typically favours value stocks and cyclical industries, while slower growth and lower inflation is a better environment for growth sectors like technology and consumer discretionary.

Using some fixed income terminology, value stocks tend to be lower duration assets and thus they outperform when yields are increasing. Alternatively, growth stocks have a higher duration and tend to come under pressure when yields start to rise. Small-cap stocks tend to act more in line with value, meaning they have a lower duration or positive correlation to yields given they are more sensitive to the economy.

According to Scotiabank, value's positive correlation to yield's and growth's negative correlation have both been increasing, which we see playing out in the market this year.

Momentum swings in favour of value, small-cap and cyclicals when economic growth and yields look to be headed higher but then shifts toward growth and big-cap tech when growth prospects dim and yields fall. From the beginning of the year until early April 10-year yields were rising and the Russell 1000 Value index and the Russell 2000 Small cap index were outperforming the Russell 1000 Growth index. Since May, however, 10-year yields have reversed course and the Russell 1000 Growth index has regained its market leadership.

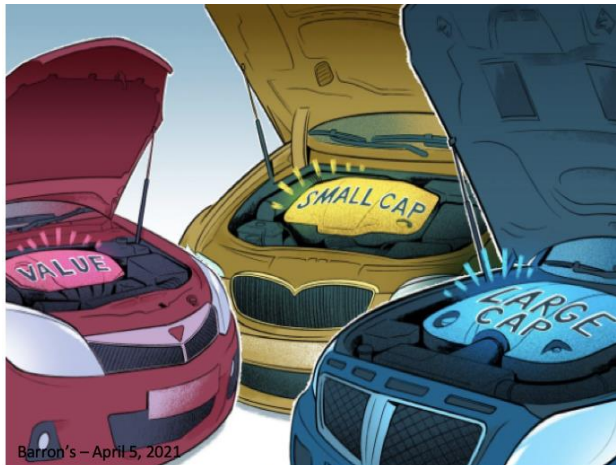


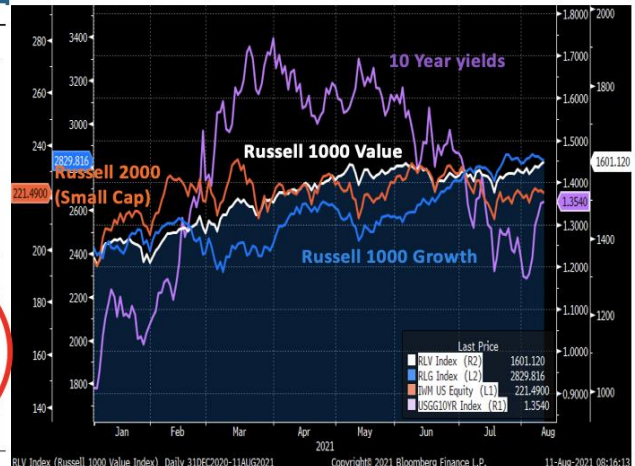
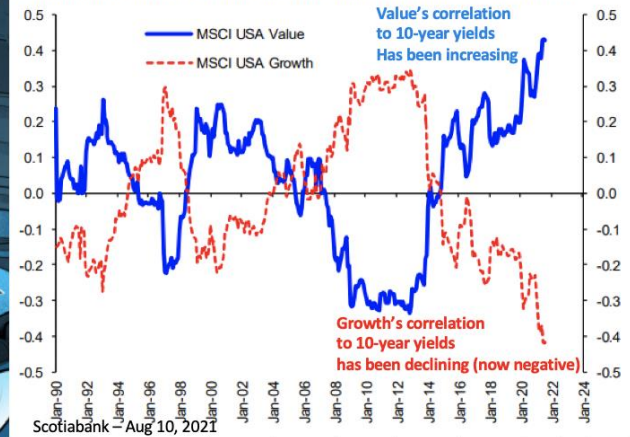
Exhibit 1: Recommended Style & Sector Exposure Based on Inflation/Growth Expected Outlook

		Expected Growth Surprise	
		Positive	Negative
Expected Inflation Surprise	Positive	Explosive Growth OW: Value, Momentum UW: Div Yield Metric, Quality, Low Vol/Beta Sections: Industrials, Financials, Base Metals, Canada Bottom Value/Specific Non Value	Stagflation OW: Momentum, Accrual Metric UW: Low Vol/Beta Sections: Gold miners, Healthcare, Media, Canada Top Value Specific Banks
	Negative	Goldilocks OW: Div Yield Metric, Value UW: Momentum Sections: Technology, Discretionary, Gold miners, Real Estate, Canada Specific	Slow Growth or Recovery OW: Quality, Low Vol/Beta UW: Value Sections: Technology, Utilities, Discretionary, Canada Specific, Bottom Value/Non Value

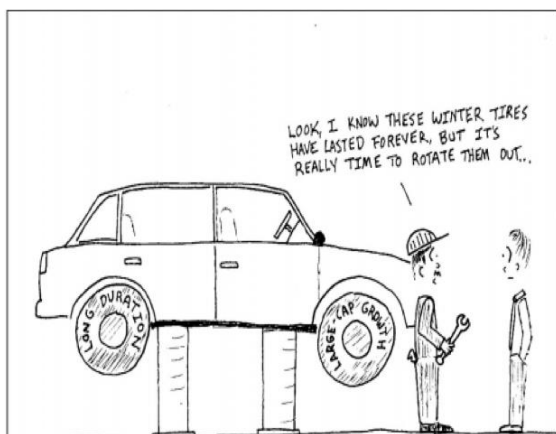
Source: Scotiabank GBM Portfolio Strategy.

Scotiabank - May 25, 2021

Relationship* Between Yields and Styles Has Reached Extreme Levels



As we highlighted last month, stocks are expensive, especially long-duration growth stocks. If interest rates stay low or even go lower, growth stocks valuations can still go even higher, but the upside gets trickier from here. Alternatively, shorter duration sectors and stocks are cheaper and could see their valuations increase if yields move higher and investors start to shift their portfolios towards more cyclical, economically sensitive investments. In terms of geographies, Europe and Asia are considered shorter duration and more cyclical than the US, while from a sector perspective, consumer discretionary (retail and media) and technology are long duration, while energy, real estate, utilities, and financial are shorter duration.



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Exhibit 52 : Higher US 10-year bond yields support non-US and more cyclical/ value stocks

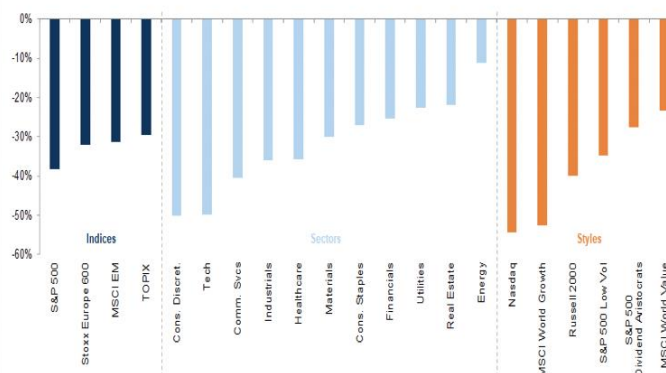
Correlation of 12m relative returns vs. MSCI World with changes in US 10-year yields since 2010



Source: Datastream, Goldman Sachs Global Investment Research Goldman Sachs – Oct 29, 2020

Exhibit 51: There are large differences in equity duration across markets, sectors and styles

Equity duration estimate for +100bp in discount rate (based on inverse of dividend yield)



Source: Datastream, Goldman Sachs Global Investment Research

Goldman Sachs – Oct 29, 2020

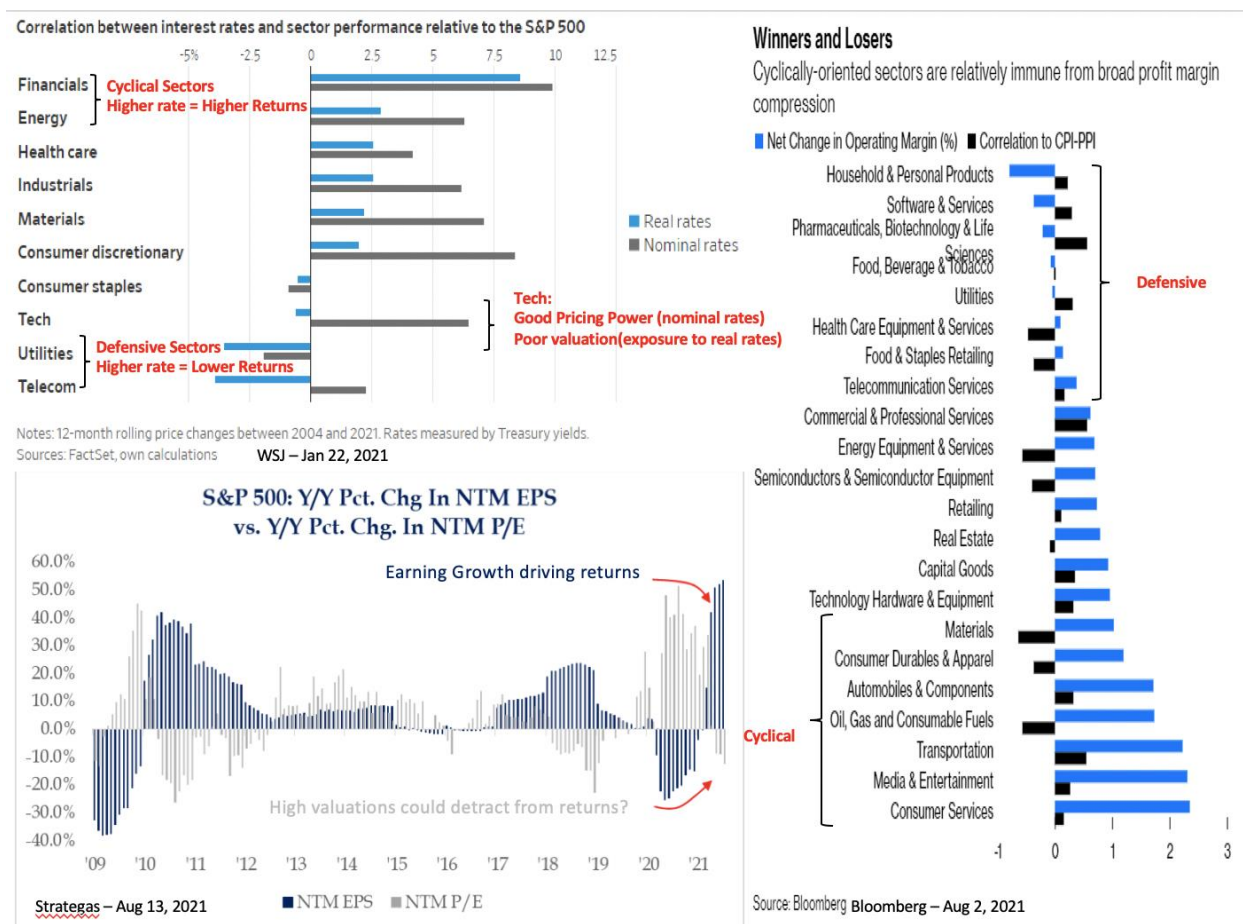


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Still, higher nominal rates by themselves don't tell the whole story. Also, a consideration to be made is how much of the increase in yield is due to higher real interest rates and how much can be attributed to an increase in inflation. Some companies and sectors do better than others when rates increase and inflation is higher, while others struggle. For specific stocks and sectors, defensive sectors like household & personal products, where companies have more difficulty passing on input prices to customers, fare worse in inflationary environments than cyclically orientated industries like oil and gas, where profit margins tend to increase when prices are on the rise. With sectors like technology, correlations between returns and interest rates are more nuanced. Some tech companies have very good pricing power and can protect their profit margins from inflation. Though if nominal rates increase more than inflation, the resulting increase in real rates can be a headwind to this high duration sector's valuations.

This is important because, with valuations already at elevated levels, Strategas has pegged earnings growth as being the more important variable over the next year. Over the next 12 months, changes in valuation could detract from returns, with earnings growth carrying the entire load for investors. Still, one has to be careful not to generalize. The performance of individual companies can vary significantly, even if they are in the same sector and industry. In an inflationary environment where interest rates

are moving higher, we suspect picking the right stocks will become more important and active management will out-shine passive index fund returns.



We have generalized the potential impact by referring to sectors, but the impact of higher interest rates and inflation on profit margins and valuations are very company-specific. Depending on a company's growth rate and the sensitivity of its valuation to changes in interest rates, higher nominal rates will impact some companies more than others. Same with inflation. Companies able to pass on price increases easily will protect their profit margins more than those that cannot. If rates and inflation remain low, higher growth companies, regardless of their ability to raise prices, should outperform, while more cyclical and economically sensitive names will do better if rates and inflation spike higher.

Rather than choose between these two scenarios and outcomes, perhaps in answer to the question of "what good looks like", companies able to navigate either environment and provide a better job of balancing offence and defence is the answer. Generically described by some as "quality", companies with strong balance sheets, consistent earnings growth, and above-average returns on equity, have historically provided good performance over the long term, particularly during markets drawdowns. When equities

wobble and valuations come under pressure, quality outperforms, both in the US and Canada.

Longer-Term Annualized Total Returns for High Quality Stocks Have Been Very Consistent



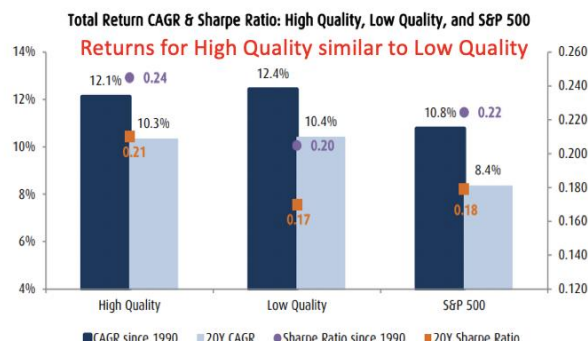
BMO – June 11, 2021

Source: BMO Investment Strategy Group, FactSet, S&P.

**CUMULATIVE INDEX PERFORMANCE – PRICE RETURNS (USD)
(JUL 2006 – JUL 2021)**



While Performance CAGRs for High & Low Quality Are Similar, the Risk-Return Profiles Clearly Favor the High Quality Group

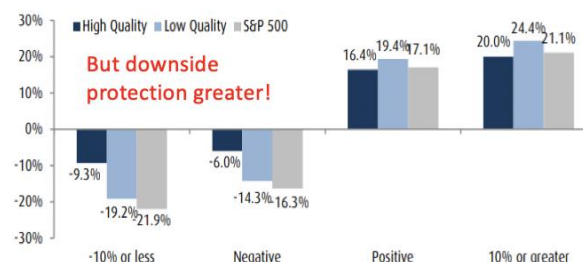


BMO – June 11, 2021

Source: BMO Investment Strategy Group, FactSet, S&P.

Low Quality Names Post Severe Losses When Broader Market Wobbles, While High Quality Names Tend to Do a Much Better Job of Balancing Offense and Defense

Average 12-Month Total Return Based on S&P 500 Return: High Quality and Low Quality
based on monthly total returns since 1990



Source: BMO Investment Strategy Group, FactSet, S&P

BMO – June 11, 2021

For Canadian investors, quality can also be in the form of a consistent and growing stream of dividends. Canadian equity markets are blessed with an ample supply of consistent dividend payers from which to choose. CIBC recently pointed out that the overall S&P/TSX dividend yield is currently above its 30-year average and considerably above the S&P 500. Dividends have historically represented a larger share of returns in Canada, comprising over 30% of total returns over the past three decades, compared to just over 20% in the US.

Ok, this should be a roll of Canadian \$100 bills, but you get the point!



Barron's – Mar 28, 2021

Exhibit 8: Equity Index Dividend Yields – S&P 500 And S&P/TSX – 1990 To Current



Source: Bloomberg, FactSet, Compustat and CIBC World Markets Inc.

The relative improvement is shown more clearly in the two bar and line charts depicting relative yield in Exhibit 9. The chart on the left-hand side simply subtracts the yield of the S&P 500 from the yield on the S&P/TSX, while the right-hand chart shows the yield on the S&P 500 divided by that of the S&P/TSX. Both ratios have moved meaningfully over the past five years and are at extremes.
CIBC – Aug 17, 2021

Exhibit 1: Equity Returns – Compounded Returns On The S&P 500 And The S&P/TSX – Select Time Periods

CAGRs	S&P 500 Total Return Breakdown				S&P/TSX Total Return Breakdown			
	Price Return	Dividend Return	Total Return	% Div Rtn of Total	Price Return	Dividend Return	Total Return	% Div Rtn of Total
30 Year	8.5%	2.2%	10.7%	20.7%	6.0%	2.6%	8.7%	30.4%
20 Year	6.7%	2.1%	8.9%	24.0%	5.0%	2.8%	7.9%	36.0%
10 Year	13.2%	2.3%	15.5%	15.0%	4.7%	3.2%	7.9%	40.5%
5 Year	15.5%	2.2%	17.7%	12.6%	7.1%	3.3%	10.4%	31.7%
2 Year	22.4%	2.2%	24.6%	8.9%	11.8%	3.6%	15.4%	23.1%
1 Year	36.6%	2.2%	38.8%	5.6%	26.9%	3.8%	30.7%	12.4%

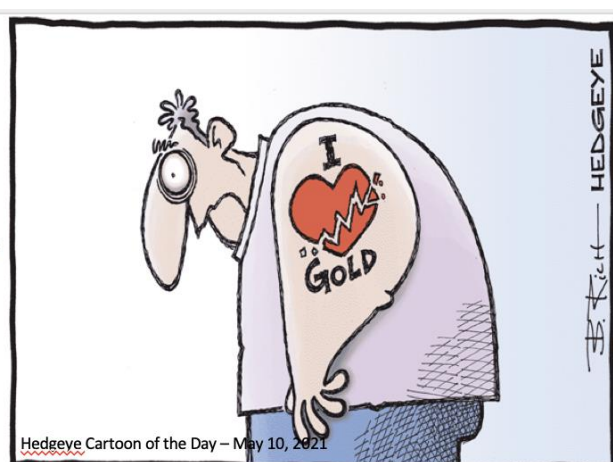
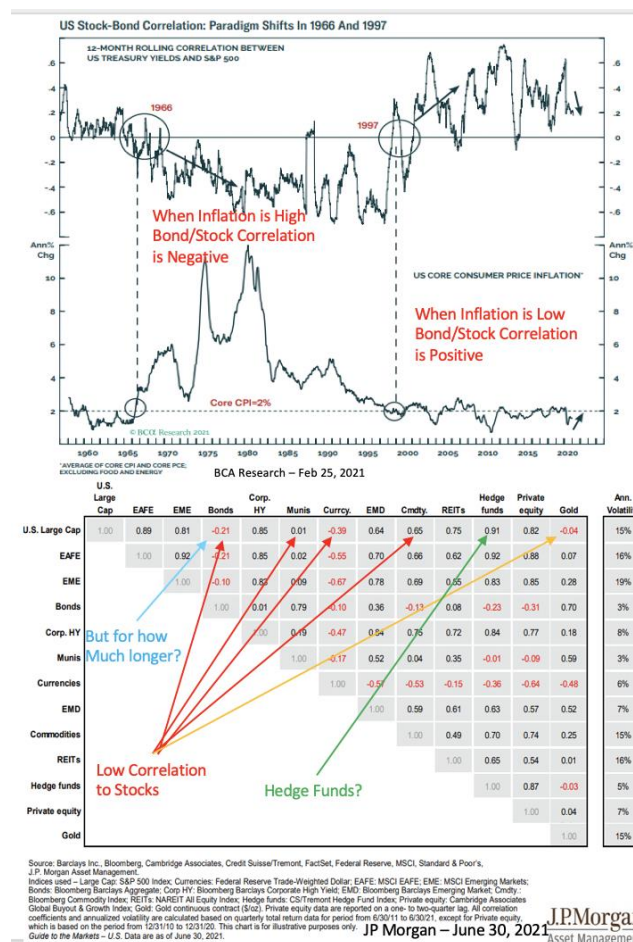
Source: Bloomberg and CIBC World Markets Inc.

CIBC – Aug 17, 2021

The unravelling of the traditional stocks and bonds portfolio.

For taxable Canadian investors, dividends also have an advantage over normal interest income, which becomes even more important given the poor outlook for fixed income returns going forward. From a portfolio construction point of view, the future return profile of bonds in a higher inflation world becomes quite problematic. In a traditional portfolio comprised of just stocks and bonds, the positive correlation between stock prices and bond yields (negative correlation between stock prices and bond prices) helps diversify risk. The impact on returns from lower stock returns is mitigated by lower bond yields and thus higher bond returns. Investors can offset some of the downside risk of their stock portfolio by holding bonds. In a higher inflationary environment, however, this historical relationship starts to unravel and the correlation between stocks and bond yields turns negative, meaning bond yields are moving higher (bond prices down) at the same time stock prices are moving lower. Higher inflation is seen as the common risk factor for both stocks and bonds, thus impacting both negatively. No longer can investors offset their stock risk by buying bonds, meaning alternatives need to be found. Dividend-paying stocks, while not a perfect substitute, can help fill the void from an income perspective, particularly if profit margins were inflation-proof and companies can increase dividends in line with higher prices.

Commodities, currencies, and emerging market debt also have low correlations to large-cap equities and could help diversify portfolios. Interestingly, hedge funds as a broad group have historically had high correlations to equities, but we would argue this is misleading. There are many different hedge fund strategies, but net long equity tends to dominate. This isn't what good looks like from a diversification perspective, but some strategies are, especially those able to provide good risk-adjusted returns, regardless of the market environment. Gold is also an interesting asset class to consider. It has a negative correlation to stocks, but its real value is its negative correlation to real interest rates. If you believe real rates are destined to stay low or even move lower, gold is just what the "good" doctor ordered. The relationship between gold and real rates has started to fray a bit of late, with gold failing to move higher as real rates drift lower, but we would put this down more to a lack of belief in the continued downward fall in real rates than the inability of gold to maintain its historical relationship with real rates in the longer term. Real rates may move higher in the short-to-medium term as nominal rates are allowed to drift upwards at a faster rate than inflation, but if one agrees in the longer-term plan of higher deficits, elevated inflation, and capped nominal rates, real rates can't be allowed to move materially higher.

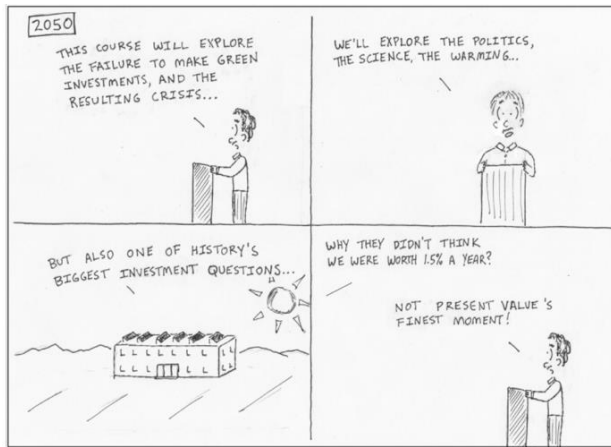


So where does this leave us? What does good look like, are we already there, and this is as good as it gets? A lot depends on one's view of inflation and the future direction of interest rates. If the economy slows and inflation proves transitory, yields can stay low, or even go lower. This is good for bonds and high duration equities like high growth technology stocks, where earnings growth is discounted further out into the future. Valuations are high, but in a very low-interest rate world supported by fiscal and monetary stimulus, ample liquidity can always push valuations even higher. Cyclical stocks, however, would lag, as would international, value, and small-cap.

The market would continue to narrow, and eventually, rollover. If inflation proves more durable, however, and nominal yields move higher, bond returns will likely be negative. Depending on how high inflation goes and the ability of individual companies to pass price increases on to their customers, stock returns could broaden out, with cyclical companies outperforming and earnings growth taking over from valuations in helping keep the current rally intact. If the central bank's cap yields and real rates stay low, even growth sectors like technology should participate in the party given their strong pricing power.

Looking forward.

The future path of the pandemic and how governments utilize monetary policy and fiscal policy could determine which path the global economy follows, inflation or deflation. One last thought when it comes to the continued use of fiscal and monetary policy, and the potential of central banks like the Federal Reserve effectively capping interest rates at low levels. While it can be argued we risk excessive inflation and financial markets will inevitably face a reckoning at some point, government spending and low rates can also be used to invest in much-needed productive infrastructure, like green energy. Already, solar and wind are less expensive on a cost per megawatt-hour basis than gas, coal or nuclear. While it's true effectively "free money" can lead to investment bubbles, its legacy can also be important infrastructure, like the 71,000 miles of railroad built in the US during the 1880s, or the fiber optic networks that were constructed as a result of the dot-com bubble. A report last month by the UN pins the blame for recent extreme weather events on human intervention and even claims some climate change effects may be irreversible. To avoid facing a climate disaster that one would only hope to witness on a Hollywood screen rather than in person, the time for action is now. As irresponsible as cheap capital may seem from a financial perspective, it might help save humanity: a very harsh reality.



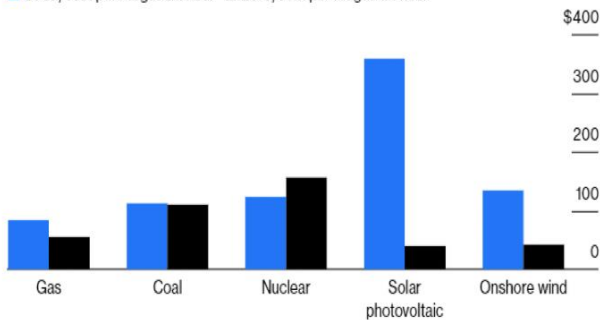
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Morgan Stanley – Aug 16, 2021

Reversal of Fortunes

Solar and wind are now less expensive than fossil fuels.

■ 2009, cost per megawatt hour ■ 2019, cost per megawatt hour



Source: Our World in Data

Bloomberg – Aug 10, 2021



WSJ – Aug 11, 2021



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