LORICA
INVESTMENT COUNSEL INC.

March 2021

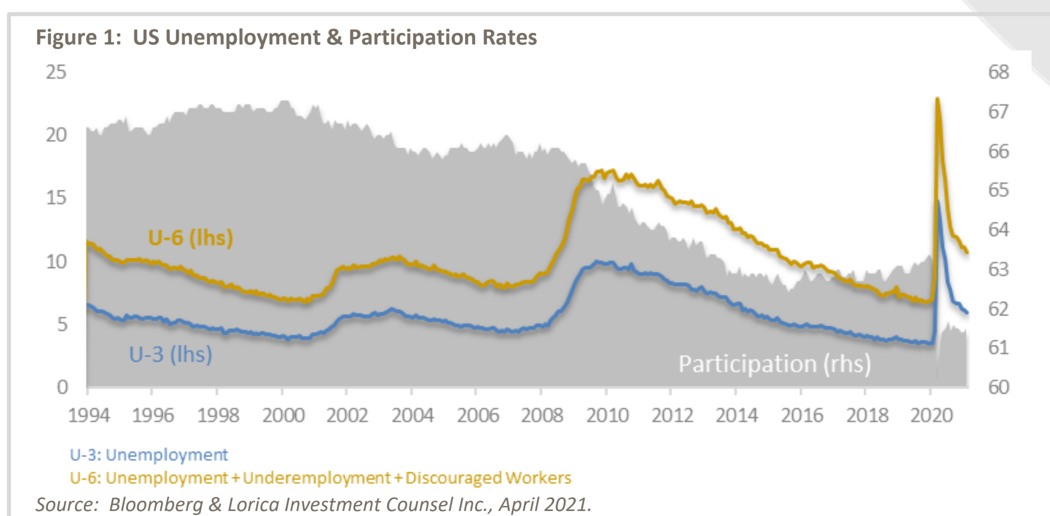
What We Think…

The effective Fed Funds policy rate is 0.07% and US core CPI is running at 1.55%. However, the real US Treasury curve implies that short-term real yields will rise by 1% over the next two years (Bloomberg) and the 5-year Inflation Expectation Rate is 2.12% (St. Louis Fed). Clearly, investors are optimistic for the medium-term future of the US economy. And there is a lot to be hopeful for, scientists have produced vaccines at record speed having exceptional efficacy, central banks have turned on the taps with no hint of turning them off and the Federal government is pumping unprecedented amounts of fuel into the economy. But there are still lots of issues that may yet impede growth – whether it is the widely divergent vaccination rates globally, the emergence of variants domestically or just the simple difficulty of getting people back to employment, much could still go wrong with the rosy outlook.

February was the worst US bond market performance since 2016, whereas in Canada it was the worst since 1994. Investors decided that vaccines are going to ensure a V-shaped US recovery accompanied by higher inflation; Canada would be dragged along in the process. There is little doubt that the vaccines are going to lay the foundation for a US recovery (especially given the domestic vaccine production capacity), but it remains to be seen whether the trajectory of the recovery will satisfy investor expectations. There are still many unknowns related to the virus that could impact the recovery including: percentage of the population that will ultimately get vaccinated, the evolution of mutations, achievement of herd immunity, what form of changes to social and business activity will persist, and what about the rest of the world. For now, we think investors are assuming the best-case scenario.

As with the rapid economic contraction that took place last year, the expansion will likely be difficult to gauge through real-time data. It is possible that, unlike during the most acute phase of the pandemic when the economy was vacillating between lockdowns and partial openings, the re-opening of the economy will be on a steady upward trend with few significant reversals. But the pandemic has no precedents and there are still many unpredictable facets. At this point, it is too early for any trends to have really emerged and the data is still volatile. We think it likely that eventually the path of recovery will stabilise, but that the speed will not meet current expectations. In our minds there are two key uncertainties to the recovery that are likely to disappoint: (i) many jobs have been displaced during the pandemic, and it will take considerable time before they return; and (ii) the recovery of the global economy outside the US, where vaccination rates are low, and restrictions are still in force.

Figure 1: US Unemployment & Participation Rates

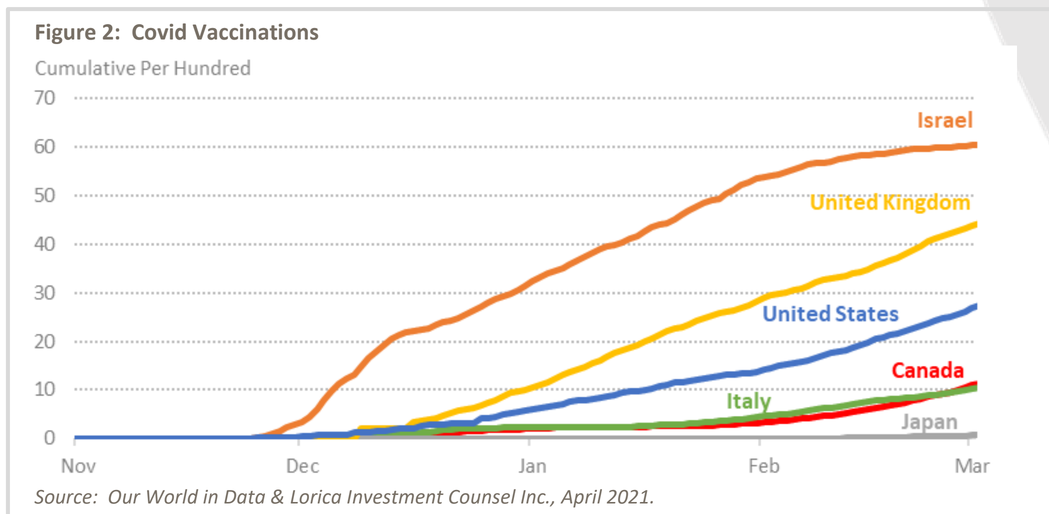


Source: Bloomberg & Lorica Investment Counsel Inc., April 2021.

Prior to the pandemic, US unemployment (U-3) was running at 3.5% and the participation rate was just over 63% (see Figure 1). While the participation rate was much higher in the 1990's and 2000's (66 to 67%), secular trends suggest that most workers that had left the labour force during the credit crisis and were going to return had returned. At the end of 2019 the unemployment rate was at a 50-year low and, although the notion of full employment has declined (Fed Governor Lael Brainard, speech February 24, 2021), it was evident that further progress on unemployment was slowing

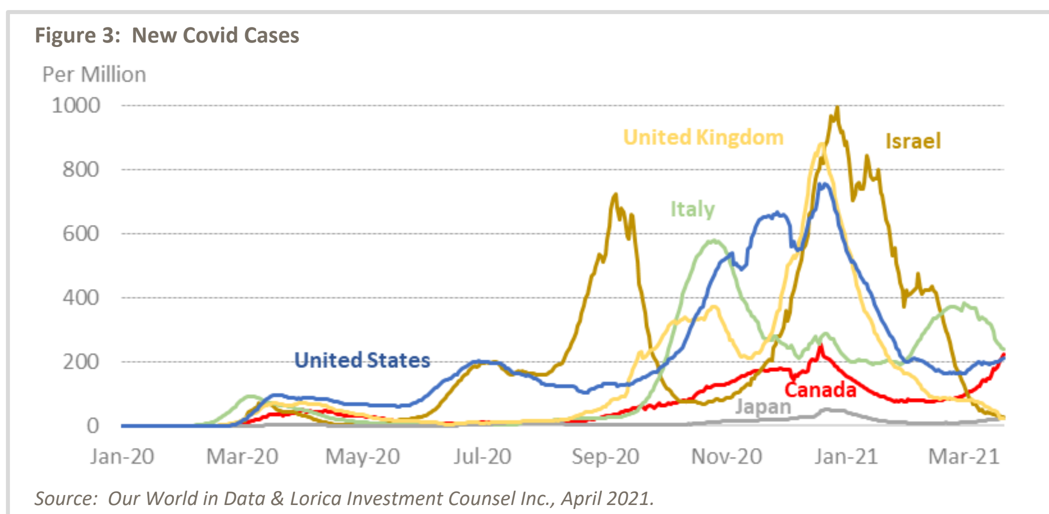
down. Following the initial lockdowns, the US unemployment and participation rates spiked to 14.8% and 60.2%, respectively, but have subsequently rebounded to 6.0% and 61.5%. Further gains are a certainty, however, after an initial jump, we think it likely that progress will be more gradual and drawn out.

While it is true that the US economy is more self-sufficient than most, there is still a significant portion that is dependent upon exports (around 12%). As long as the globe is still mired in the pandemic, global economic growth will be constrained, which will have an impact on the US recovery. The US vaccination rate (people with at least one dose) is now at 35% and rising quickly, Canada's vaccination rate is unfortunately only half of the US's, with the gap likely to increase over the coming weeks, as will be the case for much of much of the rest of the world. In fact, the worlds largest economies, except for the US and UK, all have vaccination rates lower than 20% (see Figure 2) and are not vaccinating rapidly enough to alter the picture before the fall, if not this year. It remains to be seen at what percentage of a country's population, vaccination will plateau and whether that level will prevent the emergence of further harmful variants and ultimately permit a return to normalcy – early results from the Israel and the US are promising.



Source: Our World in Data & Lorica Investment Counsel Inc., April 2021.

The US is mostly open for business with only a few states, primarily in the south-west, imposing businesses restrictions or stay-at-home orders (mask usage is still mandatory in the west and north-east). In contrast, much of Canada is in a state of lockdown, facing a third wave with virus cases (mostly of the British variant) still increasing. A quick glance at the Covid case chart (see Figure 3), suggest that the US has not faced a third – variant dominated – wave, and ultimately may not given rapidly expanding vaccinations. (There are early signs of the British variant spread in Michigan, Florida and Minnesota amongst others.)

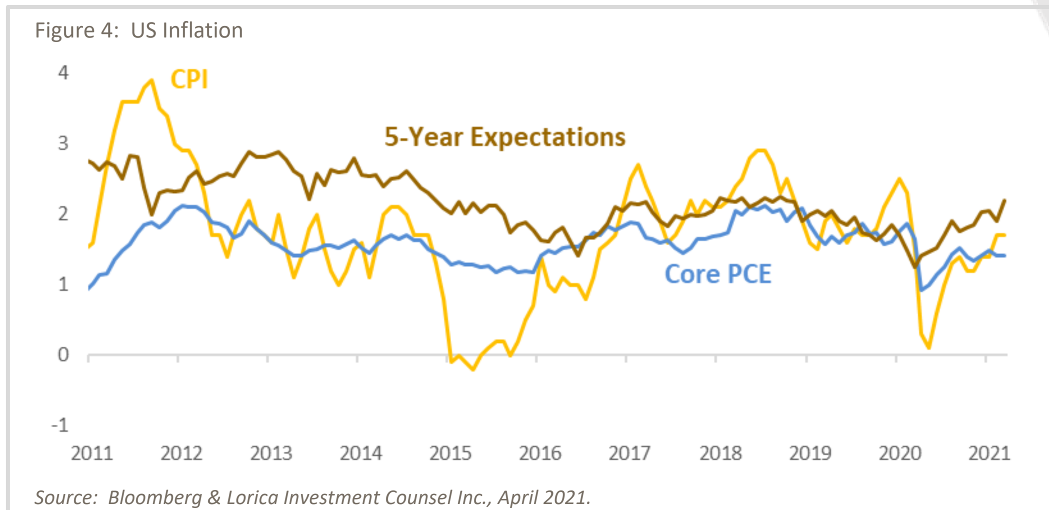


Source: Our World in Data & Lorica Investment Counsel Inc., April 2021.

It is too early to see how the Canadian and US economies will diverge, especially as the Canadian economy has continually outperformed expectations – over the last six months Canadian employment gains have averaged 74K per month versus 376K for the US. While the US unemployment rate is now 2.4% higher than before the pandemic, the Canadian rate is 1.8% higher – now at 7.5%. And, while the US participation rate has fallen significantly during the pandemic (see Figure 1), the Canadian rate has fallen only slightly to 65.2% from 65.5% prior. The different fortunes of the unemployed in Canada and the US is indicative of the varied protections offered workers and businesses between the two countries as well as other structural differences. Going forward, the deeper hole in the US suggests a larger and perhaps longer rebound, but also could suggest further adjustment ahead in Canada.

Besides the optimism for higher growth, there are also expectations of higher inflation (see Figure 4). US CPI was 1.7% YoY in February and the PCE Deflator was 1.6% YoY while the core PCE Deflator was 1.4% YoY. Before the pandemic, US inflation had been running steady with the PCE and PCE Core averaging 1.81% and 1.85% over the prior three years. Inflation expectations have risen to 2.11% after having fallen to 1.10% last year. There is no question that in the very short-term inflation rates will rise, as year-over-year comparables are easily surpassed. However, there remains a significant output gap in the US economy which will eventually restrain inflation after the base effects have passed – the St. Louis Fed's measure of the output gap was -3.19% as of December versus 0.99% twelve months prior.

Figure 4: US Inflation



Source: Bloomberg & Lorica Investment Counsel Inc., April 2021.

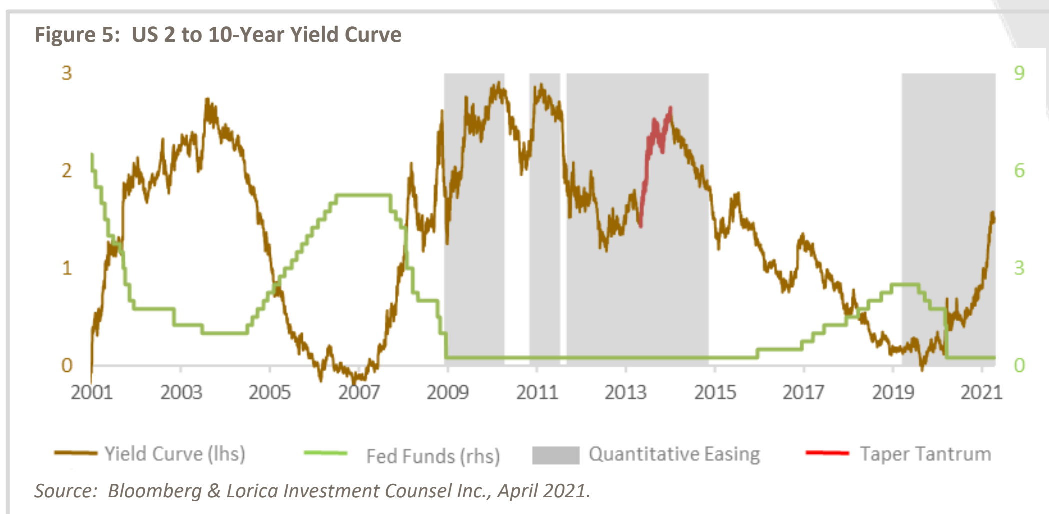
Ten-year US Treasury yields are now at 1.66%, off from the pandemic intraday high of 1.77%. As inflation expectations have risen, so have real yields – 10-year real UST yields are now at -0.67%, having risen by about 45 basis points from the pandemic lows. Notably, the Fed has maintained that it will not raise rates, despite anticipating "temporarily" higher inflation, until the output gap closes with lower unemployment. We do not expect that the Fed will be forced to reverse course. Investors appear to be taking the Fed at face value, at least for the next 12 months, but not beyond – over the subsequent 12 months expectations are for around three rate hikes, according to forward curves (Bloomberg). Twenty-four months is a long way out, but we would expect to see investors mute their expectations as unemployment declines more slowly than anticipated – a scenario we see as likely. We think this will translate to lower real yields across the yield curve. As for the Fed's QE program, we expect the status quo for the time being. We had thought the Fed would have been concerned with a steepening of the yield curve, but they appear not to mind, so long as the equity market doesn't either. With the S&P at an all time high, investors do not yet appear bothered by higher longer-term yields.

We would be remiss if we did not mention the ramifications of the aggressive fiscal policies that have been enacted in response to the pandemic. Countries have responded with a host of actions to support hampered businesses, furloughed and unemployed workers and implement programs to combat the pandemic. Vast sums of money have been borrowed to pay for the response. US debt to GDP is expected to rise from 79% (Dec. 2019) to 110% or more, depending upon additional spending plans, by 2023 (the Brookings Institution). Canadian government spending has kept pace with the US with debt to GDP expected to rise from 65% to 95% over the same period (the Conference Board of Canada). Much of government spending is unlikely to result in more than a one-time boost, e.g., household payments and healthcare, and it

remains to be seen whether infrastructure spending will be ample and timely. Finally, there is the question of taxes and what the cost of any increase in corporate or personal tax rates will be to the economy. Ultimately, we do not see either spending or taxes likely to be the cause of a sustained uptick to growth or inflation.

The slope of the US yield curve (10 to 2-years) is now at 150 bps, after reaching 162 bps last week, which is just 8 bps shy of the level last seen in 2015 – the steepest the yield curve has been since the "Taper Tantrums" (see Figure 5) of 2013. During the credit crisis the Fed had implemented several rounds of QE as well as its infamous "Operation Twist" to reduce longer term rates and stimulate the economy. The unemployment rate was slow to fall, and still at a lofty 7.9% at the end of 2012, prompting the Fed to explicitly target the unemployment rate (at 6.5%) with QE. As the unemployment rate declined to 7.5% by May of 2013, Chairman Bernanke indicated that the Fed would begin tapering QE. The "Taper Tantrums" ensued resulting in a knee-jerk backup of longer-term yields – 10-years rose by 1% and the yield curve steepened similarly. It took over a year, but eventually yields fell, and the curve flattened and then rose to the 170 bps (described above), only to flatten further with the rise in short term rates. Without the likelihood of another tantrum, and a secular move of inflation, we feel it is difficult to justify further steepening of the yield curve in the current environment.

Figure 5: US 2 to 10-Year Yield Curve



Source: Bloomberg & Lorica Investment Counsel Inc., April 2021.

Ten-year Government of Canada yields are trading slightly below those in the US at 1.50%, also off from the pandemic intraday high of 1.58%. Canadian real yields have also risen by about 45 bps from the pandemic lows to -0.28%. Despite, uplifting economic data, we do not see the Bank of Canada leading the Fed with a rate hike; rather the Bank has already relaxed its outright bond purchases, and could well also do so further, on a duration basis. We think that both the Fed and the BoC will be concerned with longer-term yields backing-up before the economy is ready, but the Bank's QE program was predicated on maintaining function of the bond market, which is no longer a main concern. Finally, we note the concern that low rates are propelling Canadian house prices to unreasonable levels and leading to house buyers taking on risky mortgages, but we have already seen a macroprudential response, and we expect that will continue to be the direction policymakers go in.

Buoyant equity markets and narrow credit spreads suggest that investors are both optimistic for the recovery and confident that monetary policy will remain supportive. In principle we agree with both, albeit perhaps not to the magnitude that is priced into the stock market. Equity valuations have risen as growth forecasts have been nudged higher, and as discussed above, may be overly optimistic. However, we are comfortable with the assumption that interest rates will remain low and continue to anchor the entire yield curve. A return to some semblance of normalcy for many businesses should serve to alleviate some of the business risks that vulnerable sectors have faced during the pandemic. However, that does not mean that all sectors will thrive post-vaccination, given the uncertainty surrounding the virus, vaccines, human behaviour, etc. and the divergent paths of recovery globally.

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