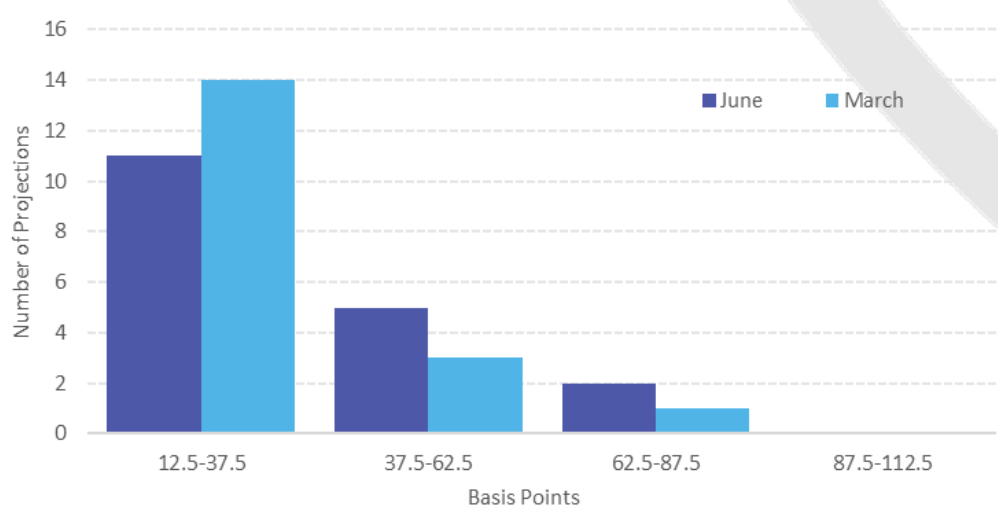
June 2021

What We Think…

At the end of Q1 it appeared investors were convinced that bond yields were heading higher as the post-pandemic V-shaped rebound was in play and higher inflation was going to be a direct corollary. Not so fast… Q2 revealed that after the knee-jerk rebound in employment, further gains would be more difficult, supply constraints would hamper growth and, perhaps most importantly, the rest of the world would be lagging the US recovery. Yields treaded water for much of Q2, but in July the yield curve started flattening such that US long bond yields are over 50 basis points below their March peaks of 2.45%; Canadian yields peaked in May and the 30-year yield is now about 40 bps below its peak of 2.19%. Although Canadian yields have generally tracked US yields, the 5-30's Government of Canada curve is about 30 bps flatter than the US Treasury curve.

Most of the decline in long-term yields has come from the fall of real yields (long US indexed linked yields have fallen below -0.2%) suggesting skepticism on the growth outlook and the wherewithal of the Fed to raise rates. Investors are now pricing in just over 50% probability of a hike by November of next year according to Fed Fund futures. Some commentators took the last FOMC meeting and press conference as indicative of a pivot by the Fed towards tighter policy. However, in our view, the dot plot estimates published by the FOMC revealed only a slight shift towards higher rates earlier, with only slight movements by 3 of the 18 members in 2022 (see Figure 1). In the week after the June meeting, there was a surprising number of FOMC members publicly expressing alternate views on the path of inflation and policy rates from that of Chairman Powell. We believe that the FOMC was trying to convey the dispersion of views within the Fed to maintain inflation fighting credibility, while still conveying a clear stance that inflation will remain on trend and thus require only gradual policy change. Interestingly, during the large yield decline to quarter-end, inflation expectations were roughly 40% (or 20 bps) of the move according to the Fed's 5-year, 5-year forward expectation rate. Expectations have since fallen another 10 bps suggesting investors are starting to gravitate towards a more benign inflation outlook.

Figure 1: FED Funds – FOMC Projections



Source: Summary of Economic Projections, FOMC & Cidel, June 2021.

INFLATION

It is hard for me to recall a time when the bond market was as polarized around the inflation outlook as it is today. The diverging views are fairly straightforward: is the current elevated level of inflation the beginning of a secular trend or is it just a temporary by-product of the imbalances created by the pandemic. There is no question that inflation is currently running hot – all measures are substantially higher than what we have seen for the last ten years. But the current data is particularly difficult to extrapolate given the acute shock to the economy caused by the pandemic and lack of historical precedence. Both the Federal Reserve and the Bank of Canada have positioned themselves on the "temporary" side suggesting that, longer-term, inflation will remain within target (with no immediate need to adjust policy rates).

We are also in the "temporary" camp. The current data unequivocally shows that inflation is well above target, but we believe factors that influence the medium to long-term are more likely to result in a reversion to the mean of the last ten years. In Figure 2, we show the key factors at the basis of the diverging views on inflation. Those that support rising inflation relate mostly to the immediate supply/demand imbalances that have been caused by the pandemic and the parts of the economy that have been most impacted. Whether it has been the rotation from the consumption of services to goods, or from leisure spending to home improvement, many of the factors that have caused supply shortages and subsequent price increases are far more likely to be transitory as pandemic-related behaviour fades and old consumption patterns resume. In contrast, those factors that suggest an eventual return to more moderate levels of inflation will not readily change including employment, consumer debt and weak global growth.

Figure 2: Rising Inflation: Start of a Trend or Temporary

Start of a Trend	Temporary
Tight commodity supply	High unemployment / low participation
Shortage of qualified workers	Consumer indebtedness
Higher capacity utilization	Goods-to-service rotation
Easy monetary policy	Weak global growth
Supportive fiscal policy	Temporary adjustments

Source: Cidel, June 2021.

Perhaps the area causing the greatest concern for those worried that inflation has already taken off is commodities. Accelerated demand for commodities related to durable goods, automobiles, housing, and the like has resulted in supply-demand imbalances. In many cases, demand has grown due to a temporary shift in consumption – either through timing or magnitude. For example, automobile demand, which declined significantly during the early quarters of the pandemic as rental agencies reduced their fleet and employees worked from home, has subsequently rebounded as travel and commuting have picked up. Another example is the switch from leisure-related services to goods (e.g., gyms for exercise equipment) which has temporarily increased goods spending, but which will likely abate as many purchases are one-time and service demand resumes. We think that the demand for commodities underlying much of this consumption will not take long to moderate. On the other side of the equation supply has been impacted by temporary and isolated factors including pandemic-related manufacturing shutdowns, pandemic-inhibited capital investment and shipping backlogs (Suez Canal). Here we see an eventual improvement as one-time factors disappear, and the demand picture offers more clarity for capital investment.

Housing-related supply-demand imbalances are more difficult to predict. While low interest rates and government subsidies combined with reduced household consumption enforced by stay-at-home policies have supported spending on new homes and renovations, it is not clear how quickly that spending will revert to pre-pandemic levels. We expect there to be some level of demand that relates to lingering pandemic-induced preference for single-family dwellings over multi-unit residences (condos). However, we are inclined to believe that broad housing-related consumption will ultimately shift back to trend, as more normal service demand (vacations, restaurants, haircuts - for those having not gotten backyard visits, etc.) resumes, subsidies disappear, and households reduce spending related to their homes. The current housing data, while showing an upward trend (housing starts and building permits), has been particularly volatile and of limited use. The supply of housing will not adjust rapidly to demand due to insufficient resources – both labour and materials, and therefore has the potential to be inflationary as builders continue to play catch-up.

CREDIT

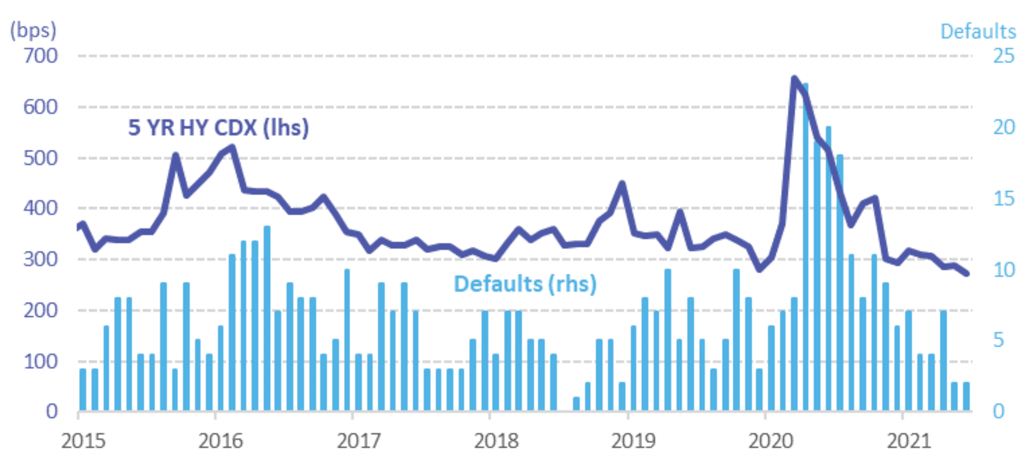
With the Fed signaling "no change" to interest rates (and the Bank of Canada tacitly in agreement) credit markets continue to have an unrelenting, yet somewhat predictable, bid. US and Canadian investment grade yield spreads (according to the Bloomberg Barclays US Corporate Bond Index and the FTSE Russel Canadian Corporate Bond Index, respectively) are at their post-credit crisis lows and just shy of their pre - crisis lows (see Figure 3). In a replay of the post-credit crisis "easy monetary policy" environment, risk assets are being "protected" by central banks and investors are obliging. There was a momentary blip in March, when credit spreads edged 10 bps wider (according to the US index), as expectations of tighter policy began to take hold, but the subsequent policy assurances from the Fed precipitated a reversal and an additional 10 bps narrowing. Canadian spreads have followed a similar pattern.

Figure 3: US & Canada Corporate Mid-Term Yields

Source: Bloomberg Barclays US & Canada Corporate Bond Indices & Cidel, June 2021.

Although the economic recovery from the pandemic is likely to remain volatile, credit defaults that surged last year appear to have peaked and are now on their way down. Credit default swap levels which were elevated in the spring of 2020 have fallen back down close to pre-pandemic levels; and according to S&P, US speculative-grade defaults have fallen to levels last seen in 2018 (see Figure 4). There is still the possibility that as fiscal policy support declines, if inflation rises structural problems may appear leading to a resurgence of defaults. However, we are inclined to believe the longer central bank support remains in place, businesses will have a chance to rebuild their balance sheets.

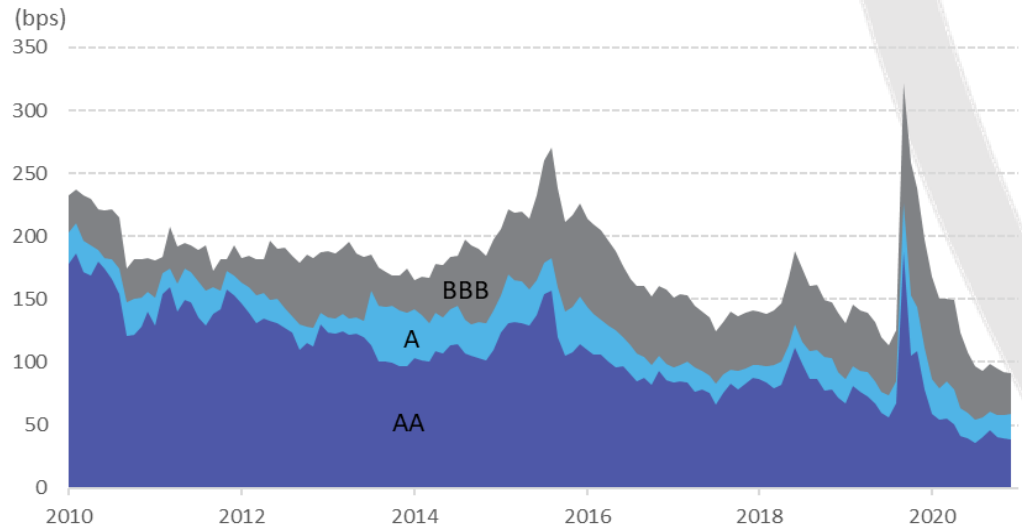
Figure 4: US 5-Year High Yield Credit Default Swap Index & Speculative Defaults



Source: Bloomberg, S&P Capital IQ & Cidel, June 2021.

Notwithstanding the current improvement in default rates, we would be remiss if we were to ignore that the risk/reward relationship in the corporate bond market, particularly for distressed debt, is relatively poor from an historical perspective. Although underlying government yields are off their historical pandemic-lows, tighter corporate yield spreads mean that corporate breakeven yields are not far from their historical lows of last December. (Note that breakeven yields are the amount that yields can rise before capital losses overwhelm the running yield for debt securities. Generally, breakeven yields are higher the shorter the term and the lower the credit quality.) However, in today's environment with a relatively flat yield curve and spread contraction across credit tiers (see Figure 5), breakevens are not overly attractive across the board. Nevertheless, so long as monetary policy remains supportive, we would still advocate holding substantial exposure to corporate bonds with a preference for shorter term, higher quality liquid issues.

Figure 5: Corporate Spreads



Source: Bloomberg; Bloomberg Barclays Canada Corporate 3-5 Year Index & Cidel, June 2021.

The Pandemic

This is the first commentary in six quarters where we have not framed the prospects for the economy as revolving around the prospects for the pandemic. But that might be overly optimistic. The pandemic is not over by a longshot, even if the lockdowns are, at least in the US (and likely for good). In Canada, lockdowns will end soon, although we are not as emphatic that another will not return. The pandemic is still roaring in other parts of the globe, and variants may yet be a problem in North America, especially in under-vaccinated regions. The fact that many countries vaccination programs are still in their early stages or vaccine hesitancy/resistance is prevalent, and case counts from variants are relatively high means their economies will continue to suffer and impart knock-on effects on North American economies.

We see the US and Canadian economic recoveries both split into two parts: the first part being domestic recoveries related to the sorting out of imbalances created by the pandemic and related policies, together with reversion to longer-term trends; and the second part the ongoing pandemic, which is still preventing many economies globally from embarking on recoveries. In the US, we have had the initial post-lockdown bounce, and are now witnessing a more moderate follow-through. The supply/demand imbalances, discussed earlier, will cause domestic growth to remain volatile through the balance of this year and part of the next, but we expect will eventually level off to something resembling pre-pandemic levels. Slow recoveries globally will not be supportive as foreign demand for exports will continue to be negatively impacted by the pandemic. Ultimately, we believe that the acute V-shaped US economic recovery, that many assumed at the end of Q1, no longer seems valid. We would expect to see a similar economic bounce in much of Canada this summer, but here too, the follow through will be disappointing.