LORICA

What We Think…

June 2022

Higher Prices, Rates and Wages…

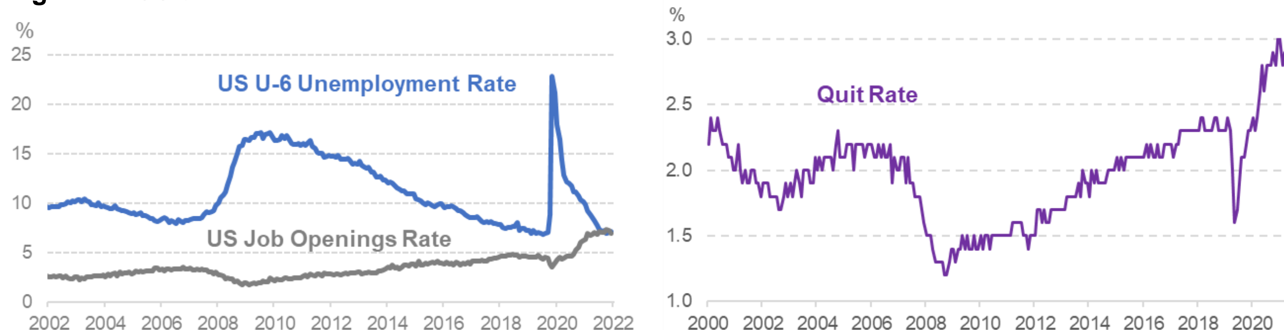
The rise of consumer prices and interest rates this year has been abrupt. Conventional wisdom would suggest that consumer spending will slow, and with it, North American economies. The bond market believes the slowdown will be some time next year – Fed Fund futures currently peak in March and indicate a rate decline by July. We are not so sure. We think the consumer is going to prove resilient, which will keep economies going past the end of 2023. Balance sheet improvements made during the pandemic have not been fully given back and further wage gains are likely. Stubborn inflation will necessitate that NA economies eventually slow materially, very possibly into recession. But we think that is still at least a year and a half off. In the meantime, get set for more bond market volatility and lots of false signals.

The pandemic has meant that traditional economic indicators have proven less useful than usual (which admittedly doesn't say much). The peaks and troughs of commodity prices, goods supplies, employment, etc., brought on by the pandemic and further aggravated by the Ukraine war, are still embedded in the economic data. It has become impossible to discern between trend signals, left-over economic imbalances, and distortions in the data. Capital market moves have been large – the bond market sell-off has been the largest in 40 years – and corrections have also been large, but policy moves have been the largest in 20 years and have caught investors off-guard (years of relatively benign policy will do that).

Since it became accepted (by the Fed) that current inflation pressures are not transitory, investors have had to deal with the rise of inflation, and central banks' reactionary responses, in earnest. Although policy rate increases have been aggressive, we think the lag between action and economic response will be longer than anticipated. The US economy is still overwhelmingly domestic consumer driven and consumers are coming off a long period of easy money and forced savings, that has allowed them to improve their balance sheets and delay the impact of higher borrowing costs. More importantly, almost any worker who wants a job has one and, despite some decline in job openings, there are still more vacancies than unemployed workers. The current labour shortage and the pressures of inflation expectations are resulting in nominal wage gains, although real wages have not grown.

We believe we are still in an environment where workers are in position to pressure wages higher and are actively doing. The US U6 unemployment rate (a broader measure of unemployed which includes marginally employed and economic part-time) has been overtaken by Job Openings for the first time and the Quits Rate is the highest ever (see Figure 1). We expect the supply and demand of labour to eventually revert to a more sustainable equilibrium, but in the meantime, wages will continue to rise. Anecdotally, new hires are receiving significant increases, that have yet to translate to incumbent workers – increases, we believe are still to come. Employers are going to be stingy with giving raises, having been unaccustomed to cost of living adjustments over the last few decades. But as long as job openings remain high, employees will negotiate with their feet and employers will have no choice but to respond, or deal with unproductive turnover.

Figure 1: US Jobs Market



Source: Bureau of Labor Statistics & Cidel Asset Management, July 2022.

Long-term inflation expectations had been well-contained for the better part of the last forty years. “Relative” peaceful relations amongst world powers, expanded commodity supplies, and supply chain innovation have allowed globalization to flourish and contributed to low and stable inflation. Monetary policy has ostensibly smoothed periodic inflationary episodes, although the pressure on central banks more recently, has been to prevent deflation. However, the pandemic has provided and unanticipated dose of reality, as dislocations to the economy from uneven commodity supply, arrested supply chains, and locked down workers, have resulted in the highest rates of inflation since the 1980’s. Perhaps, more importantly, the pandemic has revealed troubling underlying structural issues that have long-term growth and inflation implications: the vulnerability of globalization, weak labour demographics, and the demands of the environment amongst others.

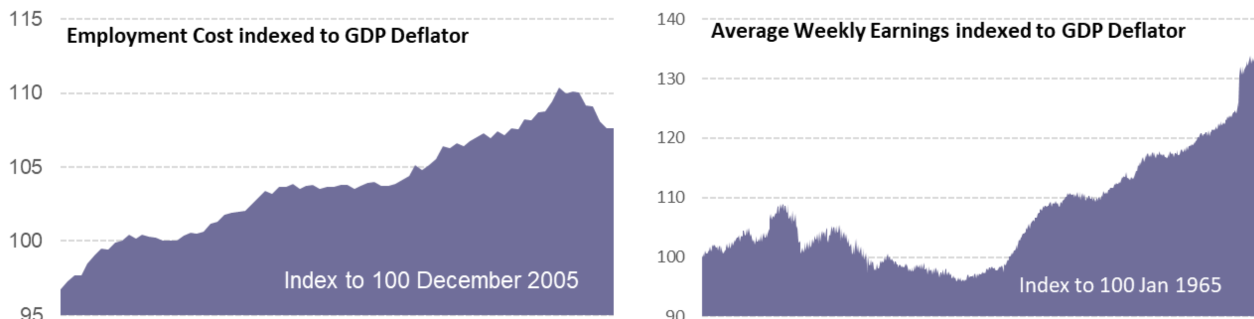
At the beginning of the pandemic, inflation tumbled as lockdowns and the temporary fall in employment cut consumer spending sharply. But consumption – especially for goods – rebounded, supported by stimulative monetary and fiscal policies. Unfortunately, the supply of goods, and now services, have not been able to keep up with the demand, resulting in sharply higher inflation. Two years from the trough of inflation, we are yet to see a convincing decline of inflationary pressures. We expect that commodity shortages will eventually dissipate, and supply chains will be mostly repaired, albeit susceptible to deglobalization trends, but worker imbalances will likely continue to be problematic. Developed countries face ongoing labour shortages arising from a bulge in retiring workers, insufficient immigration, the demands of “on-shoring”, and the rise of ESG concerns.

Markets are grappling with how quickly rising rates will translate into slower growth and less demand for labour. Without an easing of labour demand, we believe inflation pressures are unlikely to dissipate. There are signs that consumption is slowing, but how much of the slowdown is being driven by inadequate supply versus higher prices and higher borrowing costs is difficult to now. When building materials, appliances and trade workers are in short supply, is new home construction being held back by costs, financing, or availability. And when travellers cancel their trips, is that because of lack of rental cars and baggage handlers or because of higher air fares and hotel rates. We think as long as the majority of workers are employed, they will continue to consume, albeit on a more drawn-out schedule, as supply takes longer to materialise.

We think a more important question is how constraining is the current decline of real wages. The chart (see Figure 2) of the Employment Cost Index (ECI) adjusted for inflation (GDP Deflator) shows significant deterioration of real wages over the last 24 months. However, there was also a sharp acceleration of real wages early on in the pandemic; it was only fully erased by the end of 2021. Real wages are now at levels last seen at the end of 2018. The distortions created by the pandemic make it difficult to assess how dramatic the current decline of real wages in fact is. According to the ECI, we have not seen a fall in real wages anywhere close to the recent fall (-2.21% yoy to March) over the twenty-year history of the ECI. However, the decline against March 2019 is -0.5%, not much below declines seen in September 2011 and March 2006 (not recessions). There is no question that even a 0.5% decline of real wages from 2019 levels, suggests that workers are worse off than before the pandemic. However, there were significant pandemic policy responses that would have mitigate the loss of real wages, including near-zero interest rates and fiscal policies.

A longer-term chart of real wages shows US Average Weekly Earnings (AWE) adjusted for inflation (GDP Deflator). Similar to the chart of real ECI, real wages shown to have risen fairly steadily for the last twenty years, with the exception of the pandemic period. However, looking further back, we saw steep declines in real wages between 1973-75 and again between 1987-82 – both periods when the US went into deep recession. To date, Real AWE have not fallen below pre-pandemic trends; however, should inflation continue without corresponding wage gains, that will no longer be the case. We believe that further steep declines in real wages will be a good signal of imminent recession.

Figure 2: US Real Wages



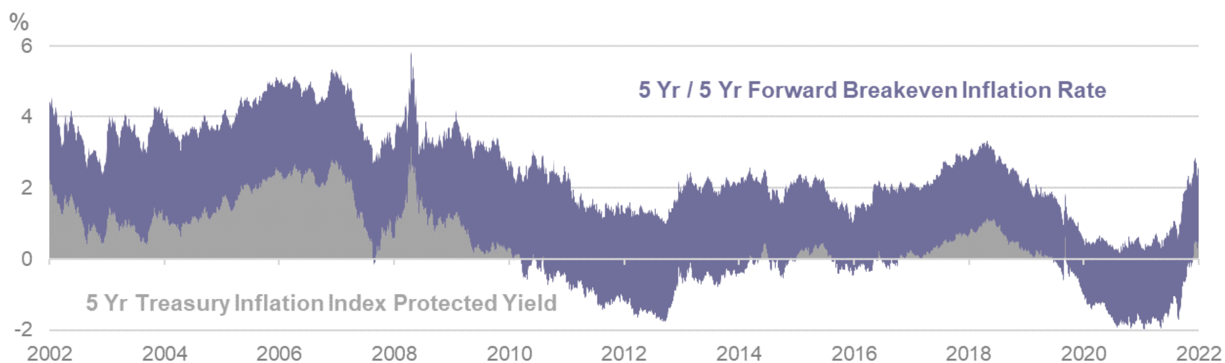
Source: Bureau of Labor Statistics & Cidel Asset Management, July 2022.

YIELDS & YIELD SPREADS

For the time being, longer-term US and Canadian bond yields appear content to trade in a range (10-years between 2.90% and 3.40%) that is just below the top of explicit policy rate guidance (dot plots) from the Fed and indications from the Bank of Canada. It seems that presently there is broad acceptance that policy rates will peak at 3.5% in both the US and Canada, and that will be sufficient to slow demand and bring inflation down to sustainable levels. Conversely, it may be that investors expect the supply-side factors that have been contributing to inflation to right themselves by the time rates hit their peak. The uncertainties of the pandemic make all of this difficult to predict, but we are generally doubtful that the economy will slow so quickly, and not without material labour market destruction. We are more concerned that a round of wage increases will maintain upward pressure on inflation.

We have witnessed the worst half-year performance for the US bond market since 1981, -10.35% according to the Bloomberg US Aggregate Index. In 2020, the US Agg returned an outsized 7.51%, due to the pandemic and the precipitous lowering of rates and implementation of QE by the Fed; the next year the index returned -1.54% as rates rose slightly with little yield. It is reasonable to interpret a substantial portion of this year's losses as reversal of the outsized capital gains of 2020. With the sharp reversal of monetary policy, real yields have risen from the lows that persisted from early-on in the pandemic until the first quarter of this year, to beyond pre-pandemic levels (see Figure 3). The balance of this year's losses has been the result of real yields rising to levels last seen in the first quarter of 2019, and the expansion of inflation expectations. Notably, inflation expectations, which had risen from their pandemic-lows and peaked at just over 2.5% in April, have now fallen to just over 2%.

Figure 3. US Real Yields & Inflation Expectations



Source: Bloomberg & Cidel Asset Management, July 2022.

Despite the rise of current inflation, the Fed appears to have regained its credibility… it was precarious for a stretch. Larger-than-normal (or recent) rate hikes together with the clarity of forward guidance (not a tool used in past inflationary episodes) and the abandonment of flexible inflation policies (nary a mention) have drawn longer-term expectations close to 2%, despite some challenging structural factors. However, it remains to be seen how quickly current inflation will fall, especially given simmering wage pressures.

The rise of real yields, while a necessary consequence of raising rates to reduce inflation, has many investors concerned that lower demand will ultimately mean higher unemployment, with a recession not far off. There is no question that the abrupt rise of real yields is a shock for households who had gotten accustomed to the easy money of the pandemic. But in reality, real yields are still below the peaks of the last ten years and not much above the pre-pandemic average. For reference, 5 and 10-year TIPS are trading at 0.5% and 0.63% versus the peaks of 1.16% in November 2018, and 5-year averages between 2015-19 of 0.2% and 0.47%. In that context, how constraining are real rates or how long will it take real rates to be constraining?

Government yield curves in the US and Canada are very flat, with slight inversions – the 2 to 30-year curves are -2 and -23 bps for the US and Canada, respectively. Both curves flattened by 12 bps following the Bank of Canada's 100 bps July policy rate increase. We believe that yield curves imply a significant slowdown ahead. Fed Fund futures are priced for a reversal of Fed policy rates in the second half of next year – we think this is premature. The calculus that investors are making is that the dual impact of rising prices and rates will engineer a slowdown that central banks will smooth by subsequently lowering rates. We think the timing is further off and that the longer it takes for indications to emerge that inflation is dissipating, the less likely the slowdown will be smooth. We expect yields to be volatile, as investors look for indications that the economy is slowing and for lower inflation – investors are accepting that this will happen around the time that policy rates peak in the Q2, next year. However, we are seeing more forceful manoeuvres from the central banks which could upend the timeline and trajectory of policy rates. We are content to maintain shorter duration in our portfolios as we still perceive risk of higher yields.

Credit markets appear to be taking the rise in bond yields and the potential for slow down or recession with cautious optimism. High quality corporate yield spreads have widened, and new issue markets have thinned, but the damage has been contained. In the high yield market, where spread widening has been the most acute, levels are still well below wide levels seen during other periods of economic stress. Given, our belief that the economy will trudge along, albeit slowly, we are comfortable with spread levels for higher quality corporate bonds, but prefer to minimize exposure to riskier, longer duration positions.

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