Connor, Clark & Lunn
INVESTMENT MANAGEMENT

OUTLOOK

SEPTEMBER 2022

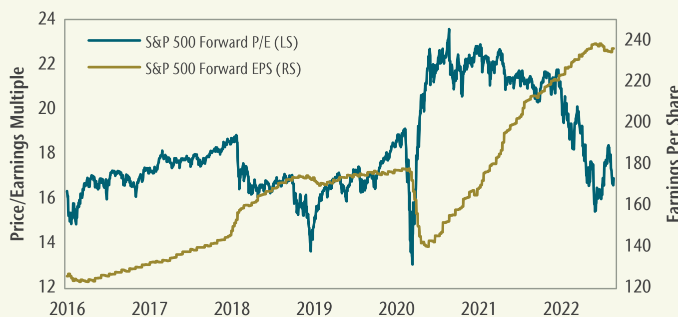
A little de-risking. Markets have been selectively absorbing news through the summer, rallying when inflation edged off its highs or when Federal Reserve (Fed) Chair Jerome Powell raised the possibility of a slowing in the pace of rate hikes. Bad economic news was cheered as helping to ease the Fed away from aggressive policy. We argued that there is still a great deal of work ahead to bring inflation down to target and time required for effects to be fully realized. Some corners of the market have come around to that thinking, for example, in the US bond market, rate cuts totaling about 0.75% by the end of 2023 have been pushed off into 2024. However for equities, even with the selloff at the end of last month, this is less clear.

Year to date, equities have sold off steadily, but much of that move reversed over the summer. It is notable that those moves have been almost entirely due to changes in valuations, not earnings. The forward price-to-earnings ratio (P/E) for the S&P 500 de-rated by about 20% from about 20x in January to 16x in June; during the summer rally, valuations recaptured 6% to end August at 17x (see Chart 1). The move in valuations in turn closely followed the sharp rise and then leveling off in interest rates, reflecting the change in the cost of capital. There was no increase at all in the equity risk premium (a measure of the excess return associated with investing in stocks versus a risk-free asset), which should have adjusted to the tightening in financial conditions, high inflation and slowing economic activity.

Earnings forecasts have also been remarkably resilient. The consensus estimate for S&P 500 earnings has only edged down 1.5% from its peak, stabilizing at roughly $240 in 12 months (see Chart 1). This implies an increase of about 8% over 2022, which in the context of higher rates appears to us to be overly optimistic. Operating margins have also been resilient through this period at about 13% (see Chart 2), holding in above the average of the past five years, which itself has been a period of strong margins. Notably though, margins in the energy sector are substantially above their long-term average. In Q2, overall S&P 500 earnings grew 6.3% y/y according to data from FactSet, but excluding the buoyant energy sector, earnings would have declined by 4%. Indeed, cyclical sectors, such as financials and consumer discretionary, posted large declines of 23% and 18% y/y, respectively, in Q2. Given the lag with which policy works to slow activity and top line growth, the move by companies to guide earnings lower likely only just began in Q2.

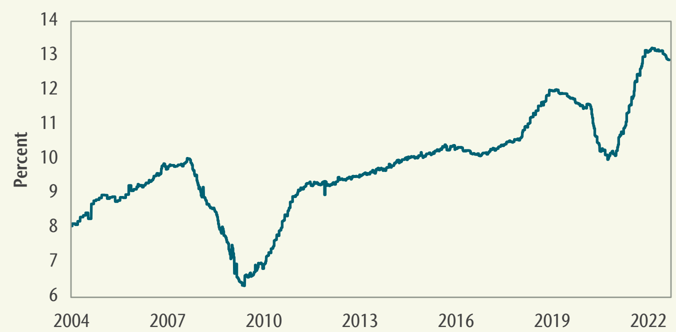
As we wrote in our June *Outlook*, one of the biggest hazards to risk assets is that we have not yet seen the downgrades to earnings revisions that typically accompany an economic recession. While there is a high level of uncertainty within the current environment, we know that a slowdown in activity is coming. Leading indicators such as the ISM New Orders to Inventories ratio and the Conference Board's Leading Economic Indicator (LEI) are reflecting the aggressive actions by the central bank to reduce demand across the board in order to control inflation. We are currently in an interim period, where past central bank actions have only hit the most interest rate sensitive parts of the economy, and the full impact is not yet visible. Looking back over historical periods of US recessions since 1928, on average, earnings fall by 30% during a downturn, so downside risks to the outlook for risk assets remain elevated.

Chart 1: Valuations Rebounded, while Earnings Remain Elevated



Source: SPDJI, I/B/E/S, Macrobond

Chart 2: Resilient S&P 500 Profit Margins



Source: I/B/E/S

GLOBAL INFLATIONARY CONCERNS

While we have focused in recent months on the core problem of high inflation and the proposed remedy of tighter monetary policy, there are many issues orbiting inflation around the world. Numerous countries are seeing high food and energy costs, resulting in protests and work stoppages in an effort to force higher wages. China's outlook continues to weaken due to the ongoing contraction in its property sector. Despite lower benchmark borrowing rates, demand for new homes is cratering given risks with developers. The most recent lockdowns to control COVID in large cities across China also bodes ill for a rebound in goods production and shipping.

In Europe, markets believe the ECB needs to tighten policy significantly, even though inflation is far from being demand-driven (the kind of inflation that central banks can actually deal with). Europe is dealing with a different kind of high inflation than is the case in North America. Inflation is largely driven by an energy shortage, where natural gas prices, to take one example, have surged almost threefold this year in Europe. This in turn is showing up in German producer prices that are up a massive 37% y/y in August. In the UK, newly minted Prime Minister Liz Truss has made her mark by promising radical fiscal expansion, including cutting taxes, raising spending and boosting economic activity by running large fiscal deficits. Joining in is Germany, which is looking at a 65 billion euro relief plan in response to higher utility costs. Ultimately, these policies imply even tighter monetary policy than is currently priced in. Said another way, fiscal policy now appears to be working against monetary policy as governments work to mitigate the effects of inflation.

Our problem today can be traced back to past policy actions. A recent study[1] estimated that about half of the increase in US inflation (4pp of CPI) was due to "fiscal inflation" from the 2021 stimulus package, whose announcement feels so very long ago and speaks to the long lag from policy to the economy. While fiscal policy may be exacerbating the problem, monetary policy is drawing on more tools, notably faster quantitative tightening (QT). On September 1, the Fed began to allow roughly $95 billion of bonds per month to run off its balance sheet, double the pace of the last 6 months. For context, only about $100 billion of balance sheet reduction has been done so far this year; and during the last period of QT, in late 2018, a grand total of $343 billion rolled off. Taken all together, inflation is a problem that is being taken seriously by policymakers, in a variety of ways. Ultimately, interest rates are in a higher range, earnings should ease and liquidity is drying up, each of which raises concern for risk assets.

CAPITAL MARKETS

After a difficult first half the year when equities fell 20%, stocks have rebounded strongly through the summer, reversing about half of those declines. Most recently, August was a mixed month overall, with the rally in stocks reversing mid-month. In aggregate, equity markets overall ended down for the month. The S&P 500 posted a 4.1% drop for August, with a similar decline on the Nasdaq, while the S&P/TSX Composite fell 1.6% and the MSCI ACWI dropped 2.9% in local currency terms.

The initial positive sentiment was pushed forward by a benign read of US headline inflation that fueled expectations that inflation was peaking, thus leading to a possible easing in policy. However, the optimism turned sour after a series of Fed speakers stressed the need for higher interest rates, culminating in Chair Powell's speech at the Jackson Hole Economic Symposium. He made it clear that fighting inflation would cause "pain" and require restrictive policy for a period longer than markets were pricing in. More specifically, he pushed back on the market's anticipation of rate cuts in 2023.

Similarly, even though the BoC has been quiet through the summer after the outsized 1% hike in policy rates, any market optimism over softer CPI data in Canada was dashed with an op-ed penned by Governor Macklem in a national newspaper asserting that high inflation required forceful actions. Specifically, he warned that absent the fortitude to hike aggressively, a worse slowdown would follow. Thus, after a reprieve during the summer, sovereign bond yields jumped another half a per cent with larger increases at the shorter end of the yield curve (2-year yields up about 70 bps vs. 48 bps at the 10-year term), further inverting the yield curve. Provincial bond spreads were also wider and in combination with higher sovereign yields left the FTSE Universe Bond Index down 2.74% for the month.

PORTFOLIO STRATEGY

The next few quarters will see numerous challenges around the world. Regardless of the specific issue confronting individual countries, most are combatting higher inflation and higher interest rates while at the same time are trying to limit the fallout to individuals, in some cases via fiscal spending. We believe central banks will remain singularly focused on inflation, tilting the balance of risks towards a worsening economic outlook. Markets are coming around to the slowing in economic activity but have been slow to price in declines in earnings. And while we have been in a bear market this year, the selloffs that lead to a market bottom typically come from both EPS estimates and forward P/Es declining in tandem, such as in both 2000 and 2008.

[1]Bianchi, Francesco and Melosi, Leonardo, Inflation as a Fiscal Limit (August 30, 2022). FRB of Chicago Working Paper No. 2022-37, Available at SSRN: https://ssrn.com/abstract=4205158

Equity valuations, even during the mid-June sell off, were in the range of fair value. Any sustained upside for equities will not begin until economic activity and earnings estimates begin to reaccelerate.

As a result of this challenging environment for risk assets, we have shifted balanced portfolios to a more defensive position following the summer rally. Today's elevated earnings imply limited upside and the potential for considerable weakness should earnings start to reflect the slowing activity that we expect. Thus, the risk versus reward outlook favoured reducing equities to an underweight. This was done by reducing the modest overweight to Canadian equities and maintaining the underweight to global equities. The allocation to fixed income was increased as we trimmed the underweight to bonds, while maintaining a modest cash position. Fixed income markets have been anchored by the steady drumbeat of central bank rate hikes to around or just below the 4% range at the shorter end of the curve, and yield curves are at their most inverted in about 20 years. It is hard to see that move deepen much further unless central banks determine a need for a much higher terminal policy rate in this hiking cycle, and so we have reduced active exposure to the yield curve. Equity portfolios continue to be defensively positioned, with a focus on companies with resilient earnings and strong balance sheets that can withstand the slowing in overall activity. Caution is warranted, and we are reducing risk in favour of defensive positioning as we head into choppy waters.

Source: MSCI. The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. MSCI makes no express or implied warranties or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. This report is not approved, reviewed or produced by MSCI.