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Investments

2021 Mid-Year Capital Markets Outlook

Executive summary

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Let's begin

Executive summary

Everything that we survived. It's gonna be alright. Just lucky we're alive. Got no vision, I've been blind. Searching everywhere. You're right here in my sight.

Hands on a miracle. I got my hands on a miracle. Believe it or not, hands on a miracle. And there ain't no way. I'll let you take it away.

- Foo Fighters. In Your Honor (2006), lyrics to "Miracle"

The healing has begun

The race between containing the COVID-19 virus and its variants versus vaccine rollout and efficacy is being won by the miraculous work of scientists and health care workers. However, equity markets and commodity prices have moved a long way toward pricing in this optimistic scenario.

While "peak everything" may be near, the size of the mountain matters. There is still growth in economic activity and earnings, but the rate of change is moderating. **Markets prefer positive and growing data – but they can live with stabilizing metrics. It's just that stability generally doesn't drive the kinds of double-digit appreciation in stock prices we have seen – it likely leads to more modest gains.**

The environment is likely to remain supportive as monetary policy is only beginning to tighten at the margin; it remains very accommodative. Fiscal spending is poised to continue flowing, and pent-up savings should be released as people venture out. There is also the elongated inventory cycle due to the surge in demand for goods while services were significantly restricted during the pandemic lockdowns. Businesses have a long way to go to restock inventories, and this is a positive for sustainable demand. In the face of upward pressure on bond yields and narrow credit spreads, **we see equities outperforming bonds over a six- to 12-month time horizon.**

Our base case scenario is one where earnings growth does deliver, and the disease is kept at bay. However, the path to that outcome may face some setbacks and disappointments along the way. Should a bout of volatility arise, balanced investors will be thankful for some exposure to the safest of fixed income assets.

Miraculous surprises!

Pandemic winners are expected to keep on winning. The measures taken to save businesses and households appear to have worked (with little regard for the size of the tab).

Pandemic losers survived! And have been coming back strong. For many of the hardest-hit companies (airlines, hotels, car rental, hospitality), first, simply managing to survive was an upside surprise! Then came the reopening trade, as share prices rose from the ashes on early signs that once reopening is allowed, a robust recovery in leisure and hospitality would follow (at least for some period) as the public returns in earnest to make up for lost time.

Government spending is going to continue. Despite spending trillions to combat the pandemic, governments are emboldened to spend even more. Companies will be happy to soak up the government's largess. Should the bond market vigilantes come out of hibernation and push yields too high, it could be a rude wake-up call. Indeed, what may placate the bond market (higher taxes) is usually not welcomed by stocks.

Peak everything

Now that we are lapping the worst of the economic damage from 2020, it is time to contemplate how capital markets will react if the good news peaks, the rates of positive change peak, and the injection of emergency monetary and fiscal stimulus peaks. **Going forward, the magnitude of the upside surprises that equity markets have enjoyed appears challenging to replicate.**

Risks on the other side of the mountain

Equities have come to expect the support of central bankers and government intervention. **The removal or moderation of these supports is a potential hurdle for risk assets and creates some uncertainty around the path of the economic cycle.**

There is also the question of whether supply chain issues and labour shortages will persist to the extent that markets would need to price in adverse outcomes. **These negatives include margin pressure due to rising costs** for enterprises **or sharply tightening monetary policy** due to untethered inflation expectations.

On the disease, we are not yet out of the woods. In the near term, **uncertainty exists around COVID variants. There is a risk that a COVID-19 variant breaks through and causes a setback. We see this more as a tail risk**.

Asset mix: Slight overweight equities vs. fixed income

We hold a long-term constructive view on risk assets. Economic activity is forecast to be above average through 2022. An improving labour market, rising wages and future drawdown of very high savings rates bode well for robust aggregate demand – a positive environment for risk assets.

The Mackenzie Global Investment Committee recommends a slight overweight to equities relative to fixed income, with the **equity overweight concentrated in Canadian equities**. Within fixed income, we recommend **underweighting sovereign credit**, with a bias toward domestic fixed income and short duration. Furthermore, we recommend a further reduction in sovereign bonds **favouring a slight, equal overweight to investment grade credit and high yield credit**.

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Asset mix recommendations

Equity

	Under			Neutral			Over		
Equity	○	○	○	○	○	●	○	○	○

We feel equities reflect a fair degree of optimism; future positive surprises will be harder to come by, leaving equity markets fragile. Most markets are overdue for a normal correction (~10%). Should that scenario unfold, we would be buyers of risk assets. While earnings growth is expected to be robust, we see the peak for upward revisions closing in and expect valuations to compress. We do see a robust economic environment capable of delivering expected earnings into 2022.

	Under			Neutral			Over		
Canada	○	○	○	○	○	●	○	○	○

Canadian equities provide higher exposure to global growth. The value and cyclically oriented sector composition is favourable in an economic recovery, rising yield, rising commodity price environment. The TSX trades at a P/E multiple discount relative to the S&P 500 and offers an attractive 2.6% estimated dividend yield.

	Under			Neutral			Over		
US	○	○	○	○	●	○	○	○	○

We expect solid S&P 500 earnings reflective of strong GDP growth. This will be necessary to offset likely downward pressure on margins from rising input costs. U.S. equity valuations remain elevated, and hence we expect overall US equity returns to be positive but moderating with opportunities more selective than over the last twelve months. The 1.4% estimated dividend yield is modest relative to other markets.

	Under			Neutral			Over		
International	○	○	○	○	●	○	○	○	○

International developed market equities are expected to perform well in a pro-cyclical economic recovery scenario due to their more value, cyclical, industrial and global trade-oriented exposure. Tailwinds include easy monetary policy for longer in Europe, the EU's €750bn recovery fund lends further support, and European consumers armed with excess savings should fuel a robust consumer-led recovery into 2022. China policy tightening is a headwind. The MSCI EAFE Index 2.8% estimated dividend yield is attractive.

	Under			Neutral			Over		
Emerging Markets	○	○	○	○	●	○	○	○	○

EM equities are levered to a global expansion scenario and contain many exciting new economy and technology companies. President Biden has continued with a tough stance against China; however, markets have grown accustomed to the new normal in superpower geopolitics. US dollar strength, a more hawkish tone from the US Federal Reserve and Chinese policy tightening are headwinds. EM valuations are attractive relative to developed markets. EM equities have been consolidating following the March-May 10.8% correction. They are beginning to trade more constructively, ending the second quarter near their post-correction highs.

● As at June 30, 2021

Fixed income

	Under			Neutral			Over		
Fixed Income	○	○	●	○	○	○	○	○	○

The rise in bond yields has been significant and sharp. We believe higher yields lie ahead and that the consolidation period of the retrenchment in yields is closer to the end than the beginning. The pace of the increase going forward should not match the speed we have witnessed in Q1 2021.

	Under			Neutral			Over		
Sovereign bonds	○	●	○	○	○	○	○	○	○

With continuing economic recovery and easy monetary policy, and historically generous fiscal policy in the US, real and nominal yields may rise as investors seek returns and increase their risk appetite. Forecasts for tighter monetary policy in 2022 may increase over the next few quarters. On a 2-3 quarter forward view, yields can continue to rise, perhaps less forcefully when compared with the moves in Q1 2021. We believe some exposure in the event of a short-term bout of risk-off sentiment is prudent.

	Under			Neutral			Over		
Investment grade corporate bonds	○	○	○	○	○	●	○	○	○

Yields on corporate bonds look attractive in this low yield environment. As the economy continues to reopen, we expect sequential improvement in corporate fundamentals. The default rate is already below long-term averages. While we see a supportive environment for credit, there is limited spread tightening potential given the massive rally since March 2020. We believe that the total return opportunity is attractive, as spreads can remain low and in this range for an extended period.

	Under			Neutral			Over		
High-yield corporate bonds	○	○	○	○	○	●	○	○	○

High yield spreads have narrowed significantly. Yield pick-up contributes to total return and helps to mitigate the potential rising rate environment. We believe it's important to have the flexibility to move up/down the capital structure and across rating categories to produce strong risk-adjusted returns. Credit selection is essential to position correctly for best relative value in both high yield bonds (against embedded duration risk) and loans (against re-pricing).

● As at June 30, 2021