Inflation, valuation, and the market outlook transcript
Mark Bayko & Jim Allworth
3/29/21

Mark Bayko:

Hello, and welcome to an audio recording for RBC Wealth Management. Today is March the 29, 2021. My name is Mark Bayko and I'm head of the portfolio advisory group at RBC Dominion Securities. I'm joined today by Jim Allworth, co-chair of our firm's global portfolio advisory committee. Today we'll be discussing some of the themes that have had an impact on global markets so far this year. Jim, thanks for joining us today.

Jim Allworth:

My pleasure as always Mark.

Mark Bayko:

Since we last met late last year to have a discussion, some of the major uncertainties have been resolved. Joe Biden is firmly in the White House now and effective vaccines are being rolled out across the world. Where do you think we're headed from here?

Jim Allworth:

Well, I think in terms of the economy, we're in recovery and really have been since last summer, and I think there's more of that to come. There's a great deal of fuel on the fire if you like. We have, first of all, the response of the federal reserve and other central banks to take interest rates essentially down to zero or lower in some cases, and a promise to keep them low for quite some time. Banks who were starting to tighten credit standards as the recession bit have backed off from that and are lowering the lending standards again in order to find some borrowers. We have massive stimulus. In the US the response just to remind ourselves was $2 trillion back in the spring of last year in relief payments to households and businesses, followed by almost another trillion, 900 billion and at the end of the year authorized, which has only been going out in the last few months.

Jim Allworth:

The new Biden administration has tacked on another 1.9 trillion onto that and we have yet to hear from the Biden administration on an infrastructure program, but I saw a number this morning suggesting it might be as high as $3 trillion. Now, infrastructure programs usually take years to unroll and we probably wouldn't see money on that spent until next year. But what it suggests is that there's going to be a lot of government support beyond this year in terms of the economy. At the same time, we have a change in the economy. It's reopening in fits and starts, but reopening, and there's nothing more powerful than reopening the economy. That's the biggest bit of stimulus there is.

Jim Allworth:

In our judgment, we have quite a ways to go here. I think for purposes of this discussion, or always, it's useful to think of it this way. When you come out of a recession, this is definitely, let's acknowledge, this is a very different recession in some respects. Unlike every other recession for more than a hundred years, this one was triggered not by tight credit conditions, has always been the case otherwise, but by government diktat. Governments shut economies down in the space of a few weeks and starting about six weeks later, they started to reopening them. The result was a plunge in GDP. The drop in the second quarter GDP in the US and Canada, and all the developed countries was the steepest drop quarterly drop in GDP in recorded history. Once reopening began, the rebound in the third quarter was the steepest most powerful quarterly recovery in GDP in recorded history.

Jim Allworth:

So we had a huge V low and a rebound and pretty strong growth ever since, and that's very typical coming out of recession. For a year to 18 months coming out of a recession, the economy just keeps powering higher. It's being influenced by pent up demand. People who postpone doing things in the time of uncertainty, and now get back to doing them. You get companies who've run their inventories down for the same reason, who not have to replenish their inventory set as demand returns. You have usually accommodative monetary policy like we have right now, and the delayed impact of stimulus from government efforts to get you out of a recession. All of those things are still very much in play and are probably going to keep giving us good growth rates through to the end of this year. And as I said, some of them are going to continue on into next year.

Jim Allworth:

It's worth remembering that both in the US and Canada, that those huge amounts of money transferred from government to individuals to bridge people over this unpredictable, unexpected event have landed in savings accounts. As things returned to normal, some significant proportion of that money is going to get spent and add further to growth. So, there's a lot still to come here. The next thing you remember from past cycles is that at some point that kind of levels off. That instead of being in the red hot growth phase, you're in a more sustainable growth period. The transition from red hot to sustainable, which I could liken to being in a jet taking off from the airport and when it gets to altitude it levels off, always gets a kind of queasy feeling in your stomach. That may well be how it feels when we level off a bit in this and that sometimes produces some market volatility along with that. All those things may be ahead, but I think they are ahead. That's going to be the operating condition we're in for some time yet. By sometime, I mean years.

Mark Bayko:

You know, one of the things I've learned in my career is that there always seems to be concerns and uncertainties that investors have to deal with. While some of the concerns and uncertainties from last year has indeed faded, new ones have come about this year. Government bond yields in particular have moved up quite a bit over the past few months, and at the same time, there's more of a conversation now about the possibility of rising inflation. These two things connected and where do you think they're headed?

Jim Allworth:

Sure. Well, I think your observation is the correct one. The good old days are always only visible in the rear view mirror. You're never aware of them when you're living in them, because there are always things out there that seem risky and all too likely to come to pass. I guess we've dispensed with that kind of volatile environment we're in, in the last administration in the US. We worried about whether we'd get a vaccine. Well, we've got one. So those things have definitely improved in our judgment. Now we're finding other things to worry about.

Jim Allworth:

As you said, one of them is the government bond yield to move up. They were down, not that long ago, the ten-year treasury in the United States yielded less than half a percent, but that was its coupon rate. Today it's around between 1.60 and 1.70, which is still a low number by anybody's standards, but it's a lot higher than half of 1%.

Jim Allworth:

And those yields moving up have worried people. If you link them to their other worry, which is that all this government largesse that's out there in fiscal stimulus is tantamount to money printing, and that money printing is the kind of thing that people have associated in the past with inflation, is that what's driving bond yields higher? What is the possibility that inflation is going to be a problem that pushes bond yields even further higher? And does that threaten the economy and does that threaten markets? I think would be a very long run-on sentence that describes the situation.

Jim Allworth):

Well, let's sort of examine them by themselves for a moment. Bond yields have moved up to 1.60, but we should remember that before the pandemic started, they were between one and a half and two and a half percent. In effect, what we've done is we've passed a period when people thought the world might be ending and wanted the safety of a government bond that didn't care if they got a return, they just wanted to know their principal was safe. To a world where we're coming out the other side, where people are much more optimistic about the future is still worried. There are no longer feeling the need to hide in government bonds and yields have moved up to something much more like what they were just before this event all began. Could they go higher? Certainly. What's our own view? Our own view is probably that they move up between here and 2% between now and year end, and that they move up closer to 3% in the following year. Still, very much inside the kind of area they've been in for a number of years.

Jim Allworth:

Let's examine it inflation by itself. We know we're going to get some lousy inflation numbers over the next two or three months for one reason in particular, and that is that last year at this time prices were actually falling in April and May, so the CPI index was falling and we're going to be comparing today's CPI index with last year's and in each of those months. In each of those months, the index is going to be lower than it was the month before for the comparison purposes. What we're going to have is a ballooning in inflation. Even if today's CPI index just stays where it is for the next couple of months, inflation is going to go up because it was going down at the same time last year.

Jim Allworth:

That's going to provoke a conversation and it might easily be worse than that for a couple of months too, because if you'll remember at this time last year, we were going through a bizarre situation in the energy side where oil prices actually went for a few days negative. In other words, you had to pay people to take oil off your hands if you were an oil producer, which was extremely unusual and a perverse kind of financial market situation, which ended pretty quickly. But ever since then, all prices have been moving up, they're no longer at zero or $5 a barrel or $10 a barrel, which they were for a fair bit of time in there. They're now up at over $60 a barrel when gasoline prices have moved up a long way.

Jim Allworth:

They haven't just moved up on a year over year basis, they're moving up right now, week after week. We're going to get some inflation numbers that are disconcerting instead of the one and a half percent, year over year inflation rate you come very used to, we're definitely going above two and could easily print 3% over the summer months at some point. Well, the Fed for its part and other central banks by implication and association are saying, "You know, we can see this coming too we can read the same data that everyone else says. We know we're going to get some inflation numbers that sound bad, but there's special reasons why that they're, they're coming and we think," says the Fed, "That they will in fact diminish as the rest of the year goes on, and that they won't stay up there at two and a half or 3%. They'll move back down over the course of this year and on into next year and that this inflation problem is really just a transitory one and that it won't be a big issue beyond that."

Jim Allworth:

Well, first I think it's wise to say what you think and that's what the Fed is doing, but it could be easy for these numbers to be troubling for longer than that Fed comment is suggesting. I'll just cite a couple of things. A lot of commodity prices, especially a lot of industrial commodity prices have been moving higher over the course of the last number of months, copper, pretty good example, doing very well, up a lot. Lumber prices, very strong, in the strong housing market. Other industrial metals, in some cases anyway, in a rising uptrend, many of those things are inputs in manufacturing costs. They're going to start showing up in finished goods inflation over the course of the next few quarters.

Jim Allworth:

Even things like freight rates and shipping rates are up a long way. All of those get built into the cost of goods. Then we've got agricultural commodities, soybeans, corn, wheat, things like it, all been pretty strong. In some cases, very strong, and that portends higher food prices down the way. So, not only are we going to get some higher inflation, we may start to get the kind that really hits consumers directly in a way that starts changing their inflation expectations. I think this is a conversation worth having. Inflation may be in a period where it may be changing to some degree anyway, and instead of running it this worryingly low rates from the standpoint of the Fed of about one and a half percent a year could quite easily be moving up into a level of somewhere between two and 3% a year.

Jim Allworth:

Should we be worried about all this? And what's the connection between bond yields in that? Well, I think that bond, that is part of the reason why bond yield is up maybe moving up is anticipation of more inflation. If inflation went on to rise further that we think, then it would probably put even more upward pressure on bond deals. But generally speaking, bond yields going up are a sign of more growth than the economy, inflation going up is usually a sign that more growth in the economy. If there's more growth than even we anticipate, and we're looking for pretty good growth, then you might see corporate earnings moving higher than people think too. They're already rebounding quite strongly. People are already revising the rest of it, for the earnings of most companies for this year and for next year. They've been revising them higher and an even stronger economic picture, what would get them revising them still higher.

Jim Allworth:

The effect of rising earnings we think will overtake the effect of higher interest rates and higher inflation on stock prices, at least for a while. I think this is something to watch, because if it turns out that the Fed is too optimistic about inflation coming back down and inflation turns out to be stickier and more persistent, and maybe even higher than the expectations that are out there today. Then at some point, that could be the thing that forces the Fed and the Bank of Canada and the Bank of England and the ECB off their comfortable position of promising to keep interest rates at very low levels and force them to react to a gathering momentum in prices and raise rates. The Fed raising rates has historically been a precursor to the arrival of the next recession. Recessions, as I think I've said in this venue before, and we'll say again, are the thing that give us bear markets.

Jim Allworth:

Every bear market for a hundred years has been associated with a US recession. Paying attention to where the Fed is and where they're headed is worth doing. But I would say in all of that, even under the most pessimistic of conditions, it's a long time between where we are today, the Fed promising to keep rates low and transitioning to withdrawing that promise eventually actually raising rates and then raising them far enough to actually send the economy into a tailspin. We're talking about in our judgment years. So far so good.

Mark Bayko:

Thanks for that, Jim. Certainly something we'll be watching closely in the months and years to come. Maybe we can finish with one sort of last question on another concern that I think investors have been grappling with. That's just around the overall market valuations in particular the global equity markets. I think there's a sense out there that stocks don't feel cheap and reflect much of the earnings, recovery and growth that's expected to come as economies reopened around the world. There's even been talk about stock market bubbles, are these worries justified in your view?

Jim Allworth:

I would say no at the moment. But if you get to a point where they will be more important than I think they are today, there's a few things. First of all, a lot of people's perception about stocks being overvalued comes with their comparison between where shares are now and where they were back in March. If you compared where they are today, compared to where they were in February, just a month before the bottom of the market, the gains between now and then are much more pedestrian. They aren't the kind of thing that makes you say, "Holy smokes, look at that." Part of this is just the measuring period in which you're looking at. If the only two data points you had were where the market was in February of last year and where it is today and looked at those two, and that's all you knew there would be nothing particularly remarkable about it.

Jim Allworth:

In fact, in some cases with some markets, you'd noticed they're down over that period, not up. The second thing is that the talk about revaluation has kind of stemmed from price earnings multiples, but the only price earnings multiple out there on a market wide basis that sounds even rich really is the US market. The S&P 500 is trading at around 22 to 22 and a half times earnings. Anytime you're over 20 times earnings people fret about valuations. And in fact, I would just remind everyone listening that it would be hard to go back and read the major financial press, the Financial Times of London and the Wall Street Journal and the Report On Business, all of them over the course from the end of the financial crisis to the top of the economic cycle and the market cycle in late 2019, early 2020, it would be very hard to read them at any point along that time and not see people saying stocks were expensive and maybe dangerously expensive.

Jim Allworth:

This seems to be a perennial concern of people. Well, at the same time as the US market is trading at 22 and a half times earnings, which is admittedly above its long-term PE multiple average of about 17. The Canadian market is trading at 16 and change times earnings. The European markets are trading even more cheaply than the Canadian market. So is the footsie in London and the Japanese market is trading at an unremarkable PE multiple. It's the US market that is trading at what looks to be a rich market. When you look at what the difference between the S&P 500 and all those other markets, one of the things you know right away is that the S&P 500 has a very large technology component. In fact, it has the largest cap tech companies in the world with a couple of exceptions are part of that index.

Jim Allworth:

Those are the stocks that are dragging the PE multiple, the S&P 500 higher. If you took those stocks out of the market, you'd see a PE multiple that didn't concern anybody. The high tech, high cap tech stocks that are attracting this high PE multiple and accounting for it are doing so largely because they're very successful and have been extremely successful through the pandemic. Their sales and their earnings are growing much faster than the economy. So the money is flowing towards the businesses that are doing particularly well which is completely understandable. Those businesses are not well-represented in the Canadian market or the British or European markets or Japanese market. They're mostly residents of the American market. And in fact, they've corrected over the last couple of months and they're not at quite the heady evaluations they were at two months ago.

Jim Allworth:

There still are multiples that are adding to the overall multiple of the S&P 500, but they're not quite as frothy as they were. The other thing to notice is that valuation is a very bad timing tool. There is no line in the sand that you get to, that where everyone says, "Well, that's it, can't go any higher." If you look back at bubbles to get to that topic and the only advantage to being around in this business, as long as I have is that you've seen a few. One of the things you notice is that those bubbles, the ones I'm thinking of are things like the commodity boom in the 1970s that peaked in 1980, or the tech boom that ran all through the 1990s and peaked in 2000. In both cases, the bubble that ultimately we got to was much bigger than the one we're in today.

Jim Allworth:

I'll give you a reference to that in a second. The second thing though, is was that those bubbles didn't deflate because of their own weight. In other words, they didn't get to some unsustainable level which then blew up and that took the economy and the stock market down. No, the economy deflated the bubble. The economy in both cases reacted to much tighter credit conditions, rising interest rates and unwillingness of banks to lend, which started to undermine the economy and send the economy south, which undercut all the assumptions that allowed people to imagine an ever better future that would allow these stocks to go to higher and higher levels. To give you a sense of the relative size in the tech bubble of late nineties at the peak in 2000, the tech sector alone, which is just one of 10 sectors that the market's made up of, one sector, the tech sector accounted for 50% of the value of the S&P 500 at the peak.

Jim Allworth:

If you go back to the commodity boom in 1970s, which peaked in 1980 at the peak of the market, the five largest oil companies in the United States accounted for almost 50% of the value of the S&P 500.

Today, if you look at these stocks that everyone is talking about comprising a bubble, you add them all up there about 22% or 23% of the market. Yes, that's a big number, five stocks out of 500 accounting for a quarter of the market. But history says it could get much bigger. And again, I'll go back to the point. These are highly successful companies who for the most part have no debt whatsoever, have great sales, great earnings, and don't have a huge amount of speculation in them about the future.

Jim Allworth:

Whereas in the other two bubbles I mentioned, it was everything was on the cusp. The current environment couldn't possibly support the values that they had at the time. I'm not particularly disturbed by valuation. High valuations come home to roost when credit conditions tighten enough to send the economy south and the earnings outlook starts to deteriorate. That's when overvaluation and bubbles take their toll. They're worth keeping track of to know what kind of risk you're facing if those conditions worsen, but those conditions haven't worsened. We think it's going to be quite some time before they do.

Mark Bayko:

Great perspective. Why don't we wrap it up there. As always, Jim, thanks for your time today and thank you to everyone who's taken some time to listen to us. If you have any questions or feedback, please reach out to your representative at RBC Wealth Management.