Economic & Market Update transcript
Mark Bayko & Jim Allworth
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Mark Bayko:

Hello, and welcome to an audio recording for RBC Wealth Management. Today is September the 7th, 2021. My name is Mark Bayko, and I'm a member of the Global Portfolio Advisory Committee. We hope everyone's enjoyed their summer, and with the season winding down and fall just around the corner, we wanted to take an opportunity to provide an update on the global economic situation and the investment outlook. Joining me today is Jim Allworth, Co-chair of our firm's Global Portfolio Advisory Committee. Jim, as always, thanks for joining me today. The economic picture has evolved quite a bit since we last spoke. Growth still seems to be strong, but the momentum we witnessed late last year and earlier this year appears to have faded somewhat through the summer months. Can you shed some light on why this is and whether this has you concerned at all?

Jim Allworth:

Sure, Mark, and thanks for inviting me again. I've always enjoyed this. Well, there's a couple of things that stand out right away. The first one is just the comparison that we're making with the same time last year accounts for a fair bit of this. We were comparing things with the months when the economy was collapsing last year, and the comparisons were easy and they were gigantic and they got those sorts of numbers in people's minds. Now we're comparing with the period when the economy was reopening in the US, or everywhere in the summer of last year. So the comparisons are more challenging, and so the number's not quite as fat as it was in there.

Jim Allworth:

That said, there's still the economy is not back to where it was yet in many parts of the world anyway before the pandemic, and that's still to happen. And there's still a lot of excess capacity out there, and particularly, on the labor front, and that's going to be used up. We're still growing, we're just not growing at that exaggerated pace. Then, as usual, along the way, come some bumps in the road that you might not have anticipated, and we've had some certainly to do with the pandemic with successive waves of the pandemic and concerns about it, and various efforts made by governments to try and mitigate it. That certainly has affected Canada in the summer as the Delta variant part of the equation has played out.

Jim Allworth:

But even with those things happening, the economy, nonetheless, is growing. Not just from year over year, but for the most part quarter over quarter as well. An answer to your question, no, there's nothing that has me particularly concerned about this. Very often when you come out of recession and you can look back at any number of them over the last 40, 50 years, or as far back as you want to go, you get this period of extreme growth. You get this period when a lot of unemployed people are going back to work. That's one of the biggest factors in the economy growing is people going back to work. So you get several quarters running of the economy really running at a very rapid pace off a very low base. Once that period is over, then the economy usually goes on growing for the remainder of the cycle, but at a more subdued pace.

Jim Allworth:

We think that we're in that inflection point right now, probably peak growth for the developed economies of the world was the second quarter of this year. That just means that was its fastest point of fastest acceleration, if you like, or fastest growth. Beyond this, we're going to keep growing, it's just going to be at a, probably, a progressively more sedate pace quarter after quarter. Until we get down to a level of the economy can sustain in this cycle, which is certainly not 6% growth and it's not even 4% growth. It's probably something below that, and we've been running faster than that up until now. I think the slowdown is exactly what the arithmetic would normally tell you would happen. It has different factors around it that are peculiar to each cycle, but the idea that an economy grows quickly at the beginning and then grows more sedately for the rest of the cycle is pretty well par for the course.

Mark Bayko:

Thanks for that. The past few years have felt unusual in so many ways. We don't have enough time to talk about all of those ways in which it's felt so unusual. But one, in particular, as it pertains to the economy and the markets has been just the speed and depth of the contraction caused by the onset of the pandemic and the lockdowns. Followed fairly quickly by the speed and strength of the recovery. I guess I'm wondering if this presents a challenge in your view in trying to evaluate where we are in the economic cycle? Given we normally tend to see an early stage and then a mid stage and then a late stage to the economic cycle. But I'm just wondering if we should be concerned at all that assessing those stages may be more difficult given the unusual environment that we've come through?

Jim Allworth:

Well, I think it is more difficult, if what you're always trying to do is marry certain developments to what they're going to do with the economy or what they have done to the economy. In my experience, every cycle has been entirely different. We always are, whether we know it or not, in uncharted waters. But, hindsight, persuades us that somehow or other, all the other periods we've lived through were normal and understandable and that this one isn't. The first thing I'd say is that question and that idea has been raised in every economic cycle I've lived through. There's always a feeling that we're in a particularly precarious, unusual, unpredictable situation.

Jim Allworth:

The fact is, in some respects, it is unpredictable, but in terms of the economic cycle, not so much. Now this one had one distinct difference, and that was that unlike virtually every other recession in the last century, it was not triggered by tight credit conditions where loans became very hard to get and the cost of those loans went through the roof. This one was essentially delivered to us, thanks to government shutting the economy down, which had not happened before. In that respect, very, very different, and that maybe there's a lesson from that. Now we have to include what can cause a recession, not only tight credit conditions, but something that forces the government to shut the economy down, of which there I would say there's a very limited menu of things that can do that.

Jim Allworth:

I'm reminded of looking at long pictures of the stock market or the economy where people attach headlines to the chart. At a peak of the market, they talk about something that was going on, as the market going down, they talk about something that's going down. So the financial crisis in 2008 and '09, or the tech wreck in the early 2000s. There's headlines around it, and that somehow or other, as long as you're able to see the headline, you would have known what the market was going to do. I think closer examination of that, sort of, a picture tells you that is not something that you would call predictable and all that. And yet this cyclical form of how the economy proceeds from recession, into recovery, into expansion, into rolling over into a contraction, again, usually driven by credit conditions.

Jim Allworth:

It is the shape of the path that the economy takes, and I think this looks the same. If you took all the headlines off, you'd see an economy that went downhill quite quickly, got rescued essentially by the Fed at the bottom, turned around and started moving higher and with bumps and things along the way has gone on doing so, and we think it will go on doing so. We believe that the next recession, when it arrives, will arrive the good old-fashioned way via tight credit. But that's a long way down the road. I'd add one thing to that too, which I think might be useful from a standpoint of tools you can use, and that says something about this as well.

Jim Allworth:

Eric Lascelles, who's the Chief Economist at Global Asset Management and who we all have a very high regard for, has a table that he publishes and we publish it in some of our documents too. Which looks at 17 different economic variables. I think he does it for the US, but he could just be easily be doing it for Canada and some other countries, and it would tend to tell you the same message. Each one of those 17 economic variables behaves a particular way when the economy is in recession, when it's coming out of recession, when it's in expansion mode, when it's rolling over to go back into contraction, and so on. Each of these 17 have this identifiable mark that says what part of the cycle they're in.

Jim Allworth:

What he does is, every month, is he looks at all 17 of them and he scores them, "What part of the cycle are they in according to their behavior?" Then he adds up the scores for all of them and portions it across the possible spectrum and decides where the economy is. First I'll tell you that it says we're in early cycles still, but more and more things showing up as being mid cycle. But the attraction to this is that, I think, is that one or two of these might be wonky, maybe because of peculiar circumstances in this cycle. A couple of them are really giving you crazy signals. It's unlikely 17 would be wonky. When you average this out and look at it that way, it kind of tells you where you are in the economic cycle today within a certain range of probabilities. It is behaving the way it normally would coming out of recession and going into an expansion that still has further to run.

Mark Bayko:

You mentioned access to credit, so why don't we go there because everybody has been laser focused on the US Federal Reserve of late, and they certainly appear to be preparing for a shift in policy over the

next number of months. But they have been quite careful in indicating that any interest rate hikes are still a ways away. What are your thoughts on this pending change and the implications for investors?

Jim Allworth:

Well, I'm hugely impressed by the historical evidence that tells me that tight credit conditions, eventually, and I'm going to underline and bold eventually, eventually produces recession. You have to get credit tight enough, but we kind of know how tight that has to be, and that, that will give you a recession. It's fair to be focused on the Fed and what they're doing and what they say they're going to be doing in the future. But it's wrong, in our view, to imagine that even if we woke up tomorrow, when the Fed announced that it was going to hike rates for the first time, that, that would have economic impact. There's a long lag time between what the Fed does and even the arrival of tight money and the eventual downturn in the economy.

Jim Allworth:

It's that lag time that fools people every time. They focus on this, they focus on this, they focus on this. Money gets tighter and tighter and tighter. The economy doesn't succumb, and they say, "Well, this time it's different." Then about the time they're saying this time it's different, finally tight money does click in and turns the economy south and into recession. I think it's understanding that there is a long lag between monetary policy and its impact on the economy, and that lag is anywhere from six months to a year. But, first of all, you've got to get things tight enough to actually present that threat. There's two things I'm going to mention that people can maybe watch if they want to, or at least think about.

Jim Allworth:

One of them is a nice piece done by Eric Savoie, another one of our strategists at Global Asset Management, who went back and looked up all the cycles since the '40s or '50s, I think. And asked the question, "What does the stock market do once the Fed starts hiking rate? What does it do prior to the first Fed rate hike and what does it do after the first Fed rate hike? So the answer is, it turns out, the market does rather well in both those periods. It goes up quite nicely in the year up to the first Fed rate hike, and in a way that's understandable. What ultimately prompts the Fed to hike is a feeling the economy is running too fast and it's getting overheated. An economy that's been running too fast tends to produce strong corporate earnings, strong business confidence, strong investor confidence, and the market does very well. Double-digit returns in that year prior to the first Fed rate hike on average.

Jim Allworth:

What about after the first Fed rate hike? Well, it goes on going up for another year, and this gets to my point of the lag defect. The Fed is never one and done. They don't raise rates one time and somehow or other everybody falls into line and the economy slows down. There is a process that usually spins out over any number of months, and you have to have a series of Fed rate hikes that finally get rates up to a point that they can slow the economy down. Even then it takes some time for that slow down to show up, and it takes a fair bit of time to take away the confidence of businesses and the confidence of analysts who keep raising estimates and the stock market keeps rising.

Jim Allworth:

The history says that the stock market does very well in the year prior to the first Fed rate hike, so who knows when that first Fed rate hike comes, but we might be in the first year, and so there's maybe no surprise the stock market's been doing well. It goes on doing pretty well in the 12 months afterwards with very, very, very few exceptions along the way. We have a long runway here looked at that way. Not only have we not had the first Fed rate hike, but the Fed has gone out of its way to say, "It's going to be quite a while before you get one." That we might start tapering our bond purchases, but the idea of actually raising interest rates really isn't even on our mind yet. I would say that, that alone would say things look not bad.

Jim Allworth:

Now, the second thing I will point out is the answer to that question, how high do rates have to go to kill the economy and send it into recession? And there is an answer to that. The answer is that it has always taken a Fed funds rate higher than the nominal growth rate of the economy, and I'll explain that in a second, to turn the economy south. What's the nominal growth rate of the economy? It's the growth rate without adjusting for inflation. Usually, when you hear the U.S. economy grew by 3% last quarter, they mean it grew by 3% after taking the effective price increases out. They don't want to count price increases as economic growth. They take the growth rate of the economy before adjusting for price increases and adjust it.

Jim Allworth:

What we want is the growth rate of the economy before they've made that adjustment, and this year, that growth rate is going to be running at pretty close to 9% for the U.S. economy if you don't adjust for inflation. And next year, we think it's going to run for most of the year to something pretty close to 6%. When we look back, historically, what we find is before you get a recession, you have to get the Federal Funds Rate up, equal to or above, that nominal growth rate of the economy. If, let's say, we're right and next year then that nominal growth rate of the economy without adjusting for inflation is about 6%, history would say, "In order to get a recession, you've got to get the Federal Funds Rate up to 6%." The fund's rate is currently at a quarter of 1% or less.

Jim Allworth:

The Fed usually raises rates a quarter of a point at a time, very occasionally at 50 basis points at a time. The Fed only meets 10 times a year. Even as the Fed started raising rates tomorrow and raised rates a quarter of a point at each meeting, it would be into 2023 before it had rates high enough to give us a recession. In fact, well, it'd be in the latter part of 2023 before you rates high enough As I said, the Fed isn't even contemplating raising rates for another year or longer. I'm not sitting around quaking and worrying about the economy slipping back into recession. I don't think that's the issue of the moment for investors, for sure.

Mark Bayko:

Great. Why don't we maybe end on a question around global equities in general. You mentioned a reassuring message there around the Fed didn't and access to credit overall. The runway that we've got

ahead of ourselves, but developed equity markets have been resilient all year. They've done quite well this year, and obviously, finished strong last year. Moreover, valuations are above average in many jurisdictions implying that stocks may be on the more expensive side of things. How do you think investors should think about the return prospects of equities going forward?

Jim Allworth:

Well, I think that is the question of the moment, and there's a couple of things I'd say. First of all, we're reasonably constructive on our outlook for equities. We think stocks over the next 12 months will deliver worthwhile returns, including dividends. But I think there's reasons to think that it would be unwise to expect that somehow or other the pace of gains of the stock market over the last year, year and a half are telling you anything about how fast it's going to go up over the next 18 months. Evaluations have changed fundamentally from where they were at the bottom of the market in March. I will just refer to something I've said on prior calls, people may have heard it, but I can repeat it again.

Jim Allworth:

The value of a business or the value of the stock market, which is a collection of businesses, the proper way to value it is to say that it's equal to… As the owner of the business, the value of that business is the value of all the profits that business can deliver it to you out into the far future. In other words, it's this year's earnings plus next year's earnings plus the year's after earnings, and you go on doing that out 20, 30, 40 years. And you take each one of those earnings out in the future. This is the proper way to do it and discount it back to the present. Accounting for the cost of money along the way, and the risks you might be taking up that you might be wrong in your calculation. You discount it all back to the present and that's the value of the business.

Jim Allworth:

I'm not saying that's an easy thing to do, it's difficult enough. But what it tells you when you think of that methodology is that you could blow up this year's earnings altogether and blow up next year's earnings too, and you'd still have decades of earnings coming at you in that business. It tends to tell you what sort of damage a failing present economy, if it were around, which was the case a year ago March, could actually do to the long-term value of businesses, which was limited. But it wasn't limited as far as the market was concerned, the market went down a huge amount, 35% in just a matter of a couple of weeks. Suddenly, in March and April of last year, the market was being priced as if there was no future, as if businesses were permanently damaged beyond repair off into the future for decades.

Jim Allworth:

Our view was, and I think anyone who's sat back and thought about this, would be that was being overdone and that stocks were extraordinarily cheap and attractive. Of course, it would've been nice to be able to ring a bell and act on that, but fear had taken over with it with everybody. The worry was that things would even get cheaper still over the coming months, and so it was hard for people to act. Well, we've come out of that period and the market is no longer being priced as if the world is permanently damaged into the future. It's being priced as though this will get a complete recovery from this and move on, and that's fine, except I'd say this is not a place to be in with both feet.

Jim Allworth:

It's a place to be invested and to be deciding now the kinds of things you'd watch for that would tell you that the economic situation was going to change. That perhaps another recession was coming and that would mean earnings would fall, and usually the market does poorly in that sort of a period. For all the reasons we've talked about before this, that's what looks like that's a long way off. But it's worth thinking about when we look at a portfolio every day or every month or every year how we're structuring it, how we're diversifying it, and how we're positioning it to take advantage of owning these great businesses for as long as possible, but not overstaying our welcome.

Mark Bayko:

Great. Let's wrap it up there. Jim, thanks as always for sharing your perspectives, and I look forward to doing this again in the not too distant future. I want to thank everybody for listening, and if you have any questions, please reach out to your representative at RBC Wealth Management.

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