A more challenging start to the year

Mark Bayko:

Hello, and welcome to an audio recording for RBC Wealth Management. Today is February the 15th, 2022. My name is Mark Bayko and I'm head of the Portfolio Advisory Group in Canada at RBC Dominion Securities. I'm joined today, once again, by Jim Allworth co-chair of our firm's Global Portfolio Advisory Committee. Today, we'll be discussing the challenging start to the year for equity markets and how investors should think about navigating through this environment.

Mark Bayko:

Jim, thanks for joining me today. The year, as I mentioned, has gotten off to a bit of a bumpy start and I think it's fair to say most of the weakness can be attributed to markets digesting the implications of higher rates, both in Canada and the United States. We've already seen the Bank of England take action a few times, as well as some other central banks around the world and what we've seen in the past is volatility around the first rate hike is not necessarily uncommon and so maybe the weakness to start the year may be par for the course.

Mark Bayko:

I'm just wondering, have you been surprised at all by how the year has started thus far?

Jim Allworth:

I wouldn't say surprised, and let me just say thanks for having me again, Mark. It's always my pleasure, as you know. I wouldn't say that I am surprised if you look at it in this context. I think for some time we've been of the view and I think stated even on this call that when you're coming out of recession, you go through a rocket ride that lasts for a year sometimes or more and then instead of going straight up, you kind of level off a bit at cruising altitude and you're climbing, but it's not the same way and that, that transition from the rocket ride for the economy and for the market to the more sedate pace, is one that is a little bit unsettling when it happens that you're going to feel the thing doesn't have the same power it did and you wonder whether this is the start of something worse and we don't think it is.

We think it is a normal transition and I think at that period, people focus on the thing that's worrying them the most or the things that are worry the most and they ascribe that to what's happening and I understand we've had some ugly inflation numbers, although I'd hasten to point out that we were forewarned of those, because the people who do this kind of forecasting have been telling us through a good part of last year that we were going to get ugly inflation numbers if only because of the year-over-year basis, but because of some of the distortions introduced by COVID and that there was the chance, very great likelihood that was going to awaken the Fed and the bank of Canada from their slumber, if you like and I don't mean that pejoratively.

I mean, things were kind of going the way they wanted and probably set us on some sort of course for higher rates and I think it's done that. It's always nice if unsettling things are over fast. I sort of think this to-ing and fro-ing part of this, with concerns maybe about the Fed for a while and then maybe who knows what goes on in the Ukraine or wherever, people will find some things to decide it's worth being unsettled about and that this period of consolidation correction could last longer and I think it's probably wise to plan for that, but I believe if not by year end, certainly shortly after that, that new highs still lie ahead for this bull market and that we'd like to be there for them.

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Mark Bayko:

Wonder if we could just stick with the topic of interest rate hikes, because what surprised me late last year and even to this day is the extent to which markets are expecting central banks to tighten and I think if I have my numbers correct, the current expectations are for close to six interest rate hikes in the U.S. and Canada this year alone. So I'm just wondering what do you make of that and how do you think investors should think about navigating through this kind of a period where central banks may be acting a bit more aggressively than we've seen in the past?

Jim Allworth:

Well, the first thing is don't believe everything the market tells you. There's an old saying, often wrong, never in doubt, well, that's kind of the market and people somehow or other are always describing it, some supernatural power of being able to see the future, but since it changes its mind over and over and over again rapidly, it seems to me not that great a predictor. It wasn't very long ago that the market thought there'd be no Fed rate increases at all in 2022, it'd be weighed out in 2023 and that wasn't simply because of what the Fed was saying, it's people's perceptions.

Well, the perceptions have changed and they've telescoped in and now the end of the world is upon us and I'm inclined not to look at it that way and I believe too, that things are characterized as somehow or other it's the Fed versus the market or the Fed driving the market and it's not, it's the economy, and the Fed has, a job of responding to the economy, so does the Central Bank in ways that they usually lay out ahead of time and that's what they're doing. The Fed isn't raising rates because the economy's weak, the Fed's raising rates because the economy's been quite strong and that's been giving us price inflation.

A lot of that has come from the distortions around COVID, which is one of the reasons why the Fed believes that, I guess, it's no longer using the word transitory, but I think that they believe that we're going to go through this ugly number of months with horrible numbers, but we're going to start to see the rates subside in the second half and subside further next year, that's our view and so, while it said it was willing to be patient, I think it has to, for its own credibility, be seen to raise rates against this, and it will, but I would just remind everybody that the Fed never starts these things, or goes on in them with the desire to create a recession.

They have a dual mandate given to them by Congress. The dual mandate is to as greater degree as possible, the fullest employment in the economy consistent with stable prices. So they have a dual mandate control prices to some degree, don't let them get out of whack in either direction in a big way, and manage monetary conditions in a way that's conducive to keeping most people employed possible.

Well, that's more than just a truism or a nice thing to say, or a mission statement that is what, what they try to do and in reality, they're pretty good at it. So since the early 1950s, when the Fed funds rate first came around and into being, the Fed has embarked on 17 tightening cycles and nine of those tightening cycles resulted in soft landing, which is always the Fed's intention and eight resulted in recession. So it's a slightly better odds than a coin flip that you're going to get a soft landing. My point is, it's very reasonable to hold that as some kind of an expectation to some degree because the Fed has managed it in the past and that would be their intention and if you believe, as we do, at the moment anyway that we're going to see inflation subside somewhat in the second half and more so next year, then at some point, the inflation will give the Fed cover for easing back on rate hikes.

So the open question that's left is, is it still possible then that they could overshoot and give us more rate hikes than the economy can bear? Well, it's possible, but I don't think people appreciate how far away we are from that, in our judgment anyway, and I would just point out this idea that there's never been a recession since the Fed funds rate has been around without the Fed funds rate first getting higher than the nominal growth rate of the economy, the nominal growth rate of the economy is the growth leaving inflation in, leaving price increases in. Normally what you and I hear is the growth rate of the economy after price increases have been taken out.

Well, we need to lead them in, in this case and when you do on that basis last year, the U.S. economy grew by 10% with price increases included. The Federal funds rate's at zero. Growth isn't going to stay at 10%. We think in the current year, it's going to drop down to something between six and seven looked at this way and the year after probably something between four and five, but you've got to go a long way above zero to catch any of those rates, even the slower ones further out, and the Fed only meets eight times a year and it only raises rates usually a quarter of a point at a time, very occasionally at 50 basis points.

So it seems to us that even if the Fed gets started in March and raises rates the way the market thinks, which is maybe six times this year or maybe even... Well, it won't have much left more than six times possible this year probably, and goes on raising rates through all of next year, you're really talking about the end of next year are much more likely into 2024 before you had a Federal funds rate that was catching up to the growth rate of the economy and that has always occurred before recession started. So, I think the question of recession is still a fair ways off and remember, the Fed is usually in raising rates, it's trying to cool off an economy that's running fast and an economy that's running fast usually means … so are corporate profits. And if corporate profits are rising, usually, so is the value of businesses. So, that leaves us in a position where we still have a constructive view on equities. We know we're in some sort of period of consolidation correction. If you're lucky, it's over quickly, if you're unlucky, it lasts longer. I'd rather be unlucky and have it last longer, frankly, because then I'm on probably a more solid base for further advances down the road that might be more long lasting.

Mark Bayko:

That's great. We've got a few minutes left. So I'm just wondering if we could stick with the economy and the risk of a recession that you already alluded to. One of the things that we often review and analyze pretty frequently is a recession scorecard and we did publish one in our Global Insight monthly publication earlier this year. I'm just wondering if you could share some of the key messages and insights that the economic scorecard was telling us.

Jim Allworth:

Sure. Well, the recession scorecard, we've used for a fair bit of time and it sort of is the first tool we go to, to pursue our investment strategy framework and that framework stated simply is if there's no U.S. recession on the horizon, then investors should give equities the benefit of the doubt and that is informed by more than a hundred years of history that shows that every bear market in the United States over that time and in Canada has been associated with the U.S. recession.

So we'd like to see recessions coming ahead of time because we know they can provide a more prolonged difficult period for stock markets but if they're not coming, we want to give equities the benefit of the doubt. Well, the recession scorecard looks at seven different indicators, all of which have some history that shows that they've been pretty good at telling us ahead of time when a recession is coming, some of them have perfect track records or at least, well, two of them do, others may be less so, but all of them are useful and what they're all saying today is that there's no recession in sight and since we know how each of them works arithmetically, we know what it would take to turn them around and get them to a level that they were no longer giving us a green light, but rather an orange light or a red light on the economy.

We think it's going to take quite some time for any of them to get to that point and a couple of them have a history of telling us anywhere from six months to 12 months before a recession starts and they're not even close to turning in a way that would eventually get them to that point. So, we feel pretty good about it and there was an article in our January Global Insight monthly that illustrates the recession scorecard and talks about a few of them.

We published that scorecard on a regular basis once a quarter but I guess the thing I would promise our clients also is that if anything changes for any one of those indicators that shifted its status, we wouldn't wait till the quarter before telling you, we'd put it out in a more timely publication. I would just say that, that's one way of looking at things. So there's seven indicators, they're all a little bit different. They're not sort of too tied up with each other. They're kind of independent and we like that.

Here's another way that I would tell people to watch for too, that is that Eric Lascelles, the chief economist at RBC Asset Management who manages all our mutual funds around the world and a lot of money for high net worth clients around the world, he looks at it this way. He looks at 17 different economic variables. They're all different, but they each have the common characteristic that they behave differently at different parts of the economic cycle. They behave differently early in the cycle from how they would behave in the mid part of the cycle or the late cycle or in recession. He looks at all 17 every month and their U.S. variables, but he also looks at the same ones in Canada and he scores them every month as to whether they're behaving like they do in early cycle, mid cycle, late cycle or recession and when he adds them all up, that gives them some sort of probability about where we are and those indicators come down highly definitively in the mid-cycle range right now.

A lot of them were in early cycle for a long time, a lot of those early cycle ones have now migrated to mid cycle. There's still a few behaving the way they would in early cycle. There's one or two behaving the way they would in late cycle. There's none behaving the way they would be in recession. I like that one too, because you know, it's possible that one or two or three of these things that Eric looks at could be wonky this cycle, maybe behaving atypically for some particular reason, but it's highly unlikely that 17 of them are wonky. So, it's a pretty good way of getting the probabilities and our job as portfolio managers is to lean towards the most likely probability in building and managing portfolio.

So I like that and the third way is just to look at the economy and take the temperature of various important parts of it ask the question... Excuse me, that's one of my Labrador disagreeing with me. Anyway, looking at various important parts of the economy and just trying to assess from looking at them are they vulnerable, are they weak, are they strong, where are we and the most important one is the consumer and the consumer's strong, he's confident, he's got a lot of money in the bank, in the U.S. and Canada, the excess savings in corporate and individual bank accounts in the U.S. and Canada add up to more than 10% of gross domestic product, which is enormously high.

Not all of that money is going to get spent, but maybe 20% of it over the next couple of years, which is all by itself enough to keep consumer spending in a reasonable range, capital spending is very strong in the United States. It's been slow to get going in Canada, but the latest survey by the Bank of Canada business conditions shows that businesses are more unanimous than they've ever been in 20 years in the likelihood they're going to spend heavily on capital spending in the next two years, which is, I think quite good news in the US, as I said it's already underway and here's the things driving it; corporate profits are very high in both countries.

Corporate profits are very often what financed capital additions and capital spending. So profits are high interest rates are low if they need to borrow the money and they can get loans without any trouble, labor shortages are the biggest issue facing companies. They're having a hard time getting all the workers they need and so they're inclined to make capital spending decisions that might lessen their need for more employees. So this is all rolling the way it's supposed to and capital spending is a much smaller part of the economy than the consumer. It's about 15% of the economy, whereas the consumer's about 70% in the U.S. anyway, but capital spending when it swings up, swings up hard and when it swings down, swings down hard and it's in the midst of an upward swing that is adding to GDP and will for a while.

So on all fronts here, scorecard, Eric's probability work, and our own view of the economy is that we've got a fair bit further to run in this second economic expansion.

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Mark Bayko:

Great. Well, look in the interest of time, let's leave it there, but Jim, as always thank you for your time today, and thanks for sharing some insight and providing some of your perspectives on the start to the year and the outlook going forward. Certainly look forward, as I always do, to doing this again in the not too distant future and thank you to everyone who has taken some time to listen to us today. If you have any questions or feedback, please reach out to your representative at RBC Wealth Management.