Inflation, the growth outlook, and some thoughts on fixed income

Mark Bayko:

Hello, and welcome to an audio recording for RBC Wealth Management. Today is May the 17th, 2022. My name's Mark Bayko, and I'm head of the Portfolio Advisory Group in Canada at RBC Wealth Management. I'm joined today by Jim Allworth, co-chair of our firm's Global Portfolio Advisory Committee. Today we'll be discussing the myriad of issues confronting investors, some thoughts on the fixed income landscape, and the outlook for global equities going forward. Jim, thanks for joining me today. We're nearly halfway through the year, and it's fair to say it's been a challenging one so far. And there certainly is no shortage of concerns out there on the minds of investors, whether it's the situation in Ukraine, inflation dynamic, and the situation in China with their lockdown policies taking place. I'm wondering if you could help us sort through all of this noise and help us focus on what you think are the most important issues going forward.

Jim Allworth:

Sure. Well, I'm happy you kept the list short of things people are worried about. There's probably a bunch more that are on people's minds too, as there often is. And very often, especially the way they're presented to people, they are presented as a threat to existing order. Let's put it that way. To get through it, I think the thing to remember is that you really want to focus on the outcome for the economy, and in particular, you want to focus on the outcome for the U.S. economy. And we know these things are affecting different parts of the world in different ways, but the U.S. remains the one that tends to set the table for the equity markets. And in a world where there's always things to worry about, the market adapts and is usually able to contend with those worries and concerns in a reasonably constructive way.

And even though there can be some to-ing and fro-ing in the market, generally speaking, it continues to kind of track growth in the economy over time. And growth in the economy over time has been a rather stable commodity over the last 75 or 80 years. That's not to say there aren't ups and downs. It's just that, if you looked at it from the standpoint of December 31st of each year, the economy most often has grown. And the instances of it not growing over a one-year period are really rather few over that span. So, the economy kind of adapts, and the market adapts along with the economy. And you and I are trying to invest in the growth that that economy generates over time. So, is there something in the current environment that would make us less willing to bank on that kind of growth continuing? And when we look back on it, the periods of time that are worth concerning yourself about are periods of U.S. recession.

And so, you could get the question down to today, are the things we're seeing making a recession more likely? Well, perhaps at the margin, they are, but so far, they're not to the degree that it would make us believe that a recession was on the way and we'd be inclined to be a lot more defensive. So, I think this idea of standing back, looking at the economy, in particular, the U.S. economy, looking at reliable things that have tended to tell you when the economy was weakening in a way that would say a recession has become inevitable, is a pretty good thing to be doing, especially when short-term things are creating a lot of anxiety.

So, so far so good. We've talked about this in the past, but I'll mention it again. We do have a recession scorecard that looks at seven things that have done a pretty good job of telling you ahead of time when a U.S. recession was coming. None of them are saying that at the moment. One of them I would argue is close to turning, but, as luck would have it, it's the one that's got perhaps the least enviable track record of the seven. It's tended to produce false positives fairly frequently. The other six, I think, are quite a ways from turning. And all I can say from our standpoint is that, if they do turn or becoming more negative in a worrying way, we would say so. I would argue that some of them are not as robustly positive as they were six months ago or nine months ago, but that's the worst you can say about them, that they still remain very much in positive territory.

And several of them have typically told you six months to a year ahead of time when a recession is coming, and it would take quite a bit arithmetically to get them to the point they were starting to say that. So, we think this is an economy that is going through a transition period, and it's got a lot to transition from. It had this huge disruption of the pandemic, which changed some features of the economy. It tended to ... It put everybody at home, for one thing. It shut off some places they normally would spend income in services, and it produced an awful lot of spending on goods. In many cases, a lot of the demand for things has been drawn forward. In other words, people may not have been intending to renovate their kitchen or put in new carpeting or get a new car in the driveway. Maybe their plan was to do that another year down the road or two years down the road, but, being at home, being able to perhaps control some of those things, having the income to do it, especially since they weren't spending on services, meant that a lot of that stuff got done. And now it's done. People are unlikely to be putting in new carpets again right away.

And so, we're going through a transition where, as the economy opens up and people go back to spending on services, they reduce their spending on goods to some degree. And the good side of the economy is having to contend with that. And we're seeing in many manufacturers reporting that inventory levels have moved up because goods are not moving off the shelf as fast as they normally would, and that may provoke a slow down in the manufacturing sector. Worth remembering, that manufacturing is about 15% of the U.S. economy, so it's much smaller than the services side, which would be 60% plus of the economy.

So, a slow down there should be manageable, but it's also fair to say that, while it's 15% of the economy, it's somewhat larger in relation to the total of the stock market. So, it may have a larger effect on the stock market than it might on the economy. In any event, it seems to us that it's possible to transition through this period, have a slow down in goods, and a reacceleration of services and not head towards recession, and our scorecard would seem to be bearing that out.

I'll mention one other thing while I'm on that topic because another way of looking at this we've also mentioned in the past is the way that Eric Lascelles, the Chief Economist at RBC Asset Management looks at it. He looks at 17 different economic variables, which have the common characteristic that they behave differently in different parts of the economic cycle. In other words, when you're just coming out of recession, and you're early in a new economic expansion, they behave differently than they do later on in mid-cycle and even further on as you get towards late in the cycle or end of cycle, and, or certainly they behave differently in recession. And he scores these every month as to where they appear to be in the economic cycle, given their behavior. And it comes down very firmly, and the strong preponderance is ... are in mid-cycle. There's still a number operating as though we were in early cycle, and there's a growing number operating as though we're in late cycle, but really the data says we're in mid-cycle.

Well, that's good to know, I think, and probably corroborates what our recession scorecard is saying. And I think, from an equity market standpoint, that a way to picture this is that, when you do come out of recession, and you can go back recession after recession and look at it, when you all of a sudden flip from an economy that's shrinking and shedding jobs and creating worries about the future, to one that has turned the corner, you enter a period of very rapid growth. You're putting a lot of unemployed people back to work. You're restarting factories. You're putting on the second shift or the third shift. Everything, a lot of unused resources come back into play, and you get very strong growth, not least because you're comparing it to the prior periods when you were in recession that were quite weak.

And so, the comparisons are quite good, and the market sees this coming a bit ahead of time and starts turning up. And you get sort of this perverse period where the economy is still weak, in people's minds anyway, and they're still worrying about all the problems in the economy, but the market is heading up, and it seems not to make sense, but, finally, everybody's psychology kind of joins in and recognizes that things are improving. And you have gone through this period of perhaps a year, maybe longer, where all things are kind of going straight up. And then, the rocket ride is over if you like the ... You are kind of up in an altitude where you switch from climbing constantly at a rapid rate to kind of leveling off, and the economy growing, but at a more sustainable, not an explosive rate. And that transition from the rocket ride to leveling off, it very often creates volatility in people's expectations and in different parts of the economy performing differently, and in the equity market's response to that, and the fixed income market response to that. So, I would argue that's what we've been going through since late last summer. We've been in that transition period, and it has presented some uncertainty and some volatility along the way.

Now, it depends where you go from here, but our view is that the transition may take the better part of this year in some respects, but that there remains a period of sustained growth for the economy out through this year and next year, and may well beyond, not necessarily, but beyond, and if that's the case, that markets will adapt to this and they've been doing that, and, but will regain their footing, and at some point move on to new highs. That's how we are looking at it, and in the absence of more disturbing signals from our recession scorecard, that's how we would try to position it.

So, I just would reiterate that it's the economy that drives things, especially the U.S. economy. It's having a sense of where that's going that's important. There are varying opinions out there about where it's going. We have new things thrown into the mix we haven't had to worry about in a long time like inflation. There are opinions, but our view is that, inflation or not, that we are going to have positive growth this year, not as strong as it was last year, but nonetheless positive, and that that will continue on into 2023, and that even if we were headed towards a recession, because inevitably, at some point rates would get high enough to choke off growth, that that point is not yet close. And that is going to be some time before it is. So, that's where we are at the moment, and I think, comfortable being there.

Mark Bayko:

I'm wondering if we could just spend a few minutes on the inflation side of things, just because I think that's probably an issue everybody's concerned about. I mean, we're facing higher prices it seems like on a lot of goods, whether it's oil or food, or just everyday things. You mentioned the general leveling off of growth, as we transition from goods to services. Do you expect to maybe see the same thing on the inflation front? Are we getting close to the point where inflation starts to be a little bit more contained than we've seen up to this point?

Jim Allworth:

Yeah. Well, I think we do. And the first reason is because we're starting to enter the period where we're no longer comparing the inflation that we've got right now with a period a year before when inflation, if anything, was headed the other way, and prices were weak, to a period where we're now comparing it to a time last year when a lot of prices were already up a fair bit. And so, the comparisons are a bit more legitimate, if you like, and oranges to oranges. And we saw in the most recent quarter that there was a very minor decline in the inflation rate, still at an uncomfortably high level, but not quite as high as it been the month before. Whether that continues without ... Is that a real change in trend, and we're headed in that direction? Well, still hard to say, but there's some reason to think that that's correct.

And it's hard to get your mind around this, but, for example, gasoline is still going up in price, and it's hard to imagine the inflation rate is leveling off or coming down if it's still going up in price, but what you really need is for gasoline not to go up as fast as it was going up in the prior period. And there's some signs on many fronts in pricing that that's happening. So, a lot of people believe that the inflation rate has peaked. We're probably in that camp. And then, it becomes a question of how fast do you think the inflation comes down? And there's definitely divided opinion about that. There are people who think that this is being totally underestimated, and it's going to be stickier and much more difficult for a longer period than people understand.

And then there's other people who believe there's going to be a sharp reduction in inflation over the rest of this year. And since both camps have people in it who have lots of credentials and track record and are highly regarded, it's hard to dismiss either one out of hand. So, there are a couple of people out there who believe that, by the end of this year, inflation is going to be down pretty close to the Fed target, on a core basis anyway. If you take out food and energy, that you're going to be down to something closer to 2.0%, 2.5%, which would be a startling decline, and others who believe that it might not be coming down at all. So, maybe not unexpectedly, we're somewhere in the middle of that. Our view is, I think we'd express it this way, that inflation has probably peaked in terms of the year-over-year numbers on both the headline and the core rate, and that there is going to be some subsidence in the inflation rate over the rest of this year.

But our view is that, when we get to the end of the year, we're still going to have a number that, in the context of the kind of inflation we've had over the last 15 years or so, is still going to be unsettling and uncomfortable. So, I don't think we are thinking that we're going to have inflation down around 2%, but we might see inflation coming down into kind of the four or five range and which would still, I think, be regarded by a lot of people and us too, as high. It would be above the Fed and the Bank of Canada's target, but the direction of movement would be right. And we would expect further subsidence in the inflation rate next year because one of the things that is going to keep inflation higher than it might otherwise be over the rest of this year is the fact that services are getting their customers back, and there's some price increases going on. We've seen airfare increases and a whole bunch of things like that. Hotel room bookings are stronger, and hotel rates are up, and a variety of other areas in the service side are having more inflation that's going to add to things even if inflation from goods falls away.

And, but when we get to 2023, and that rush of people going out to get in a holiday and get on a plane and all that subsides a bit, and we go back to something more sustainable, then we may well see that inflation on the services side subsides a lot too. So, we think there'd be more improvement in 2023 and see inflation come down some more.

But I think our general view is that, if you are looking out over five or 10 years, that we went through a decade following the financial crisis and really even a period prior to that, where inflation was a lot lower than people expected it to be, and a lot lower than the Bank of Canada or the Federal Reserve's target of 2%, and that even though those banks tried hard to produce a bit of inflation, which would've indicated the economy was sort of normalizing, they were really unable to do it, and inflation stayed below their markers for quite some time. And I think our view is that, even if we improve on the inflation front, after we get past the peak, that there's a pretty good chance that, when we look back at this from the vantage point of four or five years out, that the inflation rate is going to be still running slightly above the Fed or the Bank of Canada's target, rather than below it. So, I think that can be built into expectations too.

Mark Bayko:

Great. Why don't we wrap up with the last question on a subject that probably doesn't get as much attention as it should, and that is the fixed income side of things. I think what's made this year challenging for investors has been the fact that bond yields have risen. And so, the fixed income portion of some portfolios has just not offered the kind of diversification benefits that we've seen in the past, but, at the same time, bond yields are meaningfully higher and more attractive today. So, how do you think investors should think about fixed income going forward?

Jim Allworth:

Well, I think it depends on how ... your approach to fixed income. But there are ... Our way has been to kind of build in stability and predictability, and for a long, long time, we've tended to structure our fixed income portfolios in the form of what we would call a bond ladder, where, of the money you've committed to fixed income, some portion is invested out for, let's say for the sake of argument, one year, and another portion for two years and three years and four years and so on. And you make some judgment about how far you want to go out in total. And then, what you have is a portfolio that kind of has part of its holdings maturing every year, and they get reinvested at the prevailing rates at the time. And so, gradually, the returns from your fixed income portfolio adjust to changes in the interest rate environment.

One of the implications of that is that you're going to hold these investments to maturity. Having said that, you're required, or we're certainly required to report things as mark to market. In other words, when somebody gets their statement, it looks at what their bonds are worth. We're talking about what they're worth that day in the marketplace. You may be holding them to maturity, and they're going to mature at their full value at some point in the future, but there's a current market value that has to be reported, and that can be unsettling when rates are going up because bond prices are usually going down then.

But the approach, the laddered approach, kind of is self-adjusting and, I think, provides the things we'd like from fixed income and portfolios, which is, one, some, a shock absorber potential. In other words, it's part of the portfolio that should be less volatile in terms of market value than an equity portfolio would be and some certainty about income. Well, the certainty about income for the last number of years is it was going to be very low because even portfolios that had been laddered for a long time had gradually adjusted to a much lower interest rate environment. And now, we've got rates stepping up. But what we do know is that, as things mature in portfolios, they'll be reinvested at higher rates and that we should be seeing those higher rates gradually fill the portfolio. I think that says something about how people should be thinking because I think this has been a very difficult decision for a lot of people for a long time. They would have something mature in their fixed income portfolio on the prevailing rate if they stayed with the exact same type of instrument was ... meant that they were going to take a cut in income, and they found that hard to do.

And so, first of all, they looked around for maybe other fixed income instruments that paid more. Well, if they paid more, pretty well, by definition it meant they were riskier and lower quality. And some people also decided that, rather than reinvest in fixed income at all, they'd reinvest in equities where they could get dividend income with a good tax treatment and maybe even a higher after tax yield than they were able to get on anything on the fixed income side. And so, that people wound up seeing their fixed income portfolios diminish as a percentage of their portfolio and their equity portfolio step up.

Well, I think that the current environment, as rates have moved up here fairly sharply, means you don't have to make that kind of a lower-quality decision to the same degree. It's possible to get GIC income and government income and high-quality corporate income that's much more acceptable to people. And the market values of those things have moved to a place where they have less risk associated with them too. So, I think this should be an opportunity to be thinking about an adjustment that puts us back in our normal operating environment, where we have a certain portion for fixed income, and we keep it in fixed income, and a certain portion in equity, and we keep it in equity. And in the fixed income portfolio, we don't have to be forced to take more risk to get more income.

Mark Bayko:

That's great. Thanks for that explanation. And just in the interest of time, why don't we wrap it up there. As always, Jim, thank you 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.