AGF

July 2021

"A New Bull Market" – So far, So good

Tony Genua
SVP & Portfolio Manager
Co-Chair, AGF Asset
Allocation Committee
AGF Investments Inc.

Jonathan Lo
VP & Client Portfolio Manager
AGF Investments Inc.

A More Robust Economic Outlook

In our recently published notes, we discussed the onset of a new bull market and the prospect for a long runway for upside despite the significant market appreciation off the March 2020 bottoms so far. We thought it would be useful to update our readers on what has transpired over the past three months where we have seen a shift in expectations for the economy and for corporate earnings.

One of the biggest shifts that we have seen over the past several months is a positive shift in economic expectations, whereby consensus expectations have moved towards our view. With a promising economic "reopening" underway, substantial stimulus measures already in place, significant consumer savings and pent-up-demand to spend, we reasoned that GDP estimates were likely too low (three months ago, consensus estimates called for 2021 U.S. real GDP growth of 5.7%). We thought that there was a reasonable chance for U.S. real GDP growth to exceed 7%, conditions which historically have tended to result in strong equity market performance.

In the months since, we have seen U.S. real GDP consensus estimates move higher – according to Bloomberg, the year-over-year U.S. real GDP estimate for the end of this year is now 25% higher at 7.1% from where it was as of mid-March. This higher GDP growth estimate represents an incremental $300 billion of economic activity. We believe there is scope for GDP growth to move even higher, given that there is plenty of near-term economic momentum with the Federal Reserve Bank of Atlanta's GDPNow indicated 7.9% real GDP growth for the 2nd quarter. Pertaining to economic growth beyond this year, the recently announced infrastructure plan, while reduced from the original sought-after amount, should help sustain economic growth as the spending is to take place over the next eight years.

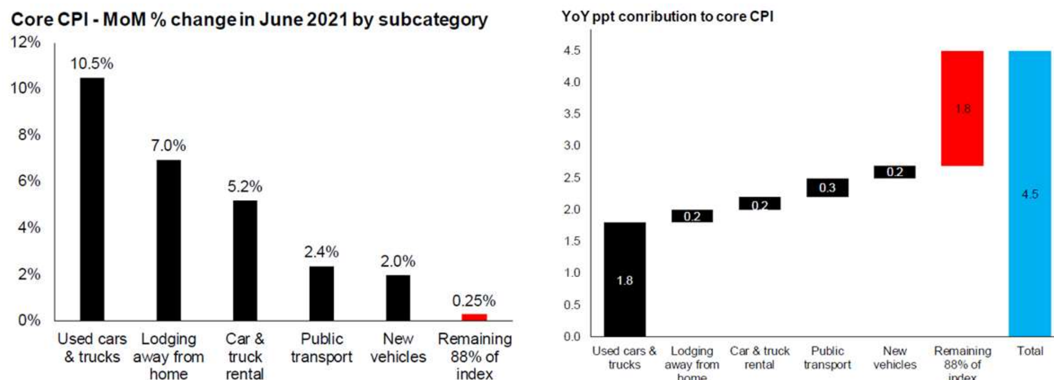
Fears of Higher Inflation and Rising Rates Moderating

Meanwhile, the fear of higher inflation resulting in rising rates has subsided somewhat - recall, this was the most pressing topic in the first quarter. And while it is still true that rising rates may dampen certain rate sensitive industries, the reality is that rising rates have historically not significantly damaged the prospects of stock market returns –in 13 out of 15 rising rate environments in the past, the S&P 500 delivered positive returns.

In the past few months, it does appear that the fear of inflation and rising rates was overblown – while U.S. core CPI in June came in at +4.5% year-over-year (the fastest pace since 1991), much of it remained concentrated in idiosyncratic reopening related categories – particularly used cars and trucks. And the U.S. 10-year yield has since

drifted back down to a low of 1.25% on July 8th and up slightly to a recent 1.38%, (after reaching a high of 1.74% on March 31, 2021).

Figure 1 – U.S. Core CPI Change by Category



Source: Macquarie Research, as of July 2021

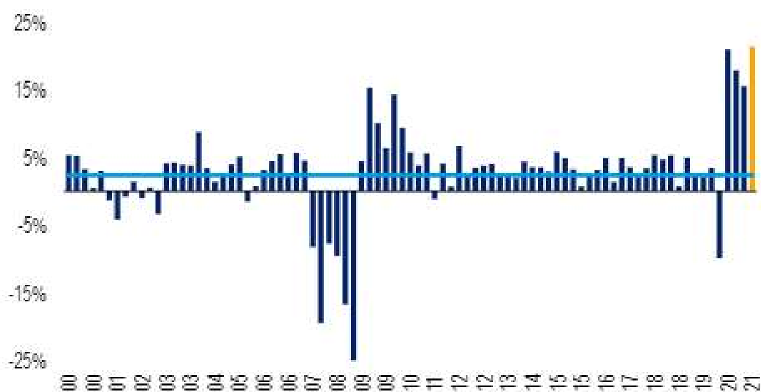
While the drumbeat on the two concerns of inflation and the Fed starting to taper and/or raise the discount rate may have abated somewhat, we do believe these market concerns will be with us for awhile. We would not be at all surprised (and in fact expect) rates to gradually move to a higher level, though not enough to derail economic growth or the equity uptrend.

Earnings Estimates Moving Higher

Three months ago, we also argued that earnings were poised to beat consensus estimates, arguing that robust economic growth was conducive to robust corporate profit results, and that typically consensus estimates are too conservative in the first year of a profit recovery. That was true in 2003, it was true in 2010, and it appears 2021 will be no different.

Indeed, in the quarter that has transpired since, S&P 500 earnings have come in with a record beat, as Q1 EPS was 21% above analyst expectations (up 57% year-over-year and up 23% vs. pre-COVID Q1 2019). In fact, the Q1 2021 EPS beat was the biggest in history when compared to the consensus estimate at the start of the quarter.

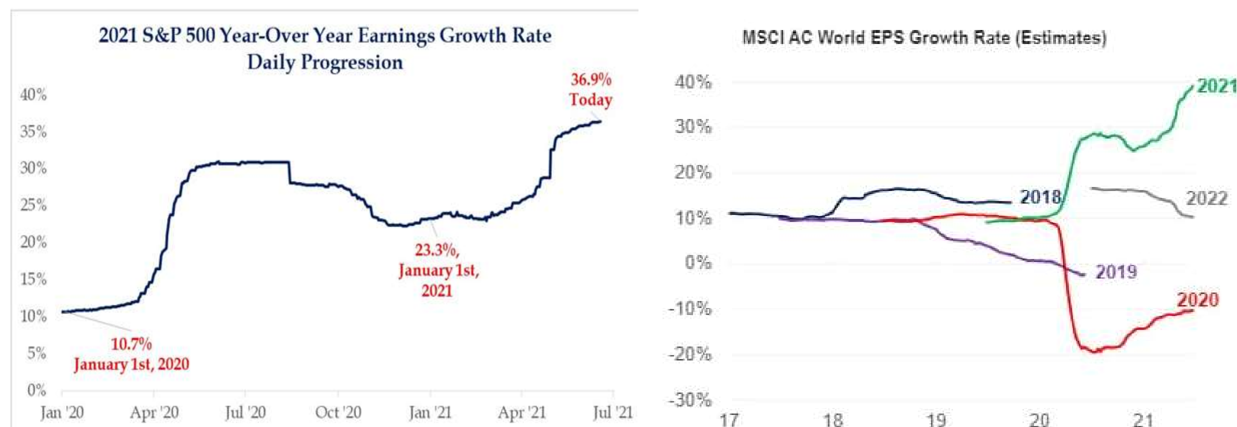
Figure 2 – S&P 500 EPS Beat (%) versus Consensus Estimate at the Start of the Quarter



Source: Bank of America Merrill Lynch, as of May 2021

Meanwhile, consensus estimates have moved higher for 2021 earnings growth to reflect the robust environment that we have seen so far. Consensus estimates are now for 37% earnings growth on the S&P 500 and 39% on the MSCI ACWI this year.

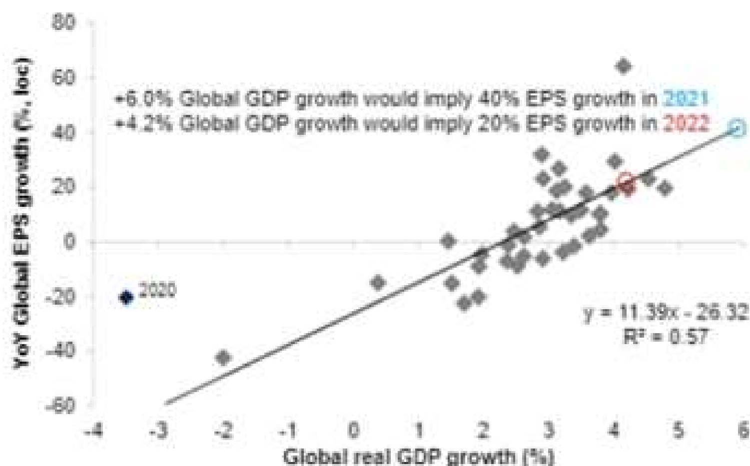
Figure 3 – Consensus Estimates Moving Higher



Source: Strategas Research (LHS), Citi Research (RHS), as of July 2021

And yet, we believe there could be further upside for earnings estimates, as the historical relationship between earnings growth and real GDP growth suggests that 40% earnings growth is implied by 6% GDP growth. Given that current 2021 real GDP growth estimates in the U.S. are over 7% with scope for further upside, we similarly believe that earnings could be revised higher yet.

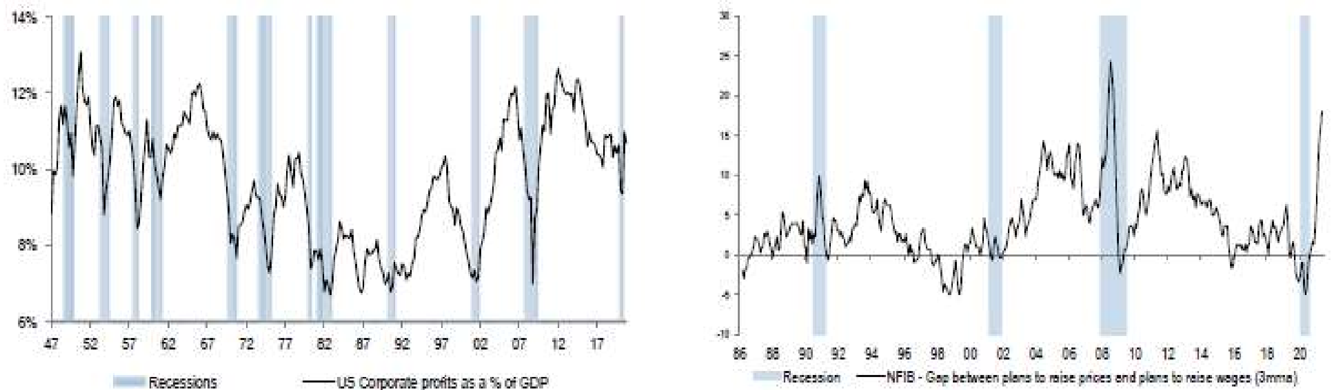
Figure 4 – Global Real GDP Growth and Global EPS Growth



Source: Citi Research, as of July 2021

Perhaps one aspect that will enable U.S. corporate earnings to surprise to the upside are improving profit margins. Though many investors have worried about input cost pressures, U.S. corporate profit margins have begun to inflect higher, with profit margin proxies – output prices minus input costs – showing significant strength recently. One aspect to also consider is the margin leverage from robust revenue growth. Since it appears nominal GDP (real GDP plus inflation) has a very good chance of exceeding 10% this year, we can expect corporate sales results to also exhibit healthy growth since revenues are highly correlated with nominal GDP growth. This in turn should help to mitigate higher wages and input costs. Lastly, it appears productivity is on the rise which also contributes to keeping unit labour costs in check.

Figure 5 – U.S. Corporate Profit Margins (LHS), NFIB Survey – Plans to Increase Prices Minus Plans to Increase Wages (RHS)



Source: J.P. Morgan, as of July 2021

What's Ahead Next

What's after the "reopening"? We have been reticent to use the word "reopening" to describe some of the stocks that have led this year, preferring to describe them as "economically sensitive" instead. The word "reopening" is rather narrow, referencing only the brief period that we are seeing now – but what happens after this immediate period of pent-up demand?

Recently we have been putting a lot of thought into what emerging trends are likely to have a significant runway of growth after the reopening. In the period after reopening or in the "COVID-aftermath", some developments are more clear than others and below is a partial list of our considerations:

- A high likelihood of less favourable fiscal and monetary policies, with the Fed beginning to reduce stimulus measures and governments backing off aggressive spending
- COVID, with its many and emerging variants, will remain with us for awhile to come, though not at levels that would necessitate more lockdowns
- Some higher baseline level of inflation may remain
- A new normal with hybrid work weeks will usher in new growth opportunities in areas such as 5G and data security
- Favourable trends not dependent on economic growth in areas such as personalized medicine, health and wellness, and renewable energy
- For the rest of this decade, an increasing role for AI and robotics.

These views and others are the building blocks of how we position the portfolio to participate in new growth opportunities. Over the coming months, we will expand on some of these ideas in subsequent pieces.

The commentaries contained herein are provided as a general source of information based on information available as of July 12, 2021 and should not be considered as investment advice or an offer or solicitations to buy and/or sell securities. Every effort has been made to ensure accuracy in these commentaries at the time of publication however, accuracy cannot be guaranteed. Market conditions may change and the Portfolio Manager accepts no responsibility for individual investment decisions arising from the use or reliance on the information contained herein. Investors are expected to obtain professional investment advice.

AGF Investments is a group of wholly owned subsidiaries of AGF Management Limited, a Canadian reporting issuer. The subsidiaries included in AGF Investments are AGF Investments Inc. (AGFI), AGF Investments America Inc. (AGFA)and AGF International Advisors Company Limited (AGFIA).
AGFA is a registered advisor in the U.S. AGFI is registered as a portfolio manager across Canadian securities commissions. AGFIA is regulated by the Central Bank of Ireland and registered with the Australian Securities & Investments Commission. The subsidiaries that form AGF Investments manage a variety of mandates comprised of equity, fixed income and balanced assets.

The “AGF” logo and “Invested in Discipline” are registered trademarks of AGF Management Limited and used under licence.

Publication date: July 16, 2021