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AGF INSIGHTS

MID-YEAR OUTLOOK

It Depends on Inflation

The economic recovery from last year's pandemic-induced recession gained more steam during the first half of 2021, but given the sheer strength of the rebound in countries like the United States where lockdowns seem like a thing of the past, inflationary fears have now come to the fore and may play the biggest role in determining the outcome of both equity and bond markets going forward.

Members of AGF's Office of the Chief Investment Officer recently sat down (virtually) to discuss the economic backdrop and what investors might expect from central bankers, in particular, over the next six months as it continues to evolve.

Questions and answers that follow have been edited for clarity and length.

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>
> **– Kevin McCreadie**

Let's start with the global economy. The recovery from last year's recession was underway heading into 2021. Has it continued to progress so far this year the way you thought it would?

Kevin McCreadie (KM): It's been clear since the outset of the pandemic and initial lockdowns that the pace of re-openings around the world would dictate the strength of the recovery. But what's been interesting to see play out is the impact that vaccine rollouts in each country have had on economic activity this year – especially when considered in combination with fiscal responses. Without doubt, both have factored into the robust recovery in the United States. Not only did the U.S. get more shots in arms than most countries in the earliest weeks following the first vaccine approvals last fall, it has also continued to lead the charge when it comes to government spending. If you consider Europe, by comparison, its economy slid into a double-dip recession at the beginning of this year and the recovery continues to lag, in large part, because vaccination rates remain relatively low, but also because its fiscal commitment has not kept pace with the U.S. and may only now be starting to catch up.

Mark Stacey (MS): Some investors may have envisioned a more synchronous global recovery given how coordinated the initial lockdowns were, but the multi-speed rebound is evident across the world including right here in Canada where the economy has picked up despite ongoing restrictions, but not nearly as swiftly as it has in the U.S. And then look at a country like Brazil. It's had such a rough first half to the year, but now that vaccinations are starting to pick up, there's growing optimism that it may be closer to turning a corner.

Stephen Way (SW): Japan is another country whose economy has also been impacted by a disappointing vaccine rollout. But now the government says it's on track to have close to 70% of the population vaccinated by the fall and that should bode well for Japan's economy in the second half of year as well as its financial markets. At the very least, it should breed greater confidence among Japanese companies who have been extra cautious with their guidance over the past few quarters.

David Stonehouse (DS): In fact, this may be part of what defines the global economy in the second half of the year: Countries that have lagged to date because of slow rollouts may grow more quickly as the vaccination rates pick up and their economies re-open more fully.

KM: And those that continue to struggle with their rollouts may lag. This may end up being most evident in the Emerging Markets where, aside from China, vaccination rates are not expected to reach a critical mass until next year at the earliest.

SW: Yet, when you look at the Emerging Markets as a whole, they will likely exit the pandemic with far less debt than the rest of the world. They've spent far less than the developed markets, choosing instead to focus on structural reforms, and that may end up being a better platform for growth over the long term.

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Aside from the multi-speed recovery that is playing out, what other aspects of the recovery to date will have implications for investors over the next six months?

SW: Inflation has emerged as perhaps the biggest concern and it will likely have a huge influence on markets going forward, both in the short and long term. In particular, the pace of U.S. economic growth, has been much greater-than-expected – even when taking into account the tremendous fiscal and monetary accommodation of the past year – and that has led to increased demand for a number of products and services. But the tremendous price increases we've seen in things like lumber and copper are equally the result of labour shortages and supply chain disruptions that have also come to the fore. The big question now is whether these inflationary pressures are long lasting or more transitory as the U.S. Federal Reserve has repeatedly said over the past few months.

KM: Part of the supply chain disruption stems from the fact that demand has been somewhat concentrated while the economy was locked down and then again as it re-opened in stages. Think of all the people who renovated their homes or outfitted their place with home gyms and exercise bikes over the past year. In part, that's because they have been limited in what they can do with their money. But now, just when production has ramped up on goods and materials related to these types of projects and activities, there's every chance that the demand for them will wane as life returns to normal and there are more and more ways to spend going forward. In other words, we might end up with too much supply, which would result in lower prices, not higher ones, in certain cases as we move into the future.

DS: And because people haven't been able to just go out and buy everything they wanted all at once, we may end up with a more robust, sustained recovery over time as opposed to one that for some might seem destined to overheat. It's also important to remember that most of the fiscal stimulus – in the U.S. at least – is now behind us and while there's still more on the table, it's unlikely to be the sure-fire economic catalyst it has been over the past year.

KM: Moreover, let's not forget that inflation data is mostly based on year-over-year comparisons. Prices had nowhere to go but up following last year's recession, but it is going to become increasingly difficult for them to keep growing at the same pace when taking into consideration the higher base that will be used to calculate the percentage change from here. Either way, we may not know what's what until the fourth quarter, when kids are firmly back to school, people go back to work and, in the case of the U.S, the extended unemployment benefits expire. Even then, we may get a head fake. Spending might not be what some expect if employers go with a hybrid model and people continue to work from home and choose to save on what they would spend on their daily commute versus using it to fuel discretionary spending.

SW: Even if the recent spate of higher prices proves transient, it does feel like we're on the cusp of a more persistent style of inflationary environment – maybe not quite like the 1970s, but certainly unlike anything we've experienced in a long time. For example, if you consider fiscal and monetary policy as it stands today, it is not

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only massive in scale, but also very focused on righting social disparities through programs that promote fuller employment and higher wages over time. In fact, as most of us know, the Fed changed its mandate last year to let inflation run hotter than it would have in the past in hopes of getting the unemployment rate down as far as it can go.

DS: I agree. The seeds of higher inflation are being sowed but may not fully flower until things first settle down in the near-term, post pandemic. And then, once prices do start to grow more stubbornly, I'm not sure it's a runaway event. There are still deflationary aspects of the economy including too much overall debt and an aging population that could eventually weigh on economic growth – and, therefore, inflation – unless productivity ratchets up considerably from current levels.

KM: If inflation does prove more persistent in time, it may end up being more like the 1990s with inflation in that 3% to 5% range as opposed to the double-digit inflation of the 1970s. But that's still 20-plus years ago and there is a whole generation of investors who have never invested in an inflationary environment like that, which is potentially problematic in and of itself.

SW: On top of that, this idea of inclusive growth is new to investors. While it may be the right thing for society, it may lead to higher taxes and social spending as well as lower equity valuations. Of course, that may not be so bad if profits continue to grow.

DS: There's also an argument to be made that more inclusive growth will actually keep inflation lower by reducing the current level of populist rancour now evident around the world, as well as keeping at bay the threat of re-unionization which could be even more inflationary in the end.

Given this uncertainty about inflation, what are your expectations for financial markets in the near term?

John Christofilos (JC): Secular bull markets tend to last anywhere between 15 to 18 years depending on the research being cited, so, from my perspective, there's still scope for equities to move higher over the next six months – at least in the aggregate. But here's the caveat: While stocks almost always lead the economy into and out of recession, the magnitude at which they have done so this time around suggests more volatility may be on the way

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and could result in more muted gains or even a sizable pullback before the next big leg-up can occur. In fact, if you look at the S&P 500 Index, over the past month or so, it has traded in a very tight range despite one of the strongest U.S. earnings seasons in a very long time.

Rune Sollihaug (RS): We may experience the occasional spike in volatility in the near term, but something similar in magnitude to what occurred this past February as opposed to a massive spike like last year at the height of the pandemic's initial wave. The Volatility Index (VIX) has gradually fallen from its high-water mark back then then and is now hovering near pre-pandemic levels. That's generally a good sign for stocks going forward.

MS: We're probably all in agreement that it's too early to call an end to the equity rally, but we probably also agree that there is a risk of a correction in the near term. To that end, the Fed seems to have convinced most investors that inflation is, in fact, transitory and it has been adamant that it has no plans to raise rates until 2023. But what if it's wrong – or not exactly right – and the labour market tightens faster than expected? This could force the Fed's hand sooner than it wants to and, whether it raises rates in the next six months or not, that would probably be bad for equities and likely bonds as well.

JC: But if the Fed is right and investors are reassured that interest rates are going to stay low for longer, that could be the catalyst that ends up propelling stocks higher.

KM: In that scenario, investors might eventually start to worry about deflation. As we noted earlier, even as the recovery rolls on, it's going to be difficult to maintain the same pace as the past two quarters. And while that wouldn't be terrible for stocks, it could push investors more towards growthier parts of the market again. But quality growth names this time. The speculative side of the hyper-growth trade that dominated last summer is probably behind us for now.

DS: Government bonds are probably in tough either way over the next few months. There's likely too big a gap between the 10-year U.S. Treasury yield and growth rates right now to keep yields from moving higher. And that seems logical even if inflation doesn't persist at today's higher levels. To be clear though, investors should not be expecting the Fed to raise interest rates this year even if inflation proves more stubborn than it anticipates. The Fed is too committed to its new employment mandate to pre-empt that objective for the sake of taming slightly higher inflation. At this rate, the tail end of 2022 seems like the earliest it might act unless something dramatic changes on the jobs front.

SW: No interest rate hikes, but there will be more talk of the Fed tapering its quantitative easing program in the second half of the year. That could end up being a headwind for stocks if history is a guide and how Fed Chair Jerome Powell chooses to communicate on that front will be key. So far, he's been much clearer about his intentions than his predecessor, Ben Bernanke, was when he set off the Taper Tantrum in 2013.

DS: The Fed is being much more transparent about it this time around, but it's still a binary event. Either it tapers or it does not. Plus, the current market rebound has been one of the best in history, so it sets the bar high for weathering a tapering initiative without a hiccup.

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MS: The market environment is very different today than it was in 2013. There wasn't inflation back then, just a low unemployment rate, and the stocks leading the equity market higher were concentrated within interest rate-sensitive sectors like Real Estate Income Trusts (REITs) and Telecommunications. If tapering took a bite out of markets this time out, it would be cyclicals getting hit and defensives might rally – especially if investors take it as a sign that higher interest rates are soon to follow.

What opportunities does this macro environment afford investors?

MS: When I look at Purchasing Manager Indexes (PMIs), which have probably peaked, but will likely stay elevated for some time still, it suggests we're at a stage in the economic cycle that will give a bit more lift to factors like quality and low-volatility. As that relates to sectors, many of the so-called early cyclicals (i.e. lumber companies and automakers) – have already had a massive run up, but "late" cyclicals including energy, financials and infrastructure stocks are starting to look more attractive.

SW: Quality cyclicals tend to do well in this type of environment and that includes select industrials names that could benefit from an expected increase in capex spending and productivity, as well as the ongoing re-shoring of manufacturing. Defensive sectors such as healthcare and consumer staples, meanwhile, may become attractive as we move closer to the end of the year. While valuations look good now, more clarity around the trajectory of Treasury yields is needed to commit more fully to these bond proxies. Lastly, valuations are generally more attractive for stocks listed outside the U.S. than they are within, in large part, because the rest of the world is at an earlier stage in the recovery.

DS: From a fixed income standpoint, bond investors should prepare for another leg up in government bond yields after what was a tough first quarter. Credit spreads are also tight because of the economic backdrop, but given cash flows are solid and defaults remain minimal, high-yield bonds should help offset any weakness in government bonds. Moreover, convertible bonds should also be a good diversifier, largely because equity markets are likely to do better than bonds over the medium term, but whether Emerging Market debt can outperform may depend on what happens with the U.S. dollar. If the greenback weakens from here, that could be very positive.

KM: The opportunities are out there for investors, but as we've noted, the second half of 2021 is likely going to be a bit trickier to navigate than the first half of the year. As such, investors will need to pick their spots carefully and maintain broad diversification across asset classes in case things don't quite go according to plan. But if the economic recovery continues to gain steam without overheating and policymakers can stay the course, there's good reason to be optimistic for how the next six months will unfold.

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In the role of CEO, Kevin is responsible for the overall success of AGF, overseeing the firm's mission, vision and strategic direction. He also leads AGF's Executive Management Team and serves as its liaison with AGF's Board of Directors. As Chief Investment Officer, Kevin provides direction and leadership to AGF's investment management teams and leads the firm's global institutional business. In carrying out these responsibilities, he leverages The Office of the Chief Investment Officer, a structure put in place in August 2018 that encourages collaboration and active accountability across AGF's investment management teams and broader organization, capitalizing on the firm's depth of talent while driving forward the teamwork that is necessary for the long-term success of its investment management.

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John leads a team responsible for trading the more than $36 billion in Assets Under Management across AGF's Retail, Institutional, High-Net-Worth and ETF portfolios. He is also a member of AGF's Business Development unit with responsibility for reviewing and leading Capital Markets opportunities and technology advancements. John is also a member of AGF's Office of the Chief Investment Officer.

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Publication Date: June 28, 2021. RO: 1696800

FUND1199-06-21-E