Fits and Starts

QPW Perspectives – May 2021

"Fits and starts" is an expression used to describe circumstances in which activity can be intermittent, variable in intensity, and prolonged by interruptions. As will be discussed, it's an appropriate way to describe the current environment as economies work towards recovery from the pandemic.

First, a quick review of 2021 so far.

2021 Jan. 1 – Apr. 30 Returns	Base Currency	CAD $ Equivalent
Canadian equities (S&P/TSX Index) CAD$	+10.6%	+10.6%
U.S. equities (S&P 500 Index) USD$	+11.8%	+6.2%
International equities (MSCI EAFE Index) USD$	+6.6%	+2.6%
Canadian fixed income (FTSE Canada Bond Universe Index) CAD$	-5.0%	-5.0%

Source: Bloomberg and FTSE Russell.

The first part of 2021 saw a continuing trend of strong equity market performance despite global concerns regarding COVID-19 variants and slower than expected vaccine roll-outs in several countries, as markets chose to focus on optimism around future post-pandemic earnings.

Some of the themes supporting positive returns were different for 2021. Canadian equity markets were strongly supported by a rebounding Energy sector which returned +23% on a year to date basis as of April 30, 2021. This was a notable offset to the sector's 2020 full year return of -26.6%. Strong energy sector performance also provided a boost to the Canadian dollar, which appreciated by approximately 3.6% for the first four months of this year. The other material contributor to Canadian equity index returns came from the Financials sector which returned 17% for the first four months of this year and carries a sizeable 30.6% weighting in the index. These factors allowed Canadian equities to outperform their U.S. and international counterparts on a Canadian dollar basis.

For 2021 so far, there has also been a shift in the performance of "growth" versus "value" equities, with "value" outperforming. Using U.S. equities as an example, as of April 30, 2021 the S&P 500 Value Index returned 14.9% on a year-to-date basis, versus the S&P 500 Growth Index which returned 9.1%.

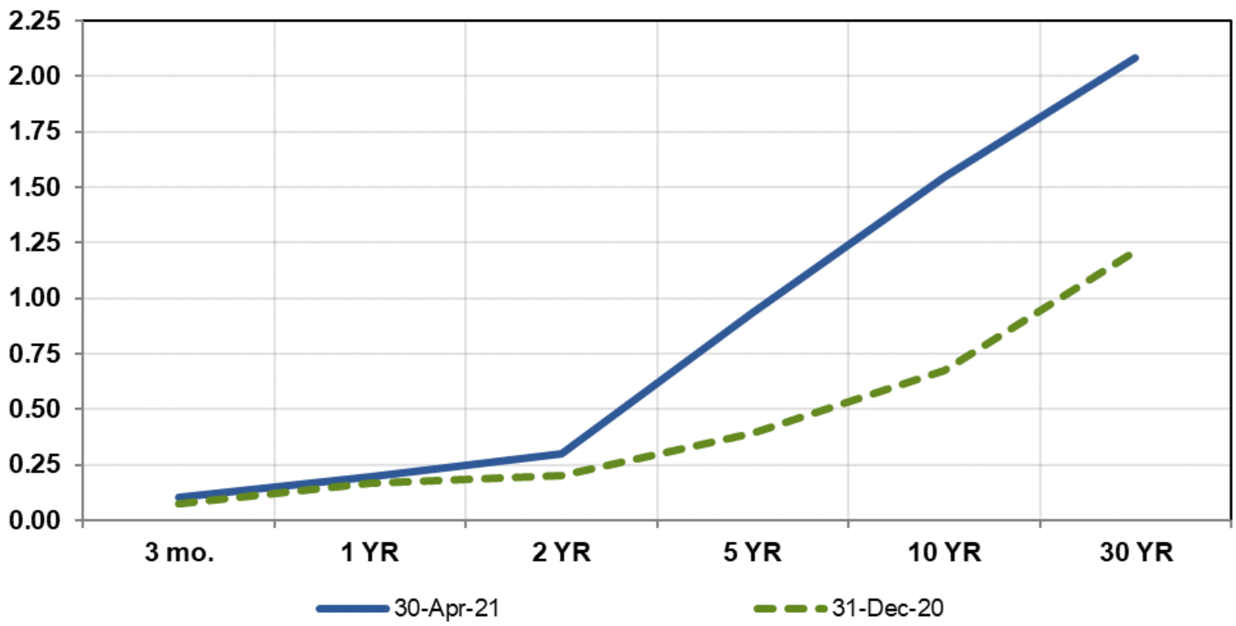
Broad Canadian fixed income markets returned -5.0% for the first four months of 2021. Taking a closer look at the overall return reveals a notable divergence in fixed income performance between the maturity groupings.

FTSE Canada Bond Universe Index	Effective term to maturity	2021 Return Jan. 1 – Apr. 30
Entire index	10.5 years	-5.0%
Short-term bonds	2.9 years	-0.4%
Mid-term bonds	7.5 years	-4.0%
Long-term bonds	22.9 years	-11.1%

Source: FTSE Russell.

Given the inverse relationship between bond prices and yields (or interest rates), the negative performance breakdown illustrates how long term yields have increased more than short term yields. From a yield curve perspective, which is a graphical representation of the term to maturity of a bond versus its yield, this would be referred to as a steepening of the yield curve.

Canadian Yield Curve



Source: Bloomberg

These changes in the yield curve are typically considered indications that market participants are expecting higher interest rates in the future, as long term interest rates have increased while short term interest rates are relatively unchanged.

The notion of inflation and increasing interest rates has dominated recent news articles, leading some to believe that inflationary conditions may resurface sooner than expected. This is not necessarily the case.

Inflation – This Time is Different

In assessing the potential for inflation, there are key indicators central banks look to in making monetary policy (and interest rate) decisions:

- Bank of Canada – The rate of inflation is the primary decision making tool used for monetary policy decisions. The Bank of Canada focuses on the Consumer Price Index (CPI) and looks to maintain an inflation target of 2% with a control range of 1% to 3%. Changes in CPI reflect the degree to which prices in a common basket of goods are increasing.
- U.S. Federal Reserve – The U.S. Federal Reserve views two measures as having equal importance in making monetary policy decisions, one being the rate of inflation and the other being the level of employment.
- European Central Bank – Similar to the Bank of Canada, the European Central Bank seeks to maintain an inflation target of 2%.

From a Bank of Canada perspective, accelerating increases in CPI in excess of 2% would typically indicate the need for restrictive monetary policy actions (i.e. increase interest rates) in an effort to stave off inflation. But these aren't typical times. We've spent the past year in a pandemic, and the pandemic has fueled a widening economic divide, depending upon which sector a business or individual is in.

Sectors such as hospitality, travel and leisure, among others, are a long way off from recovery. Across all business sectors, many small and medium sized businesses are struggling and these companies represent the majority of economic activity, as opposed to large companies that are publicly traded on an index. On the other extreme, certain sectors, such as Information Technology and segments of the Consumer Discretionary sector, have flourished. Online based businesses and businesses that support them have experienced tremendous growth as people have embraced online commerce and communication. These economic sectors will experience inflationary conditions well before the businesses that lost ground during the pandemic.

There is also a widening divide in individuals' economic experiences. Those working in sectors that were not negatively affected have accumulated wealth over the past year, due to lower lifestyle spending given the pandemic restrictions. Conversely, people who work in sectors and businesses hard hit by the pandemic have lost income and/or jobs.

What's a central bank to do? The Bank of Canada's traditional inflation indicator (CPI) doesn't take the varying effects of the pandemic to businesses and sectors into account nor does it consider employment levels. Making a decision based purely on increasing prices for an overall basket of goods and services will not be sufficient given the economic differences in various goods and services.

The Bank of Canada does realize the need to rethink factors that determine monetary policy decisions. As discussed by Bank of Canada Governor, Tiff Macklem, at a speech to the House of Commons Standing Committee on Finance last week:

> *"The Bank remains steadfast in our commitment to support Canadian households and businesses through the full length of the recovery. For working Canadians, a complete recovery means a healthy job market with good opportunities. And that includes low-wage workers, women and young people who have been hit hard by this pandemic."* And that *"As the recovery continues we will be paying close attention to a broad spectrum of indicators of slack, including a number of labour market measures".*

The Bank of Canada has signalled it will look beyond its traditional primary measure (CPI) and pay closer attention to employment data, similar to the U.S. Federal Reserve. Hence, Canadian monetary policy considerations to manage inflation are a bit different this time around and justifiably so.

Fits and Starts

Given our understanding of how the pandemic has negatively affected certain sectors while benefitting others, there will be an unevenness to how the economy, as a whole, recovers to full capacity and beyond. And there may be pauses along the way, depending on the ebbs and flows of the pandemic recovery.

There will also be fits and starts to how various economies around the world recover as they will not all come out of the pandemic at the same time. Depending on the degree to which certain countries or companies rely upon others for goods and services, this will cause fits and starts. For example,

- As U.S. automakers seek to increase production capacity, many parts are arriving late and overseas assembly plants are not operating at full capacity because of COVID-19 related worker absences and a congested shipping system.

- There is a global semiconductor chip shortage which is leading to production delays across many sectors. Bluntly put, this shortage is the result of more demand and less supply. The pandemic resulted in increased demand for home networking equipment and other products being used for the "stay at home" era. Correspondingly, there was a decrease in supply as the pandemic affected production capacity and several key suppliers of semiconductor chips have also experienced production disruption due to natural disasters.

  These semiconductor chips are used in computers, electronics, gaming systems, vehicles, televisions, and home appliances to name a few items. Recently, Apple announced that iMac and iPad production will be delayed due to the chip shortage and is forecasting $3-4 billion of lost revenue next quarter.

Given these dynamics, there will be economic volatility which may translate to financial market volatility over the short to medium term. Also, as the economy recovers, increased taxes are expected which may further delay the need for inflationary measures.

Keep the Fits and Starts out of your Financial Plan

A sound financial plan has the discipline to maintain focus on the long term irrespective of short term volatility. One could argue that the pandemic doesn't feel like a short term event, but in the context of an individual's long term financial plan, it is.

Predicting the timing of when we will fully recover from the pandemic is not realistic. When it comes to investing it is best to focus on things that you have control over. QPW continues to maintain a long term view and focuses its efforts on asset allocation policy, manager selection, and systematic rebalancing in light of each client's individual financial circumstances.

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