Second Quarter 2021

Double, Double, Inflate and Bubble, Then… Nothing?

Commodity Prices Rocket 🚀, Inflation Expectations Rocket 🚀, Stock Rocket Remains in Air 🚀, but China Looks to Tame the Rockets 😔

We Couldn't Help Ourselves in the Emoji Era
[Note that the Emojis do not reflect any sentiment we may have toward any security or asset class]

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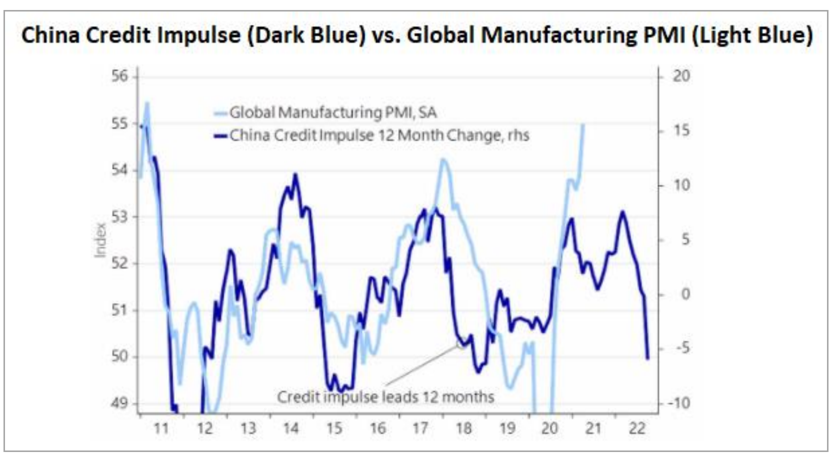
Quarterly Summary and How We're Positioning for Q3

If Q2 needed to be synopsized to one single theme, it was rapid commodity inflation and the second-order effects of that inflation. Lumber prices, as measured by the CME's Random Length Lumber Continuous Contract, rose as much as 66% in Q2 causing panic among homebuilders, contractors, homebuyers, and birdhouse manufacturers alike. Lumber prices have since reversed all of those gains and ended the quarter down 29%. This pattern is consistent throughout much of the commodity complex, from food to fertilizer to base metals. While most commodities simmered down in Q2, many are still up substantially in 2021.

Energy prices on the other hand have bucked this trend and finished the quarter at multi-year highs. Oil prices climbed significantly in Q2, rising 24%. China has little control over energy prices due to slow supply growth in response to the spike in demand (which we saw post-COVID) and OPEC+'s dominance over marginal supply. Energy prices may follow other commodity prices lower if global economic growth wanes and broad commodity price weakness persists. Equities performed okay throughout Q2 as they often do during periods of average or slightly above average inflation, with the S&P 500 and TSX composite rising 2.3% and 2.5%, respectively.

The rapid rise in core commodity prices, as well as supply shortages for various core components like semiconductors helped contribute to a rapid rise in the price of houses, appliances and vehicles, emblems of middle class life. There is growing concern that higher commodity prices and ongoing supply shortages will pull at the very fabric of our societies as many may be bumped out of the middle class. While we recognize this concern, and note it as a risk, the key driver of global price inflation, Chinese economic policy, is pointing in the opposite direction of this concern. Below is a chart showing China's "credit impulse" (i.e. a measure of debt/credit growth in China) versus a measure of global manufacturing activity showing a high likelihood of a slowdown in global economic activity.



So China, the "factory of the world", is shifting into lower gear. What are financial markets saying about future commodity prices and inflation? Despite central banks pulling back stimulus measures introduced in 2020 to combat the pandemic and forecasting higher interest rates in future, government bond yields and inflation expectations actually fell throughout Q2. Bond markets seem to agree that China's actions will keep inflation in check. Below is a chart of US 30 Year Treasury bond yields clearly showing that long-term inflation expectations for the US economy peaked in March 2021.

So while financial media continues to run stories about rampant inflation, all evidence points to the opposite – a return to the pre-pandemic global GDP growth of ~3% and a high likelihood that global inflation also returns to the pre-pandemic level of ~2% sometime in 2022. You won't hear this expectation anywhere else but it is hard to expect otherwise when the US 30 Year Treasury bond yields ~2% and the Chinese economy is cooling considerably.

It would be fitting that a return to normal life post-COVID also comes with a return to normal with respect to economic growth and inflation. ***What would a return to pre-pandemic economic growth and inflation rates mean for investors?*** On its own, nothing particularly bad. If economic growth was slowed too much to the point of recession, then the slowdown wouldn't be great for equity markets but not taming inflation could be equally bad for equity markets.

As for equity markets, the 'Great Rotation' from growth stocks to value stocks that we highlighted in our last quarterly commentary reversed in Q2 with growth stocks outperforming. This back and forth between growth and value highlights the market confusion about where interest rates are going and how economic growth will look in the next year. The "Reddit raids" of Q1, which included stocks like GameStop (GME), BlackBerry (BB) and AMC Entertainment (AMC), resumed in Q2 and remain a wildcard for equity markets and a potential positive catalyst for select small cap stocks.

How To Position Portfolios Going Forward?

Broad equity market valuations are near all-time highs, not just in the US but globally, which gives us some concern. That said, elevated equity market valuations are primarily due to a handful of large cap technology and health care stocks that skew the average valuation higher. The median stock is still a little expensive historically but somewhat reasonable given where bond yields lie. We still see many good opportunities in equity markets, especially for blue chip value oriented stocks and growth stocks which have durable long-term or generational growth outlooks in truly disruptive subsectors. We believe that stock picking will be increasingly important in a market consisting of stocks with very different valuations.

We continue to prefer many of the names introduced in early 2021 which provide growth at reasonable valuations including Intel (INTC), Cisco Systems (CSCO), Constellation Brands (STZ), Pfizer (PFE), Berkshire Hathaway (BRK.B) and Sonova Holding (SONVY), as well as generational growth plays like Alphabet (GOOG), Amazon (AMZN) and Illumina (ILMN). Defensive stocks like Telus (T), North West Company (NWC), Kimberly Clark (KMB) and Saputo (SAP) remain attractive due to historically average valuations, consistent earnings and slow but steady growth.

We continued to top up our position in long-term US Treasury bonds (via TLT and/or FGO) throughout Q2, though falling yields make adding to these positions less attractive going forward. Outside of the very special situations included in a fund like the Lysander Corporate Value Bond Fund (LYZ801A/F), credit securities like corporate bonds, debentures and preferred shares currently offer historically depressed yields and are not very attractive relative to defensive equities and government bonds. Shorter term government bonds or GICs are now the best place to park low risk capital.

We have started to incorporate more risk-managed equity solutions into portfolios that we believe should reduce risk relative to equities and provide long-term returns above that of fixed income. Adding risk-managed equity funds also helps further diversify portfolios and reduce overall risk as it introduces securities that are not highly correlated with either equities or fixed income. Solutions that we have added in recent months are the Purposes Tactical Asset Allocation ETF (RTA), TD Retirement Conservative Portfolio (TDB2745), Forge First Long-Short Equity Fund (FOR110) and CI Munro Alternative Global Growth Fund (CIG4192).

We continue to like alternative investments in this market environment. Our focus remains on mortgage pools and credit/merger arbitrage funds though we continue to evaluate various private credit funds and private equity funds for investment.

We are working constantly to position your portfolio appropriately to maximize return, while managing your overall portfolio risk exposure.

Sincerely,

Steele Wealth Management

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