CIBC Asset Management

MARKET SPOTLIGHT - MAY 2021

The COVID battle – are we winning yet?

The outlook for the global economy has certainly been improving and financial markets are reflecting that reality. We're seeing new highs in many markets, fairly robust economic data and earnings surprises from a number of companies, with upbeat management commentary to match. That being said, the return to normal is still complicated by vaccine availability, vaccination reticence and conflicting guidelines about what is or isn't safe. Can the rally continue?

In this edition, we also consider the **soaring price of lumber** and the **outlook for Canadian banks**, with a look back at bank performance in the years following the Global Financial Crisis. There are a number of similarities in the current situation.

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Senior Editor

The Question of Inflation

Michael Sager
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Nearing the peak in global growth, but recovery remains on track

The pace of the global economic recovery is reaching a peak that will be associated with very strong growth in the middle quarters of 2021. The subsequent slowing in growth is expected to be relatively benign, with the rate of global expansion likely to remain above its long-term trend rate for the foreseeable future. Pent-up consumer demand, particularly for services, will be supported by increasingly effective national vaccination programs and will overtake fiscal policy as the primary driver of growth. Although the Bank of Canada has started to taper asset purchases, and the Bank of England will soon follow suit, no major central bank is expected to increase its policy interest rate in the next two years. As a result, monetary policy will continue to support growth.

How to invest as inflation rises

U.S. inflation is also projected to peak around the middle of this year, before waning a little into 2022. We expect a confluence of U.S. dollar depreciation, rising commodity prices, supply bottlenecks, strong domestic demand, and a more tolerant Federal Reserve. These factors will support U.S. inflation, which is likely to remain a more prominent risk in the next few years than it has been during the past decade. This suggests prolonged, heightened investor demand for real assets. The variability in inflation rates in other major countries is expected to be more muted.

The outlook for growth, inflation, and monetary policy has important implications for financial markets. First, bond yields have room to rise a little further, as markets continue to digest the implications of our projections.

In contrast to the first quarter of 2021, when the rise in yields was concentrated in the U.S. (and provided temporary support to the U.S. dollar), we expect the magnitude of any further rise to be similar across North America and Europe.

Second, higher yields are not expected to adversely impact the prospects for equity markets. Long-term equity valuations do appear increasingly stretched in a number of developed and emerging markets. But continued robust cyclical growth is likely to remain an important support, and we expect equity markets to trend higher over the next 12 months as a whole. Third, the outlook for growth, inflation and yields favours a continued outperformance of value equity markets over growth. This suggests a rotation in equity leadership away from U.S. large-cap stocks towards select emerging markets that have weathered the pandemic without significant adverse impact on long-term economic fundamentals. Some examples in Asia are Malaysia and China and in Europe, Russia and Poland.

Lessons from the Global Financial Crisis

Bart Dziarski
Senior Analyst and Portfolio Manager, Financials and REITS

The big six Canadian banks returned +11%, on average, during the recovery period following the Global Financial Crisis (GFC). All indicators now point to a similar environment in the current recovery.

We are bullish on the big six Canadian banks due to:

- lower provisions for credit losses (PCL)
- positive operating leverage
- strong dividend growth
- increasing interest rates over the medium term

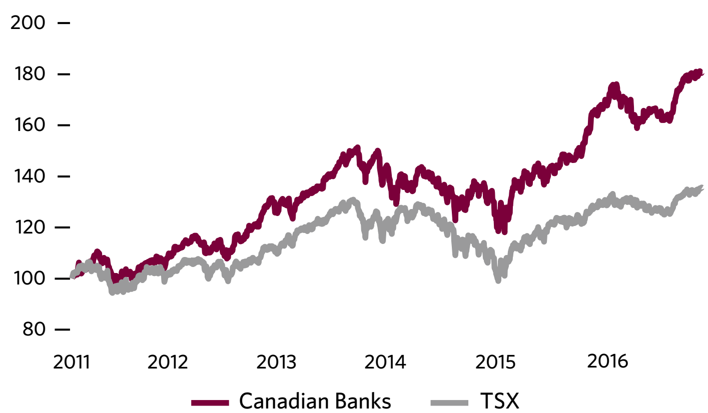
History is often a useful guide

From 2012 to 2017, Canadian banks meaningfully outperformed the S&P/TSX Composite. This strong period of performance represented the full recovery as banks' earnings power normalized following the global financial crisis (GFC). It's similar to the earnings recovery we anticipate following the COVID-19 pandemic. Bank stocks have performed well recently, but we could be entering a multi-year period of above-trend earnings and dividend growth which will further contribute to stock outperformance.

Look for an improving outlook on credit losses

Provisions for credit losses (PCL) declined 5% on average post-GFC. Currently, banks are in a similar position, with $31B accrued on bank balance sheets for credit loss allowances at the end of Q1 2021. As the economy reopens and continues to strengthen, many reserves will likely be released, further reducing PCL ratios. With the U.S. economy further ahead on reopening, credit reserve releases have accelerated, positively contributing to bank earnings. We expect to see the same in Canada.

Bank Index Performance 2012-2017



Source: CIBC Asset Management, Bloomberg

Consumer loans likely to outpace commercial

Due to the unique nature of this crisis, commercial loan growth is expected to lag consumer loan growth as commercial borrowers remain cautious, a departure from 2012-2017. However, we expect continued growth in the mortgage and personal loan segment. As the economy reopens, we also expect consumers to return to their habitual credit card spending which has been declining during the pandemic. Overall, we expect net loan growth to be positive over the coming years, driven by stronger economic growth. Operating leverage (revenue growth minus expense growth) should also remain positive as banks deploy capital in a more targeted manner and revenues continue to accelerate.

With banks targeting 40-50% dividend payout ratio and improving earnings, we expect dividends to rise more than the 8% seen in the 2012-2017 recovery period.

Interest rates remained flat during 2012-2017, but we expect rising interest rates in the medium term to drive higher NIMs (see box below).

What is It?

Provision for Credit Losses (PCL)

The provision for credit losses (PCL) is an estimate of a company's potential losses due to credit risk—expected losses from delinquent and bad debt or other credit that is likely to default or become unrecoverable. The PCL is treated as an expense on the company's financial statements.

Net Interest Margin (NIM)

Net interest margin (NIM) compares the net interest income a financial firm generates from credit products like loans and mortgages (usually tied to longer-term interest rates) with the outgoing interest it pays holders of savings accounts and GICs or CDs (usually tied to shorter-term interest rates).

Soaring lumber prices add to housing inflation

Pablo Martinez
Vice President and Portfolio Manager, Global Fixed Income

Lumber prices are presently at all-time highs. Increased demand from the construction industry and supply chain disruptions have created the perfect conditions for a never-before-seen surge in prices.

New consumer patterns increase lumber demand

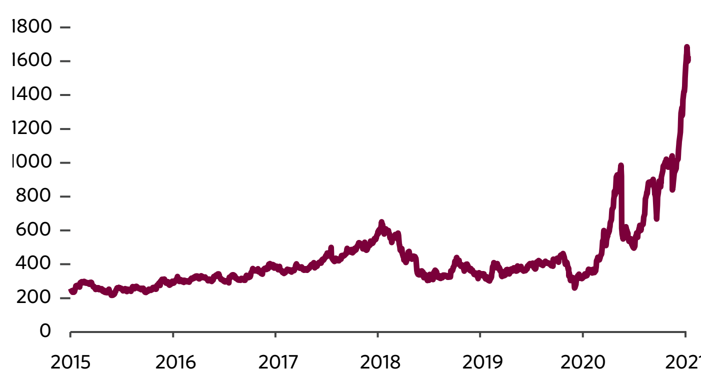
The pandemic changed consumer behaviour—many rushed outside of core city centers into less densified areas to reduce the risk of infection, creating a dramatic increase in demand for single-family housing. Single-family homes require up to three times the amount of lumber compared to multi-unit constructions. The high number of confined consumers with increased savings and time on their hands who launched renovation projects provided an additional eager source of demand.

Too pessimistic, mills reduce production

On the supply side, lockdown orders, new safety protocols and multiple wildfires slowed production. But adding to an already dire situation was the reaction of mill operators, who read 2020 completely wrong. As the pandemic struck and multiple construction projects were put on hold to protect workers from the virus, lumber mills substantially reduced production, expecting the stoppages to last. As governments quickly allowed essential construction to restart (the definition of essential is fairly lax), demand resumed and mill operators simply did not have the required inventory to meet their clients' needs. Mills finished 2020 with still very low inventory, expecting the market to cool off after such an exceptional year. This leaves the market short of lumber as we head into peak construction season.

Those sky-high prices for lumber products are the result of exceptional conditions which will probably (hopefully) not last longer term. For the next few quarters though, demand from the construction sector should remain strong as central banks maintain their low interest rate policy. Supply will increase, but producers simply don't have the capacity to meet this sudden surge in demand.

Lumber prices ($ per thousand board feet)



Source: CIBC Asset Management, Bloomberg