PICTON MAHONEY
Asset Management

Q3 2021

INVESTMENT REVIEW & OUTLOOK

The Beginning of the Middle (Not the End)

- LIKELY AT MAXIMUM POLICY STIMULUS AND ECONOMIC ACCELERATION IN THE U.S.
- CHINA: FIRST TO RECOVER, FIRST TO SLOW
- THE FED SHOULD BE "TALKING TAPER" AT THIS POINT
- STOCKS APPEAR MORE VULNERABLE TO CORRECTION
- MID-CYCLE CORRECTION IS A GROWING POSSIBILITY, BUT CYCLE STILL HAS LEGS
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- INFLATION DATA TO REMAIN ELEVATED AND IGNORED. BUT WHEN DOES IT START TO MATTER?

OVERVIEW

Peak stimulus and economic acceleration in the U.S. could soon give way to decelerating metrics in the coming quarters. From monetary and fiscal stimulus to economic growth rates and investor sentiment, many metrics are likely "as good as it gets." China's recovery is already decelerating — a harbinger of what will happen in the U.S. The likelihood of some sort of corrective action in risk assets has increased, especially as investors start to worry about the potential for tightening monetary policy conditions. Pullbacks will likely be shallow, however; there is a long runway to economic growth, given the backdrop of generally stimulative conditions, significant pent-up demand and low interest rates around the world. In a few quarters, when base effects normalize, we believe inflation will be a key risk factor to monitor.

PICTON MAHONEY HOUSE VIEW

VIEW	PMAM VS. CONSENSUS
RISK	
After hitting a four-year low in June, macro risk is on the ascent again as leading indicators start to fall from their peaks and growth expectations begin to decelerate. Higher-than-expected inflation may also mean that the era of very easy monetary policy will be shorter-lived than previously thought.	HIGHER
MACROECONOMIC	
GLOBAL REAL GDP Continued easing of lockdowns in the third quarter as vaccination levels ramp up may help buoy global GDP in the quarter, even as a few regions may be grappling with new surges in virus activity.	HIGHER
U.S. REAL GDP The U.S. was ahead of most countries in its vaccination efforts and led the way to reopening. The surge in economic activity that followed seems to have peaked and will likely decelerate from here, although we expect performance to remain positive in absolute terms.	LOWER
CANADA REAL GDP After a slow start, Canada has caught up in its vaccination effort and now boasts one of the highest vaccination rates in the world. The third quarter will likely see a further bounce-back in suppressed economic activity.	HIGHER
U.S. INFLATION U.S. inflation keeps surprising on the upside, and there will likely be a few more months of upside surprises before pent-up demand is met and low inventories are replenished.	HIGHER
EQUITY RETURNS	
U.S. EQUITIES We expect U.S. equities to face some temporary headwinds as high sentiment cracks due to decelerating growth expectations and a less favourable U.S. Federal Reserve (the Fed). Uneven regional vaccine uptake may also become a new problem that the U.S. will grapple with in the third quarter.	LOWER
EUROPEAN EQUITIES Europe's vaccine rollout and recovery will likely take another quarter to fully take effect, before the economy and equities can get back on track.	SAME
CANADIAN EQUITIES Canada's recovery is back on track this summer, and we expect the retail sector to reap the benefit of pent-up demand in the third quarter, although commodity-related exposures may face some short-term reversals as peak global growth decelerates.	SAME
BOND YIELDS	
TREASURIES (U.S. 10-YR) Rates will likely continue to head higher as expectations of higher inflation permeate the space over time; however, decelerating growth expectations may provide at least a short-term headwind.	HIGHER
INVESTMENT-GRADE CORPORATE BONDS Investment-grade spreads have fully compressed back to pre-crisis levels, and issues have remained in high demand, though already-low Treasury rates may limit their upside.	SAME
HIGH-YIELD CORPORATE BONDS With the Fed having stepped in as a buyer of last resort, most corporate bonds remained buoyed throughout the crisis, and therefore are already fully valued. Further upside will require continued improvement to the growth outlook over time.	SAME
OTHER	
WTI CRUDE OIL Oil fundamentals remain robust, with lower inventory levels and the futures curve still in backwardation, implying a strong demand for current oil. A weakening U.S. dollar and a rebounding global economy will also help over time.	HIGHER
EPS GROWTH (S&P 500) Earnings growth will likely continue to rebound in 2021, although supply chain and labour constraints may delay available production capacity even as demand remains robust.	HIGHER
P/E (S&P 500) Multiples are at multi-year highs, but we believe it will drop again over time as real rates rise, particularly in the high-growth technology sector.	LOWER

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at June 2021.

LIKELY AT MAXIMUM POLICY STIMULUS AND ECONOMIC ACCELERATION IN THE U.S.

The policy response and subsequent economic recovery since the COVID-19 pandemic began have been nothing short of breathtaking. Equity markets have soared over the past year, including in the second quarter of 2021, when the S&P 500 and S&P/TSX Composite Indices generated matching total returns of 8.6%, and the MSCI All Country World Index rose 7.5%.

However, surging economic data in developed countries are likely on the verge of beginning a process of normalization that will usher in more mid-cycle characteristics, for economies and markets alike. With conditions normalizing, the need for excess monetary and fiscal policy stimulus measures will likely also abate. In its policy update on June 17, the Fed signalled that it is now "talking about" tapering off some of its monetary policy stimulus measures. That meeting saw five members forecasting a rate hike in 2022, up from three members in the first quarter. The number of Federal Open Market Committee (FOMC) members anticipating two rate hikes next year doubled, to two. During his post-meeting press conference, Fed Chair Jerome Powell indicated that the Fed is further along the path of achieving its inflation goals, and that this "success" had happened sooner than initially expected.

At the same time, President Joe Biden's fiscal stimulus plan is likely to come in below what was expected earlier, and when it is finally rolled out, that should mark the peak of the U.S. fiscal push.

Generally, in the first phase of an economic cycle, the economy accelerates out of a recession, but then reaches maximum growth rates and will then likely decelerate. The ISM Manufacturing purchasing managers' index (PMI) began the second quarter at heights last seen in 1984, and has since started declining.

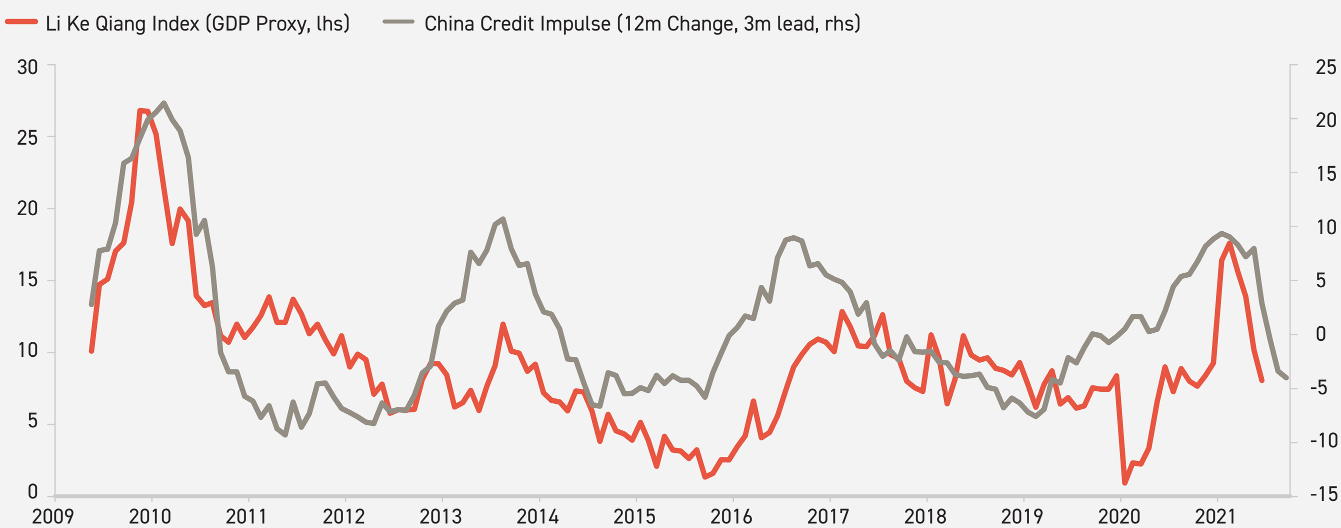
CHINA
FIRST TO RECOVER, FIRST TO SLOW

China, as the first country to deal with the coronavirus and emerge from mass lockdowns, provided a bullish blueprint for developed world economies. At this point, however, consensus GDP growth estimates for China have declined from an eye-popping 24% at the end of January this year to a more restrained 8.0%.

More concerning is the country's pace of credit expansion. China's incredible growth story has historically been spurred by bank lending for infrastructure and real estate construction. Recently, however, the nation's regulators have taken measures to restrict credit growth in an effort to reduce inefficient investment and inflation pressures.

The result has been a drastic tightening of financial conditions. China's credit impulse (year-over-year credit growth as a percentage of GDP) has dropped from 9.1% in November 2020 to -3.4% at the end of May 2021. Historically, credit impulse has been an effective indicator of GDP growth.

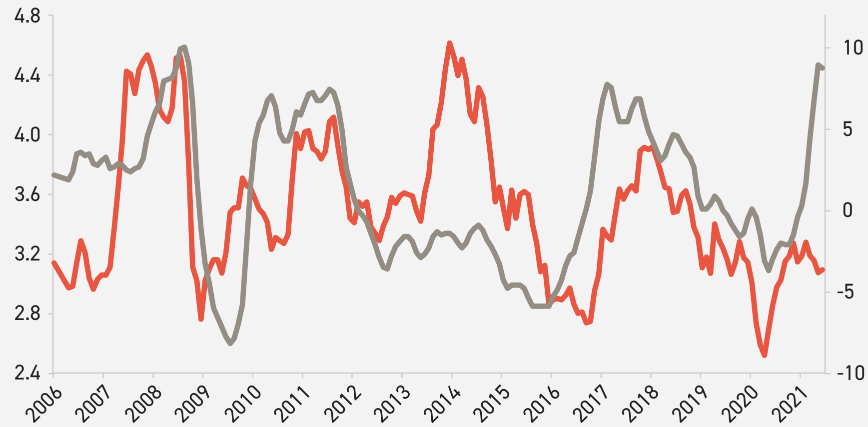
FIGURE 1: DECLINING CREDIT GROWTH MAY LEAD TO CONTINUED GDP DECELERATION IN CHINA (%)



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

Chinese authorities seem much more intent on dealing with inflationary pressures than their U.S. counterparts. Perhaps that is why Chinese government bond yields appeared quite restrained relative to the surge in producer price indices in China. Perhaps a similar phenomenon is occurring in the U.S., given recent declines in longer-term bond yields.

FIGURE 2: CHINESE GOVERNMENT BOND YIELDS REMAIN CONSTRAINED (%)



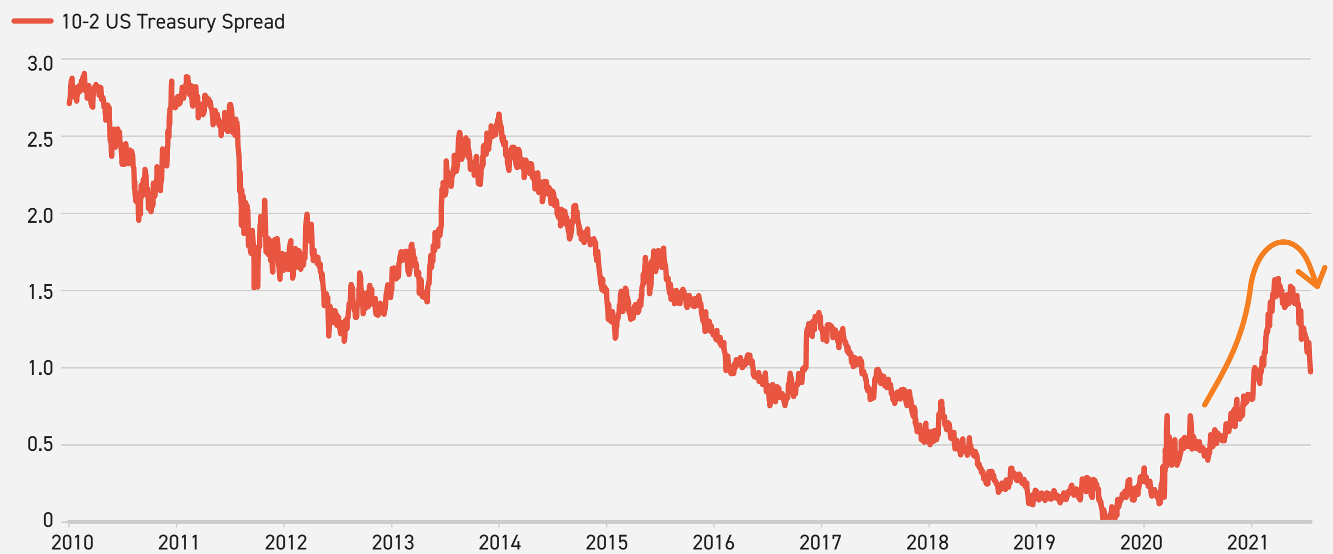
Source: Bloomberg, L.P., PMAM Research. As at June 2021.

MOVING TO A MID-CYCLE ECONOMIC ENVIRONMENT

A somewhat surprising rally in ten-year bonds, and a consequent flattening of the yield curve, is only one indication that economies and markets are shifting from an early-cycle, high-growth recovery stage to a slower-growth middle-cycle environment. This transition period of decelerating (but still positive) economic growth has often been accompanied by corrections in risk assets and changes in sector leadership.

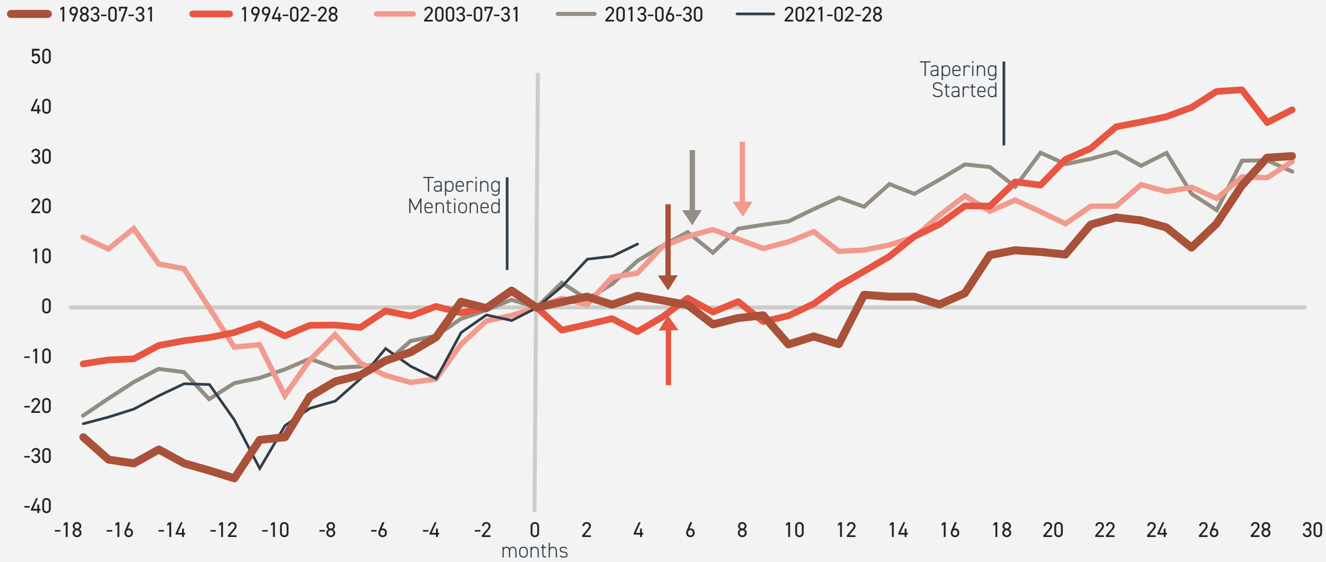
The flattening yield curve implies that the fixed income market is tempering future growth expectations, perhaps as a result of a tapering process that gets underway sooner than expected.

FIGURE 3: THE YIELD CURVE HAS FLATTENED DRAMATICALLY (%)



Source: Bloomberg, L.P., PMAM Research. As at July 17, 2021.

FIGURE 4: S&P 500 PERFORMANCE AROUND PERIODS OF RISING INTEREST RATES (%)



Source: Bloomberg, L.P., PMAM Research. As at June 2021. Coloured arrows indicate points of ISM PMI peak. Tapering indicators refer to the 2013 line only.

Our macro distance modelling attempts to find periods in past market cycles that are similar to current conditions to identify a potential road map for future market behaviour. Figure 4 shows the performance of the S&P 500 Index around market environments similar to the current one. The "0" point in the graph has coincided with jumps in longer-term bond yields of approximately 100 basis points. At this point in these past environments, stock markets have tended to pull back, or to consolidate, for a few quarters before beginning their next advance higher.

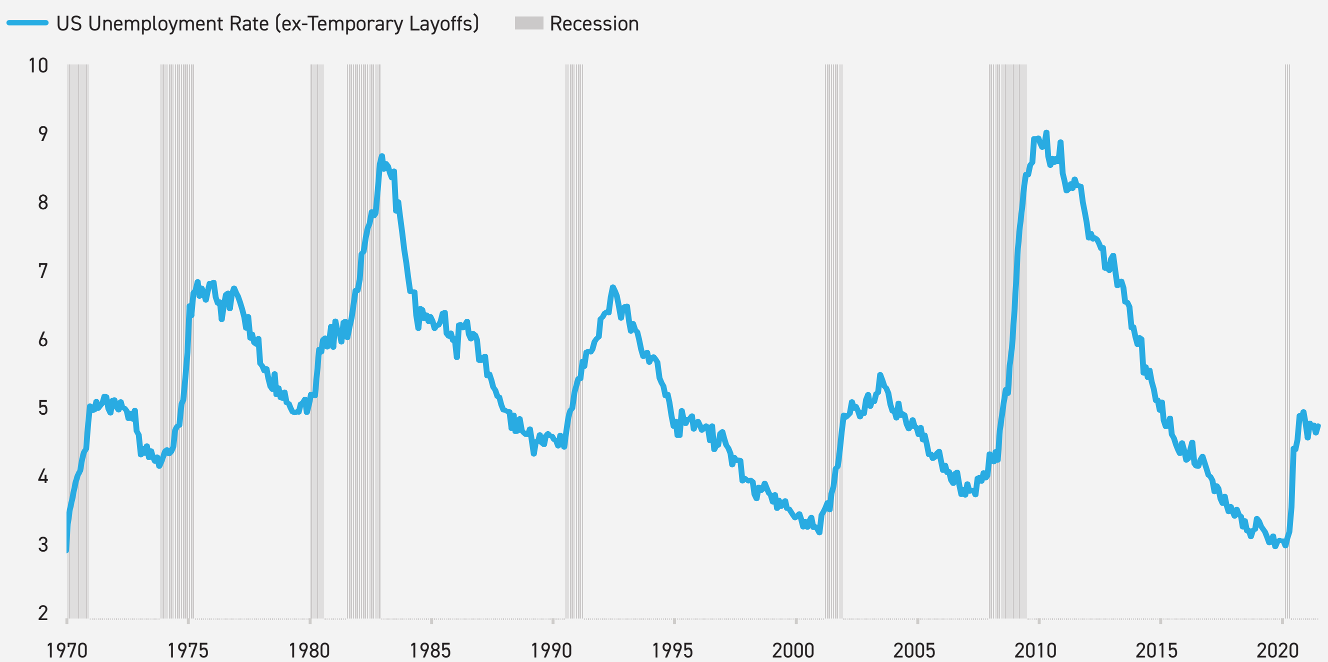
There is only one historical precedent for the Fed tapering off quantitative easing, in 2013–2014. It is worth noting that in that case, the S&P 500 Index actually rose during the period when the Fed was talking about tapering, until it actually did taper.

THE FED SHOULD BE "TALKING TAPER" AT THIS POINT

The list of reasons for the Fed to start reducing monetary stimulus has grown longer by the day as the economy has boomed. The Institute for Supply Management Services Purchasing Managers Index hit an all-time high of 64 in June. The Philadelphia Federal Reserve Bank's Manufacturing Business Outlook Survey climbed above 50 in April, for the first time since 1973. The National Association of Home Builders Housing Market Index, a leading indicator of construction activity, set a new record of 90 in late 2020, and remains in elevated territory.

Fed Chair Powell has frequently cited full employment as a primary goal behind the ongoing monetary stimulus. Unemployment levels remain elevated, although the headline numbers may not tell the full story. If we adjust for COVID-related temporary layoffs, and assume those workers will shortly rejoin the labour force, June's 4.6% unemployment rate is not extreme by historical standards (Figure 5).

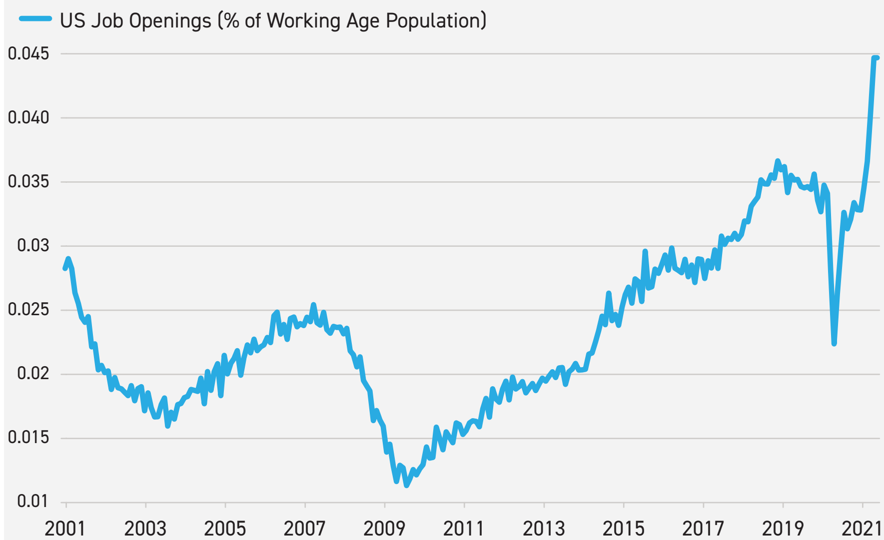
FIGURE 5: ADJUSTING FOR PANDEMIC RELATED TEMPORARY LAYOFFS, THE UNEMPLOYMENT RATE IS NOT SO HIGH (%)



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

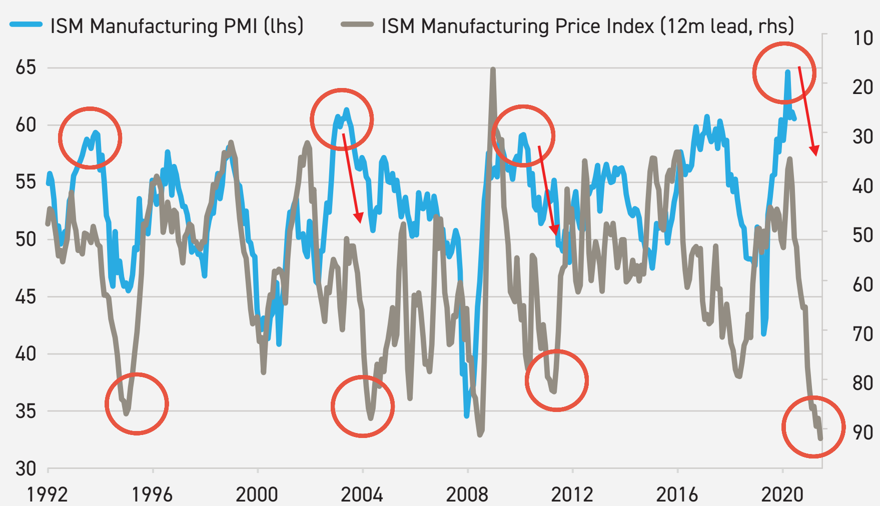
However, the Fed has to weigh these reasons for tapering off the stimulus against other contradictory data. Job openings may start to fill up as the generous government financial support for workers displaced by the pandemic starts to expire in the coming months, forcing many potential workers back into the labour force. A general skills mismatch is also exacerbating the job openings data. The fastest-growing sectors during the pandemic, notably software and telecommunications, are seeing a depleting pool of qualified candidates to support their expansion.

FIGURE 6: POST-PANDEMIC JOB OPENINGS ARE AT ALL-TIME HIGHS



Source: Bloomberg, L.P., PMAM Research. As at May 2021.

FIGURE 7: RISING PRICES CAUSE DEMAND DESTRUCTION AND LOWER PRODUCTION



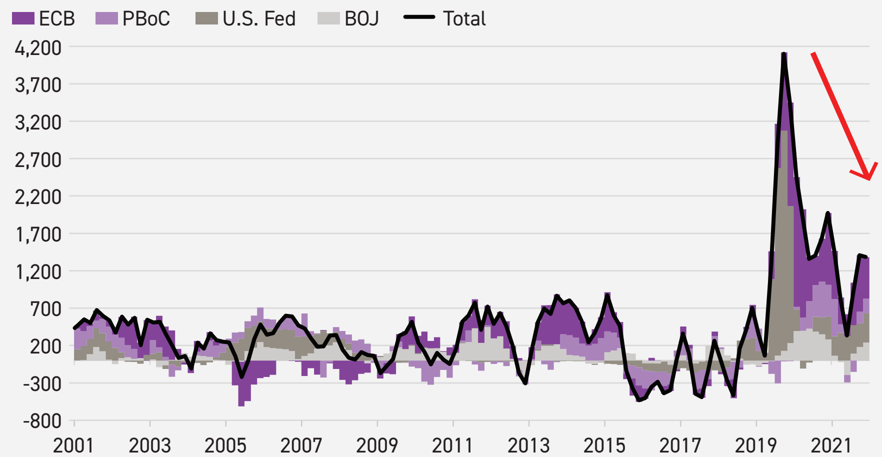
Source: Cornerstone Macro, Bloomberg, L.P., PMAM Research. As at June 2021.

Rising materials costs, as we're seeing now, also signal slower business activity ahead. Figure 7 shows a 12-month lag as rising prices cause demand destruction and lower production levels. The historical correlation suggests a sharp deceleration in activity similar to transitions early- to mid-cycle conditions seen in 1994, 2004 and 2011.

STOCKS APPEAR MORE VULNERABLE TO CORRECTION

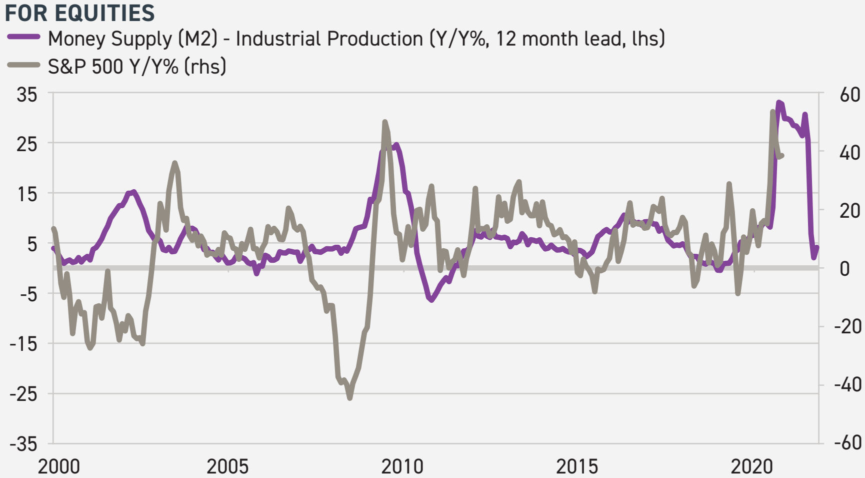
Bank of America Securities Head of Global Research Candace Browning-Platt recently argued compellingly that global equities are more sensitive to the combined money supply growth rates of the big four central banks – the Fed, the Bank of Japan, the European Central Bank and the People's Bank of China – than the Fed alone. Ms. Browning-Platt noted that these combined central bank balance sheets are expected to climb another US$1.6 trillion before year end, providing support for risk assets (Figure 8).

FIGURE 8: CENTRAL BANKS ASSET PURCHASES HAVE FALLEN BUT STILL HIGH RELATIVE TO HISTORY (USD, in billion)



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

FIGURE 9: LOWER FLOWS INTO THE FINANCIAL ECONOMY IS A HEADWIND FOR EQUITIES



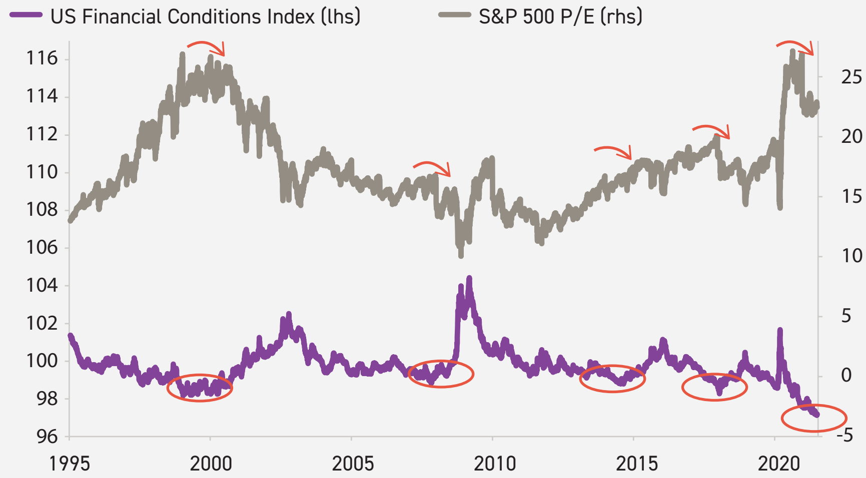
Source: Bloomberg, L.P., PMAM Research. As at June 2021.

However, some of this liquidity will be soaked up by economic expansion, making less of it available for risk assets. Figure 9 shows the interplay between money supply and industrial production increases, compared with S&P 500 Index returns, highlighting the reduction in excess fuel for markets as the economy recovers.

According to Cornerstone Macro[1], financial conditions have been as easy as they get, and are not likely to get any easier as the recovery matures – implying that stock market P/E expansion is likely over as well.

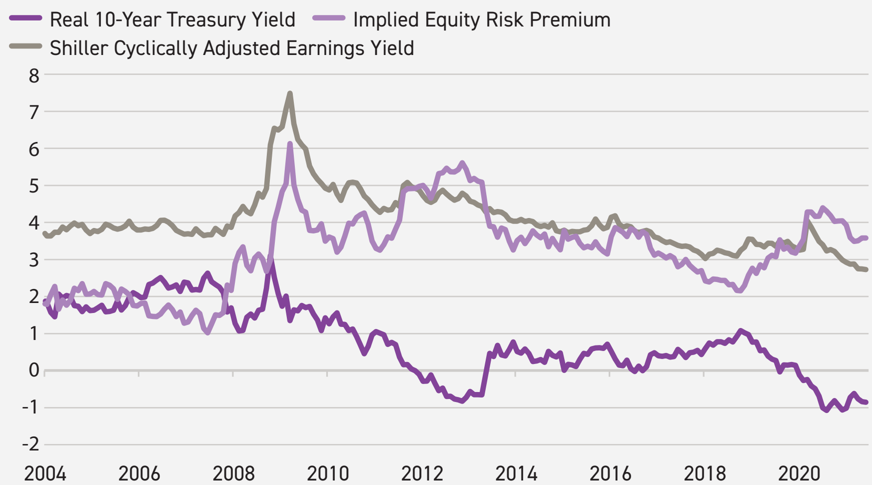
The Shiller Cyclically Adjusted PE ratio (CAPE) hit another cycle high in June, depressing the earnings yield available in equities. Stocks seem expensive on most measures, with the exception being their attractiveness relative to real yields. However, stock markets are vulnerable to any significant increases in real yields (Figure 11).

FIGURE 10: EASY FINANCIAL CONDITIONS CORRELATE WITH VALUATION TOPS



Source: Cornerstone Macro, Bloomberg, L.P., PMAM Research. As at June 2021.

FIGURE 11: EQUITY RISK PREMIUMS ARE SET TO FALL AS REAL RATES RISE (%)



Source: Robert Shiller, Bloomberg, L.P., PMAM Research. As at June 2021.

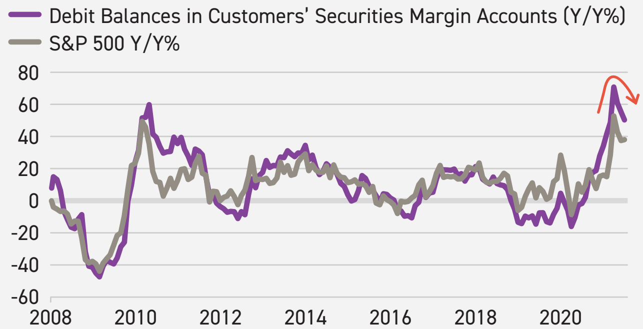
[1] Cornerstone Macro, January 7, 2021, https://research.cornerstonemacro.com/ResearchPortal/Download?E=bacdckfcbdc

BULLISH SENTIMENT IS CONCERNING

The past era of depressed nominal bond yields led to the "TINA" argument for equities – "there is no alternative" – and this contributed to driving individual stock ownership to record levels. Household equity ownership recently reached a new record, at 36.5% of total financial assets. In the past, peak household ownership has signalled muted equity returns for the following decade.

It doesn't help that some of this increase in stock ownership has been financed through debt increases in margin accounts. Past corrective environments have been exacerbated by the unwinding of margin debt excesses (Figure 12).

FIGURE 12: EXCESSIVE MARGIN DEBT IS SET TO ROLL OVER



Source: FINRA, PMAM Research. As at June 2021.

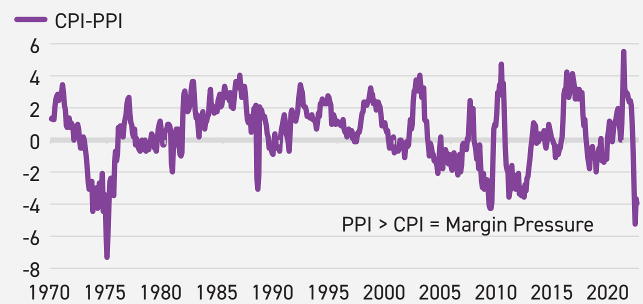
Most prominent measures of investor sentiment have reached peaks associated with market corrections. Citi's Panic/Euphoria marker remains firmly in "euphoria" territory, suggesting negative 12-month returns. The Bank of America (formerly the Bank of America Merrill Lynch) Sell-Side Indicator, historically a reliable gauge, is approaching a range last seen in 2007.

The American Association of Individual Investors survey of retail investors is close to bullish extremes, as is the Investor Intelligence Bulls/Bear measure of investment advisor sentiment. New investors are racing into markets; new brokerage accounts at Schwab/TD Ameritrade made new all-time highs earlier in 2021.[2]

NEAR-TERM PROFIT MARGINS ARE LIKELY AT RISK

Earnings growth consistently exceeded estimates by a wide margin as the global economy accelerated. However, cost pressures that threaten profit margins have been increasing. Purchasing manager surveys in both manufacturing and services industries find businesses almost unanimously unable to meet demand because of labour shortages and high prices for other inputs. Figure 13, comparing producer and consumer price growth, highlights businesses' inability, so far, to pass higher costs on to consumers. While we believe labour shortages have been overstated, the normalization process is likely to cause unwanted margin pressures in the near term. Pandemic-related supply chain and shipping bottlenecks have further complicated operations.

FIGURE 13: BUSINESSES' INABILITY TO PASS ON HIGHER COSTS TO CONSUMERS PRESSURES MARGINS



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

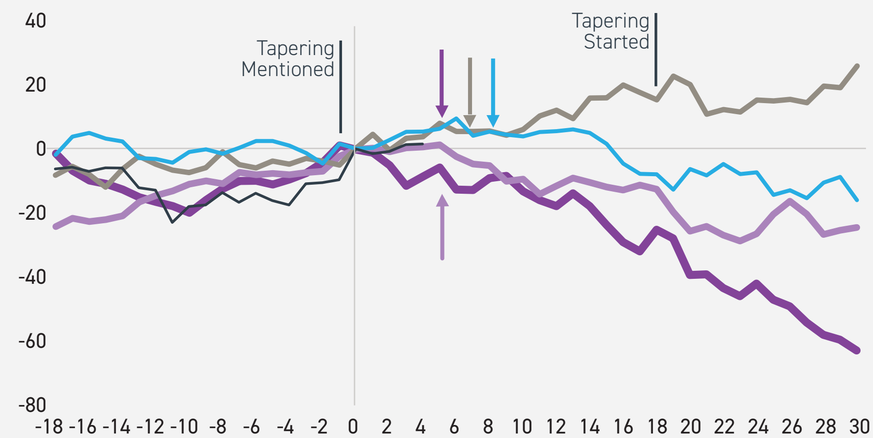
MID-CYCLE CORRECTIONS: SECTOR AND FACTOR IMPLICATIONS

A conventional market cycle begins with the most beaten down, economically sensitive stocks leading the way as the markets recover. These are frequently the companies with the lowest-quality balance sheets and poorest earnings outlooks.

[2] Schwab/TD Ameritrade

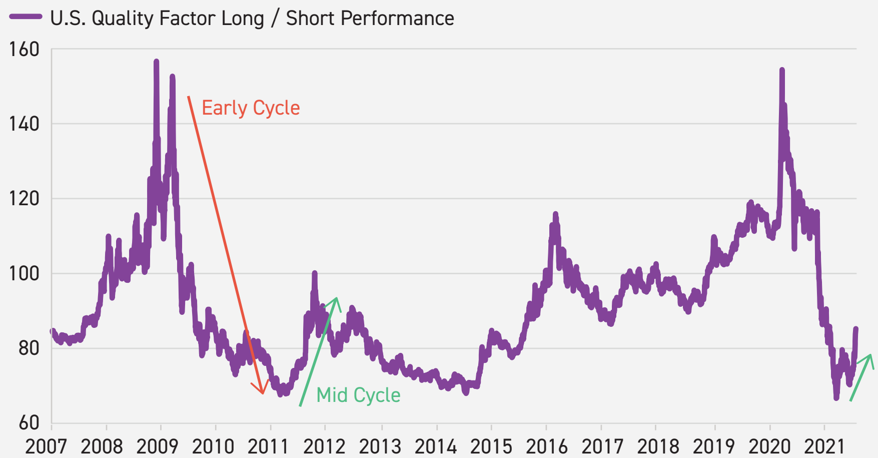
Typically, the relative performance of these higher-beta/lower-quality stocks starts to fade as we reach the end of the recovery stage and move to the mid-cycle stage of the recovery. Figure 14 shows this deterioration in the relative performance of cyclical versus more defensive sectors around the same early-cycle transition periods discussed above.

FIGURE 14: S&P CYCLICALS / DEFENSIVES PERFORMANCE AROUND PERIODS OF RISING RATES (%)



Source: Bloomberg, L.P., PMAM Research. As at June 2021. Coloured arrows indicate points of ISM PMI peak. Tapering indicators refer to the 2013 line only.

FIGURE 15: A REBOUND IN QUALITY FACTOR PERFORMANCE HERALDS TRANSITION TO A MID-CYCLE ENVIRONMENT



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

The rotation away from cyclical sectors also has implications for the performance of low-quality companies, relative to high quality. Figure 15 shows the returns from a long high-quality/short low-quality portfolio over the past 15 years. This quality portfolio fell sharply from 2009 to early 2011, the early stage of that cycle, indicating low-quality outperformance. This eventually reversed itself as the cycle progressed.

A similar pattern is evident from pandemic lows in March 2020. The past 12 months have seen a similarly drastic underperformance by high quality that could be poised to reverse.

MID-CYCLE CORRECTION IS A GROWING POSSIBILITY,

BUT CYCLE STILL HAS LEGS

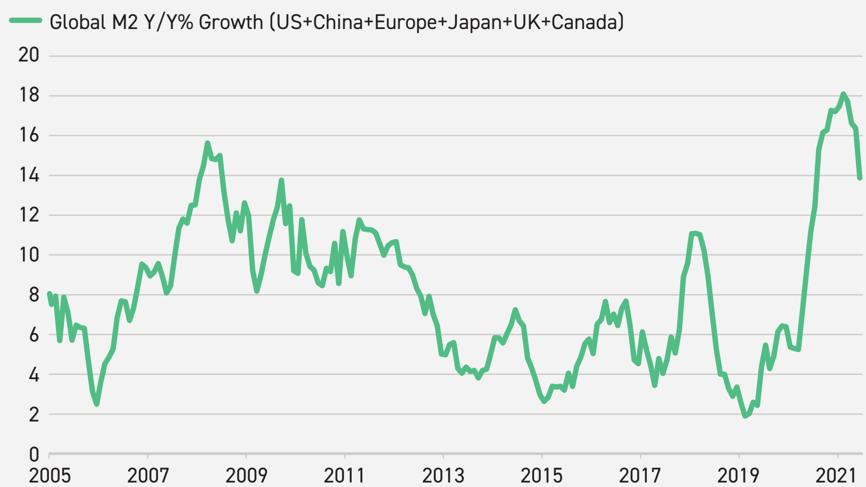
Significant market corrections are common at this stage of the cycle, but they do not necessarily signal the end of the bull market. In this case, investors will likely be repositioning and absorbing the implications of reduced monetary stimulus. The most important drivers of the rally seem to remain in place.

GLOBAL MONETARY POLICY IS STILL BULLISH

Global monetary policy stimulus continues to support for stock prices, although less than during the depths of the pandemic (Figure 16).

Real government and corporate bond yields sit near generational lows, suppressing financing costs and driving investment into higher-risk asset classes. Monetary policy stimulus will remain a positive force for equity markets for the foreseeable future, providing a long runway for equity prices until central banks are confident that much fuller employment has been reached.

FIGURE 16: GLOBAL MONEY SUPPLY GROWTH IS TURNING LOWER BUT STILL HIGH



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

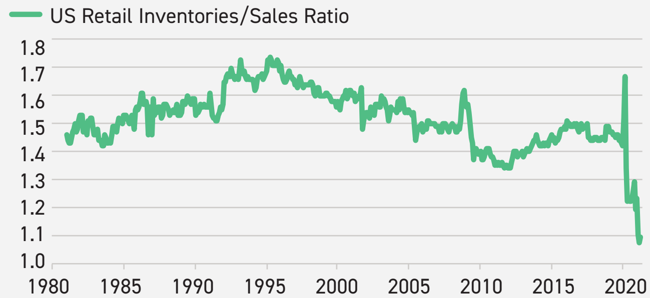
SIGNIFICANT INVENTORY AND EXPERIENCE REBUILDING LIE AHEAD

Business inventories were near record lows after the first quarter, but instead of building have proceeded even lower, setting new records. The state of the retail inventories-to-sales ratio is particularly dramatic, plumbing depths well below previous bottoms. Manufacturing inventories are also unprecedentedly depleted (Figure 17).

The labour and input shortages discussed above may slow inventory rebuilding, but it is inevitable over the mid- and longer term. A sustained slowdown in goods production and revenue growth is highly unlikely until inventories normalize (Figure 18).

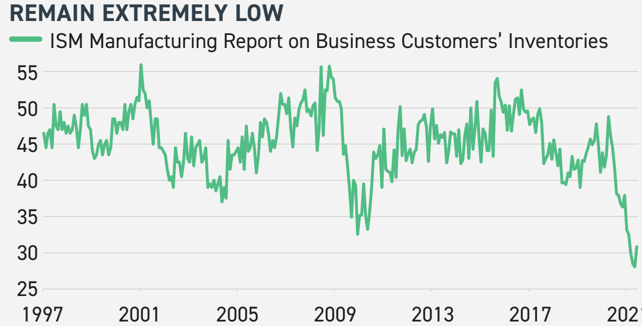
Meanwhile, consumers flush with cash will finally have the opportunity to renew their favourite pastimes, once the final components of the economy start to reopen around the world. It may take years before everyone catches up on their desire for the travel, entertainment and leisure activities they had to forgo for a year and a half. Of course, these activities will not take place at the same rates around the world, with a big variable being the speed of vaccine rollouts.

FIGURE 17: U.S. RETAIL INVENTORIES-TO-SALES RATIO CONTINUES PLUMBING NEW DEPTHS



Source: Bloomberg, L.P., PMAM Research. As at May 2021.

FIGURE 18: MANUFACTURERS' CUSTOMERS INVENTORIES REMAIN EXTREMELY LOW



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

HOUSEHOLD BALANCE SHEETS CAN SUPPORT SIGNIFICANT CONSUMPTION INCREASES

For the first time in 51 years (seven recessions ago), the rate of nominal disposable income growth accelerated during a recession in the U.S., thanks to fiscal support from governments. In real terms, the pandemic period has been the best fourteen-month stretch for disposable income growth in the 70-year history of the series, reaching a level three standard deviations above the mean.

Households are now sitting on a mountain of excess savings – about $2.3 trillion[3] – providing considerable resources for a consumption binge. Consumer spending will likely be turbocharged for a number of years to come. Wealth created by home price appreciation and equity market gains will likely further support consumption levels as we approach a full economic reopening.

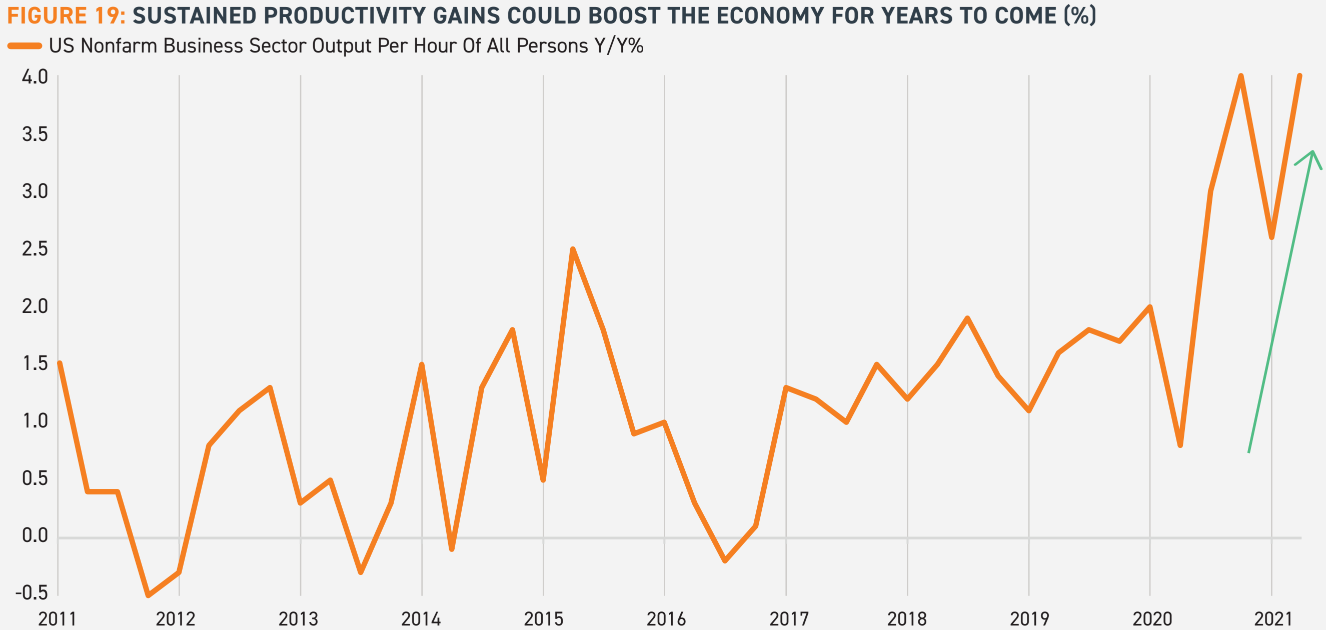
[3] Bloomberg

SUSTAINABLE GAINS
IN PRODUCTIVITY

Significant improvements in economic productivity were a silver lining amidst the tragedy of the pandemic. Total goods produced in the U.S. climbed 7.0% during a period when the labour force working in the related sectors dropped 2.5% (Figure 19). These types of efficiency gains have historically led directly to higher national wealth creation.

Productivity in terms of output per worker frequently improves during recessionary periods as inefficient businesses shut and companies slash costs. Many efficiency improvements, notably working from home and goods distribution logistics, could increase profitability well beyond what could be expected from the global economic reopening alone. Jefferies strategist David Zervos believes that the weaker-than-expected employment growth is a direct result of productivity gains. He points to the red-hot auto dealer sector, where employment is 4% lower than the February 2020 peak, even with sales exploding higher.[4]

FIGURE 19: SUSTAINED PRODUCTIVITY GAINS COULD BOOST THE ECONOMY FOR YEARS TO COME (%)



Source: Bloomberg, L.P., PMAM Research. As at Q1 2021.

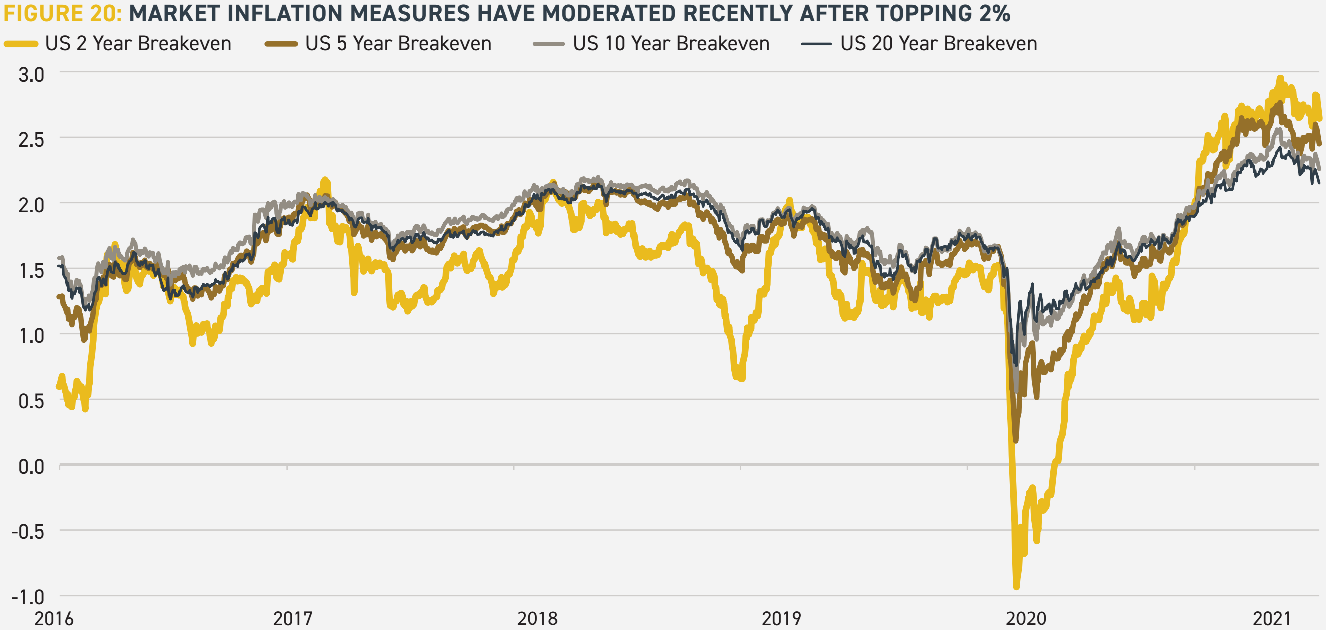
[4] Jeffries Research

INFLATION DATA TO REMAIN ELEVATED AND IGNORED. BUT WHEN DOES IT START TO MATTER?

Recent inflation data certainly would have given cause for alarm in previous economic and market cycles, especially given how early we are in this new cycle. United States Core Consumer Price Index (CPI) for May came in at 0.9% month-over-month, the highest since the 1980s. This is occurring against a backdrop of monetary policy conditions that are still very easy, and before a potentially large U.S. fiscal package is rolled out by the U.S. government. However, Fed Chair Powell remains sanguine about the prospects for future inflation, and the bond market seems to agree. The Treasury Inflation-Protected Security (TIPS) break-even implied inflation values can be used to gauge the market's inflation expectations; while back considerably as well.

A significant increase in inflation data was to be expected, given the easy pricing comparisons between now and the worst point of the COVID-related deflationary mini-environment that existed last year. These base effects alone were expected to contribute to a headline inflation print of at least 2.5% in the second quarter, but are then expected to drop back to a more moderate 3.3% contribution in the third quarter. The market might expect other factors that are driving inflation higher to be transitory as well. These include supply chain bottlenecks, a dearth of available inventories for sale and temporary labour shortages due to extended government employment benefits.

FIGURE 20: MARKET INFLATION MEASURES HAVE MODERATED RECENTLY AFTER TOPPING 2%



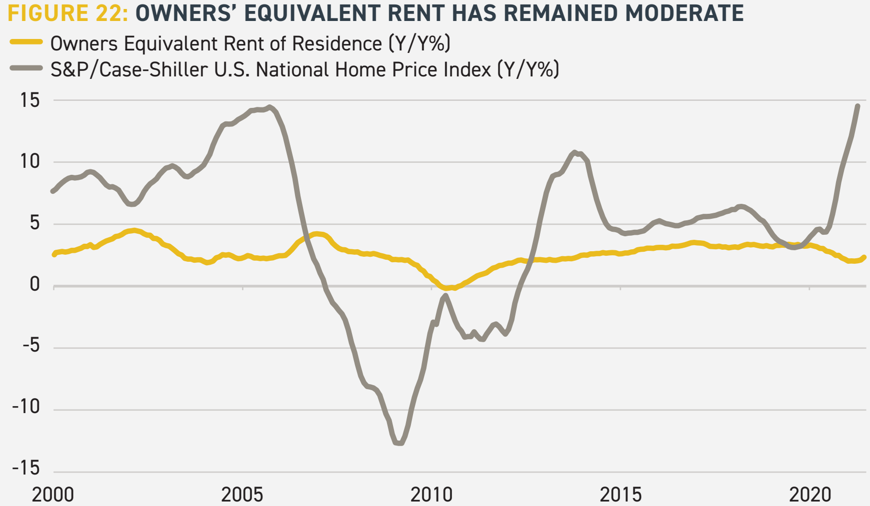
Source: Bloomberg, L.P., PMAM Research. As at July 19, 2021.

These are all known variables, and the market seems to have accepted that price pressures will remain high for the next six to 12 months without much cause for further concern, especially given the significant decline already occurring in some input costs, such as lumber, for instance.

FIGURE 21: FALLING LUMBER PRICES GIVE HOPE THAT THE SPIKE IN INFLATION WILL BE SHORT LIVED (USD/1000 BOARD FEET)

Source: Bloomberg, L.P., PMAM Research. As at July 19, 2021.

FIGURE 22: OWNERS' EQUIVALENT RENT HAS REMAINED MODERATE



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

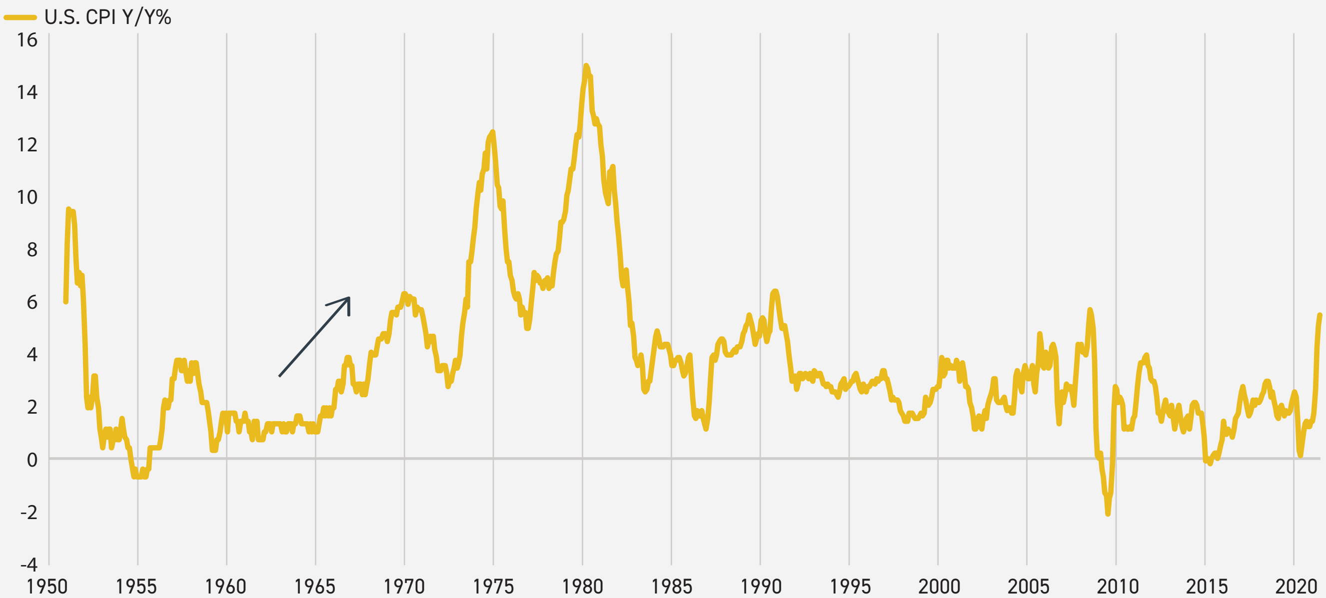
Another interesting data point in support of moderating inflation is the lack of increase in owners' equivalent rent, given the surge in U.S. home prices over the past year. Owners' equivalent rent is an important component of consumer price index (CPI), so this is an important moderating force for inflation, at least for now.

However, while consensus expectations seem to be factoring in a significant abatement in inflationary pressure next year, we are concerned that certain inflation pressures may not be mostly temporary. It has been decades since investors were confronted with real inflation and its negative effects on security prices. New factors may force them to refamiliarize themselves with inflationary market environments in the coming years. For instance, globalization was a main driving force of deflation in the last two decades, but this trend may abate somewhat, given growing geopolitical tensions, especially between the U.S. and China. In addition, many countries are now bringing back domestic manufacturing in some industries, as a security measure, or to improve supply chains after having been caught off guard during the pandemic.

Those who are confident that inflation is temporary point to how the loose monetary policy of the past decade didn't lead to any meaningful uptick in longer-term inflation expectations. However, that stimulus occurred against a backdrop of balance sheets in need of repair at both the consumer and banking level. It also occurred during a period of ramping up excess capacity in many commodities, such as copper and oil. This new cycle, however, is beginning with very strong consumer and banking balance sheets, especially in the U.S., meaning personal consumption will not be as limited as it was in the last cycle. Around the world, large debt loads have now been transferred to governments, which wouldn't mind some inflation that would help erode the real value of their massive debt burdens. We also believe that many commodities are beginning longer-term price uptrends. After more than a decade of falling commodity prices and a lack of investment, supply-demand dynamics are shifting once again in favour of higher prices. Finally, the technology boom that contributed so much to deflationary pressures may not continue to have the same impact, especially after so much disruption was pulled forward in 2020.

There is even a chance that the current economic backdrop is similar to what was seen in the 1960s, during the leadup to rampant inflation in the 1970s. In the 1960s, GDP growth was falling, while consumer prices climbed from roughly 1.5% to 4%. The tight labour market of the period lasted five years before the wage/price inflationary spiral began.

FIGURE 23: RECENT INFLATION TRENDS ARE SIMILAR TO THE ONES SEEN IN THE LATE 60'S



Source: Bloomberg, L.P., PMAM Research. As at June 2021.

What if the Fed is wrong, and inflationary forces are not transitory after all? If these increased inflation expectations become more rooted as the economy grows, there is a growing possibility that the Fed will have to start tightening monetary policy more quickly and/or more aggressively than market participants currently anticipate. This might lead to suddenly higher interest rates that may pop the inflating stock market bubble.

We do not, in fact, view this as a near-term risk for equity markets, since the current elevated inflation data have been mostly discounted in market expectations. However, over the coming year, as base effects normalize, as pent-up demand is increasingly satisfied, and as supply chains begin to operate more smoothly, continued hot inflation data would not be well received by investors.

IN CONCLUSION

We expect some normal near-term market consolidation.

After the dramatic run-up in stock prices, bullish sentiment is extended, which could lead to bouts of market weakness that help alleviate overbought conditions. We expect any pullbacks to be shallow for now, unless bad news arises around the world on the COVID-19 front. However, over the next year stock markets will have to deal with other hurdles, such as reduced monetary policy stimulus and decelerating economic growth measures. Given that we are still early in a new economic cycle, we expect that stock market pullbacks related to these events should be contained. However, a significant increase in longer-term inflation expectations that suddenly drove interest rates higher would cause us to revisit this positive outlook in a hurry.

SECTOR
OUTLOOKS

INDUSTRIALS

The demand for freight, construction and machinery remains strong, and profit forecasts still have the potential to rise. We are poised to reap the benefits of both the shored-up weightings in our high-conviction compounders and cyclical names with secular stories. We are confident the businesses we like – including those that have run with cyclical exposure – will continue to meet our long-term return thresholds over time.

We continue to favour companies with a history of compounding, idiosyncratic growth angles and/or opportunities to improve returns on invested capital. Toromont Industries Ltd. (TSX:TIH), Waste Connections Inc. (TSX:WCN) and WSP Global Inc. (TSX:WSP) remain preferred names, given their high rates of internal return and their ability to grow free cash flow through cycles. We have also recently initiated a position in Mullen Group Ltd. (TSX:MTL), a well-managed trucking and logistics company steadily diversifying away from oilfield services. The company is an astute acquirer with a long runway for M&A-based growth. Our stake in modular office solution provider Willscot Corp. (NASDAQ:WSC) has significantly outperformed the market since we initiated the position last summer; the investment thesis is predicated on its free cash flow-generating potential, bolstered by its merger with portable storage solutions provider Mobile Mini Inc. (NASDAQ: MINI). We also remain bullish on longer-term air traffic and aerospace demand trends globally. We believe companies we own that are exposed to these sectors, such as CAE Inc. (TSX:CAE) and Heroux-Devtek Inc. (TSX:HRX), should gradually benefit from improving demand trends in the coming years.

MATERIALS

The S&P/TSX Materials sector bounced back in the second quarter after a weak first quarter, trading largely in line with the broader index. While most cyclically exposed subsectors, including copper, diversified miners, fertilizers, and steels, continued to outperform, equity performance slowed as the quarter progressed, with investors questioning whether recent gains had outpaced fundamentals, and as concerns about peak growth emerged. Gold equities slightly lagged the sector, after more meaningful weakness in the previous two quarters.

We have reduced some of our cyclical exposure in the sector, positioning for a potential normalization of commodity prices, which currently sit well above cost support and incentive price levels. That being said, we remain positive on copper, given secular demand tailwinds from global decarbonization trends and a more muted medium-term supply outlook that reflects both constrained capital spending over the past few years and limited development pipelines. We continue to hold First Quantum Materials Ltd. (TSX:FM) and Hudbay Minerals Inc. (TSX:HBM). We maintain tactical exposure to precious metals, with a focus on names that we believe can add value without relying on higher prices.

INFORMATION TECHNOLOGY

The MSCI World Information Technology Index increased 11.3% for the second quarter of 2021; the technology subsectors rebounded broadly after a weaker first quarter. The Information Technology sector in the S&P/TSX Composite Index increased 23.0% for the second quarter, led by outsized performance from Shopify Inc. (TSX: SHOP), which continues to add services and to enable merchants to extend their reach to additional channels such as social e-commerce platforms. Interactive media and services was the strongest subsector in the quarter, led by outperformance from Facebook Inc. (NASDAQ: FB) and Alphabet Inc. (NASDAQ: GOOGL). Both stocks benefited from a recovery in digital advertising spending. Entertainment was the weakest subsector, driven by underperformance by "stay at home" stocks such as Netflix Inc. (NASDAQ: NFLX) and Activision Blizzard Inc. (NASDAQ: ATVI), both of which are expected to face tougher comparisons in a reopening environment.

Looking ahead to the third quarter, we are monitoring the pace of economic recovery, which could have some impact on the semiconductor subsector. We are also monitoring the trend in real interest rates, which could influence valuations in the software subsector. In the interactive media and services subsector, increased regulatory scrutiny and potential antitrust lawsuits in the U.S. and E.U. could continue to weigh on valuations. Fundamentally, supply constraints continue to be a challenge in the semiconductor sector, while spending remains strong in the software and interactive media and services subsectors. In the internet and catalog retail subsector, Amazon.com Inc. (NASDAQ: AMZN) is breaking out after a year of relative underperformance. Andy Jassy has formally taken on the CEO position, Prime Days in June boosted e-commerce results in the second quarter, and Amazon Web Services (AWS) and advertising are continuing to make strong and profitable contributions. In addition, there should be some leverage from declining costs related to COVID. Shipping will continue to be a competitive advantage as the company invests more in last-mile delivery and rolls out logistics services to more merchants.

HEALTH CARE

In the second quarter of 2021, the Health Care sector (up about 8.6%) slightly outperformed the S&P 500 Index (up about 7.3%). The best subsector performers were life science tools (up about 15%) and hospitals (up about 11.3%), outperforming the S&P 500 Index. All other subsectors underperformed the S&P 500 Index, the worst being biotechnology (up about 3.8%), laboratories (up about 3%) and distributors (down about 4%).

Globally, vaccination rates continue to be spotty, which will potentially delay a full economic recovery to the second half of 2021. In the U.S., vaccination rates have plateaued, and the unvaccinated population is increasingly resistant. The new delta strain is more infectious and spreading largely among the unvaccinated population, and any new wave of infection is likely to be limited to those areas with low vaccination rates.

As vaccination rates ramped up in the second quarter, investor focus shifted to post-COVID recovery across all Health Care subsectors. Procedure volume recovery began in March–April and is nearing 100% of normal. The pace of recovery is strongest for cardiac cases, followed by gastroenterology, general surgery and oncology. This trend is generally positive for hospitals (for example, HCA Healthcare Inc. [NYSE:HCA] and Tenet Healthcare Corporation [NYSE:THC]) and medical device companies (for example, Edwards Lifesciences Corp [NYSE:EW], Abbott Laboratories [NYSE:ABT] and Boston Scientific Corporation [NYSE:BSX]). However, the pace of recovery for elective surgery, for example orthopedics like Zimmer Biomet Holdings, Inc. (NYSE:ZBH), seems lagging, with patients choosing to take advantage of easing pandemic restrictions rather than undergo a surgical procedure. Hospital capital expenses have also greatly improved and are at or above 2019 levels, which bodes well for device companies such as Intuitive Surgical Inc. (NYSE:ISRG). On the flip side, managed care performance has continued to stagnate due to uncertainty around continuing COVID-19 related costs and increasing non-COVID utilization, despite positive management commentary on reduced utilization. Tools is the best-performing subsector: investors are favouring the base business recovery theme supported by a normalization of cyclical (academic and industrial) end markets, improving capital allocation and diminishing concerns about margin headwinds.

The pandemic also resulted in some fundamental shifts in health care delivery, such as an increased use of telemedicine, which increased from <5% pre-pandemic to nearly 60% at its peak around March and April 2020. With increasing vaccination rates, telemedicine use has been declining across all specialties, except for behavioural health, as patients become increasingly comfortable again with in-person visits. However, the use of telemedicine in mental health services (about 50%) remains high: the tool has helped narrow the gap between high demand and low supply. During the pandemic, telemedicine services were reimbursed at parity to in-person visits, but it is unclear which services and specialties will continue to have this favourable reimbursement in the post-pandemic era. Broad reduction in reimbursements or a meaningful restriction in utilization will have a negative impact on telemedicine-related companies (for example, Teladoc Health Inc. (NYSE:TDOC), American Well Corp (NYSE:AMWL) and LifeStance Health (NYSE:LFST)).

The NASDAQ Biotechnology Index index performance continues to stagnate (up about 3.3%) with small- to mid-cap biotech companies most affected, because of their high valuations, while large-cap therapeutics continued to trade better, because the uncertainty is already reflected in their multiples. During the quarter, the U.S. Food and Drug Administration granted accelerated approval for Aduhelm, a drug from Biogen Inc. (NYSE:BIIB) for the treatment of Alzheimer's disease. It is the first drug approved for the disease, and opens up a new mega-blockbuster market. Instead of having a positive impact for the broader biopharma sector, however, the approval triggered renewed questions about drug pricing.

On the policy front, the issue of drug pricing resurfaced in President Joe Biden's executive order calling for reducing drug costs to the federal government and addressing price gouging and Canadian drug importation. The issue will likely remain an overhang as long as there is no clarity as to how far any drug pricing proposal will go. Subsectors that remain insulated from policy-related volatility, and that are positively leveraged to the reopening themes, include medical technology, tools and medical equipment.

CONSUMER DISCRETIONARY

The Consumer Discretionary sector slightly underperformed both the S&P 500 and S&P/TSX Composite Index in the second quarter as investors grappled with rising inflation, fading government stimulus support, peak multiples and the potential for weaker earnings growth next year. The emergence of the delta variant stoked concerns about an economic slowdown driven by the reintroduction of lockdowns in parts of the world. Against this backdrop, cyclical stocks came under the most pressure, with multiples compressing, despite the likelihood of a strong second-quarter earnings season over the coming weeks.

Longer-term, we remain positive on the sector, and continue to view underlying conditions – including still record-low interest rates, depleted inventories and pent-up demand – as favourable. We have reduced some of our cyclical exposure and continue to prefer structural winners trading on reasonable multiples where we believe earnings upside will be more durable. These include Magna International Inc. (TSX:MG), Spin Master Corp. (TSX:TOY) and BRP Inc. (TSX:DOO) in Canada, and TJX Companies Inc. (NYSE:TJX) and General Motors Company (NYSE:GM) in the U.S.

CONSUMER STAPLES

Consumer Staples lagged the broad market by about 3% in Canada and 5% in the U.S. for the second quarter of 2021. As cost pressures mount due to inflationary pressures, consumers leave grocery stores in droves and Consumer Staples lap difficult comparisons from last year, and the sector remains out of favour with investors. We expect sentiment to remain poor as inflation pressures earnings in the second and third quarters. The environment is expected to improve as we exit the third quarter, and pricing actions start to flow through as the sector seeks to offset cost inflation.

We have positioned ourselves among names that provide with growth at a reasonable price. Simply Good Foods Co. (NYSE: SMPL) provides exposure to U.S. mobility and health and wellness trends, which have significantly improved as we emerge from the pandemic. We remain bullish on Walmart Inc. (NYSE: WMT) and Procter & Gamble Co. (NYSE: PG), two names that have gained share, and we expect will continue to gain share, given strong execution. We believe there has been a structural shift to people being at home more than they were pre-pandemic that is being underappreciated by the market.

FINANCIALS

The Financials sector continued to build momentum in the second quarter, up just over 7% and performing in line with the S&P/TSX Composite Index. The performance in Financials was led by the bank group, which dramatically outperformed the life insurance group as bond yields declined throughout the quarter.

We have been positive on banks since the group began to post positive returns in the fourth quarter of 2020. We believe many of the headwinds the group has faced for the better part of three years are now set to become tailwinds, and the group appears adequately provisioned, well capitalized and in the early innings of a positive earnings revisions cycle, supported by a strong economic recovery and increased consumer and business confidence. Returns are expected to improve for the group alongside economic expansion, and we believe banks can outperform the broader index after nearly three years of underperformance. As for name selection, we continue to prefer banks that are exposed to consumer lending, rather than commercial lending, as well as banks with strong fee income streams that are less reliant on net interest income, with structurally higher ROEs.

Outside of the banks, we continue to have a favourable view of a few positive change stories, including Trisura Group Ltd. (TSX:TSU) and Element Fleet Management Corp. (TSX:EFN). We also believe that Intact Financial Corporation (TSX:IFC) offers significant upside following the announcement of its joint purchase of RSA Insurance Group (LSE:RSA).

COMMUNICATION SERVICES

It was a good quarter for telcos; declining bond yields led the Big Three (Rogers, Bell and Telus) to outperform the broader index. From our standpoint, nothing much changed in the second quarter. We expect the group to benefit in the second half of this year as lockdowns come to a close, immigration comes back, and travel resumes. Our favourite pick continues to be Rogers Communications Inc. (TSX:RCI/B), which was the best performer of the Big Three in the quarter, returning 14.6%, compared with 8.6% for the S&P/TSX Composite Index. Our positive view on Rogers hinges on two factors: 1) a recent deal announcement is a positive, and we believe there is upside to an already impressive synergy target (CA$1 billion); and 2) the deal will likely put Rogers in a better place to make substantial investments in 5G. The path to consummation won't be smooth, and will most likely include remedies (particularly around wireless). Notwithstanding, we believe the positioning of Rogers post-deal will be attractive. Also, Rogers will likely benefit the most from reopening, given that its exposure to wireless (about two-thirds) is the highest among the group.

UTILITIES

A decline in bond yields should have been a tailwind for Utilities, and one would have expected the sector to perform well in the second quarter. However, contrary to expectations, utilities struggled, delivering just 1.3%, compared with 8.6% for the S&P/TSX Composite Index. While it is difficult to pinpoint a reason, we believe the underperformance of utilities is due to two factors: 1) a pullback in renewables following what had been a strong preceding 12 months; and 2) no real acceleration in growth among the regulated entities.

For a second straight quarter, our top pick, AltaGas (TSX:ALA), handily outperformed the group, delivering 25.6%. New management has done an excellent job at shedding non-core assets, turning around the operations of its regulated utility business (which will be mostly complete by the end of 2021) and strengthening its midstream franchise (completing Ridley Island Propane Export Terminal (RIPET) and the strategic acquisition of Petrogas Energy Corp). Notwithstanding the run-up, we think there is more upside left in the story, as there is upside for both midstream earnings and valuation (as deleveraging continues).

REAL ESTATE

Aided by optimism about reopening and lower bond yields, REITs continued to outperform the broader index in the second quarter, returning 11.0%, compared with 8.6%.

Growth opportunities with a long runway and great managements are hard to find, but we still see Colliers International Group Inc. (TSX:CIGI) as one such stock, and our preference for the company remains unchanged. Given Colliers' balance sheet (with a net debt to EBITDA of about 1x), we believe there is potential here for another large acquisition that can be materially accretive. Further, commercial real estate brokers have demonstrated throughout COVID-19 that they are no longer just leveraged capital market entities and are more rounded and diversified business entities. While the stock has rerated since the lows of Covid – up 12.5% in what was another good quarter – we believe there is more upside here, both organic (economic recovery) and inorganic (acquisitions).

ENERGY

Oil prices were up over double digits during the quarter; demand is rapidly increasingly as economies reopen. The oil markets remain currently undersupplied due to OPEC+ holding back a significant number of barrels; global oil inventories continue to fall and are now tracking below the five-year average. At the end of the second quarter, the failure of OPEC+ to agree to new production quotas created further uncertainty.

The Canadian Energy sector was the second-best performing sector of the S&P/TSX Composite Index over the three-month period and the top sector year-to-date, up 14% and 36%, respectively. We continue to have a positive view on Suncor Energy and MEG Energy; both are benefiting significantly from higher commodity prices. We also have a positive view on Tourmaline Oil Corp., given its premier management team, scale benefit and cost-of-capital advantage, via dropdowns of royalty and infrastructure assets to Topaz Energy to lead to further accretive acquisitions.

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