**March 2021**

**Global economy – nothing to worry about?** We believe the February selloff in bonds and rally in commodities validates the case for the world economy gradually healing. The marked increase in bond yields and oil prices represents a tax on growth. However, since this tightening is occurring early in the business cycle, we think it is unlikely that it will trump the strong momentum in manufacturing activity, which should continue to be fuelled by hyper monetary and fiscal reflation. The momentum in global earnings revisions and Asian exports should alert investors whether a tightening in financial conditions is taking its toll on the global economy. For now, revisions are hugely positive and exports of the Four Asian Tigers are roaring higher.

On bonds, we believe the selloff in February has a lot to do with bond vigilantes sending a clear message to central banks that rising bond yields are fine but too rapidly rising yields could choke the economic recovery before the pandemic subsides. For now, the ECB, RBA and BoJ have come out to say that they could step up their bond purchase programs to slow the rise in bond yields. As for the Fed, most members seem not concerned, but their attitude may change if yields gallop toward the 2% handle. If historical rate shocks are any guide, bond yields will not climb that far and the bulk of the increase may already be behind us.

While there is widespread consensus among investors that economic conditions are set to improve going forward, one must be mindful about the risk that the ongoing rate shock postpones the projected recovery. As such, there are three inter-market relationships we monitor to gauge this risk. These are a sudden flattening of the 30y/5y bond-yield curve, underperformance of homebuilder and lumber stocks, and a marked widening in high-yield bond spreads. Deterioration in these three risk gauges would signal heightened interest-rate risk, which may prompt investors to brush aside first quarter US GDP growth spurts.

**Asset Mix – a regime shift.** Over the last two decades, market volatility has been dictated by growth scares with investors hiding in bonds through risk-off episodes. Call it the "bad news is bad news" era. In our view, February 2020 marks a shift in regime whereby rate shocks should rule market volatility. Call it the "good news is bad news" era. This shift in regime implies that stocks should take their cue primarily from inflation and bond yields and secondarily from earnings. Also, cash becomes a transitory shelter on market selloffs.

In a rising bond-yield environment, the fair value of stock markets boils down to the equity risk premium (ERP) investors are demanding to hold risk assets instead of risk-free Treasuries. One constant over the last two decades is that the market ERP is steadily rising. This is due to central banks having less ammunition to kick start growth when recessions occur. As such, a key assumption when it comes to pegging bond-yield adjusted fair values for stock indexes is that the assumed ERP in a new business cycle should not fall below that of the previous business cycle low. Unfortunately, this is where we are with growth stocks when US 10-year Treasury bond yields climb above 1.50%. However, value stocks enjoy higher ERPs and can thus absorb bond yields up to 2%, in our view, before their bond-yield adjusted valuation becomes overvalued.

We performed an analysis of historical rate shocks when bond returns are negative by February. Three key takeaways are that bond yields usually stay under pressure until June, stocks bottom well before the peak in bond yields, and stocks usually bottom in March and then grind higher until the end of the year. One caveat to our analysis is that equities should have corrected harder given the surge in yields, hence the likelihood of more price/time correction in the near term. Otherwise, a constructive view on Canadian equities is validated by the return of foreign investors and the technical confirmation that a commodity bull market is underway.

**Sector Rotation – what if inflation bursts higher?** The shift from a low to a high inflation regime is mostly detrimental to growth sectors. While defensive value usually outperforms cyclical value, we believe it is too early to shift into defensives since central banks are determined to keep policy rates anchored at zero until late 2023. Our strategy remains: cyclical value > short-duration growth > long-duration growth > defensive value.

**Energy (OW):** Hold tight to integrated as refining margins should rise briskly through the driving season.
**Base Metals (OW):** We are closing our long on base metals, short on utilities pair trade for a 19% gain.
**Gold(s) (OW):** February gold liquidation brings oversold conditions to March and December 2020 troughs.
**Cdn. Machinery (OW):** The BoC Q4 Business Outlook Survey shows a surge in M&E spending intentions.
**Auto & Parts (UW):** Share prices appear to have discounted the projected 2021 recovery in auto sales.
**US Hypermarkets (UW):** Rising shipping/import prices and wage inflation a toxic mix to industry margins.
**US Health Care (OW):** Bottoming net earnings revisions should fuel a bounce in this undervalued sector.
F**inancials (MW):** We are closing our long on banks and short on lifecos pair trade for a 6.9% gain.
**Lifecos (MW):** Lift to MW as analysis of past rate shocks suggests upward pressure on yields until summer.
**Technology (MW):** Correction likely incomplete but keep exposure at a benchmark weight.

Source: Refinitiv Datastream, Canaccord Genuity Estimates