Recovery Rolls On as COVID Rate Climbs
Quarterly Market Commentary
Third Quarter 2020

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- Global and domestic equity markets delivered another quarter of outsized gains, moving further from the March 2020 lows as the economic recovery that took hold in the second quarter persisted throughout the summer.
- Global COVID-19 infections have started to rise again, especially in the U.S. where they peaked in late July and continued to fall through mid-September, before rising once again by quarter's end.
- We sense that the next few months of what has already been an eventful year could prove critical to the future course of the global economy and financial markets.

SEI's Domestic View

Although Canada experienced a sharp contraction in overall business activity between February and April this year, it has since enjoyed an equally sharp snapback. The recovery in manufacturing has been aided especially by the economic rebound in the U.S. and the resurgence in demand for autos and metals.

There has been a V-shaped rebound in manufacturing shipments. At the worst point of the recession on April 30, manufacturers reported a 37.5% year-over-year collapse in shipments—sharper than any year-over-year contraction recorded during the global financial crisis. By July, that year-over-year shortfall shrank to 6.9%. The decline in inventories has been minimal compared with the dramatic drop in shipments earlier this year, which may temper the recovery heading into the year-end.

A possible resurgence in coronavirus cases also could short-circuit the recovery. Infection rates are climbing, largely in and around the same major metropolitan areas that saw surges in the spring; regions that did not report many cases in the first wave of the pandemic are now experiencing more serious outbreaks. Currently, the hottest spots include northern Alberta and the Edmonton region; areas around Quebec City and up the St. Lawrence River, along with the Gatineau region; the Vancouver area of British Columbia; and in Ontario, Toronto and Ottawa.

Although rising infection rates may necessitate school closures and restraints on mobility, any lockdowns will likely be localized and less draconian than those imposed earlier this year. Canada has suffered far fewer fatalities than the U.S. or the U.K. It has recorded a steady, relatively low rate of 13 deaths per 100,000 population since July, similar to those recorded in the U.K. and Germany. In contrast, the U.S. is still reporting a weekly death rate of 150 per 100,000.

After peaking at 13.7% in May, Canada's unemployment rate fell for three consecutive months to 10.2% in August. The Canadian measure is closely tracking that of the U.S., although the latter continues to run almost two percentage points lower (as it has for the last couple of years). Those on temporary layoff totaled 200,000 in August, down from an April peak of 1.3 million. Roughly one million people are reported as being permanently laid off, a considerable improvement on the 1.6 million jobs lost in April. It likely surprises no one that employment in accommodation and the food services, culture and recreation, and the transportation and warehousing sectors are still 10% or more below their pre-pandemic levels.

The Bank of Canada (BoC) has tended to downplay the recovery, much like officials at the U.S. Federal Reserve (Fed) have been doing. We believe the odds are high that the central bank will keep its target rate at 0.25% (in line with the U.S. fed-funds rate) well into 2023. There is no expectation that inflation will accelerate in a worrisome way until most of the economic slack created by the pandemic is absorbed.

Although yields have fallen, the two-year note interest-rate differential with the U.S. has narrowed considerably over the past 18 months, from a negative 0.84 percentage points to a positive 0.13 basis points at the end of September. This should make Canadian fixed-rate assets more attractive to international investors. There is positive correlation between the Canada-U.S. interest-rate differential and movements in the Canada-U.S. exchange rate. The correlation isn't perfect (while positive, it is less than one), but the relationship suggests that the loonie could strengthen further—especially if the global economy continues to improve and commodity prices move higher.

A strong Canadian dollar does have its drawbacks, particularly as the country has struggled to improve its competitiveness over the years. When the loonie is strong, unit labour costs tend to increase rapidly—which causes the country's competitiveness to suffer. The gap between Canadian and U.S. unit labour costs has been much narrower in recent years thanks to the loonie's depreciation. We think the federal government's actions to combat the virus and the longer-term political priorities of Prime Minister Justin Trudeau's government will widen the competitiveness gap once again.

On September 23, the Governor General of Canada delivered the Speech from the Throne to open a new parliamentary session and outline the Trudeau government's agenda—which has four formal themes: (1) Fight the pandemic and save lives; (2) Support people and businesses as long as it lasts; (3) Build back better to create a stronger, more resilient Canada; and (4) Stand up for who we are as Canadians. The agenda has already gained the backing of the New Democratic Party, and will thus form the basis for the next budget to be presented in November or December.

In our view, the Trudeau government will do whatever it takes to support households and businesses through the pandemic. It intends to extend the Canada Emergency Wage Subsidy to next summer (currently scheduled to expire in December). Additional support will also be given to small businesses through the Canada Emergency Business Account. The Throne Speech also called for the creation of one million new jobs with a focus on environmental sustainability. Additionally, it noted unspecified, costly commitments to social priorities including higher childcare spending and subsidies for pharmaceutical purchases.

Gross government debt as a percent of gross domestic product (GDP) has swung acutely higher in Canada over the past two quarters, just as it has for other countries. Government debt-to-GDP still runs below that of the U.S., and dramatically so versus Japan. Nonetheless, the plan put forth by the Trudeau government implies that the debt burden will continue to rise at a sharp clip in the years immediately ahead.

SEI's Global View

It has already been an eventful and exhausting year, but we have a sense that the next few months could prove critical to the future course of the global economy and financial markets. Most countries were in V-shaped recovery mode during the third quarter, moving sharply off their low points in May and June. We assume that future lockdowns to contain COVID-19 outbreaks will be far more limited in scope. For developed countries, treatments have improved, vulnerable populations appear to be better-protected, and younger, generally healthier people are accounting for a much larger share of confirmed new cases.

We doubt there will be a full return to normal economic behaviour until safe and effective vaccines are introduced and distributed globally. The news on this score has been positive, and probably is a key reason for the continued buoyancy of equities and other risk assets. According to the World Health Organization, researchers were testing 38 vaccines in clinical trials at the end of September, while 93 more were in pre-clinical testing. Ten vaccines have been approved for large-scale efficacy and safety trials. We think it is realistic to assume that a few different vaccines will be generally available by this time next year, which means that social-distancing measures must still be followed well into 2021 and, most likely, into 2022.

There's no disputing that U.S. economic activity remains far below normal. Although incomes are now recovering as more people get back to work, the lack of additional income support may drag down consumer spending as we head into the end of the year. Business sentiment appears to have bottomed, but the outlook remains sufficiently uncertain to keep us in a watch-and-wait mode. We would not be surprised to see the official U.S. unemployment rate move up in the months ahead as hard-hit industries eliminate jobs now that government support has run out.

In August, Fed Chairman Jerome Powell officially unveiled a new framework for conducting the central bank's monetary policy. The Fed has decided to see how low the U.S. unemployment rate can get before it causes the inflation rate to exceed the 2% mark by a meaningful extent. The Federal Open Market Committee's (FOMC) own inflation projection does not envision a return to 2% inflation until the end of its forecast window in 2023, so it may be a long time before the federal-funds rate rises.

In our view, all that's really left in the Fed's monetary toolbox is quantitative easing, along with the provision of lifeline support to corporations as well as state and local governments through its various credit facilities. Monetization of debt will likely continue until the pandemic crisis is well past and the U.S. unemployment rate approaches its previous lows.

The U.S. presidential election will have a major impact on the economy and financial markets in the months and years ahead. Still, we firmly believe that it would be a mistake to pursue even a short-term investment strategy that necessitates accurately predicting: (1) the election winner; (2) the policies proposed by the newly inaugurated president; (3) the ways in which Congress will modify those proposals throughout the legislative process; or (4) the impact those new laws would have on the economy and financial markets.

Regardless of the election's outcome, we assume that both candidates would see their platforms tempered before they're put into practice. There is a high degree of institutional inertia, which is partly deliberate (constitutional checks and balances) and partly happenstance (increasing polarization of opinion in the country tends to favour a draw). While there could be some market volatility plausibly attributed to the election, it is usually best to pay strict attention to the fundamentals and to ignore the politics.

The U.K. is undergoing its own unique political melodrama, with Prime Minister Boris Johnson facing a rebellion among his own backbenchers and intense criticism from senior Conservatives over his proposal to renege on the withdrawal treaty that would allow Northern Ireland to trade without border restrictions with Ireland and the rest of the EU. The move to abrogate the treaty, if successful, would almost certainly lead to a hard Brexit—a reversion to the World Trade Organization's most-favoured-nation trading rules with the EU. It also could breathe new life into the separatist movement in Northern Ireland itself, not to mention Scotland.

Prime Minister Johnson's decision reflects his government's frustration with EU negotiators. There are two main sticking points, one small (EU fishing industry demanding full access to U.K. waters) and one large (EU demanding the UK's continued adherence to EU strictures on government financial assistance to private-sector businesses).

Obviously, a hard Brexit will not help matters. But the worst impact potentially will be sustained by financial companies and other service-producing entities, since World Trade Organization rules deal mostly with tradable goods. The increase in tariffs, for the most part, will be bearable once border-related issues are worked out. In the meantime, the U.K. and the rest of Europe are facing a second wave of COVID-19 that could turn what's been a V-shaped recovery into something looking more like a W.

This year's pandemic and postponement of the summer Olympics proved to be a bitter ending to Japanese Prime Minister Shinzo Abe's record-breaking term in office. His push to lift Japan out of its deflationary spiral was somewhat successful. Prices mostly stopped declining in the aggregate, but there were few occasions when overall consumer-price inflation rose above 1%. Pandemic pressures have caused a return to outright deflation in recent months.

In our view, it is unlikely that radical changes will be made to the direction of policy under Japan's new Prime Minister Yoshihide Suga. In the near-term, the priority will be on the response to the coronavirus; fiscal policy will remain quite expansionary. The Bank of Japan will continue to buy most of the government-issued bonds, along with other types of corporate debt and equity, as it has been doing as part of its Quantitative and Qualitative Easing program over the past four years.

The contrast of the big Asian stock markets versus other large emerging-market equities is dramatic. China's strong gains can be chalked up to its rebound in economic activity. Although travel and other services are still constrained due to lingering concerns about the virus, infrastructure-related spending and manufacturing have experienced an almost-complete recovery to pre-pandemic levels. Investors seem to be unfazed by the deterioration in the US-China economic relationship or by the increasingly fraught diplomatic relations between China and other countries.

Emerging markets are already showing some good news. The price of raw industrials bottomed in early May, and have since enjoyed a sharp move higher. If industrial commodity prices advance in a sustained, multi-year fashion as they have in previous cycles, it's a good bet that emerging-market corporate profits will also rise sharply.

Our optimism is somewhat tempered by the rising debt burden facing many emerging countries. Much of the increase in emerging-market debt has been tied to the corporate sector—especially in China, where private domestic, non-financial debt has reached an eye-watering 216% of GDP. Of more concern are the mostly small-to-medium-sized countries that are running current-account deficits and are too dependent on external hard-currency debt, or do not have the reserves to easily cover their debt service.

The actions of the world's major central banks back in March, especially the Fed's provision of U.S. dollar liquidity, have helped to ease the strain on the market for emerging-country debt. Governments and other official lenders, meanwhile, have granted loan forbearance to nearly 80 countries; it's a tougher job to get private creditors to agree to do the same. Nonetheless, emerging-market sovereign yields on dollar-denominated debt have fallen back toward their previous record lows, more than reversing the spike endured in March, prior to the Fed's rescue operations.

Economic Backdrop

Global equity markets delivered another quarter of outsized gains, moving further from the March 2020 lows as the economic recovery that took hold in the second quarter continued throughout the summer.

U.S. stocks climbed steadily for the first two months of the quarter until peaking at the start of September and mostly declining for the remainder of the period. European equities moved higher over the full quarter with relative consistency, while U.K. stocks were flat in July, higher in August and flat again in September (finishing lower in sterling but higher in U.S. dollars). Japanese stocks advanced for the majority of the third quarter, while Chinese equities jumped in early July and finished the quarter with strong performance. Hong Kong stocks also started July in a rally, but finished the third quarter on a downbeat after selling off in September.

Short-to-intermediate-term U.S. Treasury rates declined and long-term rates increased, resulting in a steeper yield curve. U.K. government-bond rates increased across most maturities during the third quarter. Eurozone government-bond rates generally decreased, although shorter-term rates were mixed in both markets. The U.S. dollar continued to decline versus a broad trade-weighted basket of foreign currencies throughout most of the third quarter before beginning to recover in a mid-September reversal.

The number of people infected with COVID-19 in European countries continued to rise throughout the third quarter after having reached low points in June and July. Spain saw the earliest resurgence and ended the period with a greater percentage of its population infected than that of any other country in the region, followed first by France and then the U.K. Upticks in Italy and Germany have been much more subdued. Meanwhile, the percent of infected U.S. residents peaked in late July—nearly matching the high point Spain would reach two months later—and continued to fall through mid-September before rising once again by quarter's end.

U.S. companies announced a large wave of layoffs for workers that had been furloughed earlier in the year as the quarter concluded. Employers in the worst-affected industries—airlines, travel accommodation, sports, entertainment, retail and education—have generally run short of resources after depleting the Paycheck Protection Program loans that were helping to support workforce retention. Prospects for additional fiscal stimulus dimmed amid election-season politics, with Democrats and Republicans holding firm on their respective funding demands. However, the Congress did pass a resolution on the last day of the third quarter to continue funding the federal government through mid-December, avoiding a government shutdown.

U.K. Prime Minister Boris Johnson announced in late September new restrictions in England on pubs and restaurants, transportation, and group gatherings as COVID-19 cases in the U.K. climbed to their highest levels since the spring. At the end of the same month, the U.K. House of Commons voted for passage of an internal market bill that contradicts the Brexit divorce agreement. Johnson argued that the powers granted by the bill would allow the U.K. to override EU attempts to shut down trade between Northern Ireland and other parts of the U.K. An amendment to the bill would require the government to gain parliamentary approval for any changes to commitments in the divorce agreement, representing a concession on the government's behalf. Nevertheless, the EU announced it would pursue legal remedy given the bill's contradictions with the Brexit agreement, even as trade negotiations continued.

Japan's ruling Liberal Democratic Party selected Yoshihide Suga to succeed Prime Minister Shinzo Abe, who resigned during the quarter due to health issues. Elsewhere in Asia, China-Taiwan tensions flared around a high-level U.S. government official's visit to Taiwan; China was angered by what it saw as one of its territories assuming sovereignty by inappropriately conducting international diplomacy. Chinese planes made a show of force to coincide with the visit, prompting Taiwan to quickly mobilize its military jets. The island's government had previously condemned nearby Chinese military drills as provocations. In Beijing, a military spokesman accused Taiwan's ruling Democratic Progressive Party of "collusion" with the U.S., and said the U.S. is trying to "use Taiwan to control China."

The foreign ministries of China and India issued a joint statement in September declaring their intent to deescalate a territorial conflict that began in the spring along their Himalayan border.

U.S. technology company Oracle and retailer Walmart won a joint bid in September to serve as trusted technology partners of TikTok's U.S. operations and, in order to appease U.S. national security concerns, gain full access to TikTok's source code. However, under the current proposal, Chinese parent company ByteDance will retain an 80% stake despite the Trump administration having sought majority ownership for the U.S. companies. A U.S. judge temporarily blocked an executive order signed by Trump to ban downloads and updates for TikTok and other popular Chinese apps beginning in September.

The Trump administration announced in September that it would not pursue a 10% tariff on U.S. imports of Canadian aluminum previously announced in August, as trade is now expected to normalize in the coming months following high import levels earlier in 2020.

Israel normalized relations with the United Arab Emirates and Bahrain in early September in a US-brokered agreement that is expected to result in the mutual establishment of embassies and increased regional trade between the U.S. allies.

The EU imposed sanctions on a "substantial number" of Belarusian officials in response to fraud and violence associated with the August 9 election victory that awarded President Alexander Lukashenko his sixth term after 26 years in power. EU leaders declared that the election—which Lukashenko was said to have won with 80% of the vote despite large, ongoing protests—would need to be rerun as it was "neither free nor fair."

Armenia and Azerbaijan renewed a long-simmering conflict centered on control of the Nagorno-Karabakh region. Beginning in July, Armenia announced joint defense programs with Russia—which Azerbaijan countered via military exercises with Turkey. Both sides accused the other of employing fighters from other regional conflict zones. By the end of September, skirmishes yielded to outright battles during which Armenia claimed Turkey shot down an Armenian fighter jet in Armenian airspace.

Central Banks

- As was widely expected, the BoC held its policy interest rate at a historically low 0.25% and maintained several other programs aimed at providing liquidity and stability to capital markets. Bank Governor Macklem noted that the COVID-19 recession has been uneven, with service industries such as restaurants, retail stores, hair salons and travel-related businesses being particularly hard hit as these industries could not work remotely. While he noted that it may be difficult to target specific sectors with monetary policy, he stated that "Uneven outcomes for some can lead to poorer outcomes for all" and stressed the importance to make "policy decisions that support lasting, broad-based growth".

- The Federal Open Market Committee (FOMC) kept the federal-funds rate near zero during the third quarter. During July, the Federal Reserve (Fed) Board of Governors announced extensions of temporary U.S. dollar-liquidity-swap and repurchase-agreement facilities with other central banks through March 2021. In August, the FOMC introduced a new average inflation target that would allow above-target inflation following periods of below-target inflation. This change indicates that the FOMC will likely let the U.S. economy run hotter than in the past before taking policy action to temper growth. At the end of September, the Fed announced it would extend an order through the fourth quarter of 2020 for large banks to cut dividends and halt stock buybacks given expectations for a higher rate of loan defaults.

- The Bank of England's (BoE) Monetary Policy Committee held the Bank Rate at 0.1% throughout the third quarter after announcing at the end of the second quarter that it would expand its stock of asset purchases to £745 billion. Committee members have debated the implications of employing a negative interest rate at recent meetings.

- The European Central Bank (ECB) held its benchmark rates unchanged during the third quarter. ECB President Christine Lagarde expressed an expectation that the central bank's Pandemic Emergency Purchase Programme (PEPP)—which was granted a higher ceiling for asset purchases in June that totaled €1.35 trillion—would need to be fully employed given the current outlook.

- The Bank of Japan (BOJ) held course throughout the third quarter. Notably, newly elected Prime Minister Suga has expressed a desire to see more Japanese bank mergers on the belief that it is a crowded marketplace.

Economic Data (unless otherwise noted, data sourced to Bloomberg)

- According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) was up just 0.1% for the month and year ending August. Excluding gasoline, the annual rate of change was 0.6%; while more robust, this was down from 0.7% for the year ended July. Short-term producer prices have rebounded faster than consumer prices. The Industrial Product Price Index (IPPI) rose 0.3% in August and the Raw Materials Price Index (RMPI) was up 3.2%. On a year-over-year basis, the IPPI fell 2.3% while the RMPI was down 7.6%, as energy prices were still well below year-ago levels. The labour market remained on a path to recovery as COVID-19 restrictions were further eased. Employment in September rose by a robust 378,000 jobs, an increase of 2.1%, with the bulk of the gains in full-time employment. The unemployment rate fell by 1.2% to 9.0% in September.

- The recovery in U.S. manufacturing steadily progressed during the third quarter, ending in a solid overall expansion punctuated by strong new orders and steady employment. Services sector activity climbed out of contraction in July and returned to a healthy expansion by August, where it levelled off through September. New weekly claims for unemployment benefits declined modestly throughout the quarter, but remained above levels that were unprecedented before COVID-19-induced lockdowns. The overall U.S. economy contracted at a 31.4% annualized rate during the second quarter, improving a bit on preliminary readings.

- U.K. manufacturing activity cooled a bit in September after returning firmly to growth territory in July and peaking in August. The U.K. services sector started the third quarter with solid growth, which heated up in August before settling back to a slower, but still-healthy expansion in September. The number of people claiming U.K. unemployment benefits drifted higher by 2.8% between July and August, reaching 2.7 million. The overall U.K. economy contracted by 19.8% during the second quarter and 21.5% year over year, slightly less than recorded by earlier estimates.

- A sluggish recovery in eurozone manufacturing activity through July and August warmed to healthier levels in September. Activity in the services sector plunged from a solid expansion at the start of the quarter to an outright contraction by September. Loans to non-financial European corporations grew steadily through July and August, at 7.0% and 7.1%, respectively, continuing a trend that began in April. The eurozone unemployment rate increased through August, jumping to 8.1% from 7.9% in July.

Market Impact (Referenced Index Returns are in CAD)

Although the global equity rally stalled in September, most indexes were positive for the quarter with many having completely erased the COVID-19 losses from earlier this year. Domestic large companies are off just over 3% year to date, while small companies are down about 8.5% (Source: MorningStar). During the quarter, market leadership shifted away from the technology sector as industrials, utilities, materials and the consumer sectors posted notable gains. Meanwhile, healthcare and energy continued to struggle. Despite continued elevated volatility, U.S. equities continued to rise. Chinese stocks remained among the leaders in emerging markets as the country appears to be further along in the COVID-19 fight than most developed markets.

Fixed-income markets had another positive quarter. Real-return bonds set the pace as they are more sensitive to and benefited from falling interest rates. Residential mortgages and corporate debt also performed well, while government debt was nearly flat for the quarter. U.S. high-yield bonds were helped by more stable and higher oil prices.

Index Data (Q3 2020)

- The S&P/TSX Composite Index gained 4.73%.
- The FTSE Canada Universe Bond Index returned 0.44%.
- The S&P 500 Index, which measures U.S. equities, rose 6.83%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, returned 6.05%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 4.54% (currency hedged) and 2.68% (unhedged).
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the “fear index,” declined from 30.43 to 26.37 by the end of the quarter.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, stabilized around US$40 a barrel after a particularly volatile second quarter. Prices were up from US$39.27 to US$40.22 a barrel.
- The Canadian dollar strengthened to C$1.34 per U.S. dollar. The U.S. dollar was generally weaker versus other major currencies, ending September at US$1.29 versus sterling, US$1.17 against the euro and at 105.53 yen.

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