Falling Rates and Climbing Vaccinations Boost Equities, Bonds and Commodities

Quarterly Market Commentary

Second Quarter 2021

- Developed-market equities outpaced their emerging-market counterparts in the second quarter; Canadian and U.S. shares gained the most among major markets.
- The world's daily COVID-19 infection rate climbed to an all-time high at the end of April, while the daily number of virus-related deaths reported globally remained significantly below its early-year peak.
- Vaccination rates have slowed in developed regions, leaving more shots available to the rest of the world. We therefore expect a rolling reopening of the global economy that will extend well into 2022; this should resemble an extended up-cycle that keeps the pressure on supply chains and leads to continued shortages of goods and labour.

SEI's Domestic View

Canada has taken a more cautious and mostly unified approach to combatting COVID-19 compared to the U.S. response. This has been evident in the marked difference between the two countries' reported infection rates throughout the pandemic. During the spike that hit Canada at the turn of the year, the country's seven-day average of new cases reached a peak of 255 thousand—significantly less than U.S. high-point that averaged over 750 thousand new cases in a single week. In April, the tables were slightly turned as the Delta variant hit Canada hard, with a seven-day average of 233 thousand while the U.S. peak reading during the same period was 215 thousand.[1] Canada's slow start to vaccinate its population certainly had something to do with this shift, as did the arrival of warm weather south of the border that likely helped to moderate the U.S. infection rate. Now, however, at less than 20 cases, Canadians can begin to breathe a lot easier.

Mobility in Canada has improved considerably from the bleak days of winter. These numbers are not adjusted for seasonal ebbs and flows, so it's better to compare today's levels versus this time last year. On that basis, Canadians are now driving and walking at least 25% more; mobility for these two categories are about as high as the peaks reached last August, when warm weather helped to keep COVID-19 at bay. Transit usage, meanwhile, has soared 70% from its year-ago level, although it remains well below pre-pandemic ridership. Now that the vaccine distribution is proceeding rapidly, there is reason to hope the populace can return to normal life in the months immediately ahead.[2]

Parts of the economy have already returned to the "old normal," notably in manufacturing and extractive industries. The three-month rolling average of the Ivey Purchasing Managers Index has staged a rapid comeback. Not only is it well above pre-pandemic levels in terms of the percentage of purchasing managers reporting improving business conditions, but it has reached highs seen only on a handful of occasions in the past 10 years. Looking at some of the index's sub-components, the price index shows a remarkable near-80% of businesses reporting increases; at previous peaks, readings of 70% were the norm for this category. The other component of note is the deliveries index, which reveals the extreme difficulty businesses are having with filling orders; the only other recorded time that supply chains were more stressed was during the early stages of the pandemic last spring.

As is true in other developed markets, central bankers and economists have affirmed that these price pressures should prove transitory. The recent tumble in some commodity prices (notably lumber) give credence to this view. The total consumer-price index (CPI), which includes energy and food, has risen very sharply from depressed levels over the past year. However, measures of the core CPI, which excludes energy and food, are also rising. We suspect that price pressures will persist through the rest of the year and into 2022 as businesses that provide goods and/or services struggle to keep up with demand.

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[1] Source: Our World in Data

[2] Source: Apple, SEI. Data as of 6/29/2021

The Bank of Canada (BoC) appears to be hedging its bets regarding inflation. It already announced a tapering of its security-purchase program (albeit after having become one of the most aggressive central banks through ramping up quantitative easing last year). The bank's governing council also expects to raise its overnight policy rate in 2022, ahead of any move made by the U.S. Federal Reserve (Fed). While there have been divergences directionally (1996 to 1997, 2002 to 2004 and 2010 to 2015), the two countries' overnight rates tend to sync up sooner or later. Even if the BoC appears more ready to hike rates than the Fed at the moment, we believe that both central banks will respond in similar fashion to arising trends in economic growth and inflation.

The Canadian dollar, meanwhile, has shown exceptional strength since hitting bottom in March 2020. Much of this strength is attributed to the commodities boom, especially in crude petroleum prices. However, a strong loonie against the U.S. dollar may be viewed as a double-edged sword. While it can help to moderate inflation by lowering the cost of imported goods from the U.S., it can also hurt Canada's competitive position by increasing export costs to Canada's most important customer. Given the Canadian dollar's appeal as a commodity currency, we expect that it will continue to move higher in the near term until global growth rates normalize and the supply of raw materials moves into better alignment with demand.

Currency concerns notwithstanding, a rebounding domestic and global economy combined with strong pricing power and a limited supply of raw materials is a great backdrop for risk assets—especially for Canadian equities. Relative to history, Canadian equities are trading at a rather high multiple, but three factors should ease concerns about valuations. First, the earnings trend has been quite strong and should continue to head higher through 2021 and into 2022. Second, bond yields remain quite low, largely justifying (in our view) the high multiples sported by Canadian equities (not to mention most other stock markets globally). Finally, the price-to-earnings (P/E) ratio applied to Canadian equities looks downright cheap versus the U.S.; on a relative P/E basis, the MSCI Canada Index in price-only terms trades at a 28% discount to the U.S. Over the past 10 and 18 years, that discount has averaged 11% and 8%, respectively.[3]

SEI's Global View

Equity markets have long anticipated the economic improvement we now are watching unfold. There is increasing concern, however, that equity prices have risen so much that there is little appreciation potential left, even if the global economy continues to forge ahead into 2022.

The last several weeks have witnessed a partial unwinding of the rotation trade that began last autumn. So far, this appears to us as a temporary pause in a longer-term upswing. The global recovery and expansion have a long way to go, especially since many countries are still imposing lockdown measures to varying degrees.

We can't rule out a choppier and more lackluster performance for U.S. equities in the months ahead given their strong outperformance since March 2009 and elevated stock-market valuations relative to much of the rest of the world. We don't think there's reason to be overly concerned if stock-market volatility increases; corrections that range from 5% to 10% can occur without any fundamental reason.

In today's environment, with economies opening up and interest rates still at extraordinarily low levels, we believe the dominant trend favours further price gains over the next year or two. Still, investors must take into account that the U.S. economy appears to have reached "peak growth."

Growth slowdowns, not just recessions, can lead to equity underperformance versus bonds. The relative performance of equites versus bonds was phenomenal over the past 15 months; we believe a major narrowing of the performance gap is inevitable. Yet, with interest rates still at exceptionally low levels, it is hard to see equities losing ground to fixed-income securities while economic growth remains so robust. Not only should consumer demand remain strong as the economy opens up, but businesses, too, are in a spending mood, desperately seeking materials and workers.

In the meantime, companies are expected to enjoy a great deal of pricing power and will almost certainly pass along at least a portion of their increased costs to customers. Unfortunately, one person's pricing power is another person's inflation. The big question is whether the price pressures seen this year are transitory, as central bankers around the world say they are.

Investors in the bond market seem to agree with the central bankers. Although U.S. bond yields rose sharply in the first quarter, they have fallen over the past three months. There's no telling how long bond investors will maintain such a calm perspective if prices keep rising at a pace that has not been seen in almost 30 years.

[3] Source: Yardeni Research

In his latest testimony, Federal Reserve (Fed) Chairman Jerome Powell reiterated that the U.S. labour market still has a long way to go before it reaches full employment. Job openings in the country are now soaring. If the rise in the Employment Cost Index accelerates as we expect, inflation could become a greater concern for investors than appears to be the case at the moment.

Markets reacted negatively to a surprising extent when the central bank revealed the Federal Open Market Committee's (FOMC) updated "dot plot" of federal-funds rate projections on June 16. The median FOMC forecast now calls for two rate hikes in 2023, which was exactly what futures traders had already priced in. Those same traders have now priced in three rate hikes by the end of 2023, but a lot can happen between now and then.

The recent stumble in the rotation theme was exacerbated by the shift in Fed expectations. It is clear, however, that the U.S. central bank will be cautiously moving away from its current policy stance. The first move will likely be the tapering of its bond-buying programme, which may be announced in late August at the annual Jackson Hole conference, with actual tapering beginning in the first quarter of 2022 (at the earliest).

The path of U.S. fiscal policy is harder to decipher given strained bipartisanship and the narrowness of the Democratic majority in the Congress. A traditional infrastructure bill is a good bet, but the push for non-traditional forms of infrastructure—and the taxes to pay for all the added spending—will depend on whether the Democrats in the Senate can come to terms with each other.

We believe the combination of (1) above-average economic growth, (2) significantly higher inflation than seen in the past decade, (3) a fiscal policy that expands the size of federal government spending, and (4) extreme monetary ease aimed at suppressing interest rates is the perfect backdrop for risk assets—and for the creation of speculative bubbles.

The relative success of the U.S. vaccination effort and the country's state-by-state response have resulted in a significantly stronger economy this year than in other major developed countries. Fortunately, vaccination rates are accelerating in Europe and Japan. We anticipate that other advanced economies will record strong economic results in the second half of the year and into 2022, exceeding the pace in the US.

Although economists correctly point out that the U.S. has employed direct fiscal measures (emergency spending, income support and tax breaks) more aggressively than any other nation, other countries have used different tactics that far exceed the U.S. effort.

Several European nations and Japan have relied on equity injections, loans and guarantees. Italy (35% of Gross Domestic Product (GDP)), Japan and Germany (both at 28%) are the most notable, according to the International Monetary Fund. In the eurozone, some of these loan commitments have only just begun to flow. Italy and Spain are big beneficiaries of the eurozone's €750 billion in loans and grants as part of the so-called NextGenerationEU program.

The European Central Bank (ECB) also seems dedicated to maintaining its pandemic-related monetary support at least through March 2022. As a percentage of GDP, the ECB's balance sheet has risen more than 25% since the beginning of the COVID-19 crisis, more than any other major central bank besides the Bank of Japan (30%). The ECB's actions have succeeded in keeping peripheral Europe's sovereign bond yields well behaved through the crisis period.

While the U.S., the UK and Canada seem to be enduring a much sharper inflationary increase than Japan or the eurozone, the latter two are probably relieved to have a respite from the deflationary pressures that have been afflicting their economies for many years. There seems little reason for the ECB or BOJ to join the Fed when it comes to discussing a near-term reduction in asset purchases, much less raising their policy rates ahead of the US.

The trade-weighted U.S. dollar jumped to its highest level in three months against other major currencies in the days following the Fed's latest announcement, although the currency remains some 10% below its March 19, 2020 high. Since any serious policy move by the Fed is still rather far in the future, we continue to expect the U.S. dollar to weaken over time as the rest of the world gains economic strength.

In the meantime, we do not see much sign that the Fed's shift toward an earlier lift-off in rates is leading to a 2013-style "taper tantrum" among emerging economies. A strong U.S. dollar would certainly threaten the bull market in commodity prices.

We are still bullish on the outlook for commodities, but we are watching price trends carefully. Commodity prices of all types have enjoyed a spectacular run since March 2020 and were already in the process of consolidating or correcting in the weeks before the Fed revised its views.

We remain optimistic that the more cyclical and value-oriented areas within emerging markets will bounce back from their modest stumble in June. But there are near-term challenges besides the shift in perceptions about Fed policy and the future course of the U.S. dollar and commodity prices. Credit growth has decelerated significantly in China, similar to the slowdowns recorded in 2013 and 2018—years when the performance of emerging markets was less than stellar.

Another potential source of market volatility could stem from the increasingly fraught relationship between China and the U.S. and its allies. If there is any consensus in Washington nowadays, it is focused on countering China's growing economic and military strength; although market participants have mostly managed to look past political tensions to date.

Fundamentally, emerging markets continue to look relatively cheap versus most other regions. The forward price-to-earnings multiple of the MSCI Emerging Markets Index is still selling at a 36.5% discount to that of the MSCI USA Index. Outside the March-to-April 2020 low point, this is as cheap a relative multiple against the U.S. as seen at any time in the past 16 years.

We are counting on the advanced economies to take up the slack while vaccines ramp up in developing countries. There is a tremendous amount of excess savings and pent-up demand in North America and Europe. That said, as the northern hemisphere enters the autumn and winter, the possibility of regional spikes in COVID-19 cases cannot be dismissed. If severe enough, markets could switch back to a decidedly risk-off position.

As vaccination rates slow in the developed world, more shots will be available for the rest of the world. We expect a rolling reopening of the global economy that will extend well into 2022. This wave of recovery could resemble a prolonged up-cycle that keeps the pressure on supply chains, leading to continued shortages of goods and labour. Investor faith in the "transitory inflation" narrative probably will be tested as we head into year end and enter 2022.

Economic Backdrop

The broad-based advance in equities, commodities and riskier fixed-interest asset classes since earlier this year accelerated during the second quarter.

Trendwise, a shift among global investors toward favouring cyclical and value-oriented asset classes that began in the second half of 2020 halted in mid-June. Market observers attributed this to the FOMC—the Federal Reserve's monetary policymakers—deciding to increase its projection for the federal-funds rate in 2023. Meanwhile, for the first time since April this year, the seven-day moving average of new COVID-19 cases reported in the U.S. stopped falling in mid-June after an impressive period of declines that brought cases to their lowest levels since March 2020. The FOMC development and the bottoming of COVID-19 cases can both be taken as evidence that the rebound taking place as the U.S. economy reopens may be near its peak.

Developed-market equities outpaced emerging markets for the second quarter. Canadian and U.S. shares gained the most among major markets.

U.S. Treasury and U.K. gilt rates declined across most maturities for the first two months of the second quarter; short-term rates bounced in June to finish higher for the second quarter as intermediate-to-long-term rates continued to drop—resulting in flatter yield curves. Conversely, eurozone government-bond rates climbed throughout April and May before falling in June, but generally ended up higher compared to the beginning of the quarter.

Emerging-market debt was the best-performing fixed-interest asset class. U.S. corporate bonds followed—with investment grade outpacing high yield, and inflation-protected securities also performed notably well.

The Bloomberg Commodity Index increased by 13.3% during the second quarter, with most of the advance occurring in April and May. The FOMC's modest evolution toward tighter monetary policy spurred the U.S. dollar higher in June, tempering the rally in commodities; although the U.S. dollar finished the three-month period slightly lower, according to the U.S. Dollar Index (DXY). The price of West Texas Intermediate crude oil increased by 24.2% during the quarter to $73.47 per barrel.

The world's daily infection rate climbed past the peak recorded in January to an all-time high at the end of April as India continued to battle a severe COVID-19 outbreak. While the daily number of virus-related deaths reported globally also increased during the second quarter, it remained significantly below its early-year peak. India's daily case count began to rapidly decline in early May, leaving Brazil with the highest country-level count by the end of the second quarter. At this time, countries reporting cases at or near their all-time peaks were concentrated in Southeast Asia, Sub-Saharan Africa and the Caribbean-Central America region.

As for COVID-19 vaccination trends, Canada, the U.K. and Chile reported the largest numbers of people (relative to their total populations) that received at least one vaccine dose by the end of the three-month period. Perhaps as a result, the daily average number of deaths in the U.K. attributed to COVID-19 remained in the low double digits despite a resurgence in new infections that began in mid-May and topped 20,000 cases per day as the quarter came to a close.

The prospect of a bipartisan U.S. infrastructure deal appeared to brighten in mid-June as a group of Senate Republicans and Democrats agreed to a White House compromise that would direct $1.2 trillion toward improving the country's structures and facilities over an eight-year period. The plan would provide about $580 billion in new spending and sidestep tax increases. However, the possibility of a party-line vote on a larger package by President Biden's Democrats remained on the table as Republicans took issue with plans by the Democrats to enact other parts of their spending agenda once the infrastructure deal had concluded.

Central Banks

- The BoC held its policy rate firm at a historically low 0.25% during the quarter. The BoC indicated it expects to hold rates low until its inflation target is sustainably met. The next scheduled meeting is for July 14.

- The FOMC held the federal-funds rate near zero throughout the second quarter and continued its asset purchases apace ($80 billion in Treasurys and $40 billion in agency mortgage-backed securities per month). Its latest Summary of Economic Projections (SEP), released in mid-June, featured a projected increase in the federal-funds rate to 0.6% in 2023 (up from 0.1% in its March projection). The SEP also depicted significantly higher real gross domestic product (GDP) and inflation projections for 2021, although out-year projections were only modestly higher.

- The Bank of England's (BOE) Monetary Policy Committee (MPC) kept the bank rate at 0.1% and retained an £895 billion maximum allowance for asset purchases throughout the second quarter. It shared a projection following its late-June meeting that inflation would temporarily top 3% amid the country's economic reopening before returning toward 2%.

- The European Central Bank (ECB) began the second quarter with a pledge to increase the pace of asset purchases under its €1.85 trillion Pandemic Emergency Purchase Programme (PEPP). It reaffirmed the acceleration at its June meeting. Purchases averaged about €80 billion per month during the second quarter after running closer to a monthly pace of €60 billion during the first quarter.

- The Bank of Japan (BOJ) announced following its June meeting that the central bank's emergency pandemic-related programs would extend past their scheduled September 2021 end date. A new programme targeted at promoting lending to counteract climate change was also announced in June. The BOJ intends to announce final plans for the programme by the end of 2021, but has said it will likely be based on offering banks attractive loan terms when their lending supports mitigating the effects of climate change.

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

- According to Statistics Canada, the rate of inflation accelerated (as measured by the change in the Consumer Price Index (CPI)) to 0.5% for the month and 3.6% for the year ending May. Gasoline, furniture and beef prices have rebounded sharply from year-ago depressed levels; meanwhile, costs for shelter and passenger vehicles rose. Producer prices continued their sharp rise. The Industrial Product Price Index (IPPI) was up 2.7% in May and the Raw Materials Price Index (RMPI) was up 3.2%. On a year-over-year basis, the IPPI rose 16.4% (the largest annual increase since January 1980) and the RMPI was up a blistering 40.1% as crude energy products jumped 87.2% in the past 12 months. Canada's labour market added 231,000 jobs—with the gains coming in part-time work—as some COVID-19 restrictions were lifted in June. The unemployment rate improved by 0.4%, falling to 7.8%.

- Multiple PMI surveys depicted U.S. manufacturing at red-hot growth levels during the second quarter. The Institute for Supply Management reported record manufacturing activity during May, while IHS Markit's June reading was the strongest on record since 2007. U.S. services activity peaked during May at the highest level on record dating back to 2009, according to IHS Markit's PMI survey, before slowing to a still-remarkable pace of growth in June. U.S. nonfarm payrolls increased at an accelerating pace throughout the second quarter—by 269,000 in April, 583,000 in May, and 850,000 in June (with 343,000 new leisure and hospitality jobs during June alone)—as new U.S. jobless claims declined from about 700,000 per week at the end of the first quarter to 364,000 in late June. The overall U.S .economy grew by a 6.4% annualized rate during the first quarter.

- The U.K.'s manufacturing frenzy reached the fastest pace of growth since 1994 in May before cooling ever so slightly in June, according to the IHS Markit / CIPS UK Manufacturing Purchasing Managers' Index (PMI) survey. Similarly, services growth peaked in May at its strongest pace since 1997 before slowing somewhat in June. The U.K. claimant count (which calculates the number of people claiming Jobseeker's Allowance) declined by about 56,000 in April and 93,000 in May, with claimants representing 6.2% of the population as at May's reading. The overall U.K. economy contracted by 1.6% during the first quarter and 6.1% year over year through March.

- Eurozone manufacturing measured its fourth straight month of record-high growth in June, according to IHS Markit's PMI survey, with Spain and Greece reaching their greatest levels in more than 20 years. Services activity in the eurozone emerged from contraction to start the second quarter before accelerating to the fastest rate of growth in more than three years by June, according to IHS Markit's PMI survey. The eurozone unemployment rate declined steadily, from 8.1% at the end of the first quarter to 8.0% in April and 7.9% in May. The overall eurozone economy shrank by 0.3% during the first quarter and 1.3% year over year in March.

Market Impact (Referenced Index Returns are in CAD)

Global equities climbed higher, with Canadian equities continuing to perform near the top among major markets. Domestically, the information technology sector posted impressive gains; energy, communications services and small companies also performed well. Industrials and utilities were notable laggards, while healthcare was the only sector to post a loss. U.S. stocks were strong as well; large technology and technology-related companies regained market leadership during the quarter. Other developed international and emerging markets were generally positive, but mostly trailed well behind Canadian and U.S. equities.

Fixed-income markets partially rebounded from a difficult start to 2021. Real-return bonds were the top performer as inflation expectation have increased. Government bonds outperformed corporate debt and residential mortgages, while short-term bonds were nearly flat. U.S. high-yield bonds were positive, aided by higher oil prices and their riskier profile.

Index Data (Q2 2021)

- The S&P/TSX Composite Index gained 8.54%.
- The FTSE Canada Universe Bond Index returned 1.66%.
- The S&P 500 Index, which measures U.S. equities, rose 6.95%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, returned 5.81%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 2.77% (currency hedged) and 1.25% (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," briefly jumped above 20 several times during the quarter. Despite that volatility, it ultimately trended lower from 19.40 to 15.83 by the end of the quarter.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, rose from US$59.16 to US$73.47 a barrel to end the quarter.
- The Canadian dollar strengthened to C$1.24 per U.S. dollar. The U.S. dollar was little changed versus the world's other major currencies. It ended June at US$1.19 versus the euro, US$1.38 against sterling and at 110.99 yen.

Index definitions

The **Bloomberg Commodity Index** is composed of futures contracts and reflects the returns on a fully collateralized investment in the Index. This combines the returns of the Index with the returns on cash collateral invested in 13-week (3-month) U.S. Treasury bills.

The **Consumer Price Index** measures changes in the price level of a weighted average market basket of consumer goods and services purchased by households. A consumer price index is a statistical estimate constructed using the prices of a sample of representative items whose prices are collected periodically.

The **ICE BofA U.S. High Yield Constrained Index** is a market-value weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3 but are not in default.

The **Employment Cost Index** is a quarterly economic series published by the Bureau of Labour Statistics that details the growth of total employee compensation. The index tracks movement in the cost of labour, as measured by wages and benefits, at all levels of a company.

The **ISM Manufacturing Index** is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.

The **Ivey Purchasing Managers Index** is prepared by the Ivey Business School and is an economic index that measures the month-to-month variation in economic activity as indicated by a panel of purchasing managers from across Canada.

The **FTSE Canada Universe Bond Index** is the broadest and most widely used measure of performance of marketable government and corporate bonds outstanding in the Canadian market. FTSE Canada has been in the business of providing the benchmark performance standards for Canadian fixed income investments since 1947.

The **MSCI ACWI Index** is a market-capitalization-weighted index composed of over 2,000 companies, and is representative of the market structure of 48 developed and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The index is calculated with net dividends reinvested in U.S. dollars.

The **MSCI Canada Index** is designed to measure the performance of the large- and mid-cap segments of the Canada market. With 91 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in Canada.

The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging-market equities.

The **MSCI USA Index** measures the performance of the large- and mid-cap segments of the U.S. market.

The **S&P 500 Index** is an unmanaged, market-weighted index that consists of 500 of the largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.

The **S&P/TSX Composite** is the headline index for the Canadian equity market. It is the broadest in the S&P/TSX family and is the basis for multiple sub-indices including but not limited to equity indices, Income Trust Indices, Capped Indices, GICS Indices and market cap based indices.