Developed Markets Decouple from Emerging-Market Selloff

Monthly Market Commentary

July 2021

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- Globally, equities started the second half of 2021 with mixed performance. Developed markets generated positive returns for July, but emerging markets declined sharply—led by China's double-digit losses.
- Canada succeeded in vaccinating 72% of its population through the end of the month, followed closely by the U.K. (70%), and then France (63%), Germany (62%) and the U.S. (58%).
- Despite a tremendous amount of excess savings and pent-up demand in North America and Europe, investors could once again grow cautious of riskier asset classes if COVID-19 infection rates spike severely enough.

Economic Backdrop

Globally, equities started the second half of 2021 with mixed performance. Developed markets generated positive returns for July, but emerging markets declined sharply—led by China's double-digit losses.

Long-simmering concerns about high debt levels, heavy-handed regulation and the decoupling of U.S. and Chinese markets came into focus during July due to growing debt-driven troubles for China Evergrande Group, one of the country's largest property developers; a forced conversion of education companies from for-profits to non-profits; the imposition of new regulations on food-delivery apps; a demand that major technology company Tencent cancel licensing deals with numerous record labels; and the disappearance of Chinese ride-sharing app Didi Global from the country's app stores right after its U.S. trading debut.

Health care was the best-performing sector across global equities in July, followed by information technology. Energy stocks declined sharply. The price of West Texas Intermediate crude-oil was practically unchanged after a volatile month—initially selling off almost 10%, and then rebounding, from an announcement by OPEC+ (the Organization of the Petroleum Exporting Countries led by Saudi Arabia, plus Russia) that production will increase again in August.

Government-bond rates declined across most maturities in the U.S., U.K. and eurozone during July, with longer-term rates falling by more than shorter-term rates. U.S. Treasury inflation-protected securities (TIPS) outpaced most other fixed-income asset classes. Nominal Treasurys and investment-grade corporates also performed well as rates declined. Local-currency emerging-market debt (EMD) fell, while foreign-currency EMD, high-yield and asset-backed securities (ABS) had relatively modest gains.

The U.S. reported approximately 80,000 new COVID-19 infections per day at the end of July—more than any other country, and double the second highest daily rate of 40,000 recorded in both India and Indonesia. A large share of Africa and East Asia remained at or near peak country-level infection rates, while South America's spread eased. Indonesia suffered the largest number of COVID-19-related deaths per day at the end of the month (1,200), followed by Brazil (987) and Russia (783)[1].

Canada succeeded in vaccinating 72% of its population through the end of July; the U.K. closely followed with a rate of 70%, while smaller percentages were vaccinated in France (63%), Germany (62%) and the U.S. (58%)[1].

At the end of the month, the U.S. Senate voted to begin negotiations about a bipartisan infrastructure plan. Formally called the Infrastructure Investment and Jobs Act, the plan includes roughly $1 trillion with $550 billion in new spending over a five-year period. It is projected to add approximately two million jobs per year for a decade as the nation undertakes modernizing roads, railways, ports, public transit, airports and power grids; improving water quality and broadband access; and cleaning abandoned environmentally hazardous sites.

Despite its high cost, funding the plan does not call for broad-based individual or corporate tax increases. In a rare demonstration of widespread support, a long list of business and labour organizations—including the U.S. Chamber of Commerce (the largest U.S. business lobbying organization) and the American Federation of Labor and Congress of

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[1] COVID-19 Global Tracker." Reuters.

Industrial Organizations (AFL-CIO, the largest U.S. labour union group)—offered a joint endorsement of the deal in early July.

Finance ministers and central bank leaders from the Group of 20 (G-20), representing the world's 20 largest economies, unanimously agreed to endorse the major components of a tax plan that would establish a global minimum corporate tax of at least 15%. Finalization of the plan requires approval from national leaders. In deference to this effort, EU officials postponed review of its digital levy proposal until autumn.

Economic Data

- According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) increased by 0.3% and 3.1%, respectively, for the month and year ending June. Despite slowing from the prior reading, prices have continued to rise at a brisk pace. Shelter and transportation (in particular gasoline) costs were the primary contributors to higher prices. Producer price increases slowed, but remained generally consistent with a theme of rapidly higher prices. The Industrial Product Price Index (IPPI) was flat in June, while the Raw Materials Price Index (RMPI) was up 3.9%. Over the past 12 months, the IPPI increased a robust 16.8% and the RMPI jumped 38.1%. Prices for lumber mostly softened in June, but along with prices for energy and petroleum products they remained sharply higher year-over-year. The unemployment rate for July declined 0.3% to 7.5%; employment rose by 94,000 with the gains coming from the private sector.

- Manufacturing growth in the U.S. pushed further into uncharted territory during July, with extreme levels of supply backlogs pushing input costs higher at a record pace. U.S. services growth remained strong in July, but continued to moderate from May's dizzying peak. New claims for U.S. jobless benefits hovered around 400,000 per week during July. Overall U.S. economic growth measured an annualized 6.5% during the second quarter, just above the first-quarter pace of 6.3%.

- Manufacturing activity in the U.K. expanded rapidly in July, but continued to settle from May's peak as supply and labour shortfalls held back overall growth. U.K. services activity followed the same path—growing at a strong pace in July, but slowing since May's high point. The U.K. claimant count (which calculates the number of people claiming Jobseeker's Allowance) declined to 5.8% of the population in June from 6% in May as the total number of claimants decreased from 2.44 million to 2.32 million. The broad U.K. economy grew by 0.8% during May, representing the fourth straight month of expansion following a downtrend that persisted from November 2020 through January 2021.

- Eurozone manufacturing remained at red-hot growth levels in July, albeit just below the record pace set in June, as all countries besides Germany reported slower growth. Eurozone services growth continued to accelerate through July, hitting the fastest pace since June 2006. The eurozone unemployment rate fell to 7.7% in June from 8.0% during May. The overall eurozone economy grew by 2.0% during the second quarter and 13.7% year over year, representing a marked improvement over the first quarter's respective rates of -0.3% and -1.3%.

Central Banks

- As expected, the Bank of Canada (BoC) held its policy rate at a historically low 0.25% following its July 14 meeting. The BoC indicated it expects to hold rates low until inflation consistently exceeds 2% (the lower end of its target inflation band), which is not currently expected to occur until the second half of 2022.

- The Federal Open Market Committee (FOMC) made no changes following its late-July meeting but reported that progress had been made toward its goals for employment and inflation. Federal Reserve (Fed) Chairman Jerome Powell shared that the FOMC debated when and how to taper its asset purchases of $80 billion in Treasurys and US$40 billion in agency mortgage-backed securities per month. The Fed also announced a standing repurchase-agreement (repo) facility with a daily capacity of $500 billion to extend liquidity to primary dealer banks in exchange for high-quality collateral. It indicated plans to establish a similar facility for other central banks as well.

- The Bank of England's (BOE) Monetary Policy Committee (MPC) did not hold a July meeting; the bank rate remained 0.1% and the £895 billion maximum allowance for asset purchases was unchanged.

- The European Central Bank (ECB) unveiled the results of its strategy review in early July, adopting a symmetric inflation target of 2% over the medium-term, meaning that it views deviations above or below its target as undesirable and that it anticipates fluctuations over shorter time frames. At its late-July monetary-policy meeting, the ECB maintained its expectation that purchases under the pandemic emergency purchase programme (PEPP) will be conducted at a significantly higher pace than during the first months of the year. 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 ECB said it expects to continue its pre-pandemic asset purchase programme to continue at a pace of €20 billion per month.

- The Bank of Japan (BOJ) adjusted its outlook at its mid-July meeting; growth expectations were lowered for 2021 and increased for 2022 as the country's recovery is projected to take longer and inflation is estimated to increase for both calendar years. The BOJ also shared details about its green loan initiative, including extending 0% interest-rate credit to banks for their "green" lending efforts, waiving punitive negative interest rates for associated bank reserve requirements, and allowing foreign-currency bonds issued by Japanese companies to be eligible for the program.

Market Impact (in Canadian dollar terms)

Domestic equities posted modest overall gains led by significant outperformance in consumer staples, while a host of other sectors (materials, utilities, information technology and industrials) also notched solid gains. Health care, energy and smaller companies all tumbled during the month, which muted overall gains. Canadian equities ceded their recent market leadership to the U.S. and other developed-equity markets. Meanwhile, emerging markets plunged. Significant turmoil in Chinese markets along with generally lower vaccination rates (amid the Delta variant COVID-19 resurgence) than developed countries hurt.

Fixed-income markets continued to heal from the early 2021 selloff. Real-return bonds moved higher as most inflation measures have still been running hot. Government debt outperformed corporate bonds as the yield curve flattened. Residential mortgages, short-term bonds and U.S. high-yield debt were also positive.

Index Data (July 2021)

- The S&P/TSX Composite Index was up 0.80%.
- The FTSE Canada Universe Bond Index returned 1.03%.
- The S&P 500 Index, which measures U.S. equities, gained 3.21%.
- The MSCI ACWI Index (Net), used to gauge global equity performance, was up 1.51%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 0.36% (currency hedged) and 1.17% (unhedged).
- The Chicago Board Options Exchange Volatility Index—a measure of implied volatility in the S&P 500 Index also known as the "fear index"—moved higher from 15.83 to 22.50 mid-month, before settling at 18.24 to end July.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, rose slightly from US$73.47 on the last day of June to US$73.95 at the end of the month.
- The loonie weakened versus the U.S. dollar; it ended the month at C$1.25 per U.S. dollar. The U.S. dollar was little changed versus the world's other major currencies. It ended the month at US$1.39 against sterling, US$1.19 versus the euro and 109.75 yen.

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