Global Stocks Come Full Circle as Rates Fall into Autumn
Quarterly Market Commentary
Third Quarter 2019

- Equity markets, which plummeted in early August after climbing through July, largely recovered into mid-September around most of the globe. Government bond rates declined across all maturities in the U.S., U.K. and eurozone during the three-month period.
- U.S.-China trade negotiations came to a halt on August 1 with President Trump's announcement of new tariffs. Both sides applied new and higher tariffs beginning on September 1, but as a new round of negotiations materialized for October, the U.S. delayed a tariff measure scheduled for October 1.
- Although maintaining exposure to equities and other risk-oriented assets can feel uncomfortable during such periods of uncertainty, we believe that investors with long time horizons should avoid timing the market or making outsized sector or regional bets.

SEI's Domestic View

Canadian equity investors with a home bias have endured a long run of underperformance relative to U.S. equities: While the MSCI Canada Index (net, total returns) climbed a cumulative 150% from the beginning of 2009 through September this year, the MSCI USA Index (net, total returns) gained almost 320% over the same period. Of course, Canadian investors are not alone. Most non-U.S. stock markets have badly lagged U.S. equities in local currency-terms over the past 10 years, and even more so when factoring in the multi-year appreciation of the U.S. dollar against their respective local currencies.

If there's any good news to be had, it's that Canadian equities have improved in relative terms, only slightly lagging the U.S. since early 2018. Relative strength flattened following a sharp deterioration that began in 2011 through the end of 2017. It may seem surprising that Canadian equities have been holding their own, considering all the trade-war anxieties—with U.S. President Donald Trump's imposition of steel and aluminum tariffs on several countries including Canada early last year (which he subsequently removed for some, including Canada); Trump's renegotiation of the North American Free Trade Agreement, renamed the U.S. Mexico Canada Agreement (USMCA), that has yet to be formally approved by U.S. Congress; and the increasingly testy relationship of both Canada and the U.S. with China due to Canada's house arrest (at the request of U.S. authorities) of a high-ranking Huawei official battling extradition to the U.S.

Over the last three years, Canada's estimated growth in 12-month forward earnings per share has mostly kept pace with those of the U.S. By contrast, Canadian firms consistently lagged the U.S. from 2011 to 2016 in the profits-performance derby. Part of this long-term earnings underperformance simply reflected the fact that the MSCI Canada Index is heavily weighted toward financials, energy, materials and industrials; together, these sectors account for three-quarters of the index's market capitalization. Meanwhile, information technology amounts to only 6.5% of the MSCI Canada benchmark, but represents 22.3% of the U.S. benchmark's market capitalization. When growth in the global economy begins to reaccelerate, as it did in 2016, we expect commodity-dependent Canada to be a primary beneficiary.

The country's economic growth has been tepid, running between 1.5% and 2.0% on a year-over-year basis since the middle of 2018. Household consumption growth has been slowing since mid-2017, burdened by high mortgage debt and rising interest rates. In the second quarter of 2019, Canadian personal consumption expenditures posted their slowest rise (0.6% at a seasonally-adjusted annual rate) since the second quarter of 2012. We expect spending to improve, however, owing to the underlying strength of the labour market. The unemployment rate remains near its lowest level recorded in more than four decades. Moreover, the number of persons employed expanded by 471,000 over the 12-months ended August. Granted, part-time employees accounted for more than one-third of this improvement as the service-oriented "gig economy" has become increasingly important. Nonetheless, the number of better-paying and more stable full-time jobs has moved to a healthy level over the past year.

The tightening labour market has been putting upward pressure on compensation and unit labour costs. Average hourly wages breached the 4% mark on a year-over-year basis, the first time that has happened since the initial recovery out of recession in 2009. The other measures (total compensation per hour and unit labour costs) have not been quite as strong as hourly wage growth, but have been accelerating since the end of last year.

The rising trend in labour costs has not yet led to a worrisome acceleration in inflation. Canada's headline consumer-price index (CPI), which includes all items, and other measures of Canadian inflation tracked closely by the Bank of Canada (BoC) remain in a rather narrow range around the BoC's 2% inflation target. Of course, one can see that inflation, as measured by the CPI, has accelerated in recent years. From the 2010 to 2015, the less-volatile core CPIs mostly fluctuated near the 1.5% mark from year to year. Headline CPI tracked much lower owing to the persistent decline in energy prices.

With the buoyancy of the labour market, rising wages and costs, and an inflation rate that is close to target, BoC monetary policymakers face a dilemma. Should they keep the current policy rate or should they cut the rate in order to maintain the spread against the U.S. federal-funds rate? If they decide to keep the policy rate unchanged, the interest-rate spread would narrow. That could cause the Canadian dollar to rise against the U.S. dollar, making Canadian exports less competitive.

On October 21, Canadian voters go to the polls to determine whether Liberal Prime Minister Justin Trudeau loses his position to Andrew Sheer, the Conservative Party candidate. This outcome seems increasingly possible, owing to recent controversy tied to Trudeau—including apparent missteps related to the SNC-Lavalin affair, and the surfacing of pictures with him in blackface. But the Liberals and the Conservatives are neck-and-neck in the polls. In our view, the chances of getting a minority government (that is, when no party has a majority of seats in the legislature) appear high. There are certainly some differences between the two parties. Sheer has been running against the federal carbon tax, a stance that has enhanced his popularity in the western provinces. However, the ideological gap on economic issues does not appear to be anywhere near as wide between the two major parties as it is between the Republicans and the Democrats in the U.S. or the Conservative and Labour Parties in the U.K. While the Canadian Conservatives may be perceived as more business-friendly, we do not foresee any big policy changes coming down the pike from a change in leadership.

SEI's Canadian equity managers' allocations to stocks with value, stability and momentum characteristics remained neutral versus strategic weights. Unlike value stocks elsewhere around the globe, value in Canada does not look cheap. This includes the energy sector, which bulks large in the MSCI Canada Index. The momentum style had a nice run before pulling back in September; our momentum manager was overweight gold companies. Stability, meanwhile, continued to sport relatively high valuations.

Our fixed-income managers continued to overweight corporate credit, primarily financial stocks. They do not expect the BoC to implement an interest-rate cut, but they do expect the yield curve to flatten a bit between 2 and 10 years.

SEI's Global View

We have leaned toward an optimistic view on equities and other risk-oriented assets for the past 10 years. When markets corrected sharply in price—as several U.S. equity indexes did in 2011, 2015 and late last year—we viewed the pullbacks as buying opportunities. We believe that staying invested has been a sound overall strategy. Today, while we still doubt that a true bear market is on the immediate horizon, we are surprised by the resilience of the stock-market averages during the third quarter in the face of numerous economic and political uncertainties, both in the U.S. and globally.

The U.S. economy remains in reasonably good shape and appears to be in little danger of contracting any time soon. Granted, the manufacturing and agricultural sectors are being stressed by the trade war with China. But we think there is a limit to how far this deterioration in economic activity will go. Few economists would dispute that the U.S. consumer sector is in great shape.

Traders in the federal-funds futures market expect more rate cuts on the heels of the FOMC's July and September cuts. The central bank is also no longer letting its securities portfolio contract now that it halted quantitative easing. If the economy were to weaken in a serious way, it could ramp up its purchases of Treasurys again.

Looking at the U.S. stock market, the forward-earnings trend has flattened in recent quarters. Periods of flat-to-down earnings over several quarters occurred in the 2014-to-2015 period, and in 2011, 2007 and 1998, each coinciding with flat-to-declining stock prices, increased volatility and moderate-to-severe market corrections.

Growth and momentum styles continued to outperform quality and value for much of the third quarter. However, September saw a sharp reversal in this trend for the first time since the beginning of 2018 as value outperformed. It's hard to say whether this reversal will be sustained, although SEI's equity managers have been positioned for such an eventuality.

A trade truce between China and the U.S. would be a relief, but it would be only one piece of a larger mosaic that must first come together. Getting the world back on a faster growth track will depend on an economic rebound in the domestic economies of China and Europe.

Our expectation of an economic revival in China rests on the assumption that all the fiscal and monetary-policy measures put in place over the past year will overcome the major challenge posed by the trade war. The latest tranches of import duties are aimed at Chinese goods like apparel and toys, which usually have thin profit margins, are labour-intensive, and can be more easily produced in other low-wage nations than higher-tech products. We therefore believe that Chinese President Xi Jinping has an incentive to get a deal done with President Trump. The last thing Xi needs is a sharp rise in unemployment and corporate bankruptcies as profit margins get eviscerated.

China's currency has weakened further in recent months, reaching an 11-year low against the U.S. dollar in September 2019 that amounted to a cumulative decline of 12% since April 2018—thereby offsetting a little more than half of the imposed or announced tariff increases. The Chinese government is reluctant to encourage additional currency depreciation, fearing that capital could flee the country. Rather, there is evidence that it is getting more aggressive when it comes to pulling the monetary and fiscal levers.

Slowing growth in China, the U.S. and the eurozone does not bode well for other economies. On a positive note, many developing countries have been able to cut interest rates in recent months. Meanwhile, capital-market conditions in emerging countries still appear benign. Spreads on U.S. dollar-denominated debt remain in the middle of their range for the past eight years.

Despite all its economic and political problems, European-wide equity markets have done rather well this year in local-currency terms. The MSCI Europe ex UK Index (net, total returns) climbed 21.1% year to date, actually matching that of the MSCI USA Index. The MSCI United Kingdom Index (net, total returns) was the laggard, gaining only 13.8%—still something of an achievement considering the messy political situation in the U.K.

How does one explain the rather robust performance of European equities? It can largely be attributed to the lack of an alternative option. For example, now that Germany's sovereign yield curve is negative all the way up to 30 years (just one year after yields were positive beyond six years), its investors have no hope of building wealth in less risky fixed-income assets and are therefore forced into equities and other risk-oriented investments. Investors globally face similar challenges, even if not quite to the same extent.

While Germany's overall economy is not clearly in a recession, its manufacturing sector almost certainly is—the 6.4% decline in industrial production from the peak in November 2017 through July 2019 was worse than Italy's 2.5% contraction over the same period. Considering that manufacturing represents almost 23% of the country's GDP (much higher than the average for developed countries), it is easy to understand why the country is in a funk.

We will find out soon whether a no-deal exit from the EU actually takes place or is delayed (for a third time) beyond the 31 October deadline. The political carnage caused by Brexit is already breath-taking. The Conservatives lost their working majority in the Parliament following the expulsion of 21 members of Parliament from the party in the aftermath of a vote to wrest away Brexit negotiations from the government.

The battle between the Prime Minister and the Parliament already led to a constitutional crisis when the U.K. Supreme Court declared Johnson's move to suspend Parliament as invalid. If he defies the will of Parliament and takes the U.K. out of the EU without a trade agreement, that crisis will deepen. More likely, there will be an additional delay, with a new Brexit deadline. That would allow for a general election and, hopefully, a new mandate from the electorate. But the political landscape in Great Britain is in flux. The outcome of the next election could be an unstable coalition.

Despite the rather solid financial position of U.K. households, both consumer and business confidence are nearing levels consistent with recession. Confidence measures in the eurozone, while off the highs of 2017, have not fallen to the same degree.

Japan is also focused on home-grown uncertainty: The consumption tax hike effective October 1. And despite a tight labor market with an almost record-high number of available jobs per applicant, the decline in earnings growth from last year is surprisingly steep. Regardless of all their efforts, Prime Minister Shinzo Abe's government and the Bank of Japan have been unable to spur a lasting reflation of the economy.

Like Germany, Japan has been hurt by the slowing growth of China and the general malaise affecting Asia as a whole. To make matters worse, Japan's political relationship with South Korea has frayed badly in recent months. Both countries have expanded economic sanctions, including tit-for-tat tariff duties and consumer boycotts. Even more worrisome is the breakdown in direct military intelligence sharing at a time when China is pushing its weight around in the East and South China Seas.

In all, Japan's outlook appears to be one of stasis. In the meantime, investors will likely continue to view the country as a safe haven owing to its low volatility. We believe the yen will remain well-bid under this scenario.

In view of the uncertainties facing investors presently, the prediction game is arguably even more challenging than usual. Accordingly, as always, we believe in a diversified approach to investing. Although maintaining exposure to equities and other risk-oriented assets can at times feel uncomfortable, it is our view that investors with long time horizons should avoid timing the market or making outsized sector or regional bets. We think it is best not to assume, for example, that the S&P 500 Index and growth stocks will always be the only games in town. The recent volatility and sharp style rotations in the past quarter should serve as reminders that trends do not last forever.

Economic Backdrop

Equity markets, which plummeted in early August after climbing through July, largely recovered into mid-September around most of the globe.

U.S., European and Japanese stocks generally tracked the pattern of global equities. However, U.S. stocks were notable in that they drifted to all-time highs in late July, dropped as a consequence of President Donald Trump's escalating trade-war measures, and failed to break new highs despite recovering in September. U.K. stocks sold off especially sharply in August and didn't bounce as significantly as peers in other major developed markets, but continued to recover straight through the end of September.

Mainland Chinese stocks rebounded faster and earlier in the quarter than the rest of the world's equity markets, and then slid back down toward the end of the period. The early September bounce in Hong Kong stocks was modest by comparison, and essentially reversed in late September.

Government bond rates declined across all maturities in the U.S., U.K. and eurozone during the third quarter. Long-term rates dropped by more than short-term rates in the U.K. and eurozone, leading to flatter overall yield curves. In the U.S., shorter- and longer-term rates both declined by more than medium-term rates, compressing the difference in rates across all maturities. After remaining negative since May, the 3-month-to-10-year Treasury spread—a widely-watched recession indicator—turned positive for a single day in late July, but tumbled deeply into negative territory by late August before recovering to less negative levels by the end of the quarter.

Oil prices followed the path of global equities for much of the three-month period. They jumped abruptly in mid-September on news of an attack that targeted energy-processing facilities in Saudi Arabia that account for about 5% of global oil production. However, the spike in prices was reversed by the end of the quarter as output quickly returned to sufficient levels.

U.S.-China trade negotiations came to a halt on August 1 with President Trump's announcement of new tariffs (10% on $300 billion of Chinese goods) and China's subsequent promise of retaliation, provoking a disconcerting depreciation in the yuan's exchange rate with the U.S. dollar. Both sides applied new and higher tariffs beginning September 1: The U.S. imposed a 15% tariff on $112 billion worth of Chinese goods, while China resumed 25% tariffs on American cars and added 5%-to-10% tariffs on $75 billion worth of other American goods. As a new round of negotiations materialized for October, the U.S. delayed a tariff measure scheduled for October 1 (an increase from 25% to 30% on $250 billion worth of Chinese goods).

The U.S. and Japan struck a narrow trade agreement in late September, which reduced tariffs on U.S. agricultural exports and Japanese industrial exports, and set guidelines for digital trade between the two nations.

U.K. Prime Minister Boris Johnson faced sharp resistance from the outset of his tenure: Conservative members of Parliament defected to support a vote eliminating the prospect of a no-deal departure from the EU on October 31, and the U.K. Supreme Court reversed the Prime Minister's attempt to suspend Parliament. A general election remained out of reach for Johnson despite all of his setbacks, as opposition parties opted to wait until the no-deal threat was taken off the table.

Elsewhere, after months of demonstrations, protesters in Hong Kong saw some success when a proposed law that would have allowed for extradition to mainland China was withdrawn. Protests continued, however, amid a reported increase in China's police presence and undercover activity.

Central Banks

- The BoC noted that recent Canadian economic data were in line with its projections as it held the policy interest rate firm at 1.75% following both the July 10 and September 4 meetings. The next scheduled meeting is for October 30.

- The Federal Open Market Committee (FOMC) reduced the federal-funds rate by 0.25% in mid-September—only the second decrease in 11 years, two months after a July cut of the same size—bringing the rate to a target range of 1.75% to 2.00%. The FOMC's late-July announcement also included an accelerated end to quantitative tightening by letting U.S. Treasurys and mortgage-backed securities (MBS) mature without reinvesting proceeds. With the end of the program, the central bank has resumed reinvestment activities—focusing on moving its securities portfolio toward Treasurys and away from MBS. On a separate note, in an effort to stabilize short-term borrowing rates, the Federal Reserve Bank of New York undertook temporary repurchase agreements (known as repo operations) in September for the first time since the global financial crisis, and maintained them through the end of the quarter; a shortage of bank reserves caused by increased Treasury issuance, corporate tax payments, and a range of other factors led to a sharp spike in secured short-term rates, forcing the need for intervention.

- The Bank of England's Monetary Policy Committee took no new actions at either its August 1 or September 19 meeting, retaining a bias toward less accommodative monetary policy. However, its statement now notes that Brexit must occur smoothly and global economic conditions must improve before taking new tightening action.

- The European Central Bank (ECB) sought to provide fresh stimulus following its mid-September meeting by reducing its deposit rate from -0.40% to a record low of -0.50%—and adopting a new system to offset possible consequent bank-reserve losses. The ECB also reintroduced its asset-purchase program at €20 billion per month, to start in November and continue indefinitely. Finally, it modified its latest round of targeted longer-term refinancing operations to allow for lower bank-borrowing rates and a maturity extension from two to three years.

- The Bank of Japan left its monetary-policy orientation unchanged following its September meeting. Minutes revealed discussion about communicating the central bank's willingness to use more stimulus if needed, in light of concerns about slowing economic growth.

- The People's Bank of China (PBOC) allowed the yuan to depreciate past the psychologically significant 7-to-1 ratio with the U.S. dollar in early August following a statement by President Trump that the U.S. would impose far-ranging new tariffs on September 1. The PBOC revealed in August that it made an adjustment to the calculation of China's loan prime rate, which is expected to result in a gradual reduction in Chinese borrowing costs. The central bank also provided Chinese banks with additional relief in September by cutting its reserve requirement ratio by 0.50%, with a potential additional 1% reduction for qualifying banks in October and November, freeing about $125 billion of banking-system liquidity.

Economic Data

- According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) was unchanged in August and rose 1.9% for the prior 12 months. This was slightly below the past two yearly readings as gasoline prices were weak—excluding gasoline, the CPI rose at a more robust 2.4% annual rate. Producer prices, however, remained relatively weak. The Industrial Product Price Index (IPPI) gained a modest 0.2% and the Raw Materials Price Index (RMPI) declined 1.8% in August. On a year-over-year basis, the IPPI fell 1.0% while the RMPI dropped 6.0%, with lower energy costs as the culprit.

- Multiple reports of U.S. manufacturing indicated that activity slowed throughout the third quarter, showing signs of contraction in September and falling to the lowest level in more than a decade according to one measure. Activity in the U.S. services sector bounced to healthy expansion levels in July, decelerated sharply to near-breakeven levels in August, and grew slightly in September. The U.S. unemployment rate remained at 3.7% in September for the fourth straight month, although the labour-force participation rate continued to increase in the same period. The final second-quarter reading of overall U.S. economic growth eased by 0.1% to an annualized 2.0%.

- The contraction of U.K. manufacturing activity entered its fifth consecutive month in September. Growth in the U.K. services sector essentially ground to a halt in the same month after a mild rebound in July and August. The broad U.K. economy shrank by 0.2% in the three-month period ending June, but expanded by 1.3% year over year, according to the final reading of second-quarter gross domestic product growth. The U.K. claimant-count unemployment rate held at 3.2% in July before edging upward to 3.3% in August. Average year-over-year earnings growth jumped to 4.0% for the May-to-July period (from 3.7% and 3.4% in the three-month periods ending June and May, respectively).

- Conditions in eurozone manufacturing continued to deteriorate in September, the eighth straight month of contracting activity. Services sector activity also slowed in the month, falling below the healthy pace it had maintained for the prior few months, but remaining in expansion territory. The eurozone unemployment rate edged down to 7.4% in August from 7.5%, where it was stuck for the three months prior. The eurozone economy slowed to a pace of 0.2% in the second quarter—half that of the prior quarter—and to 1.2% year over year (a modest 0.1% decline).

Market Impact (Referenced Index Returns are in CAD)

Global equity markets remained volatile but most developed markets added to already strong year-to-date gains. Emerging markets struggled and fell further behind developed markets. In the U.S., small companies and lower-priced, value-oriented stocks finished the quarter in particularly strong fashion but still lagged behind large companies—and large technology companies in particular—for the quarter as a whole. In domestic markets, the utility sector was easily the top-performing sector as consumer staples and financials also performed well. Healthcare stocks were notable laggards while industrials slipped modestly.

Real-return bonds were the top performer in fixed income as these interest-rate-sensitive bonds continued to benefit from falling long-term rates and fairly strong consumer inflation reports. Government bonds slightly outperformed corporate debt for the quarter, although corporate issues remain narrowly ahead for the year-to-date period. Short-term bonds and residential mortgages produced more modest gains. U.S. high-yield bonds also continued to perform well.

Index Data (Q3 2019)

- The S&P/TSX Composite Index rose 2.48%.
- The FTSE Canada Universe Bond Index returned 1.19%.
- The S&P 500 Index, which measures U.S. equities, gained 3.04%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, returned 1.29%.
- The ICE BofAML U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 1.04% (currency hedged) and 2.56% (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,” increased from 15.08 to 16.24 by the end of the quarter.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, briefly spiked to US$62.90 after an attack on oil facilities in Saudi Arabia in mid-September. Despite this, oil declined from US$58.47 to US$54.07 during the quarter.
- The Canadian dollar weakened moderately to C$1.32 per U.S. dollar. The U.S. dollar was also stronger versus other major currencies, ending September at US$1.23 versus sterling, US$1.09 against the euro and at 108.08 yen.

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