Stocks Splash Higher Despite Waves of Uncertainty
Quarterly Market Commentary
Second Quarter 2020

- Equities around the world spent much of the second quarter embracing the sharp rebound that began at the end of March. Fixed-income markets also rallied as yields fell.
- Canada has made progress in the fight against COVID-19. Volatility remained elevated across capital markets as other countries, such as the U.S., continued to struggle with the disease.
- We believe that an ebb and flow of assorted concerns in the coming months will continue to spark volatility across financial markets. Such periods of instability are to be expected in any long-term investing plan; as such, SEI is just as prepared as always to navigate the current wave of deep uncertainty.

SEI's Domestic View

In the first 26 weeks of 2020, much of the world faced some of the most challenging crises of the past century in terms of public health concerns, economic upheaval and social unrest. The novel coronavirus, which causes the disease COVID-19, rapidly became one of the deadliest pandemics since the 1918 Spanish flu. Global efforts to slow the COVID-19 infection rate led to government-mandated economic shutdowns that rival the worst years of the Great Depression (1929-1933). The brutal killing of George Floyd, an American black man, by a white police officer in Minneapolis, Minnesota, sparked a wave of global outrage and protests.

Against a bleak global backdrop, Canada has made progress against COVID-19. The number of new cases measured on a weekly basis has fallen from a peak of 12,590 during the week ended May 4 to a current reading of 2,270 as of June 29. That's the lowest total in more than three months. The death rate is 23 per 100,000 population, which compares favourably to the U.S. at 38. Quebec suffered the worst experience, recording a death rate of 65 per 100,000 population, followed by Ontario (18) and Nova Scotia (6).

Although the human cost in terms of lives has been less than in the U.S. or much of Europe, the economic impact has been just as devastating. As of March, Canadian economic activity was 5.8% below the year-ago level. FactSet's survey of consensus estimates for full-year 2020 indicates a 13.95% decline, versus an estimate of -5.1% for the U.S. Service-producing industries recorded their worst-ever year-over-year plunge in March. Goods-producing industries also fell, but not nearly as much.

Like the U.S. Federal Reserve, the Bank of Canada (BOC) has employed a full arsenal of monetary-policy tools to combat the impact of the economic shutdown. It lowered the policy interest rate in March to 0.25% from 0.75%. It was 1.75% at the start of the year. It also launched a variety of large-scale asset purchase programs for mortgage bonds, commercial paper, bankers' acceptances, corporate bonds and provincial and federal government debt. While the BOC was the least aggressive major central bank when it came to large-scale asset purchases following the end of the global financial crisis in 2009, it has become one of the most aggressive during the past six months.

The Bank of Canada's actions have caused the Treasury yield curve to fall dramatically across the board. Treasury bill rates have plummeted by more than 1.4 percentage points from year-end and year-ago levels. The middle part of the yield curve has fallen nearly as much (more than 1.3 percentage points since 12/31). The long end, meanwhile, has registered yield declines of 1.2 percentage points for the 10-year maturity and more than 75 basis points for the 30-year. Although Fitch, a ratings agency, recently lowered Canada's debt to AA+ from AAA, the deterioration in the country's finances doesn't seem any more severe than what is happening in other developed countries. Note that Standard & Poor's cut the debt rating of the United States to AA+ in August 2011, with little lasting impact.

The fiscal response has not been quite as aggressive as that in the U.S., but it is nonetheless sizeable, now amounting to an estimated 12.4% of GDP. Major elements of the package include direct aid and wage subsidies to households and firms, payments to workers lacking sick-leave benefits, tax credits and child-care support, and temporary liquidity support through tax deferrals.

SEI's Global View

Despite mounting infections, hospitalizations and deaths from the pandemic—as well as the unprecedented stoppage of global economic activity—stock markets around the world managed to mount a resounding comeback over the quarter.

Our working assumption is that there will likely be another significant wave of infections going into the fall-to-winter flu season. The question is, how disruptive will it be to the global economy?

Investors seem to be ignoring the possibility that, even if a sustainable recovery gets under way, it may be a long time before most companies achieve previous levels of profitability. The after-tax profit margins of U.S. domestic businesses were already on a declining trend before the onset of the virus and shelter-in-place orders.

Margins will likely remain well below their previous peaks around the globe as long as the COVID-19 is a severe health threat. Most businesses, to one degree or another, are expected to endure lower sales, higher costs and a decline in productivity. There also will probably be a deadweight loss for industries needing extra inventory on hand in order to guard against future shortages and supply-chain disruptions caused by periodic flare-ups of the virus. "Just-in-time" inventory management will turn into "just-in-case" inventory management, tying up cash. Supply chains will likely be diversified over time, a process that was already under way as a result of the trade war between China and the US.

The extraordinary March-to-April lockdown in the U.S. necessitated fiscal measures unparalleled in scope and speed of implementation. The result has been a tsunami of red ink. The Congressional Budget Office projected the deficit will reach nearly 18% of U.S. gross domestic product (GDP) in 2020 and improve to only 10% of GDP in 2021. U.S. debt relative to GDP is forecast to rise to 108% by the end of fiscal year 2021 versus 79% at the end of fiscal year 2019.

These are unsettling numbers. Many investors wonder whether such a surge in government debt will provoke an economic crisis even after the pandemic runs its course. We don't think that it will. The U.S. has a large, dynamic economy and deep capital markets. If investors were truly concerned about the long-run fiscal viability of the U.S., the value of its currency would have been falling more convincingly and long-term U.S. interest rates would have been going up (not down).

The policies pursued by the Fed have also served to keep interest rates low. Its balance sheet has ballooned this year, far exceeding the increases logged by the ECB or the BOJ.

The U.S. certainly is not alone in engaging in a huge fiscal response that is then monetized by the central bank. In our opinion, governments are treating the fight against COVID-19 like they would a war. As many resources as possible are being thrown into the fight, supported by debt issuance that is absorbed primarily by the central banks.

Those who remember the 1970s are understandably worried by the inflationary potential of such extraordinary debt monetization. If it does lead to inflation, it probably won't be any time soon, in our opinion. Given our view that the economy will remain below full utilization of labor or productive capacity for the next few years, we believe inflation is unlikely to break out of the 0%-to-3% range it has been in for much of the past decade.

Investors do not seem too concerned about the speed of Europe's economic recovery or the impact of the health crisis on countries' fiscal positions. The bond yields of the most economically-fragile European countries remain close to those of German bund yields, although spreads have widened from pre-pandemic levels. The ECB has been quite successful in short-circuiting the liquidity crisis and flight-to-safety that threatened the euro area's financial structure.

This laid-back view would be severely challenged if the 27 members of the EU fail to approve a €750 billion emergency fund when the EU's leaders meet again in July. Although Germany has joined forces with France to push the package forward, there is still resistance from the likes of the Netherlands, Sweden, Denmark and Austria. There is disagreement, for example, over the split between grants and loans. Italy and Spain would be the biggest beneficiaries of grants to help offset their current fiscal dilemmas, while the remainder of the package would be distributed as conditional loans. Paying for the grants is an even greater source of contention. The European Commission (EC) would be empowered to issue long-term bonds, which would be paid down by giving the EC taxation authority (a power it currently does not have). The only alternative would be to increase contributions from member states (a bigger problem now that the U.K. is leaving the EU) or enact spending cuts in other parts of the EU budget.

Speaking of the U.K., the COVID-19 crisis has pushed Brexit concerns off the front pages. As the 31 December transition deadline nears, it could become an economic factor nearly as important as a second wave of the virus. If a deal on the UK-EU trading relationship is to be delivered before year-end, it probably should be concluded by the end of October so that countries have time to approve the treaty into law. Any free-trade agreement would require the U.K. to agree to permanently align its rules and regulations to those of the EU on an array of matters. The U.K. would essentially bear much of the EU membership cost without having a voice at the table that sets the rules. It is becoming increasingly likely that there either will be a modest agreement that includes tariffs or, in the worst-case scenario, a no-deal result that falls back on the World Trade Organization's most-favoured-nation rules.

While many factors determine equity performance, in the emerging-market space it has correlated with the extent of economic disruption caused by the virus. Asian and central European countries have pulled back the most on their mandates to restrict movement and social interaction. Latin America and India have eased some of those constraints, but not nearly as much as the other two regions. We continue to keep close tabs on China, as it was the first to lock down and first to unlock activity. We expect recovery patterns elsewhere in the world to follow that of China.

Central banks in the emerging world are also doing their part to help restore their economies. Interest rates have come down in almost every country in recent months to record-low levels in many cases. In addition, a dozen emerging-country central banks—including those with shakier reputations, such as South Africa and Turkey—are either buying or planning to purchase their government's debt. We think this debt-monetization may lead to an inflation problem in the future.

It's been said many times that bull markets climb a wall of worry. Maybe now they must learn to swim through waves of worry that include:

- The possibility of a second wave of COVID-19 infections forcing another round of extensive lockdowns and shelter-in-place orders that could lead to a double-dip recession
- A possible break down of political consensus regarding the way forward as economies struggle to regain strength.
- The likelihood that economic recovery will take at least a year, and likely longer—and that few economies are likely to rebound fully to pre-pandemic levels, even if most countries manage to avoid a disruptive second wave of the virus
- Expectations that companies will face higher costs and increased inefficiencies; that taxes will almost certainly rise across many economies in the years ahead; and that bankruptcies and defaults will climb as government aid programs end

We believe that an ebb and flow of assorted concerns in the coming months will continue to spark volatility across financial markets. Such periods of instability are expected in any long-term investing plan; as such, SEI is just as prepared as always to navigate the current wave of deep uncertainty.

Economic Backdrop

Equities around the world spent much of the second quarter embracing the sharp rebound that began at the end of March. Shares were universally higher for the full quarter; although every major market besides China peaked in early June and failed to make new highs thereafter. Recoveries varied in size, and some markets had their best quarter in several years. U.S. shares had the highest quarterly performance since 1998 according to the S&P 500 Index.

Rates for U.S. Treasurys with the shortest and longest maturities increased during the full quarter, while the rates of those with maturities of 1-to-10 years declined. Across maturities, Treasury rates at the end of June were almost identical to those at the end of May, as the entire yield curve moved higher through early June before reversing. Gilt rates were lower across all maturities for the full three-month period. Short-to-intermediate-term rates ended near their lowest-ever rates, while long-term rates climbed throughout the quarter after bottoming in April (albeit returning only partway to their first-quarter finish). European government-bond rates nearly completed a round trip during the second quarter—falling in April, climbing in May, and falling back at the end of June to almost exactly where they concluded the first-quarter.

The West-Texas Intermediate (WTI) oil price plummeted below zero U.S. dollars per barrel in April for the first time in history as its futures contract for May delivery neared expiration. Subsequent contracts traded higher in light of a 23-nation agreement led by the U.S., Saudi Arabia and Russia to cut production by 10 million barrels per day—and the WTI oil price finished June at $39.27 per barrel. The gold spot price climbed throughout the second quarter to its highest level since 2012 amid unprecedented government spending and deep uncertainty about the economic outlook.

The Office of the U.S. Trade Representative issued a notice in late June that it was considering imposing tariffs on about $3 billion in imports from the U.K., Germany, France and Spain. The World Trade Organization approved $7.5 billion in U.S. tariffs on European products in late 2019, and may also approve retaliatory European tariffs on U.S. products.

U.S. borders were set to remain closed to Canada and Mexico until at least July 21 as part of the Trump administration's latest one-month extension, which began on 20 March. The United States–Mexico–Canada Agreement (USMCA) took effect on 1 July, officially replacing the North American Free Trade Agreement (NAFTA).

The EU re-opened its internal borders in mid-June and prepared to open for external travelers on July 1, yet with restrictions still applied to citizens of some outside countries (including the US). Several U.S. states reported an early-June surge in their respective COVID-19 infection rates after pushing to reverse their lockdowns earlier than other states. Texas also noted a string of record-high COVID-19-related hospitalizations at the time, prompting state officials to backpedal its re-opening plans; many other states saw a rising share of positive COVID-19 test results amid expanded overall testing. As a result, several Northeastern states that served as the country's original outbreak epicenter announced 14-day quarantines for visitors from U.S. states that were experiencing recent spikes. The first dedicated COVID-19 treatment—Remdesiver—came to market in late June.

The U.K. and EU struggled to establish their regulatory equivalence in a combined effort to grant mutual access to their financial markets after the Brexit transition period concludes at the end of 2020. The two sides failed to reach an agreement by the proposed June 30 deadline; while the U.K. said it is prepared to grant the EU access to U.K. financial markets, the EU stated that the U.K. has not provided sufficient information to complete its evaluation.

China passed a new national security law for Hong Kong in June, categorizing an array of subversive activities as criminal behaviour and carrying sentences as steep as life imprisonment. The ruling also enables Beijing to supervise and intervene in the policing of these activities, as well as the final word on interpreting the law.

Several governments around the world condemned this development. U.K. Prime Minister Boris Johnson said Britain was considering a path to citizenship and relocation for British Nationals (Overseas) (a class of British nationality extended to Hong Kong residents prior to the 1997 handover). The U.S. imposed visa bans on several Chinese central government officials, to which Beijing responded with visa restrictions on Americans "who behave badly in Hong Kong affairs."

On a positive note, the head of China's Securities Regulatory Commission expressed willingness to cooperate on joint company inspections after the U.S. raised the prospect of barring Chinese companies from its financial market if they continued to block transparent audits. China also announced plans to accelerate purchases of U.S. agricultural goods to uphold its commitments to the phase-one trade deal.

In mid-June, Chinese and Indian soldiers skirmished (without firearms) along a disputed border ridge in the Himalayas. India reported at least 20 of its soldiers were killed in the fight, while China did not release information about casualties. At the end of the month, India retaliated by banning scores of mobile apps originating in China (several of which have been widely downloaded around the world).

Central Banks

- After aggressively cutting rates in the first quarter, the BoC held its policy interest rate at a historically low 0.25%. In addition to ultra-low rates, the BoC has maintained several other programs aimed at providing liquidity and stability to capital markets. The next scheduled meeting in on July 15, 2020.

- The U.S. Federal Open Market Committee (FOMC) maintained its monetary-policy path throughout the second quarter—providing assurances in early June that it would not raise the federal funds rate for the foreseeable future and that it would maintain quantitative easing via purchases of Treasurys and mortgage-backed securities (MBS). The FOMC began purchasing corporate bonds during the second quarter via programs that it established as part of its pandemic response. The Fed ordered banks to cut dividends and halt stock buybacks following stress tests on the prospect of an extended economic downturn resulting in a higher rate of loan defaults.

- The Bank of England's (BoE) Monetary Policy Committee held the Bank Rate at 0.1%, during the second quarter; following its mid-June meeting, the central bank announced that it would expand its stock of asset purchases (from an initial £200 billion increase announced in March) by another £100 billion to £745 billion.

- The European Central Bank (ECB) held its benchmark rates unchanged during the second quarter. It unveiled the pandemic emergency longer-term refinancing operations (PELTROs) in April to help facilitate proper functioning of money markets; in early June, it also announced the expansion of its Pandemic Emergency Purchase Programme (PEPP), which is designed to facilitate asset purchases, by €600 billion to a total of €1.35 trillion.

- The Bank of Japan (BOJ) held course following its mid-June meeting, maintaining its short-term rate and its target rate for the 10-year Japanese government bond. However, it did share an expectation to inject ¥110 trillion into the Japanese economy to offset the COVID-19 health crisis.

Economic Data

- According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) was up 0.1% in March but fell 0.4% for the prior 12 months. Excluding gasoline, the annual rate of change was 0.7%; while positive, this was the smallest increase since January 2013. Producer prices rebounded in May as the economy began to ease COVID-19 restrictions. The Industrial Product Price Index (IPPI) rose 1.2% and the Raw Materials Price Index (RMPI) spiked 16.4% in May. The gains were mostly due to a recovery in oil prices and higher food prices, especially for meat. On a year-over-year basis, the IPPI fell 4.9% while the RMPI was down 24.3%; despite the recent rebound, energy prices were still well below year-ago levels.

- U.S. manufacturing activity nearly returned to growth in June after contracting sharply in April (albeit not as deeply as in the U.K. or eurozone) and improving in May. Activity in the U.S. services sector plummeted more dramatically in April compared to the U.S. manufacturing sector, and did not rebound to as great a degree as U.S. manufacturing through June. American workers submitted more than one million unemployment claims for 14 consecutive weeks through late June (a level of joblessness previously never breached in the data series' 50-plus years), peaking in late March and early April above 6 million claims, but drastically slowing its rate of improvement in June. The overall U.S. economy contracted by a 5.0% annualized rate during the first quarter, and the National Bureau of Economic Research confirmed the country entered recession in February.

- U.K. manufacturing activity continued apace in June—neither contracting nor expanding—representing an improvement on the prior month's slowing contraction following an extraordinary drop in April. U.K. services activity nearly stopped contracting in June after a similarly dramatic dive in April and a modest improvement in May. The U.K. claimant count unemployment rate spiked from 3.5% in March to 6.3% in April, and then to 7.8% in May. The overall U.K. economy contracted by 2.2% in the first quarter and 1.7% year over year.

- The eurozone's contraction in manufacturing activity continued to ease through May and June after an unprecedented slowdown in April. Eurozone services activity also plummeted in April, but improved somewhat in May before nearly coming out of contraction in June. Loans to non-financial European corporations accelerated for the fourth consecutive month, increasing by 7.3% in May after gaining 3.0% in February, 5.4% in March, and 6.6% April. The overall eurozone economy contracted by 3.6% during the first quarter and 3.1% year over year.

Market Impact (Referenced Index Returns are in CAD)

Global equity markets remained volatile but also staged a massive rally during the second quarter. Many equity indexes reversed more than half of the losses they sustained in the first quarter. Some equity indexes are actually positive year-to-date, even if they are still below the mid-February highs. Domestic equities were led by information technology, materials and consumer discretionary, while small companies easily outperformed larger companies. Meanwhile, communication services and utilities were notable laggards. Outside of Canada, the U.S. led based on the strength of mega-cap technology and technology-related stocks. A markedly stronger loonie was a drag on international-equity performance. Countries that fared poorly in the first quarter (Brazil and India) rallied the most. Although China failed to keep pace during the quarter it has produced strong gains year to date.

Fixed-income markets also enjoyed a strong rally, led by riskier sectors. Corporate debt easily outperformed government bonds. Despite weak inflation reports, real-return bonds were among the top performers as they tend to have longer maturities and therefore are more sensitive to falling interest rates. Short-term and mortgage bonds were also positive. U.S. high-yield bonds benefited from the "risk on" investor mentality and a dramatic improvement in crude-oil prices during the second half of the quarter.

Index Data (Q2 2020)

- The S&P/TSX Composite Index rallied 16.97%.
- The FTSE Canada Universe Bond Index returned 5.87%.
- The S&P 500 Index, which measures U.S. equities, jumped 15.35%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, returned 14.08%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 9.37% (currency hedged) and 4.82% (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 53.54 to a still elevated 30.43 by the end of the quarter.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, were highly volatile during the quarter as the COVID-19 pandemic wreaked havoc on supply and demand dynamics. Despite nearly doubling from US$20.48 to US$39.27, oil prices plunged to negative US$37.63 on April 20—the first time in history that oil was priced below zero.
- The Canadian dollar strengthened to C$1.36 per U.S. dollar. The U.S. dollar was little changed versus other major currencies, ending March at US$1.24 versus sterling, US$1.12 against the euro and at 107.89 yen.