Monthly Market Monitor

June 2020

NEI

HIGHLIGHTS

Market rally continues but most stocks still lagging

The S&P 500 has retraced most of its losses and is now down only 5% year-to-date (in Canadian dollars it's actually in positive territory!). The market rebound has been led by large tech firms which means on an equal-weighted basis, the index is still down about 16% this year.

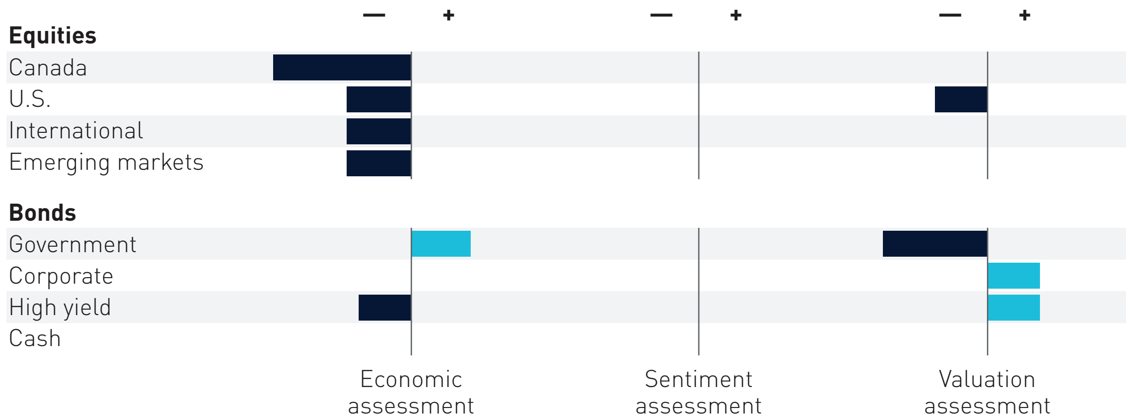
Cautious re-opening underway

Countries are taking careful and gradual re-opening measures, which should improve economic activity in the months ahead. However, we remain concerned about a "second wave" and will be closely monitoring the situation.

Risks remain balanced

Despite an upward pressure on equities, the risk of new infections, weak fundamentals, and tense U.S.-China relations are just some of the reasons we are staying cautious in the near term.

OUTLOOK SUMMARY



Source: NEI Investments. Data as of May 31, 2020.

ALLOCATION INDICATOR

MARKET REVIEW AND OUTLOOK

After the strongest April returns since 1938, the S&P 500 was rangebound for much of May, ending the month with a gain of just 4.8% in local currency. Canadian and international markets had similar mid-single digit returns. Bonds also had a quiet month. As of this writing, the Government of Canada benchmark 10-year bond yield stands at 0.53%, almost exactly where it started the month.

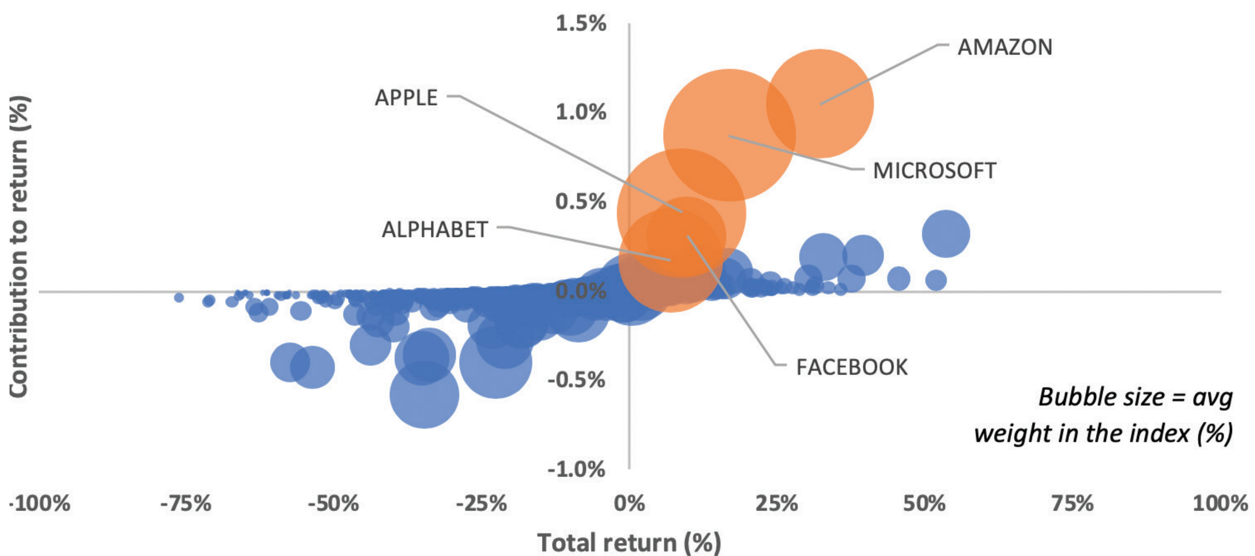
Despite the strong run-up from its March 23 bottom, market behavior hardly bears any resemblance to what is happening in the real economy. We are still caught in the middle of an economic downturn that's worse than the 2008 financial crisis. And yet, the S&P 500 has rallied more than 35% from its March 23 bottom and is only about 10% away from its February 19 all-time high. The U.S. labour market continues to see weekly unemployment filings in the millions, the April global composite Purchasing Managers' Index sits at an all-time low of 26.5 (a reading above/below 50 signals future economic expansion/contraction), all while policymakers continue to churn out new rounds of economic stimulus measures. So how does one reconcile the disconnect between markets and the underlying economy?

Perhaps the more obvious explanation is that markets are always forward looking and are therefore pricing in the eventual economic recovery. The current levels of economic output are so bad it seems the only direction they can go is up.

Another reason, one that we noted last month, is that in the context of a discount cash flow framework, lower interest rates (and therefore lower discount rates) increase the present value of future cash flows, that is, current stock prices. While it is difficult to conclude whether the increased net present value of longer-term future cash flows is sufficiently greater than the sharp decline in short- to medium-term earnings, no doubt there is some offsetting effect.

Lastly, and this is perhaps the most measurable effect, is that an examination of the S&P 500 constituents will reveal the recent rally has been led by just a few large names, as illustrated by the bubble chart below.

S&P 500 Companies YTD Performance (S&P 500 YTD = -5%)



Source: Bloomberg. Data as of May 31, 2020.

Intuitively, companies that are the least impacted, and in fact even stand to benefit in a world of physical distancing, are the software and technology companies. The five largest S&P 500 companies, Alphabet, Amazon, Apple, Facebook, and Microsoft, all belong in that sector. Year-to-date, these five companies, making up about 19% of the S&P 500 market capitalization, have had a median gain of 9.7%. The other 495 companies in the index, which make up the other 81% market capitalization, have had a median *decline* of 15.5%.

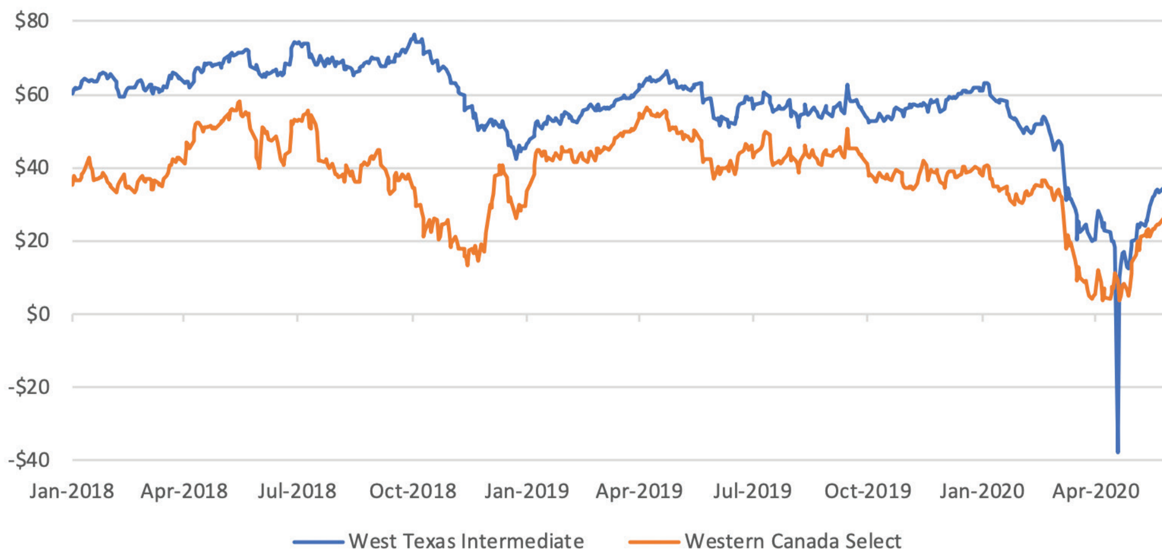
There is a large disconnect between companies across different sectors, and the difference in companies' size only amplifies that effect. A market rally carried by just a few names is not sustainable. And while market breadth has seemed to improve over the last week, we would need to see more evidence of a continuing trend to believe in a true recovery rally.

In the meantime, within our asset allocation solutions, our tactical views continue to call for a balanced positioning between equities and fixed income, with a slight overweight on duration. This will allow for participation on equity upside while offering greater downside protection should short-term risks emerge. June will be a critical month as many regions re-open and travel restrictions start to get lifted. We can also expect U.S.-China tensions to dominate headlines once again, as we draw closer to November U.S. elections. While markets clearly have an upward bias, the odds of a second wave of infection poses a key risk factor.

CANADA

On a tactical basis, we remain underweight Canadian versus global equities in our asset allocation solutions. Compared to other countries, the economic pain felt by Canada is two-fold, from both the pandemic as well as from a weak energy sector. In all fairness, Canadian oil (Western Canada Select) has seen strong recent performance, but only when compared to West Texas Intermediate. Spreads between the two grades have narrowed to all-time lows, as illustrated below.

Canadian vs Global Oil Prices (US$/bbl)



Source: Bloomberg. Data as of May 31, 2020.

Oil prices have rebounded off their low but global demand remains weak. Much attention was paid when WTI prices went negative in April due to technical issues related to the lack of storage. But the "stealth" rally went nearly unnoticed by financial news headlines. Low prices did their job, signaling to the market that supply was too high. Producers responded by cutting production targets, particularly in the U.S. shale patch, but also across OPEC+. Any further rally in the energy sector will largely depend on how well global producers stick to their reduced production targets, along with the success of re-openings which pave the way for future demand recovery.

Within fixed income, we continue to favour investment grade corporate over government bonds, with an overall benchmark neutral duration. Government of Canada bond yields remain at the low end of their historic range, but corporate spreads are still at elevated levels. It was only as recently as early May that the Bank of Canada, in addition to their $5-billion-a-week purchases in government bonds, began their corporate and provincial bond purchase programs. As the economic downturn begins bottoming out, these stimulus measures should provide a tailwind for credit spreads to further narrow from their current levels.

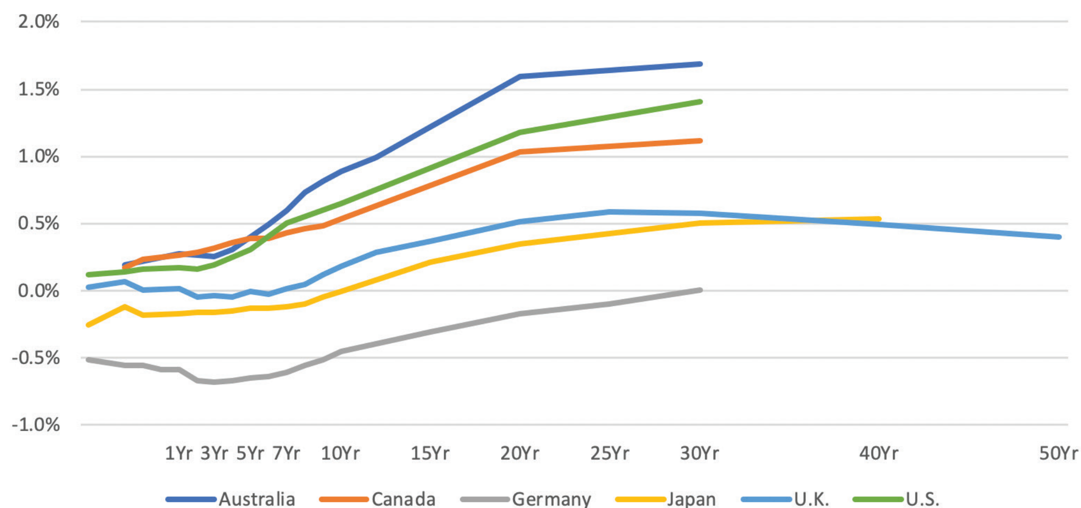
U.S.

The composition of the U.S. equity market, as outlined earlier, has structural advantages in a post-COVID world, especially compared to Canadian and international markets where technology makes up a smaller share. For this reason, along with the safe-haven nature of the U.S. dollar, the U.S. remains the most attractive equity market on a relative basis for the time being.

The unprecedented stimulus measures announced by the U.S. Federal Reserve are likely not over and done yet. The initial wave of stimulus was simply to cushion the economic impact on the way down and provide market liquidity and stability.

To get the U.S. economy out of this slump and onto a recovery path, we believe further stimulus measures will be necessary. Quantitative easing has historically been considered an unconventional monetary policy tool but at this point, in light of the global policy response we would consider it very much as a mainstream policy tool. Once the Fed goes all out on these conventional tools, they will be forced to consider other experimental measures such as yield curve targeting and/or negative interest rate policy. U.S. Treasury yields are currently among the highest in the developed world, making this an attractive segment of the bond market.

Global Government Yield Curves



Source: Bloomberg. Data as of May 31, 2020.

Briefly in early May, markets indeed started to price in negative U.S. policy rates by spring 2021, only to see those odds quickly backtrack as Fed Chairman Powell reiterated his preference for other policy tools for the time being.

INTERNATIONAL

Even prior to the pandemic, the eurozone was already facing years of sluggish growth and tepid inflation. Of all consensus estimates, the eurozone is expected to see the worst economic contraction among all the regions.

The European Central Bank is pushing policy tools to their full extent. An initial €540 billion credit facility was signed off in April by EU finance ministers, and a second €750 billion stimulus program was announced. It is an ambitious plan, not just in terms of amount of stimulus, but also in scope as it promises to be the world's greenest stimulus plan. Among the few financial details was a boost to the Just Transition Fund. This fund is set up to help regions most affected by the transition to a low carbon economy to re-train workers or aid small- and medium-sized companies to re-tool toward a more sustainable future.

Meanwhile Japan, while less hard hit by the virus, has long been faced by the challenges seen in the eurozone. Our view within our asset allocation solutions is to underweight international equities in the near-term.

MARKET PERFORMANCE

Percent return in Canadian dollars

	1 Mo	3 Mo	6 Mo	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs
Bonds								
Bloomberg Barclays Canada Aggregate	0.29	2.03	4.60	5.74	7.07	4.26	3.67	4.58
Bloomberg Barclays Global Aggregate (CAD Hdg)	0.27	0.14	2.99	3.24	6.50	4.22	3.66	4.34
Bloomberg Barclays US High Yield 2% Issuer Cap (CAD Hdg)	4.34	-4.33	-3.88	-5.70	-0.16	1.93	3.44	6.52
Equities								
MSCI World (Developed Markets)	4.32	3.89	-1.61	-2.15	9.19	6.73	8.02	12.34
MSCI World Growth	5.98	11.32	9.11	8.56	22.87	13.09	12.28	15.15
MSCI World Value	2.30	-4.18	-12.44	-12.96	-4.32	0.17	3.57	9.37
MSCI Canada	2.73	-6.24	-10.27	-10.41	-3.99	1.73	2.35	4.64
MSCI USA	4.62	6.86	2.15	1.70	15.32	10.64	11.43	15.67
MSCI EAFE	3.85	-0.87	-7.88	-8.61	-0.64	0.40	2.87	8.21
MSCI Europe	4.05	-2.43	-9.38	-10.67	-2.26	-0.93	2.09	8.09
MSCI Japan	5.41	6.73	-1.32	-0.99	9.38	4.13	5.22	8.84
MSCI Pacific Ex Japan	-0.89	-8.62	-14.08	-14.12	-12.17	-0.30	2.40	7.72
MSCI EM (Emerging Markets)	0.28	-4.18	-6.02	-10.42	-2.24	0.62	2.96	5.33
World currencies (relative to CAD)								
US Dollar	-0.49	2.97	4.06	6.59	2.24	0.77	2.06	2.79
Euro	1.06	4.27	4.98	5.63	2.06	0.41	2.36	1.79
Pound Sterling	-2.46	-0.34	-0.54	-0.53	0.29	-0.67	-2.15	1.15
Yen	-1.22	3.09	5.78	7.52	3.04	1.65	4.99	1.08

Source: Morningstar. Data as of May 31, 2020.

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