Quarterly Market Matters

Summary for Q3 2021

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Highlights

Record corporate earnings results buoy equity markets through the summer. The solid earnings are helping to bring down lofty equity valuations, with further help from September's price slide.

Bond yields see a summer slide on delta variant and peak growth fears. Fed guidance lights a fire under yields in September – the round trip is flat, but the volatility has garnered attention.

Stock market volatility storms back in September. Many major developed market equity indices experienced their most significant drawdowns of the year, erasing the summer's gains.

Capital market turbulence in China drags down Chinese and EM indices while sending a shiver across global markets.

What a quarter a month can make

Going into the second half of the year, concerns over a worldwide reacceleration in COVID-19 cases coincided with peaking economic data, which raised the question of whether markets were moving too far, too fast. However, thanks to another historic quarter of corporate earnings results, equity markets managed to climb higher in the first two months of Q3, echoing what has largely played out in the first eight months of this year. Then came September, and boy, what a quarter a month can make. Despite signs of COVID-19 infection rates peaking in early September, most major equity indices saw their first significant drawdowns of the year. The S&P 500 recorded its first monthly decline since January, falling ~5%, while emerging market stocks continued to spiral downward on an abundance of negative news coming out of China (see Chart in Focus for more). With their inflation and labour market mandates nearly met in September, the US Federal Reserve (Fed) announced that they would likely begin tapering their quantitative easing program at their next meeting on November 3. The announcement led to both bond and equity markets selling off. The move set US and, in turn, global bond yields heading higher, reversing the downward trend that had played out since the peak in March. The rising yield environment saw growth stocks battered. A sharp rotation back into value/cyclicals took place in the final innings of September, which helped mitigate the damage in the more value oriented Canadian and EAFE equity benchmarks.

Meanwhile, persistent global supply chain issues have put upward pressure on commodity prices, especially energy. WTI crude oil reached US$75/bbl, while natural gas has surged as economies prepare for winter. The world's top coal consumer, China, is scrambling to secure more supply, pushing coal prices to record highs.

US monetary and fiscal policy send bond yields for a ride

Global bond yields rose sharply in the final weeks of September, completing a quarter-long round trip back to June levels. The Fed announced they would most likely begin tapering their US$120 billion quantitative easing program at their next meeting on November 3. The US 10Y Treasury yield jumped ~20 basis points (bps) on the news to ~1.50%, breaking the downtrend that

Canadian Fixed Income	Level	Quarter	YTD
FTSE Canada Universe Bond Index	1,173	-0.5%	-4.0%
FTSE Canada All Corporate Bond Index	1,363	-0.1%	-2.4%
Bloomberg Canada High Yield Index	167	1.1%	5.7%
Global Equities	**Level**	**Quarter**	**YTD**
S&P/TSX Composite	20,070	-0.5%	15.1%
S&P/TSX Small Cap	755	-3.0%	15.2%
S&P 500	4,308	0.2%	14.7%
NASDAQ	14,449	-0.4%	12.1%
Russell 2000	2,204	-4.6%	11.6%
UK FTSE 100	7,086	0.7%	9.7%
Euro Stoxx 50	4,048	-0.4%	13.9%
Nikkei 225	29,453	2.3%	7.3%
MSCI China (USD)	89	-18.6%	-17.8%
MSCI EM Index (USD)	1,253	-8.8%	-3.0%
Currencies and Commodities	**Level**	**Quarter**	**YTD**
CDN $	$0.789	-2.2%	0.4%
US Dollar Index	94.23	1.9%	4.8%
Oil (West Texas)	$75.03	2.1%	54.6%
Natural Gas	$5.87	60.4%	109.8%
Gold	$1,757	-0.7%	-7.4%
Copper	$4.09	-4.5%	16.0%
Canadian Interest Rates	**Level**	**Quarter**	**YTD**
3-month T-bill	0.12	-3	6
GOC bonds 2-yr	0.53	8	33
GOC bonds 10-yr	1.51	12	83
GOC bonds 30-yr	1.99	15	78
Canadian Sector Performance		**Quarter**	**YTD**
Energy		1.6%	35.8%
Materials		-6.0%	-7.2%
Industrials		3.6%	10.0%
Cons. Disc.		-7.0%	8.5%
Info Tech		-1.3%	20.0%
Health Care		-19.5%	-2.1%
Financials		0.3%	21.4%
Cons. Staples		4.2%	12.3%
Comm. Services		-0.4%	14.9%
Utilities		0.1%	3.0%
Real Estate		2.6%	22.8%

Source: Bloomberg & FactSet September 30, 2021 – local currency unless noted, equity price only returns, bonds total return

had taken place since the ~1.75% peak in March, which bottomed at 1.17% in early August. The rally is reminiscent of the surge in the first quarter of this year, with interest-rate sensitive, mega-cap growth stocks suffering as money rotated toward the value/cyclical stocks. The Fed also released their updated Summary of Economic Projections (better known as the 'dot plot'). The dots outline the various Fed members' estimates for the path of interest rate policy for the coming three years and beyond. September brought the introduction of the 2024 estimates. The updated dot plot revealed that the Committee is now evenly split on whether the first interest rate hike comes by the end of 2022, bringing forward expectations around the timing and size of future rate hikes.

Continued political wrangling in the US over the Federal budget and the looming debt ceiling, along with further talk of tax increases, piled on to September's risk-off tone. The Democrats proposed increasing the top corporate tax rate to 26.5% from 21%, imposing a 3% surtax on people making over $5 million, and raising capital-gains taxes. This is all part of the impasse over the budget and infrastructure spending bills, which, if not passed, brings an Oct/Nov timeline for a breach of the debt ceiling. This also brings the possibility of a government shutdown or a technical default by the US government. While the potential exists for this to turn into a calamity, that worst-case scenario is unlikely. Politics is often a game of brinksmanship. The debt ceiling/default/shutdown scare is familiar territory for DC politicians and capital markets. There may be some drama, but an 11th-hour deal has been the norm.

Global supply chain issues worsen

Deteriorating global supply chain conditions appear to be persisting for longer than some may have expected. The recent chaos at North American shipping ports adds to the ongoing issues (shortages in commodities, semiconductors, and labour) that have wreaked havoc globally.

In September, the Marine Exchange reported that a record 70 cargo ships were anchored for weeks waiting to unload at the Los Angeles and Long Beach ports. Reports estimated that as many as half a million shipping containers sat idle. Multiple factors have contributed to the bottleneck, highlighted by surging demand for Asian imports due to home improvement spending (WFH effect) and seasonality effects, as companies rush to stock their shelves ahead of the holidays. These issues have led to a spike in freight costs and lengthy delays as they domino effect down the supply chain. Labour shortages have also lengthened the completion time in virtually all facets of the supply chain; a lack of truck drivers is especially causing delays. Nowhere is this more acute than in the UK, where a shortage of truckers (Brexit pains are part of the issue) has sparked a fuel crunch.

What is important to note is that as much as these risks are a nuisance and will undoubtedly have side effects for the economy in the short term, it is a supply-side issue that can be overcome and will not persist forever. As these supply constraints and delta variant concerns fade, global growth should once again pick up, supported by another round of pent-up consumer demand, inventory restocking, and a release of capital spending.

Chart in focus: China's summer of stock market turbulence

It has been a summer of discontent for investors in Chinese assets. Volatility started in July when global markets were rattled by the removal of ride-hailing company Didi from Chinese app stores, followed by crackdown efforts across the tech sector, ranging from for-profit educational tutoring companies to the video game industry. Chinese authorities are looking to emphatically impose their "Common Prosperity" mandate, which sits at the forefront of this year's CCP agenda. The wide-ranging crackdown efforts sent on-shore and off-shore Chinese stocks tumbling. Since peaking in February, the Hang Seng Tech Index has fallen over 40%, the broader Hang Seng Index is in bear-market territory falling over 20%, and the CSI 300 Index has stumbled ~15%.

Adding to regulatory clampdown was a fresh COVID outbreak, credit market troubles, weaker than expected economic data, and reports of the country's second-largest property developer, Evergrande, struggling under a US$300 billion pile of debt. Its shares are down over 80% this year, and its debt trades at ~25¢-30¢ on the dollar. Some fear a collapse of Evergrande could be China's version of the US' Lehman/AIG moment that sparked the 2008 financial crisis. However, we see an unmitigated spiral into bankruptcy as a low probability outcome, given that the government has the wherewithal to prevent it. Authorities have been trying for years to ween the credit market off this moral hazard with the real estate sector at the heart of the issue, leaving hopes for a total rescue outside the base case as well. A third scenario is restructuring with a partial bankruptcy, a liquidation of assets, and some debt being rolled over. The yield spread on Chinese high yield bonds has widened to an 18-month high, and shares of other real estate companies have plunged. Encouragingly, the central bank has been injecting liquidity into the economy to combat contagion but is letting equity and bond holders feel pain. Despite global investors outside of China being mostly unphased by the news, the weakness coming out of the world's second-largest economy adds to the laundry list of risks that global markets face today, leaving us to adopt a slightly more cautious stance on the outlook in the near-term.

Source: Bloomberg & FactSet September 30, 2021 – local currency unless noted, equity price only returns, bonds total return

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