Monthly Market Matters

Summary for October 2021

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Highlights

Global central banks change course and turn more hawkish, with many ending their quantitative easing programs and pulling forward their timeline to hike interest rates. All eyes are on the Fed's Nov. 3 meeting.

Supply chain disruptions continue to persist but show signs of peaking.

Q3 corporate earnings top lofty estimates again, lifting many major equity indices to new all-time highs.

White House proposes a slimmed-down US$1.85 trillion social spending framework.

Corporate America delivers the goods

Global equity markets rebounded sharply in October, with many major indices erasing last month's drawdowns and setting new all-time highs. Corporate earnings continue to deliver better than expected results, defying the growing concerns over supply chain disruptions and rising input costs. Ongoing inflation pressures have raised the prospects for central banks to tighten monetary policy earlier and more aggressively than initially expected. Bond markets have reacted accordingly, pricing in higher inflation expectations and additional rate hikes for next year. As a result, global yield curves have flattened significantly, with the front end of the curve rising sharply (See Chart in Focus for more). The increased anxiety from investors over the economic recovery shifted flows back into technology stocks, despite earnings misses from Amazon and Apple. In Washington, President Biden has slashed his social spending plan from US$3.5 trillion to US$1.85 trillion in his latest pitch to punch the bill through the reconciliation process.

Stock market's familiar hero: Corporate earnings

Corporate earnings continue to be the saving grace for equity markets. According to FactSet, the blended earnings growth rate for Q3 S&P 500 earnings currently stands at 36.6%, compared to expectations of 27.4% a month ago. Of the 56% of companies that have reported, 82% have beat their estimates. The magnitude of the beats remains impressive at 10.3%, with financials and technology leading the pack. The tech-heavy Nasdaq Composite Index stormed back this month, up 7.3%, as investors piled into tech's secular growth appeal amid worries of an economic slowdown.

Due to rising input costs, corporate profit margins were a huge question mark going into Q3. So far, profitability has held at record levels of ~13%, which means corporations continue to hold onto their pricing power, passing on their higher costs to consumers for the time being. The fourth quarter will undoubtedly test the resilience of corporate earnings. Many companies are downgrading their forward guidance for Q4 citing increased uncertainty stemming from the ongoing supply chain issues,

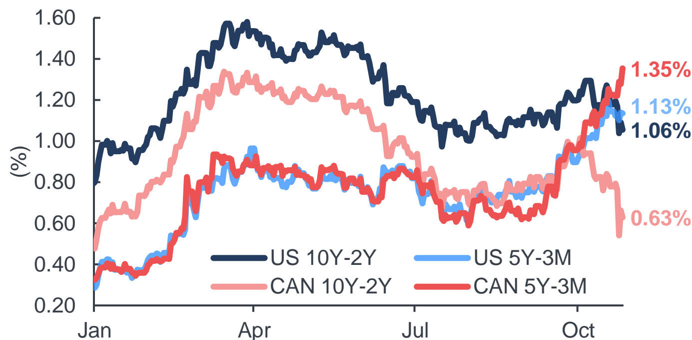
Canadian Fixed Income	Level	Month	YTD
FTSE Canada Universe Bond Index	1,161	-1.1%	-5.0%
FTSE Canada All Corporate Bond Index	1,351	-0.9%	-3.3%
Bloomberg Canada High Yield Index	166	-0.3%	5.4%
Global Equities	**Level**	**Month**	**YTD**
S&P/TSX Composite	21,037	4.8%	20.7%
S&P/TSX Small Cap	796	5.5%	21.5%
S&P 500	4,605	6.9%	22.6%
NASDAQ	15,498	7.3%	20.3%
Russell 2000	2,297	4.2%	16.3%
UK FTSE 100	7,238	2.1%	12.0%
Euro Stoxx 50	4,251	5.0%	19.6%
Nikkei 225	28,893	-1.9%	5.3%
MSCI China (USD)	92	3.1%	-15.2%
MSCI EM Index (USD)	1,265	0.9%	-2.1%
Currencies and Commodities	**Level**	**Month**	**YTD**
CDN $	$0.807	2.4%	2.8%
US Dollar Index	94.12	-0.1%	4.7%
Oil (West Texas)	$83.57	11.4%	72.2%
Natural Gas	$5.43	-9.4%	86.3%
Gold	$1,783	1.5%	-6.1%
Copper	$4.37	6.8%	24.0%
Canadian Interest Rates	**Level**	**Month**	**YTD**
3-month T-bill	0.14	2	8
GOC bonds 2-yr	1.09	57	90
GOC bonds 10-yr	1.72	21	105
GOC bonds 30-yr	2.00	1	79
Canadian Sector Performance		**Month**	**YTD**
Energy		8.6%	47.6%
Materials		5.8%	-1.8%
Industrials		8.8%	19.7%
Cons. Disc.		-0.2%	8.3%
Info Tech		4.1%	24.9%
Health Care		-6.1%	-8.0%
Financials		4.7%	27.1%
Cons. Staples		-1.5%	10.6%
Comm. Services		-0.1%	14.9%
Utilities		0.4%	3.4%
Real Estate		6.1%	30.3%

Source: Bloomberg & FactSet October 31, 2021 – local currency unless noted, equity price only returns, bonds total return

rising input costs, and increased wages. In addition, corporations will have to deal with tighter monetary policy conditions.

Rising inflation expectations have pushed bond yields higher and turned central banks more hawkish. The US 5Y breakeven inflation rate touched 3% this month for the first time on record back to 2002, before pulling back to 2.93%. Economists surveyed by Bloomberg still expect inflation to fall to ~2% y/y by 2023. The price of oil is also feeding into inflation expectations. Surging demand and shortages of natural gas in Europe and Asia have boosted demand. WTI crude oil recorded its second straight double-digit increase, ending the month at US$84, the highest level since 2014. The sharp move up for oil will put additional upward pressure on corporations' input costs.

Chart in focus: Bond yields rise, yield curve whipsaws



Yield curves are shifting meaningfully, as central banks lean further into hawkish territory, with the shorter end of the curve jumping sharply and the longer end less so. The movements imply that the market is raising the stakes that central bankers make a policy mistake, whereby slowing economic growth will collide with incoming rate hikes. There are mixed signals: the traditionally favoured 10s-2s curve has flattened; however, the 5Y-3M and 5Y-2Y curves have steepened. The mixed signals drive a weaker interpretation. In its simplest form, near term, we are in an inflationary boom. While longer-term, the pre-pandemic notions of lower for longer on inflation and growth are expected to return. Confounding the noise, the moves come at a time where market inflation expectations have shot up globally, while 2022 GDP growth estimates have downshifted (but still very healthy). With earnings growth starting to slow and inflation remaining elevated, some fear a repeat of 1970s style stagflation. For us, the stagflation argument is a non-starter for now. To be in stagflation, the economy, by definition, needs to be stagnating. With robust demand, rising employment, rising wages and well above potential GDP growth, the economy remains firmly in boom mode.

Thus far periphery central banks of Canada, New Zealand, Australia, Norway and South Korea have been setting the new tone, with the Bank of England, a middle-weight bank, also joining. In the UK and New Zealand, traders have wagered on rate hikes of as much as 179 basis points over the next year. The Bank of Canada (BoC) is arguably leading the parade. The BoC, as expected, announced it would end its quantitative easing program and move into the reinvestment phase. However, the big surprise was bringing forward their timeline to begin hiking interest rates from the second half of 2022 to as early as Q2 2022. The shift appears prompted by a sharp revision in their inflation expectations for 2022, as the Bank revised its estimates for next year a full percentage point higher to 3.4% y/y. The US Federal Reserve (Fed) will take center stage on Nov. 3, where Fed Chair Powell is expected to announce the plan to begin tapering. It will be interesting to see if the Fed is persuaded by the abrupt change in course from many of its peers. Despite Powell insisting that tapering does not equate to the start of raising interest rates, markets do not believe him and are pricing in two rate hikes by the end of 2022. As the rest of the world heads for the exits, only the European Central Bank, Bank of Japan and the Fed remain.

Political wrangling in Washington

After facing strong opposition from Republicans, the Democrats have been trying to enact a US$3.5 trillion social spending bill through the reconciliation process. In the 50/50 Senate, reconciliation requires a "yes" vote from every Democrat. Two centrists, Sinema and Manchin, have stood firmly against the bill's price tag and some of the critical aspects, including climate initiatives and how to fund it all (i.e.: increasing taxes on corporations and the wealthy). President Biden's latest pitch offers a slimmed-down US$1.85 trillion framework that still includes funding for significant party priorities such as child-care subsidies, universal pre-kindergarten, and tax credits to combat climate change. Items that were left out include the national paid-leave program and free community college. Tax increases were ditched as well.

Supply chains are still a mess, but green shoots may be surfacing

The energy crisis and log jams at shipping ports are still wreaking havoc across the global economy, but the worst may be behind us. Most regional Fed surveys reported delivery times and unfulfilled orders/backlogs had shown some improvement (still a growing problem but at a slower pace), trends in rail traffic are improving, and freight costs are rolling over. In addition, the White House has launched a coordinated effort to help alleviate the port congestions. US President Biden struck a deal with the Port of Los Angeles to move to 24-hour operations, while major retailers such as Walmart and Target will work alongside FedEx and UPS to expand their working hours. Authorities are also looking to create inland "pop-up" terminals and are working to speed up the application process for commercial truck-driving licenses, a primary driver in the bottlenecks. For capitalists, demand is the catalyst to create supply, with price signals telling you what and where – cue business investment.

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