Monthly Market Matters

Summary for May 2021

Brent Joyce, CFA
Investment Strategist

Justin Truong, CFA
Manager, Investment Strategy

Highlights

- South Korea and New Zealand central banks turn hawkish, joining the Bank of Canada - Several US Federal Reserve members raise the notion that it is time to start the taper talk discussion
- Cryptocurrencies plunge on announcements from Tesla and the People's Bank of China
- Canadian equities perform well on stellar earnings from big banks and a resumption in the cyclical rotation trade
- Inflation overshoots already lofty expectations: transitory or something more?

Market Summary

Global equity markets powered higher, with most major indices printing new all-time highs in May. Canadian equities continue to be one of the best asset classes to own this year. Big banks and energy companies are fueling the advance in the TSX as they handily beat earnings estimates. The materials sector, strengthened by a recent surge in gold prices, also contributed positively.

The sharp rise in bond yields that rattled markets in the first three months of the year continues to be digested. Yields put in a second straight month of largely sideways action, with yields ending the month slightly lower, leading to a modest gain for bond markets. Commodities strung together another solid month as lockdown measures ease while supply chains continue to be strained. WTI crude oil and copper prices managed mid-single-digit gains, while gold and silver surged ~8%. Meanwhile, Bitcoin and other major cryptocurrencies plunged on news that Tesla and the Chinese government will not be accepting cryptocurrencies as a form of payment.

Equity markets took a brief step back early in the month amid rising input costs, labour shortages becoming more acute, and inflation data coming in higher than expected. (See this month's *Chart in Focus* for more). Exceptionally strong economic data have amplified worries of the potential for the economy to overheat. This is prompting a handful of central banks to discuss whether tapering of emergency support is warranted sooner than expected. In the US, life appears to be returning to normal (full-capacity sports stadiums!). More than half of the US population has received at least one vaccine dose, while 40% are now fully vaccinated. With Americans rushing to travel and dine out, a transition from growth in the manufacturing sector (inventory restocking cycle) to growth in services has taken place (US ISM Services PMI accelerated sharply from 55.3 in February to 62.7 in April). As more and more countries fully open and stronger economic data continues to roll in, the emergency seems to be subsiding. The key question now is, shouldn't the emergency response from governments begin to subside too?

Cyclicals and banks power Canadian equities higher

Canadian equities have been one of the best asset classes to own this year thanks to the stellar performance from the big banks. The S&P/TSX Bank Sub-Index reached all-time highs,

Canadian Fixed Income	Level	Month	YTD
FTSE Canada Universe Bond Index	1,168	0.6%	-4.4%
FTSE Canada All Corporate Bond Index	1,355	0.5%	-3.0%
Bloomberg Canada High Yield Index	163	0.4%	3.7%
Global Equities	**Level**	**Month**	**YTD**
S&P/TSX Composite	19,731	3.3%	13.2%
S&P/TSX Small Cap	775	4.1%	18.4%
S&P 500	4,204	0.5%	11.9%
NASDAQ	13,749	-1.5%	6.7%
Russell 2000	2,269	0.1%	14.9%
UK FTSE 100	7,023	0.8%	8.7%
Euro Stoxx 50	4,039	1.6%	13.7%
Nikkei 225	28,860	0.2%	5.2%
MSCI China (USD)	110	0.5%	1.4%
MSCI EM Index (USD)	1,376	2.1%	6.6%
Currencies and Commodities	**Level**	**Month**	**YTD**
CDN $	$0.829	1.9%	5.6%
US Dollar Index	89.83	-1.6%	-0.1%
Oil (West Texas)	$66.32	4.3%	36.7%
Natural Gas	$2.99	0.3%	11.2%
Gold	$1,907	7.8%	0.4%
Copper	$4.68	4.7%	32.6%
Canadian Interest Rates	**Level**	**Month**	**YTD**
3-month T-bill	0.12	1	6
GOC bonds 2-yr	0.32	2	12
GOC bonds 10-yr	1.48	-6	81
GOC bonds 30-yr	2.03	-5	82
Canadian Sector Performance		**Month**	**YTD**
Energy		3.9%	26.3%
Materials		7.8%	5.5%
Industrials		1.6%	6.1%
Cons. Disc.		-0.9%	16.6%
Info Tech		0.3%	2.9%
Health Care		-3.5%	20.7%
Financials		4.3%	20.5%
Cons. Staples		4.3%	6.5%
Comm. Services		3.2%	12.3%
Utilities		-0.9%	0.9%
Real Estate		1.5%	15.1%

Source: Bloomberg May 31, 2021 – local currency unless noted, equity price only returns, bonds total return up 25% YTD (total return). All of Canada's Big-Six banks reported Q2 earnings that beat analyst estimates. All but one beat by double-digits, spearheaded by ~30% surprises from CIBC and TD. Earnings are being bolstered by strength in capital market activities and the release of the hefty loan loss provisions set in place due to the pandemic. The latter, more importantly, shows increased confidence from banks and signals that the financial issues from the COVID-19 crisis are headed in the rear-view mirror in North America. Further upside for banks will depend on the strength of the economic recovery and avoiding another wave of cases. However, shareholders are still looking forward to Canadian regulators following their US counterparts in loosening regulations on the banks' ability to resume share buybacks and increase dividends.

Also contributing to the S&P/TSX Composite advance was another strong month for the energy and materials sectors. WTI crude oil reached a new 52-week high, climbing 4% higher, while gold spiked 8% and crested the key technical level of US$ 1,900/oz.

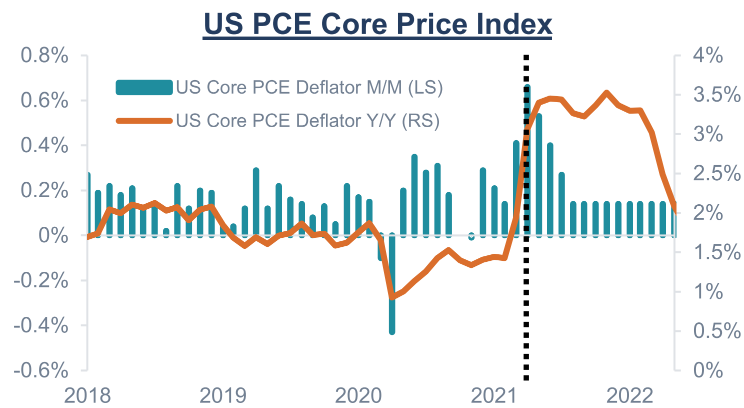
Bitcoin as a hedge? Not so fast…

After eclipsing a remarkable US$1 trillion market cap, Bitcoin has been spiralling downward. The latest leg down comes as Tesla backtracks on their recent decision to accept Bitcoin as payment due to its environmental impact. A week later, the People's Bank of China banned cryptocurrencies as a form of payment alongside warning investors against speculative crypto trading. The latter sparked a frenzied sell-off, with Bitcoin tumbling ~42% in two weeks of trading, bottoming at US$33,700, almost half of its US$63,410 high set in April. The volatile price action calls into question two commonly touted qualities of Bitcoin: that it is a hedge against traditional market risks, and it is an alternative store of value. In the last few months, inflation expectations have shot up, the US dollar has weakened, and equity market volatility has risen. Yet, Bitcoin's value has nose-dived. Bitcoin is often called 'digital gold'. Comparing the volatility of Bitcoin to gold is revealing. Bitcoin's lowest volatility (shown in our May 21 Weekly Market Snapshot's Chart of the Week) was only a hair lower than the highest-ever volatility for gold (which came during the US dollar debasement period in the early 1980s). Another comparison one might wish to keep in mind? Private ownership of gold was banned in the United States during the Great Depression and not fully reinstated until the end of 1974 - how's that for regulatory risk! The truth is, gold has a significant head start over cryptocurrencies in terms of global acceptance, and therefore stability. The volatility that has brought speculators in cryptocurrencies wild success is also likely delaying them from becoming an accepted store of value.

Central bank taper talks

Rumblings of taper talks have begun to get a little bit louder as the global economy begins ramping up. The Reserve Bank of New Zealand announced they expect to begin raising their benchmark interest rate by the end of 2022. The Bank of Korea followed suit, preparing markets for an "orderly" exit from their record low interest rate policy. Both banks now join the Bank of Canada in moving forward their dates for expected interest rate lift-off.

Chart in Focus: Transitory Inflation?



The US Federal Reserve's (Fed) preferred inflation measure (US Personal Consumption Expenditure Core Price Index or Core PCE) spiked 0.7% m/m in April, marking the second-largest monthly increase in more than 40 years. The spike sent the year-over-year number to a 29-year high of 3.1%. The eye-popping number is being taken in stride by all corners of the bond market (US nominal, real and inflation breakeven yields were little changed on the month), primarily because the boost to inflation was highly concentrated in areas related to reopening.

Whether or not inflation proves to be transitory sits at the heart of where risk may lie in the coming months. There are three key questions. Will inflation, in fact, be transitory? Simply running its course, ergo, no problem. What level (and for how long) of an inflation overshoot will the Fed tolerate? The Fed has been very vague on both fronts. And lastly, will capital markets continue to buy the Fed's admonitions around inflation? Even if the Fed ultimately turns out to be correct, capital markets can march to their own drum and be much less patient with growing inflation pressures.

Our chart depicts just such a scenario, where monthly inflation (blue bars) runs well above average (but declining) for the next three months and then settles in at 0.14%* per month after that. Under this scenario, annual inflation runs above 3% until March 2022 before falling back to more reasonable levels. For now, the message from the Fed is still consistent, inflation will be transitory, and none dare whisper the words rate hike. However, some members have turned slightly hawkish, including Vice Chair Clarida becoming the latest to favour opening the door on taper talks. To be clear, dovish members still heavily outweigh the hawks. However, if economic data (especially inflation and the employment situation) continue to be stronger than expected, it seems only a matter of time before the Fed needs to align its guidance with the reality on the ground. We do think markets see the forest for the trees in all of this, but the opportunity for a mini taper-tantrum exists.

*average monthly gain Feb 2015 to Feb 2020