Monthly Market Matters

Summary for July 2022

Justin Truong, CFA
Senior Manager, Investment Strategy

Highlights

Risk assets rally on easing bond yields. Markets pricing in rate cuts in 2023.

Oil prices fall below US$100/bbl on growth concerns. Natural gas prices spike as Europe scrambles secure energy supplies.

Global central banks continue raising interest rates to tackle multi-decade high inflation.

Labour markets remain tight, but cracks are beginning to show.

A change in tone

A broad rally in global equities materialized in July, offsetting the significant losses seen in June. US equities led the way, with the S&P 500 soaring >9%, the largest monthly gain since November 2020, while the tech-heavy NASDAQ jumped >12%. Better-than-expected corporate earnings results boosted stocks. However, the primary catalyst for the sharp rebound was the slowing growth narrative that would lead to peak inflation and peak US Federal Reserve (Fed) hawkishness. A decline in crude oil prices and medium to longer-term inflation expectations also reflected the shift in sentiment. The exception was Chinese equities, where headlines of mortgage boycotts renewed concerns about the country's struggling property sector. The MSCI China (USD) index was down double-digits. The 1% rebound in the US dollar was a detractor, but the CSI 300 and Hang Seng indices saw 7% or greater declines.

European natural gas prices soared higher amid uneasiness surrounding the continent's ongoing energy crisis. After a scheduled maintenance shutdown, markets breathed a sigh of relief when Russia reopened the Nord Stream 1 pipeline (the primary channel bringing Russian natural gas to Europe). However, shortly after the reopening, Russia's Gazprom announced that they would slash the pipeline's capacity by half to 20%, citing equipment issues. The announcement comes a week after the company declared 'force majeure' on several European natural-gas buyers. Both developments stoked fears of Russia's intention to keep supplies capped, preventing European nations from refilling their gas inventories ahead of the winter season.

Tug of war: inflation vs. growth

The drawdown in equities seen in the first half of this year was underpinned by tighter monetary policy from central banks to tame multi-decade high inflation. Although the hawkish stance has not changed, with many delivering oversized interest rate hikes, markets are now shifting their attention to signs of a slowing economic recovery. US real GDP growth came in negative for the second consecutive quarter, sending the US economy into a technical recession. Global purchasing manager indices have deteriorated significantly, with manufacturing surveys on pace to reach contraction territory in the second half of this year. Warnings of excess inventories from notable retailers

Canadian Fixed Income	Level	Month	YTD
FTSE Canada Universe Bond	1,085	3.9%	-8.8%
FTSE Canada All Corporate Bond	1,266	3.2%	-8.1%
Bloomberg Canada High Yield	157	1.4%	-5.6%
Global Equities	**Level**	**Month**	**YTD**
S&P/TSX Composite	19,693	4.4%	-7.2%
S&P/TSX Small Cap	708	7.6%	-8.6%
S&P 500	4,130	9.1%	-13.3%
NASDAQ	12,391	12.3%	-20.8%
Russell 2000	1,885	10.4%	-16.0%
UK FTSE 100	7,423	3.5%	0.5%
Euro Stoxx 50	3,708	7.3%	-13.7%
Nikkei 225	27,802	5.3%	-3.4%
MSCI China (USD)	66	-10.0%	-21.1%
MSCI EM Index (USD)	994	-0.7%	-19.3%
Currencies and Commodities	**Level**	**Month**	**YTD**
CDN $	$0.782	0.6%	-1.2%
US Dollar Index	105.90	1.2%	10.7%
Oil (West Texas)	$98.62	-6.8%	28.1%
US Natural Gas	$8.23	52.6%	125.8%
Gold	$1,766	-2.3%	-3.5%
Copper	$3.57	-3.7%	-19.3%
Canadian Interest Rates	**Level**	**Month**	**YTD**
3-month T-bill	2.65	57	249
GOC bonds 2-yr	2.96	-13	201
GOC bonds 10-yr	2.61	-61	118
GOC bonds 30-yr	2.77	-36	109
Canadian Sector Performance		**Month**	**YTD**
Energy		5.0%	29.7%
Materials		-0.7%	-9.6%
Industrials		10.4%	-0.6%
Cons. Disc.		8.2%	-11.3%
Info Tech		10.0%	-50.9%
Health Care		-8.6%	-58.2%
Financials		2.8%	-10.3%
Cons. Staples		6.9%	5.0%
Comm. Services		0.0%	-2.9%
Utilities		3.8%	3.2%
Real Estate		6.8%	-17.7%

Source: Bloomberg & FactSet August 4, 2022 – local currency unless noted, equity price only returns, bonds total return such as Walmart and Target threaten to compress record profit margins companies have enjoyed over the pandemic and, in turn, future corporate earnings. Meanwhile, many portions of the yield curve have inverted, with other areas flattening significantly – indicating that the global economy is primed to slow further.

Yet, markets have rallied significantly on these negative developments. In our view, the large bounce this month can be explained by a familiar phrase that has guided markets during numerous volatile periods over the past decade: "bad news for the economy is good news for markets". The idea behind this narrative is the belief that market movements have been driven by central bank policy. Today, as the outlook for global growth continues to deteriorate, more market participants have begun to question the Fed and other central bankers' resolve in fighting inflation. Markets are now betting that the Fed will blink and deliver a rate **cut** as early as Q1 2023 to support faltering economic growth. On June 14, markets were pricing in the Fed Funds Rate to peak at 3.92%, a touch higher than the Fed's June projection for 2023 (3.80%). As of the end of July, markets now expect the peak to come in significantly lower ~3.31%. The fact that the market's most recent bottom occurred a mere two days later on June 16, reinforces this narrative that Fed policy is the most critical driver of risk asset performance in today's investing landscape. If this theory holds, investors can likely expect more market choppiness until we receive more clarity on the Fed's rate hiking path.

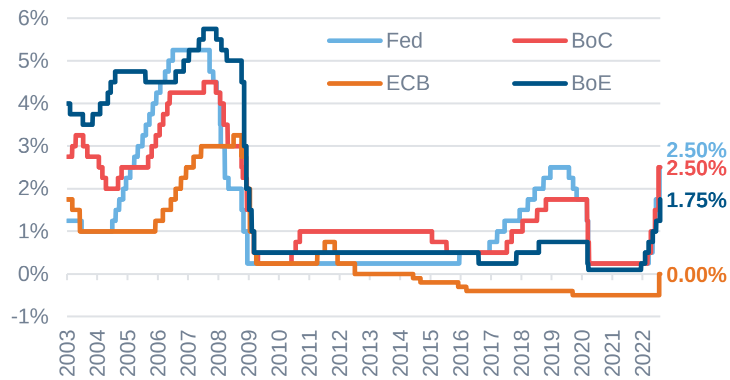
Labour market hushes recession talk

While recession fears swirl, the red-hot labour market is telling another story. US nonfarm payrolls delivered another solid result in June, surprising to the upside by adding 372,000 jobs, well above the consensus estimate of 265,000. Moreover, job openings remain elevated above 11 million, signalling that the demand for labour remains abundant. However, there are signs that the labour market may soon be reaching an inflection point, and the unemployment rate could be on its way higher. First, the household survey reported a 330k loss in the month. Second, more recent indicators such as the jobless claims data and the employment components within the ISM PMI surveys are flashing weakness. Finally, many companies, particularly in the technology sector, are announcing layoffs or hiring freezes. The inklings of weakness in the labour market indicate that sharply rising interest rates are beginning to take their toll on the economy, and many CEOs are starting to brace for potential economic turbulence ahead.

Earnings: Not as bad as expected

Although corporate earnings results have been somewhat lacklustre, companies are faring better than expected. Of the 280 S&P 500 companies that have reported, 73% are beating their earnings estimates by an aggregate of 3.1% − both measures are below their five-year averages. So far, the blended earnings growth rate for the index is 6.0%, which would mark the slowest pace since Q4 2020 (4.0%). Companies are citing the adverse effects of a strong US dollar, ongoing cost pressures and fears of recession due to Fed tightening. Despite the subpar results and mixed forward guidance, stocks are seemingly looking through the near-term bad news and out to 2023, where this year's hawkish monetary policy is expected to flip back into an accommodative stance to support a weakening global economy. This has supported the rally in global equities this month.

Chart in focus: Taking stock



Global central banks took further steps to accelerate their path towards normalizing monetary policy. Here's a recap:

The Bank of Canada (BoC) surprised markets with a supersized 100 basis point (bp) hike, bringing the overnight rate to the mid-point of the BoC's neutral range of 2-3%. The motive behind the largest hike since 1998 remains squarely on tackling inflation and keeping inflation expectations anchored. The Bank revised its inflation forecasts sharply higher across the board from its April meeting: Q2 – 7.6% y/y (from 5.8% y/y), Q3 – 8% y/y and Q4 – 7.5% y/y (from 4.5% y/y). Meanwhile, The Bank cut its 2022 GDP growth target to 3.5% (from 4.2%), and to 1.8% (from 3.2%) for 2023.

The European Central Bank (ECB) surprised markets by delivering an oversized 50 basis point (bp) hike, bringing the key deposit rate to 0.0% to fight inflation that reached 8.6% y/y in June. This marks the first rate increase in over a decade and ends eight-years of negative interest rates. The ECB also introduced a new bond purchasing program called the Transmission Protection Instrument (TPI) to cap the rise in borrowing costs while limiting financial fragmentation, smoothing monetary policy transmission across all Eurozone countries. The decision comes as the political crisis in Italy ramps up, placing more pressure on the ECB to shield the most vulnerable members of the region.

Early in August, the Bank of England (BoE) delivered a 50 bp hike, taking the Bank Rate to 1.75%. This marked the biggest increase in 27 years, as the UK faces the highest inflation in 40 years.

The US Federal Reserve's (Fed) 75 basis point increase was in line with expectations, taking the target for the Fed Funds Rate to 2.25-2.50%. Notably, the committee gave a nod to softening spending and production data in their statement. Chairman Powell also confirmed that the pace of rate hikes was likely to slow in the meetings ahead while indicating that Fed will no longer provide future guidance, with the future path of rates being data-dependent. The market interpreted his comments and the statement as dovish, supporting the market rally in the final innings of the month.