MACKENZIE Investments

Monthly Market Matters

Summary for August 2022

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Highlights

Summer rally reverses course in the back half of August amid a resurgence in bond yields

Zero-covid policy and renewed lockdown measures continue to be a major headwind for Chinese economy

US inflation cools in July amid easing gasoline prices

Hawkish US Federal Reserve (Fed) messaging negates market hopes for a potential dovish pivot

Bear market rally fizzles out

The sharp rebound in global equities continued in the first half of August amid easing price pressures, signs of deteriorating demand, and increasing speculation of a Fed pivot early in 2023. However, the rally fizzled out to end the month, as bond yields turned sharply higher in reaction to more hawkish signalling from Fed Committee members. In turn, the bond sell-off resumed after enjoying abnormal gains in July. Outside of North America, European stocks continue to be weighed down by the ongoing energy crisis in Europe, as the MSCI EAFE Index fell 5%. Soaring European natural gas and electricity prices have European leaders scrambling for a solution heading into the winter. The EU is considering price caps on Russian gas, but doing so would open the door for Moscow to further weaponize its energy exports in retaliation. Meanwhile, emerging market equities outperformed their developed counterparts, ending the month flat.

Recession fears have been most acutely felt in oil prices. Concerns over the potential demand destruction due to a growth slowdown and renewed lockdown measures in China have outstripped the tight supply conditions present today. As a result, WTI and Brent futures fell 9% and 12%, respectively.

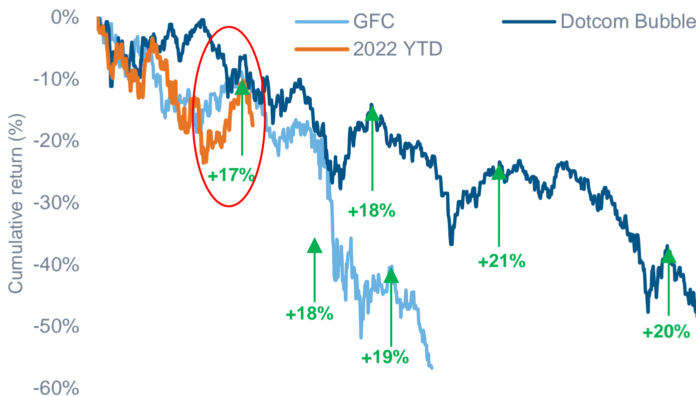
US inflation cools in July

US CPI inflation report cooled in July. The headline figure dropped more than forecasted from its four-decade high of 9.1% to 8.5% (versus 8.7% expected), driven by the sharp decline in gasoline prices. However, the real surprise was in the lower-than-expected core inflation print, rising only 0.3% m/m versus 0.5% expected, holding the annual rate at a still-elevated level of 5.9% y/y. Airlines, hotels and vehicle rentals fell for a second consecutive month, driving the decline lower for core prices, as pent-up demand for travel and leisure appears to be losing steam in the face of sharply higher prices. Although equities reacted positively to the news, the same cannot be said for the bond market. Investors still see the Fed Funds Rate peaking around 3.90% in March 2023, up from ~3.25% to start the month. July's print is an encouraging sign that inflation is heading in the right direction. However, there is still a massive mountain to climb down from, particularly with wages and rents remaining sticky.

Canadian Fixed Income	Level	Month	YTD
FTSE Canada Universe Bond	**1,056**	-2.7%	-11.3%
FTSE Canada All Corporate Bond	**1,242**	-1.9%	-9.9%
Bloomberg Canada High Yield	**157**	0.1%	-5.5%
Global Equities	**Level**	**Month**	**YTD**
S&P/TSX Composite	**19,331**	-1.8%	-8.9%
S&P/TSX Small Cap	**688**	-2.8%	-11.1%
S&P 500	**3,955**	-4.2%	-17.0%
NASDAQ	**11,816**	-4.6%	-24.5%
Russell 2000	**1,844**	-2.2%	-17.9%
UK FTSE 100	**7,284**	-1.9%	-1.4%
Euro Stoxx 50	**3,517**	-5.1%	-18.2%
Nikkei 225	**28,092**	1.0%	-2.4%
MSCI China (USD)	**66**	0.1%	-21.0%
MSCI EM Index (USD)	**994**	0.0%	-19.3%
Currencies and Commodities	**Level**	**Month**	**YTD**
CDN $	$0.762	-2.5%	-3.7%
US Dollar Index	108.70	2.6%	13.6%
Oil (West Texas)	$89.55	-9.2%	16.3%
US Natural Gas	$9.13	11.2%	148.3%
Gold	$1,711	-3.1%	-6.5%
Copper	$3.52	-1.7%	-20.2%
Canadian Interest Rates	**Level**	**Month**	**YTD**
3-month T-bill	**3.22**	57	306
GOC bonds 2-yr	**3.65**	69	270
GOC bonds 10-yr	**3.12**	51	169
GOC bonds 30-yr	**3.03**	26	135
Canadian Sector Performance		**Month**	**YTD**
Energy		-1.8%	27.4%
Materials		-0.4%	-10.0%
Industrials		-1.3%	-1.8%
Cons. Disc.		1.3%	-10.2%
Info Tech		-7.6%	-54.6%
Health Care		9.4%	-54.2%
Financials		-2.3%	-12.3%
Cons. Staples		-1.4%	3.6%
Comm. Services		-1.7%	-4.5%
Utilities		0.8%	4.0%
Real Estate		-4.8%	-21.6%

Source: Bloomberg & FactSet August 31, 2022 – local currency unless noted, equity price only returns, bonds total return

Chart in focus: History doesn't repeat itself, but it often rhymes



It was a tale of two halves for equities in August. As of August 16, the S&P 500 had rallied ~17% off its most recent low set on June 16. The June low in equities almost perfectly aligns with the most recent peak in bond yields, with the US 10-year Treasury peaking two days prior on June 14th at 3.50% on an intraday basis. Moderating bond yields allowed tech stocks to maneuver back into a market leadership role again, as the NASDAQ officially entered a new bull market, surging as much as 23% off its June 16 lows. The magnitude of the rebound had befuddled many skeptics, including us, calling this rebound a run-of-the-mill bear market rally. The S&P 500's subsequent ~9% reversal in the back half of the month has initially confirmed our thesis.

Looking ahead, we remain cautious for a few reasons. First, although corporate earnings held up better than expected in Q2, the outlook for the back half of this year remains skewed to the downside. Warnings of high inventory levels and higher prices increasingly eating into consumer savings will likely put significant pressure on corporate profit margins, which have barely budged from their record highs. Second, although July's inflation print was encouraging, inflation remains at an unacceptable level for the Fed to turn dovish as quickly as markets are currently expecting – the core figure remains nearly three times the level of the Fed's target of 2%. Lastly, history tells us that rallies during bear markets can be quite strong. During the two and half years of the Dotcom Bubble crash that yielded a 50% loss for the S&P 500, there were twelve rallies of >6% from peak to trough. As depicted in the chart above, the final three bear market rallies make the recent 17% rally seem somewhat ordinary. Running the same analysis for the Great Financial Crisis (GFC) bear market yielded eight rallies of at least 6%.

The takeaway for investors is that these bear market rallies make it extremely difficult to predict when markets will ultimately bottom. In addition, inaccurate timing of tactical trades during bear markets could magnify losses when capital preservation ranks high on the priority list. For example, during the bear market post the Dotcom Bubble, if you were to buy at the top of these >6% bear market rallies and sell at the subsequent trough, your losses would expand to ~85%. Performing the same analysis during the GFC would result in an 80% loss as opposed to the ~55% loss if an investor had simply stayed put. During volatile times like today, the most prudent approach is to remain invested, avoid overreacting to near-term news, and from an opportunistic lens, look to lengthen your time horizon to justify what will likely be attractive buying opportunities in the long-term.

China troubles continue ahead of Politburo meeting

At the heart of recent global growth concerns lie the struggles of the Chinese economy. Covid cases are back to a three-month high and authorities look poised to continue imposing their zero-tolerance policy. After a brief rebound in June, Chinese economic data resumed its downward slump. Retail sales, industrial production, and fixed-asset investment all took a step back in July, prompting the People's Bank of China to deliver surprise 10 basis point (bp) cuts to their one-year and seven-day lending rates. The surprise came just weeks after China's Politburo meeting, where top policymakers gave a downbeat outlook for growth, while making no signal for further stimulus. At the time, the conclusion of the meeting indicated that the nation's top leadership group would allow some leeway to miss their 2022 GDP growth target of 5.5%. As long as growth continues to take a back seat in favour of their strict zero-Covid policy, the Chinese economy is unlikely to hit its target. The same rationale applies to Chinese equities, which have struggled to start the second half of this year after a significant bounce in June. The MSCI China (USD) Index has fallen ~10% QTD and is now down ~21% YTD.

Equities in a Jackson Hole

A downward reversal in equities occurred in the final two weeks of the month, fueled by waves of hawkish messaging from Fed Committee members. The posturing was punctuated by Chair Powell's emphatic hawkish speech at the Jackson Hole Summit. In a short ten-minute speech, the Chair left little doubt that the Fed was firmly focussed on taming inflation and it will likely come at the expense of softening demand for labour and lower wage growth. He indicated monetary policy will need to move "forcefully" and "purposefully" in order for the central bank to reach its target of 2% inflation. Just in case the market was still holding any hope of a Fed pivot he also pointed to a potential for another "unusually large" hike at the next meeting in September. This has investors scaling back growth expectations and beefing up their bets for where the terminal Fed Funds Rate (FFR) will ultimately land. Markets now expect the FFR to peak at 3.94% at next year's March meeting, up from roughly 3.25% to start the month. Bond yields bolting higher abruptly halted the summer rally, with the US 2-year kissing off the 3.50% level and the 10-year rallying back up to 3.19%. The US 10-year less 2-year Treasury yield spread remains deeply inverted, reaching -46bps before narrowing to 30 bps to end the month. The Fed will receive one more crucial inflation print before their September 20-21 meeting. The August CPI data will likely determine whether they increase interest rates by 50 or 75 bps. As of the end of August, markets are fully price in a 50 bps move with a 75% chance of a 75 bp increase.

Source: Bloomberg & FactSet August 31, 2022 – local currency unless noted, equity price only returns, bonds total return