Global Markets Commentary

Back to the Future

BMO Private Investment Counsel Inc. | June 2021

"Wait a minute, Doc. Are you telling me you built a time machine... out of a DeLorean?"

Marty McFly, *Back to the Future*, 1985

Since March 2020, we have been stuck in what seems like an alternate reality, trying to get back to our pre-pandemic way of life. After multiple attempts at reopening and the tragic death of over 3.5 million people globally, we are rapidly moving toward that goal. But instead of a DeLorean tricked out with a flux capacitor, vaccines will provide our ride home.

The future, however, will be tweaked. A significant shift to sustainable and renewable infrastructure spending is underway. While U.S. President Joe Biden may not get the full US$2.3 trillion for infrastructure spending he requested, we can expect a massive outlay.

This shift to cleaner energy was highlighted by three landmark defeats for Big Oil on the same day in May. First, a small activist hedge fund took at least two board seats at ExxonMobil with the goal of forcing management to start pivoting away from fossil fuels. Second, Chevron shareholders voted in favour of a proposal calling for the company to reduce its carbon footprint. Third, a Dutch court ruled that Royal Dutch Shell has until 2030 to reduce its carbon emissions by 45%.

To be clear, oil is vital to the global economy and will remain so for the foreseeable future. We're not likely to be driving plutonium-fuelled cars like Marty's DeLorean any time soon – even though the market for electric cars is forecast to grow exponentially.

Most major equity markets performed well in May, despite some volatility and rising geopolitical tensions. Bond yields remain stable after spiking in Q1. They sit very close to their mid-February 2020 mark, when they started to materially decline as pandemic fears gained steam.

Canada – 1.21 gigawatts!

Although most provinces remained in lockdown to cope with the third wave of COVID-19, overall case numbers started dropping as vaccination rates climbed. By the end of May, about 60% of Canadians had been at least partially vaccinated, a higher percentage than in the U.S., which is one of the world's leaders at getting shots into arms.

Ontario aims to have most residents fully vaccinated by summer's end and is preparing to gradually ease restrictions later this month. Prime Minister Justin Trudeau said he wants 75% of Canadians vaccinated and daily cases declining before he will consider reopening the Canada-U.S. land border.

After the worst year on record, the Canadian economy grew 6.5% in Q1 of 2021. In March, GDP grew by 1.1%, a year-over-year increase of 6.6% despite intermittent lockdowns in many regions. With reopening foreseeable in the next several weeks, economists anticipate strong growth for the rest of the year. Overall, Canada's economy is expected to expand by more than 6% in 2021 (off of a low base) and 4% in 2022.

The Bank of Canada (BoC) is continuing to trim its purchases of Government of Canada bonds. In April, the BoC said it might raise its benchmark interest rate – which stands at an ultra-low 0.25% – sooner than previously expected and likely before the U.S. Federal Reserve makes a similar move.

Financial markets remained healthy after an impressive earnings season, particularly for banks. With commodity prices also providing a heavy-duty push, the S&P/TSX rose 3.45% and hit all-time highs in May, coming within a stone's throw of 20,000 for the first time ever. West Texas Intermediate and Western Canadian Select climbed to US$67 and US$52 a barrel, respectively. Gold rose to US$1,900 on inflation concerns. Our loonie strengthened 2% against the greenback in May, as markets started pricing in earlier interest-rate hikes for Canada.

The Canadian bond yield curve was relatively flat during the month after steepening during Q1. Yield on the 10-year note is 1.48% and the 3-year yield is 0.51%.

United States – 88 mph

In May, the world's largest economy continued its recovery. In the last week of the month, initial unemployment claims fell to their lowest level since the pandemic began and jobless numbers declined for a fourth straight week.

The seven-day moving average of daily new COVID-19 cases dropped below 30,000 for the first time since June 2020. While half of all adult Americans are now fully immunized, vaccine hesitancy has slowed progress in recent weeks.

Each month, the U.S. Federal Reserve buys US$120 billion in mortgage-backed securities and U.S. Treasury bonds. These purchases, coupled with historically low interest rates, have provided great support for equities. Investors are now wondering when the Fed will begin to taper its asset purchases. Consumer prices rose 0.8% in April compared to March, an annual increase of 4.2% – double the Fed's 2% upper-limit target. While the U.S. central bank has insisted that it regards rising inflation as "transient," minutes from an April policy meeting reveal that it stands ready to act if prices continue rising.

In late May, President Biden ordered the U.S. intelligence community to redouble their efforts at investigating COVID-19's origins. Beijing lashed back and accused the U.S. of "political manipulation and blame shifting."

President Biden will meet with Russian President Vladimir Putin on June 16 in Switzerland as relations between the two powers are at post-Cold War lows. Tensions escalated recently after the Biden administration imposed sanctions on Russian businesses and expelled Russian diplomats, while Russian ally Belarus diverted a Ryanair plane to arrest an influential political dissident. On Memorial Day, the U.S. and its allies, including Canada, sent a message to Russia with an operation called "Allied Sky." In a 12-hour span, nearly 100 aircraft from 22 NATO member states came together to fly over all the countries that make up the North Atlantic alliance.

U.S. equities ticked up slightly in May and returned 0.70%. According to financial markets data provider Refinitiv, since 1994 companies in the S&P 500 have surpassed earnings estimates by an average of 3.6%. In this earnings season, companies beat estimates by an average of 22.8%. These strong results have the S&P 500 on track to post the fastest growth in corporate earnings since 2010 and continue to support our overweight to U.S. equities.

Europe and the U.K. – Putting COVID-19 in the rear-view mirror

In its most recent economic outlook, the Organisation for Economic Co-operation and Development (OECD) significantly upgraded prospects for U.K. growth. On the other hand, it also said that the U.K. will suffer the most long-term economic damage of any G7 country owing to the dual impact of COVID-19 and Brexit.

Forecasting GDP will increase by 7.2% in 2021, the OECD credits the U.K.'s successful inoculation program. As of May 31, according to Our World in Data, about 60% of the population had received at least one dose. Although the target is to fully reopen venues in June, British Prime Minister Boris Johnson says caution is warranted since the new virus variant from India could detour those plans.

The U.K. equity market remains mostly muted. The FTSE 100 (U.K. equities) was up 1.08% in May, making it the worst performing Western European benchmark. It appears that markets have already largely priced in the recovery, although Bloomberg Intelligence believes the index valuation remains attractive, trading at about a 25% discount to the broader EU market. The Stoxx 50 (EU equities) gained 2.5% in May.

Across Europe, ramped up vaccinations and gradual loosening of restrictions prompted optimism, particularly for countries most dependant on tourism. Spain's economy contracted almost 11% in 2020, but the Spanish equity market (measured by the IBEX 35) was up more than 3.9% in May. The EU Commission estimated that the EU economy will expand 4.2% on average this year – a significant improvement after a 6% economic contraction across member nations in 2020.

China – A lightning bolt

China's exports have roared ahead thanks to enthusiastic demand from the world's economies, which continue to briskly recover. In April, China's exports accelerated by 32.3% compared to April 2020 while imports soared by 43.1% thanks to stronger domestic appetite and surging commodity prices. Even with this turbo-charged import performance, China's trade surplus was US$42.85 billion in April.

The Shanghai Composite gained 5% in May. Toward May's end, investors bought almost 50 billion yuan (US$7.7 billion) worth of A-shares through the China Stock Connect program that allows international investors to trade shares listed in China's domestic market.

Japan – COVID-19 in the driver's seat

With the Summer Olympics set to kick off on July 23, Japan is scrambling to keep coronavirus infections under control. Prime Minister Yoshihide Suga recently announced a 20-day extension of the COVID-19 state of emergency. A slow vaccination rollout plus new virus variants contributed to spikes in Tokyo and Osaka. Only about 8% of Japan's population is vaccinated.

Most Japanese people favour cancellation or postponement, according to recent polls. Yet, Mr. Suga is determined to go ahead. Investors also worry that the Games could spark a new outbreak and lead to political instability that would put pressure on the Japanese equity market. According to a University of Oxford study, Japan will spend about US$15.4 billion to host the Olympics, making it one of the most expensive on record.

The Nikkei recovered slightly from a dip in April and returned 0.16% in May. Optimism primarily comes from government efforts to speed up vaccinations, a drop in daily cases, and a devalued yen – which is expected to boost exports.

Our strategy

Rising inflation has been top of mind for many investors. We could be moving into a period of persistently higher inflation. Or, we might just be passing through a period of transitory high numbers caused by a comparison to a lower base, after steep declines in 2020 and disruptions in supply chains. The next few months will tell as we start to coast past the pandemic correction.

We believe inflation could remain modestly higher owing to such factors as rising commodity prices and potential changes to supply chains, but also think that substantially higher inflation numbers are temporary. Bond yields have been parked since Q1, which is evidence that many market participants concur. Our core fixed income exposure is less impacted by movements in rates, given our focus on short- and mid-term bonds.

We remain modestly bullish overall, and are maintaining our small overweight to U.S. equities based on continued supportive fiscal and monetary policies as well as the diversity and quality of companies located there.

The last word

"Why don't you make like a tree and get outta here?"
Biff Tannen, *Back to the Future*

The COVID-19 third wave seems to be receding in most major economies. Canada is a bit stalled in terms of reopening readiness, but a sharp increase in vaccination rates puts us on track to blast out of pandemic gridlock. This should lead to an acceleration of GDP growth after an expected slowdown in Q2.

At long last we are poised to get back to our old way of life. Perhaps nothing symbolizes this more than fans returning to NHL and NBA arenas and a Leafs collapse in Game Seven.

Please contact your BMO financial professional if you have any questions or would like to discuss your investments.

BMO Private Wealth

ID5139 06/21