Global Markets Commentary
Equities not feeling the back-to-school blues

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"Education is what remains after one has forgotten what one has learned in school."

Albert Einstein

The upcoming change of seasons and uncertainty about students returning to classrooms didn’t dampen equity markets in August. Once again, global equities advanced. Markets like the S&P 500 and Nasdaq Composite were teachers’ pets as they reached new all-time highs. Mega-cap tech stocks, which have fared so well since the pandemic’s outbreak, continued to fuel a remarkable run for equities.

Risk assets such as equities were buoyed by positive economic data, a continuation of fiscal stimulus programs and dovish central banks. Even though Q2 GDP numbers around the world dropped by double-digits, markets focused on expectations for a strong recovery in Q3.

COVID-19 continued its rampage – six million cases in the U.S. alone and global cases in excess of 26 million. Even so, optimism that a safe and effective vaccine is coming gave stocks a boost. Politics dominated headlines but didn’t seem to move markets much. Prime Minister Justin Trudeau prorogued Parliament until September 23 to give the government more time to plan its pandemic policy response. Chrystia Freeland took over as Finance Minister after Bill Morneau resigned.

Republicans and Democrats officially nominated their candidates at virtual party conventions. The U.S. election promises to be the biggest story on the fall timetable.

Canada – Back to basics

Canadian equities participated in the global stock rally with a 2.3% rise in August, although our benchmark index underperformed compared to most major markets. Canada’s top sector was financial services after strong Q3 earnings reports triggered an August rally in Canadian bank stocks. Healthcare was the weakest sector, held back by ongoing poor showings from cannabis stocks.

Canadian government bond yields retreated when longer-term interest rates rose on the prospect of economic recovery and worries about inflation crept into bond prices. Although Canada’s Q2 GDP shrank by -11.5%, it was better than Statistics Canada’s forecast of -12%.

We will likely see a big economic rebound in Q3. June GDP growth of 6.5% gave us a glimpse into the future. Canada’s job gains continued for the fourth consecutive month. Unemployment numbers declined to 10.2% in August. Housing was another surprisingly resilient sector – July selling prices and transaction numbers broke records across the country.

The Bank of Canada is reviewing its monetary policy framework. It may follow the U.S. Federal Reserve and allow inflation to climb a little before it increases interest rates.

New Finance Minister Chrystia Freeland will play a central role in forging a plan to rebuild our economy. Her ascent has been steady. She took the lead role as Canada’s representative in renegotiating the North American Free Trade Agreement and was elevated last year to Deputy Prime Minister. Quick to lay out priorities, she said that “all Canadians understand that the restart of our economy needs to be green. It also needs to be inclusive. And we need to focus very much on jobs and growth.”

United States – Political science

In the U.S., there’s a battle for head of the class. COVID-19, racial protests and the upcoming presidential election are all competing for attention. Everything else appears to be relegated to the rear seats.

Democratic candidate Joe Biden will face Republican President Donald Trump in the November 3 election. Although former Vice-President Biden has been leading in the polls, recent data indicate that his lead is shrinking. The market is not yet
convinced that Democrats will sweep both the presidential race and Congress. If this scenario were to play out, the expectation for higher taxes on corporations and high-income earners could create a headwind for equities. Because the election’s outcome is so uncertain, its impact on the economy is also unpredictable.

In a speech at the Jackson Hole Economic Policy Symposium, Federal Reserve Chair Jerome Powell signalled a major policy shift away from inflation targeting. He said the central bank will be more inclined to let inflation go higher than the standard 2% before hiking rates. This suggests easy monetary policy will continue and the Fed will be slower to act even if jobs numbers improve. Treasury yields increased and the yield curve steepened modestly following Chairman Powell’s speech as prospects for future inflation began to be priced into bonds.

U.S. stocks clocked new highs and remain firmly in positive territory for the year. The S&P 500 rose 7.2% in August, bringing year-to-date returns to almost 10%. Technology companies like Apple and Amazon fuelled the large-cap index. Yet, this impressive climb is dwarfed by lofty returns for the Nasdaq Composite, which hit record levels at the end of August. It rose 10% last month alone, bringing its returns to 32% so far this year.

U.S. stocks could also encounter headwinds when lawmakers return from summer recess to debate a new coronavirus stimulus package. If Congress fails to deliver additional relief measures, market sentiment could turn negative.

**Europe and the U.K. – Brainstorming for Brexit**
Recovery in Europe has been uneven across nations. A manufacturing recovery benefitted German and Italian economies, but other economies such as Spain and the U.K. have not fared as well. Germany’s large stimulus programs and reliance on the Chinese economy have propped up businesses and households. France and Spain experienced a resurgence in coronavirus cases after their economies re-opened. These mixed results were reflected in the performance of European equity markets. Germany posted 5% returns in August, while the U.K. stock market recorded just a 1.8% return. Eurozone inflation surprised to the downside, turning negative in August. A sputtering recovery means that the European Central Bank will probably have to step up its crisis response later this year.

Negotiations between the European Union and Britain produced only minor progress despite two full days of talks.

Both Downing Street and EU negotiators suggested that a negotiated Brexit deal grows less likely with each passing day.

**China – Passing with flying colours**
China is staging an impressive economic resurgence and remains on track for positive growth in 2020. Industrial production continues to lead the way with an increase of 4.8% in July compared to a year earlier. Exports jumped by a surprising 7.2% due to greater demand for medical supplies and improving global economies. Chinese equities responded favourably to the economic rebound and rose 2.7% (measured by the Shanghai Composite).

With the recovery starting to stabilize, China’s central bank announced that it would begin to tighten its monetary policy. Strength in the housing market was met with increased restrictions designed to deter real estate speculation. Chinese leader Xi Jinping laid out a major initiative to pivot China’s focus to a greater reliance on its own domestic economy. This comes at a time when the rest of the world is emerging from recession, and perhaps more significantly Sino-U.S. relations are blowing hot and cold.

The White House continues to introduce anti-China initiatives as Donald Trump stakes his re-election on a “tough on China” stance. While the trade deal appears intact, President Trump has indicated that he intends to curb the U.S. economic relationship with China by implementing plans to “impose tariffs on companies that desert America to create jobs in China and other countries.” Mr. Trump also said “we’ll hold China accountable for allowing the virus to spread around the world.”

**Japan – From Abenomics to economics**
Japanese equities remained resilient despite a surge of COVID-19 cases and an announcement that Prime Minister Shinzo Abe plans to step down. The Nikkei rewarded investors with a 6.6% return for August.

After eight years of leading the world’s third largest economy, Mr. Abe cited health reasons for his decision to resign. He will stay in office until a successor is chosen, likely sometime this month. Japan’s prime minister is most well-known for his “Abenomics” economic revival plan. Although his policies created jobs and lifted asset prices, economic growth remained elusive.

The Japanese economy contracted at a rate of 7.8% during Q2, the country’s worst reading since 1980 and the third
straight quarter of contraction. While this decline is significant, Japan’s economy has fared better than Western and European economies during the pandemic. The path to recovery, however, is much less clear for Japan. Private consumption, which accounts for approximately half of its GDP, fell 8.2% from April to June. Headwinds facing domestic spending are daunting: the virus continues to surge in larger metropolitan areas and the economy has been struggling with the impact of a 10% sales tax increase introduced last fall.

Our strategy
Markets are generally ignoring economic destruction caused by COVID-19. They are focused on economic recovery and the hope that a safe and effective COVID-19 vaccine will be ready sooner rather than later. Although a few large companies are dominating market returns, we can see early signs of increasing breadth in the recovery, namely the participation of financial and industrial stocks in the recent equity rally.

Our base case assumes that the recovery will continue modestly into Q4. Interest rates have risen only slightly and thus don’t have far to fall from these historically low levels. A vaccine remains a necessary precondition for a full economic recovery. Our positive view toward equities is intact but has recently moderated, given the level of optimism reflected in equity prices today. While the U.S. remains a preferred equity market, the relative outlook for Canada has brightened thanks to a hot housing market, improving economic growth, strength in oil prices and continued optimism for our dollar.

Nevertheless, risks remain. The U.S. election and potential controversy over the outcome are creating uncertainty. Other risks include the likelihood of COVID-19 cases increasing as students return to school and we all retreat indoors when temperatures fall.

The last word
Back to school typically stirs up a mix of competing emotions, especially in this pandemic year. A fresh start brings excitement, combined with nervousness about big unknowns – new teachers, new friends and new environments. The start of a new month for investors brings similar anxiety. New stories and events that will shape the outcome for our investments are also unpredictable unknowns. No matter how well we study markets and geopolitical events, we can expect a few pop quizzes that will test our mettle and challenge our perspective.

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