

## Q2 Market Commentary

July 9, 2021

The U.S. 10 Year Treasury note has fallen from 1.75% on March 31, 2021 to 1.33% this morning. This has been a sharp reversal after a steady climb over the past year from 0.61%. There is no clear consensus on the factors that have driven yields lower over the past three months. From our capital markets team perspective, they believe there is renewed concern that the delta variant, which is becoming the dominant strain, will slow down the 'reopening' process across the world. If this were the case, the market is signaling that earnings expectations are too high and not supported by current levels of valuations and that inflation is indeed transitory and risks falling back below 2%.

### U.S. 10 Year Treasury Rate since Jan.1.2020



The move in the U.S. 10 Year Treasury note has also been exaggerated by heavy positioning, summer liquidity (or lack thereof) and seasonality. When it comes to seasonality, the heatmap below illustrates the 10-year average basis points changes on a month over month basis. As

you can see, over the last 10 years the months of March through August show the treasury yield falling (excluding June), then picking up again in September through December. While this year has been a bit different with strength in the first three months of the year, the recent trend in April and May is consistent with the seasonal trend. Best guess is that in September we will have more confirmation that inflation is sticky at higher levels, the transitory camp will start to give up its position, and the Fed will be firmer on taper – all should lead to higher inflation expectations and higher yields.

### U.S. 10 Year Treasury Heatmap

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SN 232054 EDT GMT-4:00 H321-3239-0 21-Jun-2021 09:28:06

The post pandemic recovery has been characterized as a *'two steps forward, one step back'* process where the directions for the economy and markets would be upward but vulnerable to pullbacks. After a period of robust economic activity, the rate of economic growth has likely peaked. But by no means is the economic data signaling a severe slowdown or recessionary environment.

I believe the word *'transitory'* should not be applied to the path for inflation but more so for the recent drop in yields. Global markets have shown over the evolution of the covid pandemic that we are increasingly becoming better with dealing with momentary setbacks dictated by the virus. Over the medium to long term the fundamentals for the economy and markets

remain constructive with accommodative global central banks and a consumer willing to spend, supported by a strong balance sheet and increasing employment. It's reasonable to believe a strong economy will continue to put upward pressure on inflation and rates.

### **What are the implications for markets?**

**Equities:** Over the summer, the combination of a potentially less accommodative US Federal Reserve, a peak in economic growth and heightened valuation suggests a strong likelihood of choppy markets. However, the case remains that there is a historical amount of cash on the sidelines which makes it difficult for pullbacks to deepen into corrections or bear markets. In May, there was a pullback of roughly four percent before cash found itself coming off the sidelines. The ingredients remain in place for any pullback to be fleeting.

**Fixed Income:** Regardless of the short-term movements of the markets, I am always trying to understand where the balance of risk lies. When it comes to the current fixed income markets, you need to ask yourself, "what is the risk of being wrong?". If you are positioned with a shorter duration, and yields fall, you may gain a little on your fixed income investment. However, if you are positioned with a longer duration and yields rise, then you are at risk of having a negative return. Given the strong economic growth and what I believe is sustainable inflation above 2%, it is more likely that the 10-year Treasury yield trends higher over the next 12 months and not lower. For this reason, investors should continue to favour a shorter duration posture, with a tilt toward credit. The current drop in yields may offer another opportunity to readjust duration in fixed income portfolios.

### **Q2 Economic Environment Overview**

**Economic recovery:** The global economy led by the U.S. continues its gradual recovery—supported by economic reopening and COVID-19 vaccine distribution. Stronger consumption is expected through 2021 fueled by consumers with excess savings and pent-up demand for goods and services. The recovery ends as the services sector catches up to the manufacturing sector's recovery. In this environment, average market returns are expected during the next couple of years with some upside risk.

**Equity markets:** The S&P 500 gained 8.2% in the quarter. Similarly, the S&P/TSX Composite Index was up 7.8% for the same time. S&P/TSX Composite growth was partly due to high oil prices, which were up 24% in the last 3 months and 51% in the last 6 months. The global economic recovery is expected to bring continued high demand for commodities and crude, contributing to higher S&P/TSX profitability for the rest of the year. The MSCI World Index

**The United States:** The U.S. economy bottomed in the summer of 2020 and shifted from contraction to recovery. Since August, the U.S. ISM purchasing managers' index (PMI) shows a material increase in manufacturing activity on a month over month basis. Macro indicators suggest 2021 will see a strong earnings growth environment that may include a recovery back to 2019 levels, and even stronger growth with the release of pent-up demand and excess personal savings. Moving forward, equity markets often follow Newton's First Law of Motion—an object in motion, remains in motion. Historically, when the S&P 500 Index is up more than 20% in a 6-month period, there is a 48.6% chance it will be up more than 10% in the 6 months that follow. This is a 10% higher probability than the chance it will be up more than 10% in any 6-month period.

**Emerging markets:** In global markets, the MSCI EAFE index was up 4.4% in the second quarter. The International Monetary Fund projects that many regions around the world—especially emerging and developing Asia—could grow faster than the U.S. in 2021 and 2022. On a year-over-year basis, global exports for the 5 largest exporters in the world seem to be improving with China leading the way.

**Inflation:** In the near term, exceptionally low interest rates are likely to remain around the world. However, the Fed's monetary inflation coupled with the trillions in fiscal stimulus by the U.S. federal government has resulted in a steeper yield curve. In this environment, I believe credit does well and short duration bonds outperform longer duration bonds. Credit defaults will continue through the recovery due to the effect of COVID-19 lockdowns. In this regard, security selection and careful credit analysis is of paramount importance.