Cidel Asset Management

Looking Back

On A Quarter of Rallies & Uncertainty

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By Bill McKay, CFA, SVP, Head of Multi-Asset Class Investments

Global equity markets continued their upward trend in the third quarter. As the pace of coronavirus cases declined over the quarter, economies around the world gradually began to reopen and markets seemed to be focused on the normalization of earnings once the pandemic is behind us.

In the third quarter, the S&P 500 rose 8.9%, the TSX rose 4.7%, the MSCI AC World Index rose 8.1% and the MSCI Emerging Market Index rose 9.6%. This brings the equity market rallies from the low point in late March to just over 50% in the U.S. and just under 50% in the other regions. Given the steepness of the selloff in February and March, however, year-to-date returns are much more muted. For the first nine months of 2020, the S&P 500 leads the pack at returning 5.6% while the MSCI AC World was up 1.4% (with the U.S. providing the positive contribution and the non-U.S. components being negative). On a year-to-date basis, the TSX has returned -3.1% and the MSCI Emerging Market Index has returned -4.8%.

While the U.S. market is now positive on the year, the returns have been driven by a small number of large cap technology names. In comparison to the S&P 500's +5.6% returns year-to-date, the S&P 500 Equal Weight Index is actually -4.8% year-to-date. As this second index weighs every company equally, it essentially computes the average return of each of the 500 companies in the index. The dominance of technology company outperformance continues to be reflected in the extremes of relative performance of growth and value indices. In Q3, the MSCI AC World Value Index rose 3.9% while the MSCI AC Growth Index rose 11.7%. Further, while the MSCI AC World Index is marginally positive (up 1.4% to the end of September), the MSCI AC World Growth Index is up 18.9% and the MSCI AC World Value Index is down 14.6% over the same period. However, this is not just a sector effect of technology outperforming energy. Even when you control for sector weights, growth stocks have significantly outperformed value stocks even within their own sectors. While there are a variety of well documented reasons behind this, the relative valuation extremes between value and growth stocks has now exceeded that of the technology bubble of the late 1990s.

Interest rates were very stable over the quarter after the large moves earlier this year. In the U.S., the 10-year government bond yield ended September at 0.68%, not far off the 0.67% level at the end of June. Rates traded as low as 0.50% in the summer to as high as 0.75%. In Canada, the 10-year rate ended September at 0.56% after starting the quarter at 0.53%. Evidently, the markets are pricing in extended easy monetary policy and are not concerned with inflation or excessive debt issuance. From a return standpoint, investment grade bonds delivered muted returns on the back of low and stable rates, while high yield bonds did better as credit spreads tightened. For the quarter, the FTSE Canada Universe Bond Index was up 0.4%, bringing year-to-date returns to 8.0%. In the U.S., the Barclays Aggregate Bond Index was up 0.6% in the quarter and 6.8% year-to-date. High yield bonds performed better, up 4.3% in the quarter, but given their steep selloff earlier in the year are still down 1.1% on the year.

When analyzing commodities, oil prices were very stable over the quarter, trending around the $40 level the majority of the time - a substantial difference from the massive swings witnessed in the second quarter. The commodity that got many investors' attention during the quarter was gold, which rallied over $300 per ounce from early July to early August before selling off a bit towards the end of the quarter. . In a world of low rates, increased government spending and tolerance for growing deficits, gold has again garnered attention as a substitute currency.

On the traditional currency side, the U.S. dollar continued to weaken against most other currencies, consistent with the rally in risk assets and typical currency behavior in that environment. The Canadian dollar ended the quarter at around 1.33, rallying from the 1.36 level at the end of June.

If you surveyed investors in late March on the likelihood of markets being 50% higher 6 months from then, you probably wouldn't have found a single person who would have agreed with that statement. In fact, you may have found more people betting markets could be 50% lower given the scale of the pandemic and the potential economic collapse. However, markets are a forward-looking mechanism that discount cash flows and returns far into the future and convert them into a value today. In that context, while the scale of economic decline was massive, it was also temporary and its effect on cash flows far into the future is minimal (compared to what it feels like at the time). It is undeniable, however, that there are risks on the immediate horizon, from a second wave of the virus that is clearly taking root now, to an upcoming U.S. presidential election that has a strong likelihood of not having a clear victor on election night. Simply put, there are dynamic factors that can disrupt this ongoing market rally and indeed cause a pullback. In keeping with our investment philosophy, our current positioning is not to be underweight equities given that there are enough positive fundamentals in place ranging from immense economic stimulus still to come to the ongoing gradual recovery as the global economy emerges from this pandemic.