Cidel Asset Management

Looking Back

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Interest Rates and Valuations

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Equity markets were slightly positive overall in the third quarter, albeit with plenty of volatility along the way. During this period, the S&P 500, TSX and MSCI World indexes were up 1.7%, 2.5%, and 0.5% respectively, while the MSCI Emerging Markets Index fell 4.3%. A strengthening U.S. dollar alongside rising recessionary concerns weighed more heavily on emerging market equities than on developed market equities. After being driven by the strong outperformance of U.S. large-cap growth stocks for many years, the S&P 500 finally saw some underperformance of growth/ momentum stocks as value stocks outperformed in the third quarter of 2019. Despite this recent outperformance of value stocks, the relative valuations remain at extremes not seen since the dot-com bust in the early 2000s.

The key drivers of market movement once again largely came from the macro side, led by U.S. and China trade concerns, slowing economic data (particularly on the manufacturing side), and increased recessionary concerns in the United States and Europe. There were also increased concerns on the political front, with rising impeachment risk in the U.S. and the increased likelihood of a hard Brexit scenario in the U.K. The IMF lowered its growth forecast again in the third quarter from 3.3% to 3.2%, expecting growth to rebound to 3.5% in 2020 (a reduction from the previous forecast of 3.6%).

The perceived health of the American consumer continues to be one bright spot; unemployment is extremely low, wage gains are relatively healthy and continue to increase and household balance sheets are in very good shape.

In the fixed income market, interest rates continued to fall in the third quarter. The 10-year U.S. government bond yield fell from 2.01% at the end of June to 1.45% in early September (only 0.1% away from the all-time low seen in 2016); it then rebounded slightly to end the quarter at 1.66%. In Canada, the 10-year rate fell from 1.47% at the end of June to 1.09% in mid-August (similarly, approximately 0.1% away from the all-time 2016 low), then ended the quarter at 1.36%. Compared to the fourth quarter of 2018, 10-year rates in the U.S. and Canada have been roughly cut in half. Further, developed markets outside of North America have experienced interest rate declines into negative territory, as seen with 10-year German bonds now yielding -0.57%.

From a performance standpoint, Canadian investment grade bonds returned 7.8% year-to-date, and U.S. investment grade bonds returned 8.5% year-to-date. While these are very strong numbers over a nine-month period, investors should lower their expectations regarding returns going forward, given the lower yields we have already witnessed.

Overall, the third quarter felt like an extension of the second quarter, with bonds doing well on the back of a slowing global economy, and significant rate cut expectations being priced into the market and equities performing well on the back of more accommodative monetary policy expectations and generally reasonable valuations.

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