MARKET SPOTLIGHT - JUNE 2020

The reopening and the rally

Over the past six weeks, Canada, the U.S. and Europe cautiously took first steps to reopen their economies, as other global regions emerged as the new pandemic hotspots. Some global equity markets surprised with their strong comebacks and the oil market staged a turnaround to push back towards $40/barrel. Central banks stand ready to provide more support, as reports show economies plummeted as dramatically as forecasters had predicted.

In this edition, we try to put stronger equity and commodity prices in perspective and look at the chances we'll be seeing negative interest rates in the coming months.

The new reality

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The U.S. equity market recovered so quickly over the past two months that the Nasdaq Composite is now positive year-to-date—remarkably, this index achieved a record high in early June. While other foreign markets have lagged, perhaps providing opportunities, some may wonder whether this rally is justified. Are investors acting with blind optimism after some good news on pandemic containment and small steps towards the reopening of some economies?

Whether stocks can sustain and add to gains from here depends on a number of factors. There are massive amounts of monetary and fiscal stimulus acting on the economy and we don't see the inflation pressures that would require those to be withdrawn in the near term. From a flow of assets standpoint, the search for yield is likely to send some investors into the equity market, especially when considering the unattractive alternative of government bond yields near 0%. The technology sector especially stands to benefit from new restrictions on mobility—work-from-home solutions and virtual entertainment are two conspicuous examples. This sector now comprises a large percentage of many U.S. and international stock indices. Additionally, if this recession is dramatic but short-lived, likely the shortest in history, this brief period of enforced "non-spending" could fuel strong consumer demand once a semi-normal environment is reestablished.

Of course, there are also negatives in the current situation, even if this pandemic could be erased overnight. Valuation levels for global equities are not cheap and U.S. equities are especially pricey. Companies may see some new efficiencies from cost reductions instituted during the lockdown (work-from-home is the most visible example). But this improvement is a one-time phenomenon, while organic revenue growth could be hard to come by over the next several years. Higher corporate valuations are justified when interest rates decline, but this again is a one-time event, unless rates move even lower from here.

Market psychology seems to have shifted quickly and many investors are jumping in, worried about missing out. Others are standing on the sidelines, scratching their heads when considering the improving but still dismal jobs data and the uncertainties of social unrest and a U.S. presidential election in November. This rally may continue, but will undoubtedly face numerous speed bumps along the way. As always, we recommend a long-term perspective, geographic and asset class diversification, and some portfolio hedges to smooth the journey as much as possible.

Will interest rates go negative?

Vincent Lépine
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Negative policy rates[1] are back in the spotlight. Is this the logical next step for the Bank of Canada (BoC) or the U.S. Federal Reserve? In our opinion, the BoC won't move policy rates into negative territory because there are other better-suited policy options at its disposal, if eventually needed.

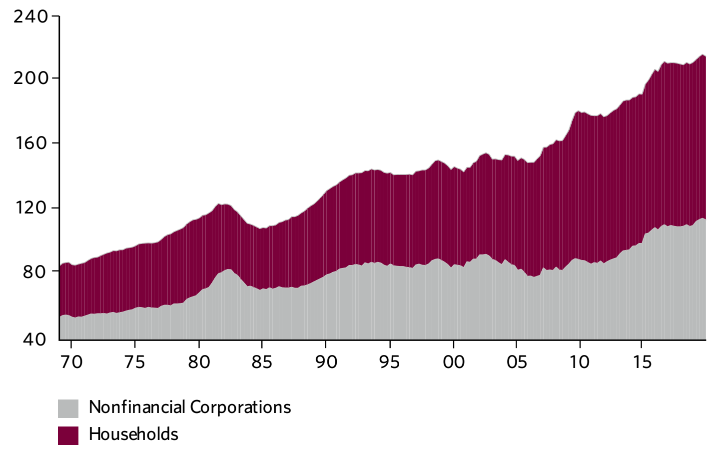
The short-term liquidity injection from the BoC has produced a significant easing in bank funding pressure, but more support to Canadian banks will likely be needed. Even with the current credit-support measures, the BoC expects the peak in non-performing loans to be higher than in 2003 and 2010.

The challenges for the Bank of Canada are very much like the ones the Swedish Riksbank is facing. In both countries, the debt load of the private sector has reached record highs. Such a heavy debt load is manageable as long as the good times continue to roll, but becomes problematic in a recession. Especially during a very severe economic downturn and an already flat-to-inverted yield curve, negative policy rates would have an adverse effect on the balance sheets of commercial banks. The European experience shows that banks can't offer negative rates on deposits, as this potentially leads to a run on the bank as depositors move their money out of the banking system. Only commercial banks would end up paying negative rates to the central bank on the excess reserves it holds with them—not an attractive option for the commercial banks.

A better solution for central banks is to implement a long-term bank lending scheme with ultra-easy lending conditions. This is what the European Central Bank and the Swedish Riksbank have been doing recently with their TLTRO[2] program.

Canada's heavy private sector debt load

Canadian household and non-financial corporate debt to GDP (%)



Source: BIS (Bureau of International Settlement)

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[1] The interest rate set by central banks.
[2] Targeted Longer-Term Refinancing Operations

Oil's wild ride

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Oil prices have been on a wild ride over the last two months, falling briefly into negative territory in April but moving back towards $40/barrel in mid-June. At this point, we've seen improvements in both the supply and demand pictures, with U.S. demand beginning to recover from pandemic-induced depths. Overall, we're fairly optimistic about the outlook for stable to higher oil prices in 2021 and beyond.

U.S. gasoline demand, which stood at about 10M barrels/day pre-COVID but dropped to 6M, has now rebounded to 8.3M, cutting the decline by more than half. China, which is about 3 months ahead of the U.S. and Europe in its pandemic progression, is back to pre-pandemic levels for energy demand; we're also seeing a rebound in demand for other commodities in China. Of course, this is an easier feat to accomplish in an economy largely mandated and controlled by a central government.

On the supply side, the OPEC meeting on June 6 extended existing production cuts by another month, to the end of July. In contrast to the drama at the last OPEC meeting, member countries seem to have coordinated strategy before the meeting, and it concluded with a relatively straightforward announcement. OPEC will be monitoring member compliance on a monthly basis, as members Iraq and Nigeria have not been meeting agreed-upon reduction levels. These extended cuts will offset new supply that Canadian and U.S. producers brought back in May and June as prices rallied and production was once more at least a break-even proposition.