2021 Second Quarter Review

With over three billion doses having been administered worldwide, vaccine campaigns are well underway and remain at the forefront in the fight against the pandemic. Global equity markets continue to build momentum as economies reopen and restrictions ease. While most developed countries are making significant progress in combating COVID-19, other developing and emerging market countries have not fared as well, especially where vaccines are in short supply and the delta variant is present.

The Canadian economy commenced the second quarter with persistent lockdown restrictions and a slow vaccine rollout. These factors contributed to real GDP falling by 0.3% for the first time after 11 months of growth. Since then, the vaccine campaign has gained momentum and restrictions have eased. Spending on accommodation, clothing, and food has rebounded as provinces started to reopen. Canadian equities, as measured by the S&P/TSX Composite Index, returned 8.5% this quarter and an impressive 17.3% year to date, marking its best performance in over a decade. Performance was driven by the information technology and energy sectors, the latter being lifted by the surge in oil prices.

The US Federal Reserve announced its decision to keep the lending rate unchanged, holding the target range at 0% to 0.25%. Data in the month of June supports improvements in the labour market as 850,000 jobs were added, beating expectations despite unemployment levels marginally rising 0.1% to 5.9%. Overall, this is a positive indicator; with stimulus programs ending and wages rising to compete for scarce workers, an acceleration of workers rejoining the labour force is expected in the coming months. The S&P 500, a broad measure of the five hundred largest US companies, returned 7.1% (CAD) for the quarter.

Internationally, despite being up for the year, developed and emerging market stocks underperformed relative to Canadian and US stocks, returning 3.8% (CAD) and 4.1% (CAD) for the quarter, respectively. Chinese stocks, rattled by debt problems, slowed credit growth, and tougher regulations by authorities, have returned only 1.8% (USD) year to date as measured by the MSCI China Index. It is the worst first-half performance for Chinese stocks in eight years.

Global bond yields remained relatively flat from last quarter despite a pickup in inflation. The US Federal Reserve pushed up its anticipated timeline on when to increase interest rates but did not signal any slowdown on its aggressive bond-buying program. Similarly, the Bank of Canada tapered its quantitative easing efforts only slightly, which helps keep interest rates low. A basket of short-term Canadian government bonds returned 0.1% for the quarter.

Following are the returns for major indices for the period ended June 30, 2021:

	Q2 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short Term (FTSE 30-Day T-Bill)	0.0	0.0	0.1	1.0	0.9	0.9
Canadian Bonds (FTSE Short-Term Bond)	0.1	-0.5	0.7	3.1	1.9	2.3
Canadian Stocks (S&P/TSX Composite)	8.5	17.3	33.9	10.8	10.8	7.4
US Stocks (S&P 500)	7.1	12.1	28.3	16.4	16.5	17.8
Non-North American Dev. Stocks (EAFE)	3.8	5.9	20.6	6.2	9.2	8.6
Emerging Markets Stocks (FTSE / MSCI Emerging)*	4.1	5.9	26.9	9.4	11.0	7.0

* Q2, YTD, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

Outlook

Looking forward to the second half of the year, there is growing optimism that vaccines are a very effective tool in the world's fight against COVID-19. Evidence from countries far along in their vaccination campaigns shows promising results where a large proportion of the population has received two doses. However, waning vaccine uptake, equity and access issues, and the emergence of more transmissible variants such as delta are all headwinds on the path to normalcy. The next several months will be very informing as to the trajectory of the recovery.

If the positives outweigh the negatives on the virus front, this will be welcomed by stocks that are poised to do better with an opening economy. This includes the in-person retail, travel and leisure, financial services, real estate, and energy sectors. These areas have strong representation in Canadian and overseas markets. Conversely, if it becomes clear that ongoing complications in dealing with COVID-19 will persist, then the "stay-at-home" segment of the market is likely to gain more attention. This includes the technology, communication services, online retail, health care, and consumer staples sectors. These areas in aggregate make up almost 60% of the US market.

At this time, developed markets are making some significant headway against COVID-19. A by-product of this is rising inflation, as recent figures have shown significant year-over-year price growth that can be attributed to a combination of (a) increased demand due to a resurgence in economic activity with restrictions being lifted and (b) retailers contending with supply chain issues. There continues to be a wide range of opinion regarding the future direction of inflation and interest rates in coming years, with highly respected economists and strategists on both sides of the debate. The inflation hawks argue that the unprecedented central bank policies and massive government debt levels can only lead to higher inflation in the future, while others argue that inflation will moderate in coming years once the initial economic surge from the pandemic reopening subsides. In their view, an aging population in China and in most developed countries combined with continued technological advancements will keep a lid on prices.

The US Federal Reserve believes any near-term inflationary pressure to be transitory in nature, as it expects the game of supply-and-demand catch-up to return to equilibrium at some point in the near future. Also, a drop in June of a key inflation indicator that measures the difference between treasury yields and inflation-indexed bonds is a signal that inflation fears have subsided, in agreement with the Fed's sentiments. However, market participants will be closely watching to see if future hot inflation readings will force the Fed's hand to raise interest rates at a faster pace than anticipated—earlier than the two possible hikes expected by 2023.

Low interest rates have helped the world's stock markets continue to break through all-time highs, and at these levels there is little room for error in valuations. So news on a meaningful change in rate policy could be a market-moving event, as investors might adjust their allocations accordingly. Certain segments of the market are more sensitive to rising rates, such as growth-oriented and emerging market stocks—companies that are more likely to rely on debt. These types of holdings may be trimmed in a rising-rates environment in favour of stocks that could offer a better outcome through inflation, along with a possible bump to fixed income holdings if relative yields become more attractive. The opposite could be true if inflation proves not to be a permanent concern. Persistent low rates would also likely continue to support interest in dividend-paying investments as an alternative to low-yielding bonds.

Portfolio Strategy

At Milestone, we do not try to forecast outcomes but rather focus on a disciplined, well-diversified strategy based on each client's objectives that balances return expectations within acceptable risk tolerance levels. While there is debate about the future direction of interest rates, the current levels remain historically low. In portfolios, we have been modestly increasing exposure to short-term corporate bonds where appropriate to enhance yield over government bonds. We avoid higher-yield junk bonds, as their returns are too highly correlated to equity markets. They typically perform well when stocks are rising, but they also have significant downside when equity markets fall and therefore provide limited diversification benefits. The current yield spread between high-yield and government bonds is also at historically low levels, meaning investors do not receive much compensation for the added risk, particularly after tax. Our bond portfolios are also heavily tilted to shorter-term issues, which reduces term risk in portfolios. Longer-term bonds are more sensitive to changes in interest rates and will decline more in value in a period of rising interest rates.

Within equities, we are becoming somewhat more cautious given the high returns year to date along with the uncertainty over central bank policy. Canadian stocks have been very strong this year, so we are typically trimming exposure to broad-based Canadian equity market positions and US stocks to either rebalance within the equity component or add to fixed income allocations. Within Canada, we continue to have a preference for dividend exposure in the current rate environment as opposed to the more cyclical commodity exposure.

Overall, equity markets are reasonably valued given the current interest rate environment. Central banks view the recent higher inflation figures as transitory, and so far the bond market agrees, with the yield on widely followed US 10-year treasury bonds falling from 1.75% to 1.40% in the past three months. This has provided a foundation for strong equity gains. Stocks may face some near-term headwinds, though, if this sentiment changes or if the delta variant gains more of a foothold and further delays the economic reopening in North America and Europe.