2021 Third Quarter Review

Major stock indices hit new highs in the third quarter of 2021 before pulling back in the month of September. The S&P/TSX Composite and S&P 500 indices neared 20,900 points and 4,550 points, respectively, but both later fell as risks to the global recovery overshadowed the investor optimism that had buoyed stocks earlier in the summer. The global vaccine rollout, with vaccines now mandated for segments of the population, has played a vital role in the fight against COVID-19, but investors were unnerved in evaluating the economic impact the highly contagious delta variant might have as we continue our battle against the virus.

Canadian stock performance, as measured by the S&P/TSX Composite Index, was mostly flat in the third quarter, returning 0.2%, but still posted strong returns for the year to date, adding 17.5%. The **resource-heavy Canadian economy was supported by rising commodity prices**, specifically oil and natural gas, from ongoing supply chain woes. Canadians took to the polls to vote in a federal election that resulted in the status quo of a minority Liberal government being maintained. As was expected, the Bank of Canada held its policy rate at 0.25%.

South of the border, US stocks remained strong, with the S&P 500 Index, a broad measure of the 500 largest companies in the US, up 2.8% (CAD) in Q3 and 15.2% (CAD) year to date. The US government narrowly avoided another shutdown at the end of September while the Biden administration worked to pass its **proposed US$1 trillion infrastructure bill and a US$3.5 trillion plan to address social services and the climate crisis**. The US Federal Reserve maintained its key lending rate in the range of 0% to 0.25%.

The Chinese economy is dealing with both a cash and a power crunch. Evergrande, China's second-largest real estate developer, was unable to meet one of several upcoming short-term debt obligations, sending its stock 80% lower. Meanwhile, a supply/demand imbalance in China's coal-mining production has created a power crunch in the country. Emerging market stocks returned -4.3% (CAD) while developed market stocks returned 1.7% (CAD) in the third quarter.

The possibility that inflation may last longer than anticipated because of supply imbalances sent global bond yields higher, with 10-year US Treasury Bills breaking back above 1.5%. The Fed did not announce when tapering will commence but suggested it could happen later this fall once existing political issues have been resolved. The Bank of Canada continues to add stimulus through quantitative easing at a slower pace. A basket of short-term Canadian government bonds remained flat and returned 0.1% for the quarter.

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

	Q3 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	0.1	0.1	0.9	0.9	0.8
Canadian Bonds (FTSE Short-Term Bond)	0.1	-0.4	0.0	3.1	1.9	2.1
Canadian Stocks (S&P/TSX Composite)	0.2	17.5	28.0	11.1	9.6	8.8
US Stocks (S&P 500)	2.8	15.2	23.7	15.2	16.1	19.0
Non-North American Dev. Stocks (EAFE)	1.7	7.7	19.6	6.9	8.1	10.3
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-4.3	1.4	13.6	9.2	8.2	8.2

* Q3, 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

Entering the final quarter of 2021, global equity markets will continue to contend with a myriad of risk factors as they try to shake off a challenging end to Q3. These include **concerns over inflation, labour shortages, ongoing supply chain imbalances, less-accommodative central bank policies, slowing economic growth due to COVID-19's delta variant, and issues with China's economy**. With stock price levels as high as they have been, there is little room for error in valuations. Volatility is therefore to be expected as investors react to market-moving information in the coming months.

Seasoned investors know that the possibility of a stock market correction is always around the corner, and many financial pundits have been discussing the likelihood of one in the near term given the headwinds the markets are currently facing. **Historically, market declines of 10% have occurred almost every year, while more severe drops of 20% have happened every three years**. No matter the landscape, a pullback of either degree is par for the course in the world of investing, as is a subsequent recovery. We think it's important to remind our clients of these points, as it helps to maintain discipline through difficult periods.

Any sell-off in the near term, though, is likely to be tempered by the current low interest rate environment. **Low yields on lower-risk investments such as bonds, high-interest savings accounts, and GICs have made it difficult for investors to find alternatives to the equity markets** to earn a respectable return. As a result, if rates stay low, equities—particularly those that pay relatively attractive dividends—should remain in demand.

We expect **interest rates to eventually go up**, as they are linked to inflation and the cost of living. In the meantime, however, investors will need to get used to low returns in the low-risk bucket of their portfolio. That said, the **allocation to low-risk holdings can also be viewed as an insurance policy**, as these assets provide a reliable funding source for both expected and unexpected needs as they arise as well as dry powder for investment opportunities that may come up.

Markets will also likely react positively if trends improve on the COVID-19 front. The delta variant—among other issues such as vaccine hesitancy and access problems as well as inconsistent public health measures to combat the virus—have prolonged the pandemic and dampened the outlook for a rapid economic recovery. Investors would, of course, welcome any news that could expedite a return to a more normal life. This could come in the form of greater vaccine uptake, approval of vaccines for children under 12, announcements of effective treatments, and/or indications that infections and hospitalization numbers are falling.

Stocks that would benefit the most from these developments are those in industries that were heavily impacted by COVID-19, such as **travel and leisure, in-person retail, real estate, and energy**. These companies, many of which are classified as value investments, had been performing well this year when compared to growth-oriented technology holdings until the emergence of the delta variant threatened to delay the economic reopening. If the recovery from COVID-19 begins to accelerate again, value companies may outperform relatively expensive growth stocks. Regionally, both Canadian and overseas markets have a greater proportion of these value investment opportunities than the tech-heavy US market.

Despite weakening in September, **stock market returns have significantly outpaced bonds over the past year and in all periods over the past 10 years**. While it is normal for stocks to deliver higher rates of return over longer time periods, the degree of outperformance has been wider than normal. This is due in large part to the unprecedented action of central banks keeping interest rates at historically low levels. Over long periods of time, the expected rate of return for stocks over bonds has been about 5% per year. In the past year, this return premium is closer to 20%, and over the past 10 years it is in the 7% range per year on average. It has been significantly higher in the US market.

Given the outperformance of stocks and current valuation levels, we remain cautious on equities given some of the risks on the horizon. We continue to favour dividend-paying stocks in Canada in the current low-rate environment. Even if interest rates drift modestly higher in the next year, dividend yields in the 4% range are still attractive compared to bonds. The Canadian stock market has been the best performer so far this year, and this trend could continue if inflation expectations continue to build. The US market, while lagging Canada year to date, has had by far the best returns over the past five and 10 years, so we continue to reduce overweighted positions as appropriate.

In the fixed income component, returns remain very low given the current rate environment. While rates are expected to drift higher next year, we continue to **focus primarily on short-term bonds maturing within the next five years to protect capital**. We have also been increasing short-term corporate bond exposure in portfolios to modestly enhance yield.

Overall, we expect **continued volatility** in the months ahead until the path for interest rates becomes clearer as we emerge from the pandemic. In time, the gap between equity and bond returns should decline to normal levels, as the more recent equity premium is not sustainable on a long-term basis. Given the current high equity valuations, we will most likely **see returns moderate in the future with higher interest rates** as central banks gradually tighten monetary policy.