Equitable
Asset Management Group

Market Comments

July 17, 2023

Rates & Credit - The rates market was volatile in Q2 as investors focused on inflation, central bank interest rate decisions, and recession probabilities. Persistent strength in U.S. consumer spending and labour markets have surprised investors and prompted further interest rate tightening from central banks. In Canada, corporate bonds outperformed government bonds and the broader FTSE Canada Universe Index during the quarter, with a total return of 0.2%, versus a loss of 1.0% for government bonds and 0.7% for the overall Index. The corporate bond outperformance was driven by a broad risk-on tone to the market, most notably in April as the market recovered from the banking sector liquidity crisis that developed during March. That said, the market tone remained cautious, with the improved risk premium on corporate bonds tempered by lingering concerns around sticky inflation, high interest rates, and the potential for slower economic growth into the latter half of the year.

Dominance of U.S. Equities – U.S. equity markets posted another strong quarter with the S&P 500 returning 8.7%, outperforming Canada and other major international equity markets. The S&P/TSX Composite, returned 1.2% in CAD. Major developed economies from Europe, Australasia, and Far East (EAFE) returned 3.2% in local currency terms. The highly anticipated re-opening of the Chinese economy has failed to materialize with economic data indicating less strength than previously forecasted. Amid sluggish Chinese growth, closely interconnected economic partners such as the European Union, as well as commodity-driven markets like Canada, have all underperformed the U.S. on a relative basis.

U.S. Fundamentals – Earnings continued to contract versus prior year, albeit at a slower pace than forecasted. Forward earnings guidance improved quarter-over-quarter with corporate sentiment returning to neutral levels. Based on our analysis, we observed that 31% of major companies expect deteriorating financial performance, while 33% expect improved performance, with the remaining expecting no material change. Overall, major U.S. companies remain well capitalized with strong operating margins. However, company guidance indicates a prioritization of cost controls amid increased consumer indebtedness and concerns about the health of the consumer.

Artificial Intelligence (AI) Mania – Despite concerns that the U.S. economy is at a late stage in its economic cycle, that monetary tightening by central banks could go too far, and the fact that earnings contracted on a year-over-year basis, equity markets became more expensive during the quarter with price-to-earnings multiples expanding. This expansion was driven by investors crowding into AI focused technology companies, with the seven largest AI/technology themed companies averaging a 26% return while the other 493 members gained only 3%. Investors rewarded businesses with contributions to AI development (hardware and software components), as well as those with the ability to implement synergies from leveraging the technology. A crowded market surge is not uncommon at this point in the economic cycle, where positive economic surprises, in this instance, strong employment and consumer spending can lead to an upswelling in investor confidence.

U.S. Quant Factors – Using our investment framework, we currently favour exposures to large cash-rich companies with innovative product offerings, which we believe offer the strongest risk-adjusted returns in the current market environment. While the valuation of AI companies seems to defy traditional rationales, the momentum has continued to push the group higher. Consequently, the Quality factor (companies with higher return-on-equity, strong operating performance, and healthy leverage levels) participated in the AI trend and consistently outperformed throughout the quarter. The Low Volatility factor (stocks with lower sensitivity to broad market movement, and lower price volatility) underperformed through the quarter. While the Low Volatility factor typically performs well at this stage of the economic cycle, the fact that a small number of stocks were responsible for much of the market's return hurt this factor. Lastly, the Momentum factor (stocks with a recent history of price appreciation) initially underperformed during the quarter before rebounding in June. This factor's recent outperformance suggests that the market is becoming complacent and possibly signals that rotations within the market are slowing as current trends remain in favour.

Canadian Fundamentals – Top line revenue missed forecasts while bottom line earnings were consistent with expectations. Softer-than-expected results out of Canadian financials, as well as underwhelming results from the materials sector, dragged on the aggregate index performance. Earnings forecasts for the rest of the year have been revised downward with analyst expecting index aggregate earnings to detract 2% to 3%. Meanwhile, the Bank of Canada raised its overnight interest rate by 25 basis points, bringing it to 4.75% on the backdrop of robust economic data releases including Q1 GDP and April CPI.

Canadian Quant Factors – The most notable dislocation in Canada was the convergence of the dividend yield of High-Dividend ETFs and Equal-Weight Bank ETFs. We believe that the drag from Canadian banks following the U.S. regional banking concerns in March resulted in a discount of the Quality factor as the performance of the group is sensitive to the movements of banks. While banks did recover around 35% of their SVB-induced underperformance, the nature of banking has attracted investor scrutiny given the view that we are in the late-stage of the economic cycle. That said, this environment is an attractive environment to add variants of the Quality factor, which would gain exposure to a rebounding industry that offers a similar dividend yield to the high dividend stocks.

Views From the Frontline

Rates – On an outright basis, bond yields across the curve continue to look attractive. Economic data remains strong however we are beginning to see the first signs of weakness in spending, jobs and inflation. Slower growth, a more balanced labour market, declining inflation, and tighter credit conditions will likely drive interest rates lower throughout 2023. Market participants remain focused on the extent of interest rate hikes and the duration of a pause required to bring inflation back to the 2% target. With inflation remaining more persistent than previously expected forecasts around the timing, pace and extent of the removal of monetary policy have been pushed into 2024.

Credit – The uncertain economic outlook and risks around slower economic growth later this year merit caution about corporate bonds and a bias towards higher-quality, shorter-dated credit where we think the risk / reward dynamic are more favourable. That said, the “soft-landing” narrative, now more pervasive in the market, could continue to provide support to risk assets, which we view as an opportunity to further pare down higher beta exposure.

Equities – Given the direction of the current economic and company fundamental data, we continue to favour high quality growth segments of the market with strong operating margins. As such, the late cycle conditions in the market reinforce our preference for large cap stocks over smaller, more U.S. domestically focused businesses. The U.S. Low Volatility factor’s underperformance is unlikely to reverse in the short term given the resilience of the U.S. economy. Furthermore, after a steep decline last quarter, we expect that cyclical value will find support in the near term, echoing the increased chance of slowing inflation without stalling economic growth. In Canada, equities are typically more cyclical in nature, which coupled with the potential for an earnings contraction, makes us view the Low Volatility factor as more likely to outperform. Like the U.S., we prefer Canadian high-quality companies to navigate through the late cycle environment. On the heels of poor Chinese economic data and underwhelming stimulus, we are maintaining our overweight to the U.S. relative to Canada and EAFE.