Global Markets Commentary
A Wild Crossing

BMO Private Investment Counsel Inc. | April 2021

Trinity: "Neo, no one has ever done anything like this."
Neo: "That's why it's going to work."
The Matrix, Warner Brothers Pictures, March 1999

Banff's famed wildlife overpasses that span the Trans-Canada Highway have reduced animal mortality rates from motor vehicle collisions by 80% and restored critical migration routes for many species in the national park. A series of innovative bridges, which are covered by trees and foliage, and underpasses keep motorists and wildlife safe.

Our crossing network for critters has become an international conservation success story – despite a rocky start in the mid-90s when this was an unproven and widely criticized concept. Delegations from around the world visit Alberta to study its success, and countries continue to adopt our model. With spring's arrival, animal mothers are using these camouflaged passages to usher their young to safety.

During the last 12 months, global economies also built bridges to navigate around the COVID-19 crisis. Until mass vaccinations provide more safety, we must rely on a variety of public health, monetary and fiscal strategies to fill the gap. On March 11, 2020, the World Health Organization declared COVID-19 a pandemic. On March 23, 2020, equity markets bottomed out. One year later, we are on the road to a global recovery.

It hasn't been a smooth journey. Q1 of 2021 saw a raft of dramatic events, including run-off U.S. Senate elections with massive policy implications, a Reddit-fuelled rally in volatile stocks, disruptions from extreme weather in the U.S., an epic Suez Canal traffic jam that cost billions in lost trade, and an uneven rollout of vaccines internationally.

Overall, most equity markets are up solidly for Q1 of 2021, and very significantly from their March 2020 lows. Bond yields continue to climb on inflation concerns.

Canada – A foot on the bridge

Last month marked the one-year anniversary of Canada's pandemic lockdown. To date, this country has surpassed one million COVID-19 cases and approximately 23,000 deaths. Ottawa plans to complete its mass vaccination effort by September. At the end of March, about 13% of the Canadian population had received at least one vaccine dose.

Canadian equities continued to break records against a backdrop of improving economics and low interest rates. The S&P/TSX Index returned 3.94% in March and is up 8.13% for Q1. Telecom, consumer staples and, most recently, energy led the way. Commodity prices continue to fluctuate. Oil gained after a skyscraper-sized vessel ran aground and for six days blocked Egypt's Suez Canal, an artery for approximately 30% of daily global container shipping. A resulting disruption in oil supply gave our energy sector a short-term boost. Conversely, technology continued to lag.

The Bank of Canada (BoC) announced it will wind down some of its pandemic programs, given improved market conditions, and held interest rates at 25 basis points. Its goal is to support the broader economy as the near-term outlook improves. Inflation sits at 1.1%, which is at the low end of the target band of 1% to 3%, but is likely to temporarily edge closer to 3% this spring, says the BoC.

Low interest rates continued to fire up home prices. Economists are now raising red flags about a potentially overheated real estate market. Although the BoC is unlikely to move rates any time soon, the bond market is adjusting quickly. Yield on the five-year bond, a benchmark for most long-term mortgage rates, rose above 100 basis points, having increased 63 basis points for the quarter. We can expect mortgage rates to climb.

Improved bond yields and oil prices continue to support our loonie.

United States – Crossing the bridge

As vaccines roll out at a rapid pace in the U.S., prospects for a return to something like normal this summer have significantly increased. In March, President Joe Biden promised to have enough vaccines for all U.S. adults by the end of May. By the end of March, almost 30% of the population had received at least one shot. On March 31, roughly 69,000 new cases were reported (up 12% over the last seven days), although that's still far below January's daily tally of 300,000.

Declining virus infections lifted the labour market outlook, prompting the U.S. Federal Reserve to anticipate stronger economic growth this year. Federal Reserve Chair Jerome Powell forecast a 6.5% growth rate for 2021, up from 4.2% predicted in December, the fastest rate in 40 years. The central bank said it will wait until there is a broader recovery before it hikes interest rates or pares back bond purchases. Sectors such as leisure and hospitality remain weak, and the economic fallout has disproportionately affected minority and low-wage earners.

Some market watchers are concerned that the economy could overheat and inflation rise. The Fed projects that inflation will hit 2.4% in 2021, far above an earlier estimate of 1.8%, although it believes the upswing will be temporary. Increased prospects for inflation prompted yield on the 10-year note to climb significantly: at one point in March, it rose above 1.7%. The broad-based S&P 500 Index finished up 4.39% for the month and 6.18% for quarter. On Wall Street, we saw a continued rotation out of high-flying growth stocks toward (unloved until recently) value-oriented companies.

On the geopolitical front, President Biden took a tough stance against China and Russia. Moscow and Beijing fired back, setting the stage for increased tensions.

Europe and the U.K. – Not burning bridges

The European Central Bank (ECB) raised its GDP forecast to 4.0% from 3.9%, and inflation expectation to 1.5% from 1% after a firm recovery in Q4 of 2020. Productivity improvements, manufacturing growth and a rebound in export demand played a large role. This forecast depends heavily on how the pandemic, vaccination rates and removal of lockdowns evolve. While the near-term outlook for economic activity remains weak, market watchers are optimistic that a normal economic environment will return in early 2022. Government bond yields crept up when markets started to look past some pandemic concerns. The ECB pledged to step up its pace of stimulus to keep borrowing costs low and support the recovery.

Member states of the European Union have been slow to deploy COVID-19 vaccinations, largely due to supply constraints. Meanwhile, the U.K. has the highest vaccination rate among major economies. The U.K. saw its economic leading indicators, such as the Purchasing Managers' Index, improve while those in Europe lagged. Vaccine shortages on the continent created tensions between the recently divorced U.K. and EU.

Brexit continues to weigh heavily on businesses in the region. In March, equity markets remained in flux. The FTSE 100 (U.K. equity) and STOXX 50 (EU equity) finished up 4.16% and 7.92%, respectively. For Q1, the FTSE 100 and STOXX 50 delivered 4.97% and 10.78%, respectively.

China – A bridge to the future

Beijing announced a 6% GDP growth target for 2021 during its annual session of the National People's Congress and reinforced commitment to its 14th five-year plan, which runs through 2025. Consumption, infrastructure spending and exports are expected to drive growth. Yet, an uncertain trade relationship with the U.S. could hamper economic expansion. For example, recent U.S. sanctions cut off China's access to American semiconductor chips, a move that threatens Beijing's plans to become a technology leader.

Corporate and local government debt is coming under scrutiny because it poses a risk to the economy. Historically, companies and local governments have been given significant leeway in financing and refinancing their growth plans, while defaults were kept artificially low. China's Communist Party has stepped up its efforts to reduce bad debts by accelerating the bankruptcy process for heavily indebted firms. It also tightened borrowing rules for regional banks, which lend to corporations and local governments.

China's tech-heavy stock market came under pressure in March thanks to yield increases in bonds and global inflation concerns. The Shanghai Composite declined –1.91% in March, finishing down –0.89% for Q1.

Japan – Drawbridge up

Japan fared well in the pandemic's early stages, but as a densely populated country it has struggled to contain new cases. GDP growth for Q4 2020 was revised down to 11.7% from an original estimate of 12.7%. Although there was a strong rebound in the last two quarters, the second COVID-19 emergency lockdown will likely cause an economic slowdown. Prime Minister Yoshihide Suga lifted the order in late March, allowing residents to resume more normal activities. Japan is still not permitting foreign visitors, however, and will bar them from attending the rescheduled 2021 Summer Olympics. This will have a major negative impact on the tourism industry.

Mr. Suga's aggressive fiscal support helped limit COVID-19's economic damage. Unemployment rose moderately to 2.8% in 2020 from 2.4% in 2019. Exports were also a bright spot thanks to heavy demand from the U.S. and China. The Bank of Japan added flexibility to its asset purchase program designed to support equity markets, but signalled it will step into the market if necessary.

Japan was one of the best performing markets among developed economies as of February and the Nikkei 225 added 1.27% in March. It was up 6.93% for Q1.

Our strategy

We made no major changes to our strategy and remain confident in our positioning. Bond yields could continue to rise modestly, driven by inflationary concerns and an abundance of new bond issues. Under these circumstances, equities are relatively more attractive.

We continue to be moderately overweight in stocks. We did trim our exposure to equities, however, in order to align our asset allocation with our target weight. The overweight position had become outsized thanks to the superior performance of equities. Specifically, we are overweight U.S. equities. The U.S. is a global leader in vaccination rates, and many states are starting to reopen their economies. The Fed has reiterated that it will remain accommodative for the foreseeable future and the federal government is providing continued fiscal support.

While we don't expect any near-term changes to our position, we continue to monitor rising bond yields and watch for opportunities that may present themselves.

The last word

We are now solidly into 2021, yet the pandemic rages on and many parts of the world are still under strict lockdown. The global outlook has been hobbled by a number of factors: an uptick in cases, including troubling new variants; challenges in vaccine rollouts; supply chain problems; and adversarial relations between the U.S. and China.

In any case, we have our bridge across the COVID quagmire. We will definitely encounter pot-holes and detours on the road to recovery, but vaccine rollouts are picking up pace and some countries are easing lockdowns — even while others are experiencing their third wave. New challenges and unexpected events will require vigilance. As we move toward herd immunity, we can start the process of migrating away from this pandemic.

Please contact your BMO financial professional if you have any questions or would like to discuss your investments.

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