Monthly Market Matters

Summary for July 2021

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Highlights

Beijing intensifies its regulatory clampdown on Chinese tech giants resulting in a ~$1 trillion sell-off in Chinese stocks

Global bond yields continue to slide lower amid a rapidly spreading delta variant

Corporate earnings exceed expectations once again, but investors have become less impressed

Growth stocks surge; solid company earnings, falling bond yields, and the delta variant threatening global growth lead to an unwinding of the cyclical trade

Market summary

Despite a surge in COVID-19 cases and China's sudden crackdown on its technology sector, global equity markets managed to march higher. A rotation back into some of the pandemic-winners (US mega-cap tech stocks) helped the S&P 500 reach a new all-time high. In Canada, the S&P/TSX managed a slight advance. A consolidation of the massive gains in the energy sector weighed on the broader index. Meanwhile, Chinese authorities roiled markets when they announced a flurry of regulatory actions on some of their largest technology companies, leading to a US$ 1 trillion meltdown in Chinese companies.

Corporate earnings continue to handily beat estimates, buoying equity markets in an increasingly volatile environment (both the VIX and MOVE indices that measure volatility in the S&P 500 and the US bond market respectively turned higher). However, investors have become less impressed with the results given the abundance of good news already priced into markets. Despite another round of historic earnings beats, lacklustre forward guidance has led to much more moderate share price gains during this earnings reporting season.

The bond market continues to signal caution over the economic recovery. Bond yields dropped further, with the US 10-year Treasury yield down 25 basis points in the month to 1.22%, recording its steepest 1-month decline since the beginning of the pandemic.The grind lower for bond yields has been driven by rising COVID cases in the US and a growing consensus that economic growth has peaked. The check back in yields has helped bond investors recoup over half of the ~5% loss in Q1.

Commodity performance remains robust. Prices continue to be propped up by supply-side constraints and expectations that global economic growth in the coming quarters will ultimately stay on track. There are rumblings that commodity prices have peaked alongside economic growth. Lumber prices have plunged ~70% from their record highs, WTI crude oil prices advanced, but at a more modest pace, while copper and gold prices recovered after falling last month.

Canadian Fixed Income	Level	Month	YTD
FTSE Canada Universe Bond Index	1,191	1.0%	-2.5%
FTSE Canada All Corporate Bond Index	1,378	0.9%	-1.4%
Bloomberg Canada High Yield Index	166	0.8%	5.3%
Global Equities	**Level**	**Month**	**YTD**
S&P/TSX Composite	20,288	0.6%	16.4%
S&P/TSX Small Cap	756	-2.8%	15.4%
S&P 500	4,395	2.3%	17.0%
NASDAQ	14,673	1.2%	13.8%
Russell 2000	2,226	-3.6%	12.7%
UK FTSE 100	7,032	-0.1%	8.9%
Euro Stoxx 50	4,089	0.6%	15.1%
Nikkei 225	27,284	-5.2%	-0.6%
MSCI China (USD)	94	-14.2%	-13.2%
MSCI EM Index (USD)	1,278	-7.0%	-1.0%
Currencies and Commodities	**Level**	**Month**	**YTD**
CDN $	$0.802	-0.6%	2.1%
US Dollar Index	92.17	-0.3%	2.5%
Oil (West Texas)	$73.95	0.7%	52.4%
Natural Gas	$3.91	8.0%	44.3%
Gold	$1,814	2.5%	-4.4%
Copper	$4.48	4.5%	27.1%
Canadian Interest Rates	**Level**	**Month**	**YTD**
3-month T-bill	0.17	2	11
GOC bonds 2-yr	0.45	0	25
GOC bonds 10-yr	1.20	-19	53
GOC bonds 30-yr	1.76	-8	55
Canadian Sector Performance		**Month**	**YTD**
Energy		-5.1%	26.9%
Materials		3.0%	1.7%
Industrials		2.9%	9.2%
Cons. Disc.		-1.3%	15.1%
Info Tech		2.9%	25.2%
Health Care		-11.1%	8.2%
Financials		-0.2%	20.9%
Cons. Staples		7.0%	15.3%
Comm. Services		0.1%	15.5%
Utilities		2.8%	5.8%
Real Estate		4.4%	24.9%

China tightens its grip on tech giants

Since Ant Group's IPO cancellation last fall, Beijing has launched an unprecedented crackdown campaign on its technology sector. The campaign turned into a blitz this month, sending a shudder through markets.

Just days after tech darling Didi's successful IPO on June 30th (raised over US$4.4 billion and valued at a remarkable US$80 billion), the Cyberspace Administration of China launched an investigation into the ride-hailing company, citing data privacy

Source: Bloomberg & FactSet July 31, 2021 – local currency unless noted, equity price only returns, bonds total return

concerns. Shortly after, the government watchdog ordered the removal of Didi from Chinese app stores, sending shares tumbling.

Next on the list were for-profit tutoring companies. Regulators banned them from going public or raising foreign capital and implemented a new policy mandating they operate as non-profits. Shares of private tutoring companies such as New Oriental Education & Tech Group plunged more than 45% on the news. Mixed in with the sweeping tutoring overhaul were new guidelines for online food platforms to protect delivery workers and the order to Tencent Holdings to give up its exclusive music streaming rights. Tencent shares have lost over a third of their value since February.

The barrage of regulations placed on Chinese companies has spooked global investors. Since their mid-February peaks, the Nasdaq Golden Dragon China Index (Chinese companies trading in the US) and the MSCI China Index have plummeted over 48% and 31%, respectively. Beijing's abrupt actions have reportedly prompted the US Securities and Exchange Commission to halt all new Chinese IPOs until it comes up with more explicit guidelines on how companies should disclose the risks posed by Chinese-based investments. The CCP has made its goals explicitly clear:

1) Prevent anti-monopolistic practices & protect consumer rights
2) Ensure social equality
3) Implement data security and privacy measures to protect against foreign influence

Bond yields slide further

It was only four months ago when bond yields seemed to be rising uncontrollably. The rise coincided with an accelerating global vaccination campaign, which would allow the global economy to reopen, and in turn, boost global growth. It wasn't a question of if, but when the US 10-year Treasury yield would break through 2%. Fast forward to today, US Treasury yields (just above 1.20%) have fallen back down to levels that prevailed before the Q1 spike.

The reason for the decline is twofold: The sharp rise in COVID-19 cases and signs of economic growth peaking. Thanks to the rapid spread of the delta variant, the US 7-day average of new cases has jumped from 12,000 to 78,000. The delta variant now accounts for over 80% of new cases in the US and over 99% in the UK. The speed of the spread is worrisome, given that the delta variant is reportedly 60% more transmissible than the alpha variant. With vaccination rates plateauing, the bond market has priced in the risk of another wave of cases in the fall and the potential for renewed lockdown measures. Secondly, recent economic data has been flashing signs that the economic recovery is peaking. Look no further than Purchasing Manager Indices (PMI). The US Markit Composite PMI survey has dropped from an impressively high print of 69.6 in May to 59.7 in July.

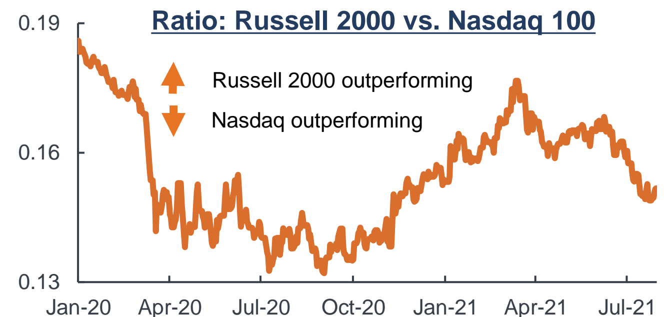
Adding to this, central banks continue to turn more hawkish. The Bank of Canada further cut their bond purchases by a third to $2 billion per week, while the Reserve Bank of New Zealand announced the end of its quantitative easing program. More importantly, the US Federal Reserve (Fed) has altered their language slightly in a nod to the improving economy. It is becoming more apparent that the Fed is setting the stage to taper soon, but the timing remains uncertain.

If economic growth has peaked and central banks' proclivity is toward tightening, further stock market gains could be harder to come by. This isn't sounding the alarm on the bull market. PMI's may have peaked, but generally, they remain at very healthy levels. Similarly, central banks are looking toward the exits for their uber-accommodative policies. We feel they will tread slowly and lightly in that direction.

Corporate earnings continue to shine; Investors ask, so what?

Of the ~60% of S&P 500 companies that have reported earnings so far for Q2 2021, 88% have beat their analyst estimates. Similar to last quarter, the margin of these beats is historic, with earnings coming in 17% above estimates. The results are even more impressive, considering estimates have already been revised significantly higher throughout the first half of this year. The beats have been broad-based, but financials were the best performers, topping forecasts by 26%. However, share prices have not reacted much to the results, given the large amounts of good news already baked into prices. In addition, equity markets are having to digest less optimistic forward guidance coming from companies.

Chart in focus: Cyclical rotation trade unwinds



Well, that was quick. The rotation into cyclical and value stocks, which has played out since the initial vaccine announcements last November, has been quietly reversing since March. After a brief pause in May, the trend favouring high-flying growth stocks accelerated sharply in July. The Nasdaq Composite (heavily-weighted in US mega-cap technology companies) is now outpacing the Russell 2000 (a proxy for the cyclical rotation trade) on the year. Back in mid-March, the Russell 2000 had a towering 15% YTD lead over the Nasdaq.

Mounting fears of renewed lockdowns due to the swift rise in cases have caused the cyclical rotation trade to unwind (since mid-March, the Russell 2000 is off ~6%, while the Nasdaq has gained ~10%). In addition, bond yields have slumped lower. In particular, real yields have plummeted to record lows (US 10-year TIPS ended the month at -1.18%), boding well for the valuations of long-duration technology stocks abundant in the Nasdaq. If the delta variant is not contained, it may force some States to renew lockdown measures, further hurting companies that have enjoyed a tremendous tailwind from the economy reopening, including cyclicals and small-caps.

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