BMO Private Wealth

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Global Markets Commentary: Relief for stocks and bonds, heartburn for crypto and social media

"How do you make a small fortune in social media? Start out with a large one."

Elon Musk, Twitter, November 17, 2022

November served up a hearty meal to equity investors and the bond market ladled on the gravy. The Canadian fixed income universe posted just the second monthly gain of 2022. The FTSE Canada Universe Bond Index is down 10.2% for the year to date, up from its low of -15.2% on October 20.

We often talk about the benefits of staying invested and the pain of missing the stock market's best days. When volatility in the bond market is as high as it is now, this "sleepy" asset class also benefits those who stay invested. Investors who panicked and dumped bonds missed July's substantial gain of 3.9% and November's 2.8% gain.

November's solid equity market returns on top of October's gains lifted markets significantly. All four major geographic benchmarks we track closely (Canada, U.S., international developed, and emerging market equities) have now climbed more than 10% from October, when they registered their lowest points of the year.

As usual, the media narrative went from the sky is falling to the clouds are parting. The reality probably lies somewhere in between. If you believe everything you read, the economy swings from desperation to greatness in the span of a month. Clickbait headlines make it hard to tell fact from fiction.

Elon Musk's adventures with Twitter, plus the collapsing crypto space, were diversionary front-page news in November. Capital markets ignored the sideshow and rightly focused on November's better-than-expected economic data. Most significant was the lowest core U.S. Consumer Price Index (CPI) inflation reading in over a year, which supported the view that U.S. inflation has peaked. That led to a frenzied rally in stocks and bonds. But a cautious U.S. Federal Reserve (the Fed) is not ready to declare victory over inflation on the basis of one good reading. The central bank is waiting for a consistent downward trend before pausing interest rate hikes. Markets are pricing in one last 2022 rate hike of 0.5% after four successive jumbo hikes of 0.75% this year. Overall, inflation numbers are generally easing globally.

November's data rekindled hopes that the economy might enjoy a soft landing. After strengthening all year on fears of slowing global growth, the U.S. Dollar Index is off 7.2% from its September peak. Additionally, many industrial metal prices have firmed up. Given all the talk of recession (even politicians conceding one might be necessary), it would be uncharacteristic for equity markets to extend the recent rally if a recession is on the horizon. It's not just equities that are behaving a bit peculiarly in the face of a possible downturn. Corporate bond credit spreads have also narrowed. Both these signals of faith in the future health of corporations are not typical if a recession is pending.

We welcome November's Goldilocks numbers, but weaker oil prices and a significant plunge in bond yields still cast a pall over the future of global growth. It is difficult to parse the retreat in bond yields: is it a reaction to lower inflation or a foreshadowing of tougher economic times? Either way, the deeply inverted yield curve is still beeping a loud warning signal.

Overall, the outlook has improved and is more closely aligned with our base case scenario. However, we note that double-digit gains to close out 2022 may borrow from some of the sizeable gains we have pencilled in for 2023. It remains our base case that capital markets and economies will continue to adjust to the current reality: high inflation; higher interest rates; less easy money; slowing growth; and increased geopolitical tensions. We believe many of the most difficult adjustments are behind us. Given the toll these adjustments have taken on many asset prices, we see brighter days ahead for investors.

Canada – Better than all

For November, the S&P/TSX Composite gained 5.3%. Gains were broad based, with the materials sector leading the charge on higher metal prices. The heavyweight financials sector was a significant contributor as Canadian banks reported better-than-expected profits. Some raised their dividends, and the Royal Bank signed a deal to purchase HSBC Canada. The energy sector managed a 0.9% gain even though oil prices slid. West Texas Intermediate oil prices fell 6.9% to US$80.55 a barrel. The loonie rose 1.6% against the greenback to US$0.746, or C$1.34.

Canada's inflation data came in largely as expected. Annual CPI sits at 6.9%, better than all major Western nations. Canadian bond yields fell. Government of Canada 2-year bond yields fell from 3.89% to 3.87%, while 10-year yields fell sharply from 3.25% to 2.94%, keeping the yield curve inverted.

Canada's economy continues to outshine just about every other country's economy after posting Q3 GDP growth of 2.9%, which was much stronger than expected. Exports boosted Canada's growth, given worldwide energy, commodity, and agriproduct shortages.

Canada's problem isn't growth today: it's the prospect of a slowing export picture should global growth slow, and our housing sector's outsized sensitivity to higher interest rates. There are hints of this in the latest data. Household spending fell 1% in the quarter, and housing activity slid 15.4%. Unlike the situation in the U.S., Canadian housing starts remain solid, but this is offset by a consumer who looks weaker. Although wage growth is stronger, so are savings. Dutiful Canadians may be battening down the hatches in advance of the recession that could be on the way.

United States – Better than most

For November, the S&P 500 advanced 5.4% despite weakness in shares of Index heavyweights Apple, Amazon, and Tesla. An equally weighted version of the S&P 500 (versus market-capitalization weighted) outperformed for a second month and sits up 17% from the mid-October low, versus 14% for the mainstay Index. This means the average U.S. stock is performing better than the Index represents. The better-than-expected inflation number saw U.S. government bond yields retreat. Two-year yields fell from 4.48% to 4.31%, while 10-year yields dove from 4.05% to 3.61%.

Overall, the U.S. economy delivered a Goldilocks mix of data. There are signs of resiliency in the consumer sector (solid retail sales) and mixed signs in the labour market, with unemployment claims rising slightly. Still, the December 2 employment numbers remained robust, including wage growth of 5.1% year over year. Softer employment and wage growth numbers would help to allay the Fed's fears that a wage-price spiral is unfolding (a prolonged loop when wage increases cause price increases which, in turn, cause more wage increases). The shelter component of inflation – rent, mortgage payments and home ownership costs – is an area of notable concern. Relief should be forthcoming here as interest rate increases have North American housing markets slowing, a harbinger of a retreat in this segment of inflation.

The removal of uncertainty around the U.S. midterms helped the rally. Thankfully, democracy managed to happen without violence. The two-party gridlock is typically market friendly, paving the way for little substantive action on policy. However, this sets the stage for a showdown as the debt ceiling approaches in Q1 2023. U.S. lawmakers have raised the debt ceiling 78 times since 1960, typically with brinkmanship and occasionally with a partial government shutdown. These are what we call known unknowns. If the 79th sequel of this movie follows earlier scripts, capital markets should take these Beltway antics in stride.

Europe – Better than expected

Following what is becoming a growing global trend, European inflation surprised to the downside. Eurozone CPI landed at 10.0% year over year versus the expected 10.4%. Europe has managed to avoid recession for now. Many indicators still point to weakness ahead, and the European Central Bank (ECB) continues to raise rates. However, the slight downtick in inflation, the behaviour of other global central banks, and the uncertain growth outlook will all weigh on the magnitude and extent of future ECB rate hikes.

Short-term European bond yields rose, while longer-term bond yields followed global bond yields lower. For November, the Euro STOXX 50, German DAX, and Britain's FTSE 100 stock market indices posted sizeable gains of 9.6%, 8.6%, and 6.7%, respectively.

Asia – Better days ahead

China featured prominently in mostly negative headlines. Yet, the equity market roared ahead, posting the best monthly return since the late 1990s. For November, the MSCI China Equity Index gained 29%, with spillover to Taiwan (+14.9%) and Korea (+7.8%). Japan was the exception – the Nikkei 225 rose just 1.4%.

This type of record-breaking rebound is not unusual for this asset class; volatility is the name of the game. Continued struggles with COVID and the attendant lockdowns, along with ongoing woes in the property sector and difficult geopolitics, deeply depressed sentiment toward China. However, a redoubling of efforts to stimulate the economy (including deliberate support to the embattled property sector, plus the face-to-face meeting between Presidents Xi and Biden) all worked to improve the narrative slightly. The hope is that the economic weakness, lockdowns, and protests will be catalysts for some positive change. Investors are betting that we are seeing the worst right now and that 2023 will bring improvement.

Our strategy – Solidly balanced

We held steadfastly to our asset mix in November. With stocks and bonds delivering gains, our slight overweight to equities and meaningful allocation to fixed income were rewarded. We believe it's still appropriate to stick reasonably close to our long-term strategic benchmarks – with some prudent tactical tweaks. In turbulent times, a well-balanced, solid foundation is the best place for investors.

Lower long-term bond yields may represent a near-term overcorrection. By and large, the fixed income market has adjusted to reflect the likely path ahead for growth, inflation, and future central bank actions. In our bond portfolios, we are reinvesting the coupon income and maturing securities to achieve higher yields. If there is a recession, we believe our bond positions will provide a level of safety.

We remain slightly overweight equities. Our geographic alignments reflect where we see the best risk-adjusted opportunities. We are underweight international developed markets (primarily Europe and Japan) and overweight to North American equities. Canada's commodity-related companies do well in inflationary environments. U.S. equity markets and the U.S. dollar have historically offered relative safety when global growth is weak.

The last word – Turning speculators into investors

Capital markets play an important role in society. They bring together those with excess savings (investors) with those who need capital – entrepreneurs who have innovative new ideas, and companies that require capital to grow their businesses. They determine an asset's price by finding a point that both buyers and sellers deem acceptable. Over time, they help guide the efficient deployment of society's resources – human, intellectual, physical and financial.

But the capital markets can also be a demanding school where people learn tough lessons. Tuition comes in the form of investment losses that educate short-term speculators so they become long-term investors. Capital markets demonstrate that although there is a time and place for speculation, speculative investments need to be kept in check. A nest egg must rest on a foundation of time-tested, well-diversified, proven investments.

The meltdown in the crypto space is proving to be tuition for some. We don't take issue with the blockchain technology behind cryptocurrencies. In fact, we look forward to its contributions in many arenas. What is happening in the crypto world will likely either mark the end of blockchain's foray into currencies or the watershed moment when crypto survived the tests of capitalism to solidify its standing as an investment. We'll let the markets decide. They will once again perform their valuable role in price discovery, the flow of capital to new ideas, and arbitrating the efficient use of society's resources.

Please contact your Investment Counsellor if you have any questions or would like to discuss your investments.