Here’s What We’re Thinking

Investment Strategy

Nascent economic recovery is a welcome sign, but risks remain skewed to the downside. The Organization for Economic Co-operation and Development (OECD) and the World Bank, both published their regularly scheduled ‘world economic outlook’ document this week. Both organizations depicted a bleak set of scenarios for the remainder of 2020 (Figure 1) and predicted global GDP contraction of more than 5%. Each organization also warned of potential ramifications from a second COVID-19 outbreak on the global economy. Following a period of globalization and growing trade, the COVID-19 pandemic has accelerated what had been a slow shift back to a more fragmented, nationalistic global economy. Indeed, many borders are currently closed across large regions and will likely remain so, as long as sizeable virus outbreaks persist. Trade flows, which had contracted for the first time in more than a decade in 2019, will likely be further strained as companies reroute supply chains and on-shore production, to whatever extent possible. The pandemic has exacerbated existing inequality issues within countries and across regions. Private debt has surged to unnervingly high levels in some countries, and business failures and bankruptcy risks have meaningfully increased. All this is to say that the recovery from the crisis will likely be protracted and uneven as some sectors, including technology and healthcare, flourish and others, that depend on consumer spending and robust aggregate demand, may lag. The same can be said for countries that have different economic sensitivities.

Figure 1: OECD projections for 2020 GDP growth now include provisions for a second wave of COVID-19

High-frequency indicators are pointing to an increase in traffic congestion and public transit utilization as many regions have entered the first or second phase of reopening. Labour market statistics and consumer surveys reflect a modest uptick in hiring activity as businesses prepare to reopen. Indeed, May employment data in Canada and the U.S. posted a record positive surprise, with job gains in both regions versus expectations of net job losses. Although, we’d point that there were some issues with these employment figures and we will discuss these later. While improvement from the bottom is easy; building momentum and ensuring a broad, robust recovery will take time. Consumer spending, which accounts for ~70% of GDP in North America, will bounce back as labour market conditions improve, and this is likely to be a slow process. While we welcome some early positive developments, our view is that we remain a long way from normal and risks remain skewed to the downside.

Equities

Equity market rally stumbles as positioning imbalances trigger a selloff in a risk-laden environment. Global equity markets stumbled in the back half of the week as investors, who had bid up nearly all of the February to March sell-off, were left asking: “what now?”. Stocks were trading within a stone’s throw of all-time highs as reopening efforts brought along the prospect of improved macroeconomic conditions. But, the U.S. and China were again locked in a war of words, COVID-19 case growth rates had not yet begun to decline substantially and policymakers said that the economy was weak. We think that these factors were priced in, to some extent, and believe positioning imbalances (particularly the recent rally in companies with weaker balance sheet) played a significant role in the recent selloff.

We expect the flow of economic data will take on increased importance as we enter the summer months. If it takes longer-than-expected for red-letter economic data points to normalize more uncertainty will be added to corporate profitability outlook and, thus, equity markets. Accordingly, we continue to believe that careful selection of individual securities, with a preference for quality holdings, will be an essential driver of portfolio performance. Further, opportunistically deploying capital into core names should benefit long-term investors.

Sources: Scotia Wealth Management, Bloomberg
**Fixed Income**

New issuance remains elevated as order books continue to be oversubscribed. Investment-grade (I.G.) new issuance for the week ending June 5th was ~US$47.0 billion, surpassing market projections. Amazon alone raised US$10.0 billion as it entered the bond market for the first time in two years. Improved sentiment and strong demand have led to a material decline in issuer concessions. After averaging 25bps in March and April, issuers are paying approximately -3bps in concessions to price the deals in June. This is mainly driven by order books that are five times oversubscribed. Remarkably, eleven deals priced through their initial guidance levels.

In the high yield (H.Y.) space, issuances were also better than expected, with ~US$12.0 billion in weekly volume. Flows into the H.Y. asset class remained strong and have helped support current valuations. U.S. H.Y. credit spreads tightened significantly and ended the week ~80bps lower, reaching levels not seen since early March. Some widening was observed this week as risk sentiment waned. Looking ahead, we expect the positive tone in the credit markets to continue, though significant improvement in underlying fundamentals will be required for any further spread compression. We continue to favour the highest-quality instruments within H.Y. due to their historically higher resilience to downside risks.

**Economics**

The Fed enters “learning mode” as it leaves room to adjust policy as needed in the future. The U.S. Federal Reserve held its policy rate unchanged at its meeting earlier this week, as was widely expected, with the lower bound of the Federal Funds Target Range set at zero percent. Policymakers continued to advocate limited appetite for negative rates at this time. The Federal Open Markets Committee (FOMC) also published its Summary of Economic Projections (SEP), which outlines each Committee member’s personal views on the trajectory of the U.S. economy and interest rate policy over the forecast horizon. The plurality of policymakers see no interest rate hikes until at least 2022, per the ‘Dot Plot’. The accompanying statement also indicated that the current target range would be maintained until the economy has weathered recent events and is on track to achieve FOMC’s maximum employment and price stability goals. To that end, Chairman Powell offered that the committee has entered “learning mode” and would prefer to wait and see how the economy unfolds in the coming months. The committee would then provide a more robust forward interest rate guidance, asset purchase parameters and its intention to pursue any kind of yield curve controls. Mr. Powell explicitly referenced yield curve control in his opening statement and explained that while policymakers have reviewed the international experience, they are unsure about the effectiveness of the tool and how it would complement existing support mechanisms. On the topic of asset purchases, guidance was strengthened modestly to reflect the Fed’s intentions to increase its holdings of Treasury securities and maintain purchases of agency residential and commercial mortgage-backed securities at least at the current pace to sustain smooth market functioning.

**Figure 2: SEP predicts sharp contraction in 2020 GDP before rebounding meaningfully in 2021 and 2022**

The SEP, which we take with a sizeable grain of salt on account of the dispersion of estimates and a high degree of uncertainty at the current juncture, predicts the U.S. economy will contract by 6.5% in 2020 before rebounding by 5.0% and 3.5% in 2021 and 2022, respectively. These figures compare to the December SEP that saw growth of 2.0%, 1.9%, and 1.8% over the same period (Figure 2). Long-term GDP growth expectations were lowered by 10bps to 1.8%. Recall, the FOMC skipped publishing their forecasts in March at the height of the crisis. Inflation is expected to track below the Fed’s 2% symmetric target over the forecast period with core personal and consumption expenditure (PCE) rising to 1.7% by 2022. Unemployment rate is expected to drop to 5.5% in the same year. The Fed Chief downplayed the strong May non-farm payrolls report, and he put it in the context of job destruction through the February-to-May period. Despite the surprise increase in May, the U.S. economy has lost more than 19 million jobs year-to-date. We think the number of unemployed was likely understated owing to the survey response and worker classification issues, and the unemployment rate was likely three percentage points higher than the reported 13.3%.
Geopolitics

Brexit negotiations end in a stalemate, ahead of the June 31st deadline. The latest round of talks between the U.K. and the European Union over their future trading relationship ended without a breakthrough last week. Negotiators are still far apart on trade and other crucial issues ahead of a critical deadline at the end of the month. The transition period can be extended by up two years by joint decision before July 1st, 2020. The E.U.'s chief Brexit negotiator, Michel Barnier, said that the two sides failed to make progress in the fourth round of talks and expects negotiations to drag into October. Mr. Barnier called for “extra political momentum,” which will likely put pressure on British Prime Minister Boris Johnson and European Commission President Ursula von der Leyen to inject themselves into the negotiation process when the two parties hold talks staring June 12th.

Deep disagreements thwarted progress on the most contentious issues, including: fishing rights, a level playing field for businesses, and the role of European judges in overseeing any deal. Nonetheless, despite some of his earlier rhetoric, Mr. Barnier signalled that he might be willing to compromise in two crucial areas. On rights to fish in British waters, Mr. Barnier said that the two sides would have to “discuss somewhere in between” their current positions, adding that “we are prepared to discuss what needs to be discussed.” On state aid, which is a key element of Mr. Barnier’s mandate from E.U. governments, he said that he has “taken account of this British concern” and wanted to “work together to come up with the appropriate toolbox.” Still, plenty of progress needs to be made before the current transition period’s deadline expires on December 31st.
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