Quarterly Commentary

April | 2019

A goldilocks rally

“Uncertainty” best described investors’ sentiment as 2018 came to a close. What had been a stellar year in corporate profit growth, was not so in the global markets which retreated on a number of worries that were seen as risks to the health of the global economy: U.S. China Trade and the possibility of rising tariffs, the U.S. Federal Reserve leading the way with interest rate increases, a U.S. Government shutdown over funding for “the wall”, and continuing Brexit negotiations. Investors worried (chart 1) that a combination of these developments would tip the global economy into recession, pushing sentiment to overly negative levels. The stock market rally that began on Boxing Day was threatened to be cut short early in 2019 by worsening trade tensions, and deterioration in some U.S. economic data. Apple, a technology bellwether appeared to have confirmed investors’ fears by warning of disappointing iPhone sales, largely due to waning demand for its ubiquitous smartphone in China.

Chart 1: Investor Sentiment at the end of 2018

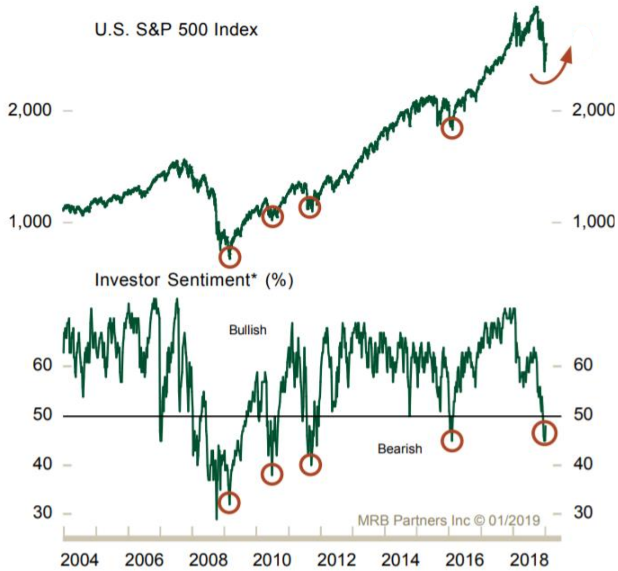
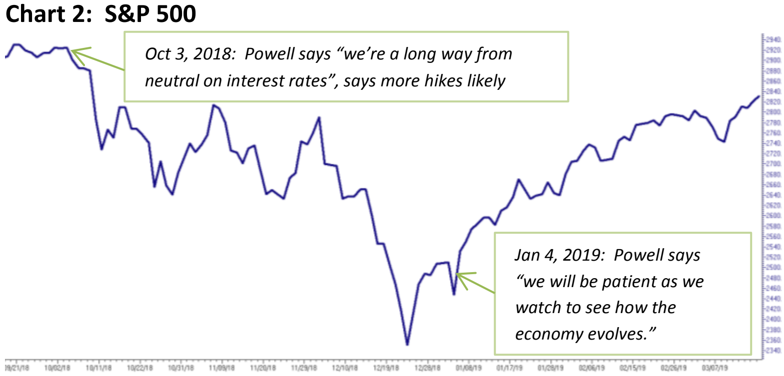


Chart 2: S&P 500

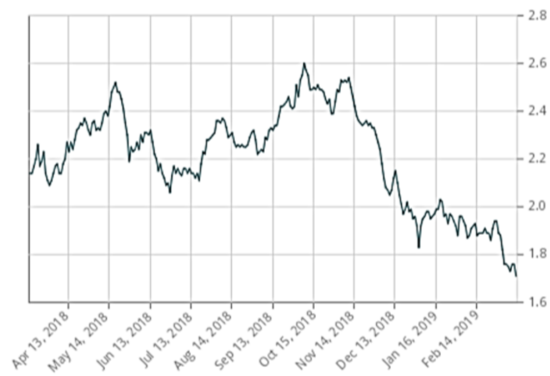


Source: Refinitiv

The next day Federal Reserve governor, Jerome Powell, while speaking at an event alongside his predecessors Janet Yellen and Ben Bernanke, appeared to reverse what had been his rate hikes narrative that had been one of the main reasons for the sharp year end stock market selloff (chart 2). Rising interest rates impact demand for stocks in two primary ways. First, by raising interest rates (aka tightening financial conditions) a central bank is increasing the rate consumers or homeowners have to pay for loans. As the rates rise, there will be a moderating effect on the economy as higher interest rates typically lead to lower demand for loans. Since consumer spending is so important to the economy, less borrowing leads to slower economic growth, possibly lower profit growth expectations, and subsequently lower values for stocks. Second, rising interest rates generally lead to higher fixed income yields including those for term deposits, GICs, and bonds. Higher yields on guaranteed investments then start to compete for the same investment dollars which might have been allocated to stocks, thereby reducing the demand for stocks investments. The Federal Reserve is now stating that they will be patient with monetary policy (rate hikes) and that sets a bottom in the stock market, with the resultant decline in bond yields leading to rekindled demand for stocks. The rally off the Christmas Eve bottom has been impressive, with most major global markets having their best first quarter performances in recent memory.

This has also been the case in Canada as the TSX has staged a strong start to the year. Like the U.S. Federal Reserve, the Bank of Canada has also changed their tone as a string of weaker economic data has led to a pause in interest rate hikes. This has been reflected in a decline in the bond yields (chart 3) and weakness in the Canadian dollar, but has provided a boost to the valuation of Canadian stocks.

Chart 3: Canada 10 year benchmark bond yield (%)



Source: Bank of Canada

Given the length of this economic expansion, the market is showing a high sensitivity to any factor that is seen to be a risk to global growth. On the very top of that list are higher interest rates.

Weakness in the global economy ironically has been a positive for risk assets such as stocks, but it is a fine line. Weakness that tips the economies in to recession would be negative for corporate profits and stock prices. Alternatively, an economy that is allowed to run too hot brings with it inflationary pressures, and unwelcomed interest rate hikes. For the stock market, it is currently as goldilocks would prefer it, not too hot, not too cold.