It Ain't Over 'Til It's Over

Equity Markets

Equity markets posted healthy gains in the second quarter across developed markets, reversing a considerable portion of the sharp pandemic-related drop of February and March as nascent signs of economic stability emerged. The domestic S&P/TSX Composite Index rose 17.0% over the quarter, reducing the year-to-date loss to 7.5% for the benchmark, while the MSCI EAFE benchmark internationally rose 9.9% in Canadian dollar terms, cutting the decline so far this year to 6.9%. The resilience in the United States has been perhaps most impressive of all, with the S&P 500 rising 15.4% in Canadian dollar terms, bringing the year to date performance to a 1.8% gain in 2020. Strength in the Canadian dollar was a headwind for Canadian investors, reducing gains by approximately 3.6%; year to date the depreciation of the Canadian dollar has added 4.3% to foreign investment returns.

In Canada the market strength was concentrated in a select few industries. Gold stocks rose sharply as the increased money supply, stemming from substantial Federal economic support measures, spurred fears about the debasement of fiat currency. Additionally, Information Technology stocks spiked as investors searched for "stay at home" beneficiaries, including Canadian rising star Shopify, now vying to become the largest listed stock in the nation. In comparison, defensive groups such as Utilities and Communication Services sectors were largely flat; while the large Financials sector only rose slightly, reflecting a level of concern about potential credit headwinds that seem to be still evolving.

Outside of Canadian borders the Information Technology sector led the way as well, and in the case of the United States, after years of strength this group now accounts for over a quarter of the entire market. Other cyclical sectors, such as Consumer Discretionary and Materials also added to market gains, while defensive sectors such as Health Care, Utilities and Consumer Staples served as headwinds to returns in all regions. The Financials sector was also a laggard in both the US and EAFE (Europe, Australasia and the Far East), and in the latter case, added to dividend pressures for investors by virtue of regulatory demands for most European bank and insurance companies to cease payments for the remainder of 2020. In the US, this has yet to happen, although recent regulatory commentary has introduced the possibility of dividend reductions for some banks if conditions do not improve, a situation that bears close monitoring.

Fixed Income Markets

Fixed income returns were broadly positive in the second quarter of 2020, as ongoing uncertainty surrounding the COVID-19 pandemic continued throughout the period. Investors continued to place a premium on government bond surety, leading Canadian government bonds to return 5.1% in the quarter. Corporate credit showed resilience in the second quarter, with banks setting aside significant reserves against future losses, but operating well inside mandated capital ratios. The Bank of Canada established a bond buying program in the quarter, buoying all bond prices – though the Bank wound up buying very few corporate instruments under the program, investment grade bonds returned 9.0% during the quarter. High yield bonds performed strongly in the quarter, as the US Federal Reserve undertook a buying program for exchange-traded funds which placed a strong bid under these assets, high yield returned 7.6% in the period.

Economic data in the quarter was expectedly poor, with year-over-year records being set for GDP contraction, job losses, and wage pressures. The Bank of Canada and the US Federal Reserve maintained extremely accommodative stances in order to keep credit markets orderly, and both have expressed support and provided relief measures for principal bond market dealers.

Fixed income markets returned to order in the quarter, reflecting the generally safe nature of investment grade debts. While wholesale economic uncertainty exists around the impact of the coronavirus, corporate debt markets suggest that bonds are likely to continue to be constructive going forward.

Commentary

To say the first six months of 2020 have been volatile would seem to be an extreme understatement – just ask any investor unable to stick to a disciplined approach throughout the period.

Those that chased the equity market rally at the start of the year to its February peaks found themselves in the wrong position as the more-than-decade long equity bull market came to a screeching halt in record time. Heightened uncertainty resulted from the economic lockdowns needed to mitigate the pace of contagion of COVID-19.

Selling in a panic and fully embracing risk aversion (bidding up the prices for safe haven assets like gold and government bonds in the process) may have seemed like a good strategy amid the substantial daily market swings in March and early April. However, investors were then left on the outside looking in as the short-lived bear market quickly morphed back into a bull market amid indications of a slowing in the spread of infection and a bottoming in economic activity. The rally strengthened as the conversations in forward-looking financial markets rapidly changed from the negative impacts of lockdowns to the pace of re-opening those areas that were forced closed. At the same time, fiscal and monetary policymakers worldwide stepped up with aggressive actions designed to help buoy their respective economies and prevent what started as a public health crisis from morphing into a financial one. Markets have substantially narrowed the gap with their previous peaks and should the resumption of economic activity continue on its current trajectory, there remains plenty of scope for further gains against upside risks to growth as the hopes of a "V"-shaped recovery are realized.

But for such a scenario to play out, the stringent measures put in place by governments around the world need to continue to be rolled back and permit consumers and businesses to return to something akin to "business as usual". That is becoming increasingly difficult in some regions (particularly the economically-important US) amid signs that COVID-19 is re-emerging.

While there is limited if any appetite for renewed lockdowns, should they be necessary to once again arrest the contagion in the absence of vaccines or therapeutics (which are on the horizon, but not yet ready), that could stop the nascent recovery in its tracks and greatly increase the possibility that growth outlook is more "W"-shaped – and this path could well mean a recurrence of what played out through March, much to the disenchantment of investors.

So as we move into second half of the year, it is important to realize that this crisis is still far from over and clouds still obscure even the near-term outlook. As such, it is worthwhile to try to hammer home the lessons that in this space often preaches, and that market dynamics have reinforced through the first half.

First, successfully timing the market remains near impossible – again, it not only requires determining when to get out of stocks, but also when to get back in and even being a day late with respect to re-adjusting allocations can have significant long-term negative performance implications.

Instead of trying to capture short-term fluctuations, it is far more prudent to maintain a long-term focus and a disciplined approach to investing – after all, it ultimately is "time in" not "timing the market" that is key to building wealth over the longer-run.

Secondly, it is wise to tether any investment decisions to well-diversified strategic portfolio allocations that are consistent with an investor's long-term risk profile laid out in their Investment Policy Statement. Such baselines prevent investor portfolios from being caught completely off guard should the winds of market sentiment change drastically and without notice.

While an emphasis on diversification may well mean that portfolio performance lags when markets are rising sharply, it also does a substantially better job of preserving capital when conditions turn for the worse. The ability to mitigate the downside matters just as much, if not more, than catching the upside in terms of meeting investment goals throughout the entire market cycle.