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WEALTH

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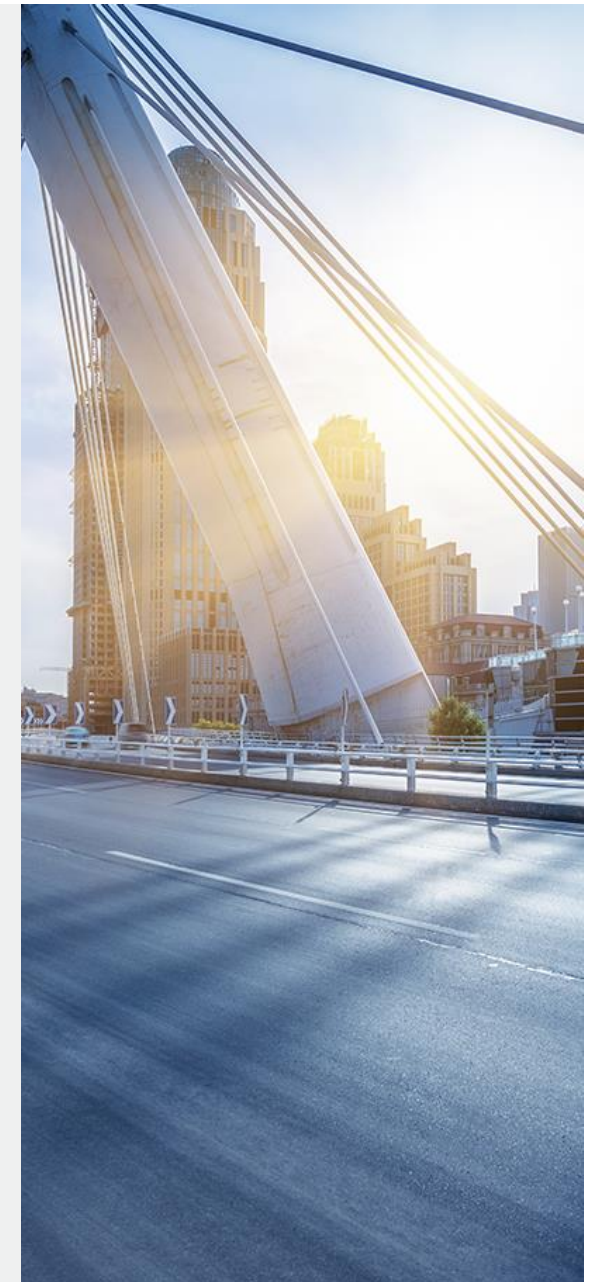

Investor Strategy

S&P 500 – 9 Months, 9 New Record Highs

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Market Recap – America powers ahead

Brett Gustafson

Chart 1: S&P 500 retakes the YTD lead

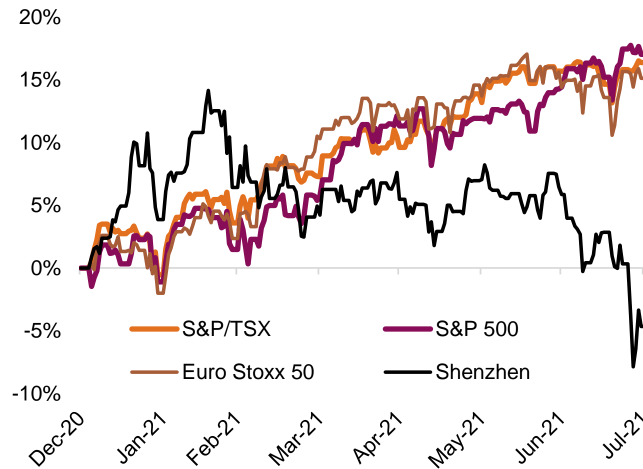
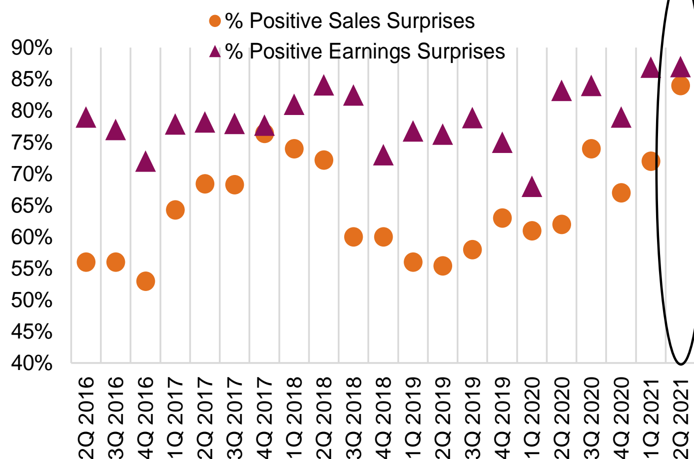


Chart 2: Strong start to earnings season



- Coming out of halftime, North American equity markets have witnessed a leadership reversal among the major indices. Canada has slowed, rising +0.8% in July, remaining higher this year by a healthy 18.2%. While Canada has paused, our North American counterpart south of the border has picked up the pace. The S&P 500 rose 2.4% in July, reaching fresh new highs. In fact, the S&P 500 has made a new record high in each of the last nine months. Too easy. This strong month for the U.S. has the S&P 500 surpassing the S&P/TSX on the year **(Chart 1).**
- One of the major drivers for the U.S. outperformance has been a very strong start to Q2 earnings season. So far, 294 companies in the S&P 500 have reported second quarter results, with an 84% positive sales surprise rate and a positive earnings surprise rate of 87% **(Chart 2).** Looking back over the last five years, this would be the highest performance results on both a standalone quarterly and average basis. The average positive earnings surprise is around 78% while the positive sales surprise is only 64%.
- Across the ocean, Europe saw modest monthly growth of approximately 0.8% for the Euro Stoxx 50. The bigger story internationally lies with Asia. Japan saw a monthly decline of -5.2% while China is working its way towards a bear market. After a drop of -7.3% in the month of July, the Shenzhen index sits at a 6.4% loss YTD even after leading the global markets earlier this year **(Chart 1).** Several reasons are being cited but the crackdown on tech in China is leading the way. The self-perpetuated pullback has been amplified by tensions with the U.S. and while new virus cases have risen globally, the share in the Asia-Pacific region remains high at 35%.
- Weakness seen in the Canadian dollar against the US dollar in June carried over into July. Entering the month at just north of $0.80, the CAD touched monthly lows of ~$0.78 but seems to be settling in around $0.80 towards the end of the month. Risk on currencies lost some ground during the month as the USD (risk off currency) continues to gain some short-term traction.
- Government bond prices in North America continued to rally, sending yields much lower for the month than where they started. The US 10 YR yield dropped from 1.47% to 1.22% while touching the lows of 1.13% not seen since February. Canada witnessed a similar decline from 1.39% to 1.20%. It was not too long ago when the US 10 YR yield was earning investors 1.74%, the good ol' days. With the elevated readings on inflation continuing in July, real rates certainly took an unexpected hit with yields falling.
- One of the more volatile investments over the last 30 days was crude oil. WTI starting the month out around $72/bbl and finishing out at $74/bbl does not tell the whole story. During the month, OPEC came to an agreement to turn the taps back on. Announcing an increase of 400,000 bpd every month until levels are back to normal pushed prices down as low as $65/bbl, a two-month low for the commodity. The market remains tight even with the extra production as consumers emerge from the pandemic.
- Amidst the summer months, a stall in performance is not abnormal in the Canadian markets. Even with the pullback in the CAD and the lackadaisical month for equities, investors have benefitted from continued double-digit equity returns and bonds regaining some ground. Strong earnings and continued vaccination deployment are two solid catalysts that should carry the economy through summer and into the fall.

Market Cycle & Positioning – Staying the course

Craig Basinger, CFA

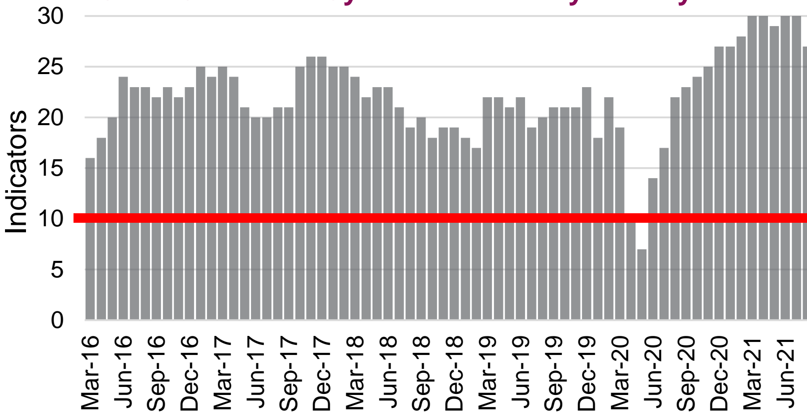


Chart 4: Current Positioning

Overall Asset Allocation	Balanced	Baseline	-				+
Equities	64.1%	60.0%			▨	■	
Fixed Income	31.1%	38.0%		■			
Cash	4.8%	2.0%				■	
Global Equities			-				+
Canada	29.6%	30.0%			■		
U.S.	13.8%	15.0%			■		
International	18.5%	15.0%				■	
Value to Growth Tilt				■			
Small to Large Tilt				■			
Fixed Income			-				+
Overall	31.1%	38.0%		■			
Duration				■			
Credit					■		
Currencies			-				+
CAD Short Term (3m)				▨	■		
CAD Longer Term (1yr)						■	

- The global economy continues to recover from the pandemic-induced recession. That being said, the pace of the recovery appears to be slowing. Comparables are becoming a bit more challenging as we move into Q3 given Q2 2020 was the worst of it, from an economic perspective. The delta variant is providing some headwinds as well.
- Neither delta nor a bit of data normalization will derail this recovery; the pace is strong. Some smaller central banks have started to pivot away from stimulus, but the biggies remain with taps pretty wide open. The consumer, with so much excess saving accumulated during the lockdown periods and pent up demand to live, is out and spending freely.
- Anecdotally, a prominent Canadian restaurateur noted the desire of patrons to spend money has never been greater. And that is Canada. A peer who recently visited Vegas noted that it wasn't just full, he had never seen table minimums set higher during any of his many previous visits.
- The economic momentum is being felt on company bottom lines. The Q2 earnings season has been a healthy one showing that even optimistic consensus estimates can be bested. The earnings surprise rate remains historically elevated. Earnings growth and momentum is increasingly important as this does help alleviate elevated valuations. High valuations have remained a sore spot in our Market Cycle indicators.
- The number of positive indicators has slipped this month. Valuations and a flattening yield curve remained bearish from before and have been so for months. Joining on the bearish side are U.S. car sales. Fear of public transit is contributing to auto demand, plus this was an area the consumer could spend money on with limited contact with others. They even deliver now. However, after running at very elevated levels for months, the pace appear to be normalizing. Supply bottlenecks are likely contributing to the slower pace as well.
- The other notable bearish signal came from emerging market (EM) index performance. EM, which has a hefty weighting to Chinese equities, roughly reached correction territory representing a 10% decline. China has been cracking down on technology companies of which its index has a high weighting. We do not believe this represents a risk to the broader market.
- Inflation remains the big question out there and the data will continue to be noisy. Headline inflation, which has jumped higher on a number of categories affected by the pandemic/recovery, should normalize over the next few months. However, beneath the headline, inflation is building across many categories. Just ask anybody who has bought something or tried to hire someone.
- We continue to have a slight tilt towards equities, lifted a bit higher due to our rules-based tactical component. Equity-wise, we continue to prefer international, then Canada, then U.S., remaining underweight on bonds with low duration. After the CAD's recent tumble we have returned to neutral in the short term.

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Reminiscent of the Nifty Fifty

Craig Basinger, CFA

Chart 5: FANGMAN weight in th index is super high but valuations not crazy

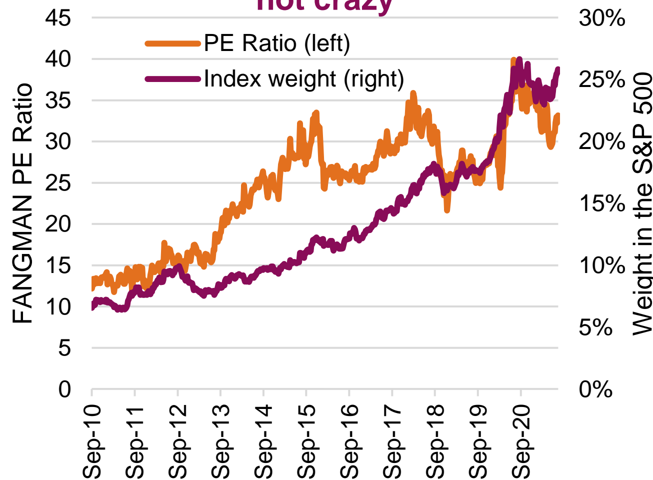
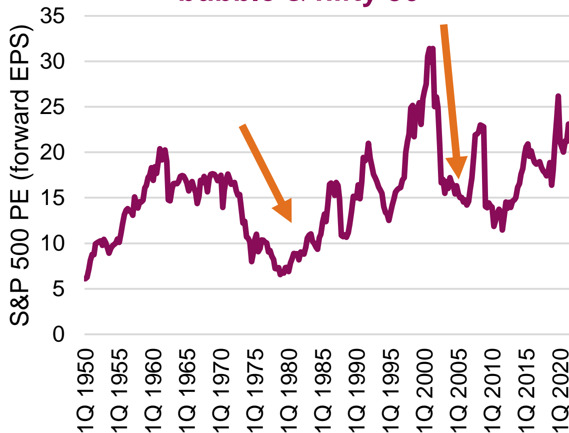


Chart 6: Big multiple contractions followed tech bubble & nifty 50



- The human brain, which is really all of us, loves to find patterns. Patterns in the behaviour of others, the weather, and yes, the markets. Finding or believing in these patterns reduces internal conflict or anxiety, and puts us at ease. Given a 10-year bull market running into a pandemic that triggered a technical recession and bear market, investors were hard pressed to find any similar historical pattern that came close. But with global equity markets rocketing up, now valued 30% higher than before the pandemic, investors are reaching to find historical patterns or precedents to help provide clues to the future path.
- If we can say 'this is just like 19XX', it puts us at ease and provides a mental playbook. Given the rapid rise in markets and valuations over the past year, led by growth and the technology sectors, it raises the question: have we seen this before? Pandemic-induced behaviours have supercharged pre-existing trends towards e-commerce, delivery logistics, streaming and reliance on the cloud. These behaviours have lifted the valuations of companies benefiting from these trends to dominate the broader index, looking at the S&P 500. The top 10 companies in the S&P 500 currently represent a whopping 28% of the overall market cap weighted index, an historical peak.
- Naturally, this may bring back memories of the tech bubble of the late 1990s. The 1990s tech boom was triggered by the rapid development of the internet; it changed the way we communicate in a disruptive fashion. Some business models were made obsolete while new ones emerged to dominate; certainly similar with the disruptive changes of today's environment. Also in the late 1990s, the top 10 of the S&P 500 peaked at about a 25% weight in the broader market. However, the top 10 companies in the tech bubble were not generating nearly the earnings of today's top 10. In the 1990s, the top 10 represented 17% of total S&P 500 earnings while today this is closer to 30%. The tech bubble pop was a collapse in the market's willingness to support nosebleed valuations. At least today, those companies generate earnings, A TON OF EARNINGS. While not the top 10, we charted the FANGMAN stocks' weight and valuations in **chart 5**.
- Perhaps a closer comparison with today's market can be found in the Nifty 50. Similar to today, the Nifty 50 was a decade-long period that growth outperformed value, running from the mid 1960s to early 1970s. The Nifty 50 was comprised of companies that were changing the world, reliable growth models that 'you simply needed to own in your portfolio'. In hindsight, Coke, Avon Products, IBM, Kodak, Xerox to name a few, didn't continue to change the world forever but at the time the market was convinced they would. Retail investors were increasingly piling in, similar to today, and a handful of names drove both the market and earnings of the overall market.
- Equally concerning may be what ended the run of the Nifty 50. Alright, we don't have Watergate diminishing faith in government or America losing a war or an oil embargo. But the Nifty 50 was slain at a time when inflation turned upwards, disrupting both business models and a pivot from growth to value investment style dominance. For both the tech bubble and Nifty 50, there was a very strong market multiple correction in the years that followed (**Chart 6**). Not saying the dominance of these companies is about to end. But investors should use caution when hearing the words 'you need to own this' or 'it will grow into its valuation'.

Canadian Dollar

Chris Kerlow, CFA

Chart 7: Petro Currency Woes

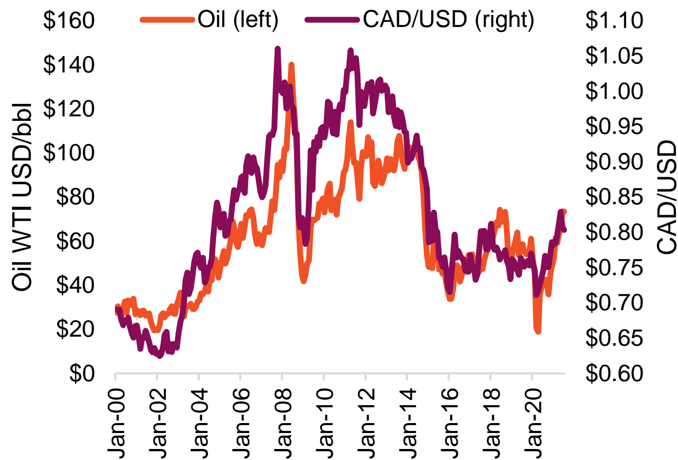
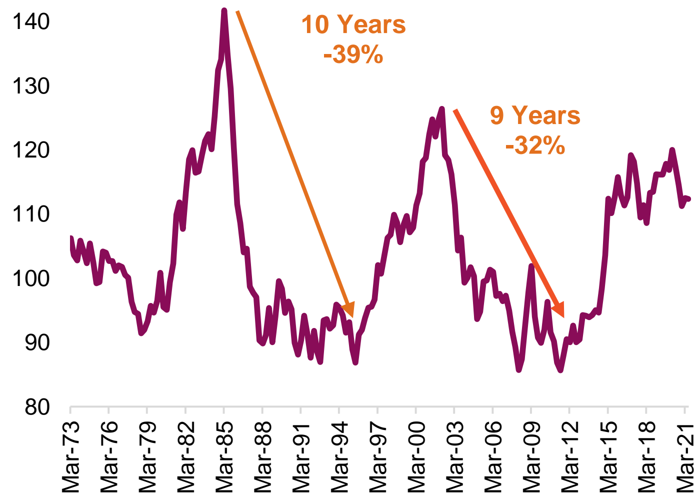


Chart 8: U.S. Trade Weighted Dollar



- June was a tumultuous month for the loonie, rising 3.3% from the end of June, almost touching $0.78 and retracing 3% by the end of the month. The weakness followed the FOMC meeting where Fed Chair Jerome Powell said there is “still some way to go” to meet the conditions to begin tapering.
- Right around the meeting, risk off sentiment intensified as the delta variant caused cases to spike around the globe. This added to the risk off benefits of the U.S. dollar. OPEC+ also confirmed that they would be stepping up production, weighing on oil prices.
- Strong appreciation of the CAD in recent months has coincided with a huge rally in commodities, particularly energy, which is a major driver behind the USD / CAD cross. At current oil prices and with the amount of production sitting on the sidelines of OPEC+ members, there appears to be more risk than reward in that aspect of the trade.
- Energy and other commodities were bid up as a bet against inflation and with excess liquidity in the market, flows helped fuel the rally. Two months ago we wrote about this **not** being the start of a commodity supercycle. We see further commodity upside to be fairly limited, but would be buyers on further weakness.
- Interest rate differentials have also favored the loonie as the Bank of Canada was among the early movers on tapering, helping drive the short end of the yield curve higher compared to the U.S.
- The recent appreciation is now on the BOC’s radar, cautioning them from further fueling the rise. However, on July 14 they further tapered bond purchases from $3bb a month to $2bb and it did not seem to push the loonie higher. At some point the FED will have to come to the table, and despite Powell’s recent comments it is probably sooner than the market is expecting.
- FOMC officials are revising their Monetary Policy Report on September 22 which will contain new growth and inflation numbers. If the numbers continue to remain elevated, the FED may be challenged to hold the line on not talking about tapering.
- Earlier this month the CAD briefly reached $0.81, pricing in a lot of good news. Our fair value is somewhere between $0.77 and $0.80. Above that level we tend to be adding USD exposure; below we tend to be peeling back.
- Longer-term we remain structurally bearish on the U.S. dollar. They are monetizing their own debt, running the most aggressive and expensive monetary policy on the planet. There is a growing movement against the dollar as the reserve currency of choice, albeit still years or decades away from being overthrown, it poises a headwind.
- U.S. households are arguably in the best shape globally and underwent a major rebalancing during the last recession. Canadian housing prices and household debt imbalances have only ballooned, leaving the economy and potentially currency at risk longer-term from a deleveraging cycle.
- Currency cycles are long in duration; although the CAD appears to have been overbought earlier this month, it is now back near fair value. For the greenback we are cautious on a longer-term basis and might have seen the peak for this cycle. The Euro provides better longer-term value and in part why we have been adding to an overweight international developed equities.

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China – Time to get interested?

Derek Benedet, CMT

Chart 9: Hang Seng Tech Index has cratered, losing all of its relative outperformance to the NASDAQ

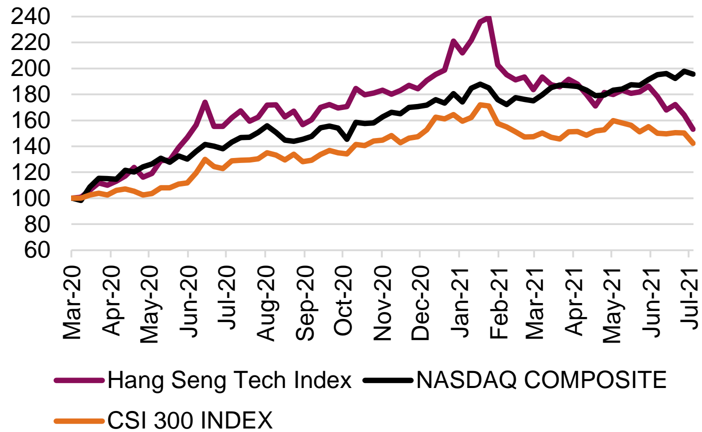
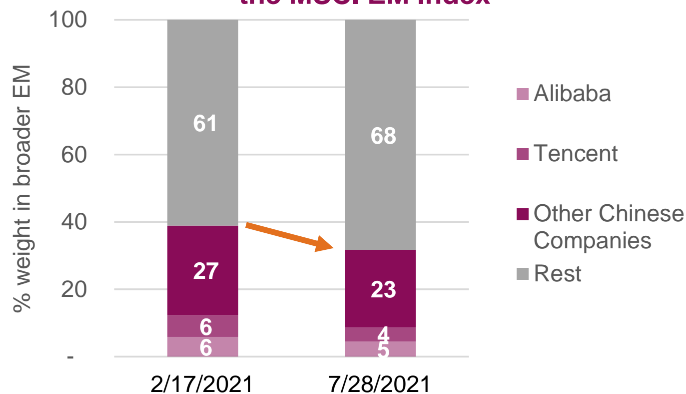


Chart 10: Shifting weights in emerging markets. China now accounts for 31.7% of the MSCI EM Index



- China's tech sector has been in the headlines in recent weeks for three key reasons: a) ownership structure (VIEs predominantly), b) regulatory risk on new policies regarding user data, and c) heightened oversight on business practices. Those who have been paying attention may have noticed that this pressure started when China effectively canceled the IPO of Ant Financial, then dismantled the company. At the time it appeared the moves were directly aimed to reign in Jack Ma, however he was just the first of many targets.
- So why is China smacking down some of its largest companies? There are a few trains of thought, but within China's opaque nexus of politics it is very difficult to know the motivations with certainty. China clearly wants to prevent the emergence of alternative centers of power, with the focus on reigning in consumer-focused 'tech'. Chinese leadership has also moved towards the view that hard tech (i.e. semi fabrication) is much more valuable than products or services that cater to living in a digital world. President Xi declared this year that while digitization is important, "we must recognize the fundamental importance of the real economy… and never deindustrialize." Some of the moves also have a clear populist angle, keeping consumers in mind by reigning in the education industry. What should be clear is that a private company in China operates in a completely different environment compared to global competitors, and the market has been swift in repricing this risk.
- The Hang Seng Tech index, launched last July and comprised of household names such as Tencent and Alibaba, has cratered 40% since February to record lows. The broad base, more diversified onshore CSI 300 index is down 17% from February, and is down -8.6% YTD. **Chart 9** reveals that Chinese tech were the early winners coming off of the market lows last year, but not so anymore. Clearly not a great time for direct Chinese exposure, but the investment implications spread further into broadly held emerging market (EM) funds and ETFs. The MSCI EM index dipped into negative territory on July 27, dropping -12.5% from its February high. The composition of the index has also had a significant change in just 160 days as seen in **chart 10**. Chinese exposure has dropped from 39% in February to 31% at present.
- The question for investors is whether the selloff presents an attractive opportunity to bottom fish. We are hesitant to recommend this with strong conviction given the elevated risks, and we expect further pressure from regulators despite authorities moving into damage control mode. Uncertainty will weigh on Chinese stocks over the near-term but we believe there are opportunities for those with a higher risk tolerance. It will simply take time for investors to build confidence in the market, but many of these companies are technically oversold and present compelling valuations especially when compared on a relative basis to U.S. tech names. We have seen on multiple occasions that as long as the involved companies complied / worked with the government, any regulatory overhang has tended to be short-lived and manageable
- One other looming risk is that U.S.-listed Chinese companies have been under close scrutiny by U.S. policymakers for the last few years. In response to Beijing's clampdown on private industry, the SEC has now halted IPOs of Chinese companies until they boost disclosers of risks posed to shareholders.

Portfolio Construction: Maintaining our Equal-Weight Exposure

An Nguyen, CFA

Chart 11: Market cap vs equal weight

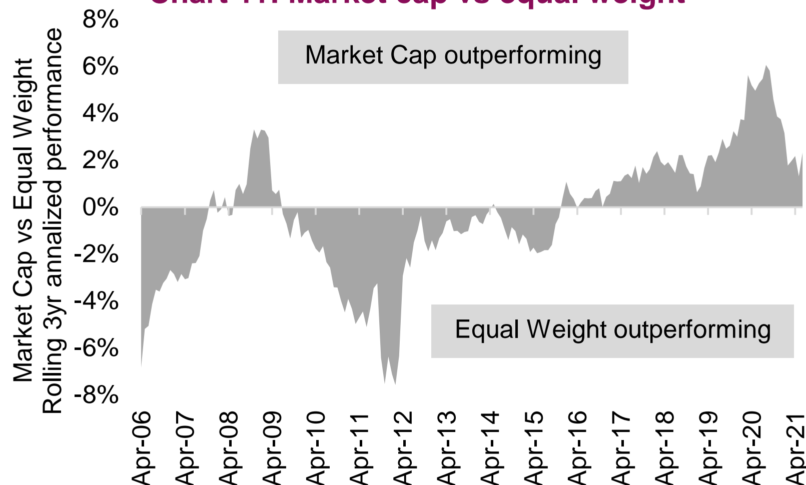


Chart 12: Sector Weight Changes Over Time

	6/30/2011 SPDR® S&P 500 ETF	6/30/2021 SPDR® S&P 500 ETF	Diff
Communication Services	6.5	11.1	4.6
Consumer Discretionary	7.3	12.3	5.0
Consumer Staples	10.4	6.0	-4.4
Energy	11.6	2.8	-8.8
Financials	16.1	11.5	-4.6
Health Care	13.3	12.9	-0.3
Industrials	11.2	8.8	-2.4
Information Technology	15.3	26.7	11.4
Materials	3.2	2.7	-0.5
Real Estate	1.3	2.5	1.3
Utilities	3.6	2.6	-1.0
Cash	0.3	0.0	-0.3

- Owning a market-cap weighted index ETF is great, for as long as the big winners keep winning. This is where we find ourselves today, and for the last several years. The exceptional performance of the top five names in the S&P 500 *market-cap weighted* index (Apple, Microsoft, Amazon, Facebook, Alphabet) has led to its outperformance over the S&P 500 *equal-weighted* index. Chart 11 shows the difference between the three-year rolling returns of a market-cap weighted index ETF over an equal-weighted index ETF. While frequent leadership changes between the two indices are common over shorter periods of time (monthly and quarterly), over the longer-term, Chart 11 shows that the outperformance, whether it is a market-cap weighted index or equal-weighted index, can be persistent over years.
- Investors have benefitted from owning a market-cap weighted index ETF, especially over the last few years. However, should the larger concentrated positions in a market-cap weighted index experience a significant drawdown, or the smaller positions perform very well, the underperformance of the market-cap weighted index will be exacerbated by the size of its positions relative to the equal-weighted index. This happened in the years following the financial crisis (2007-08) when the market-cap weighted index was overweight underperforming financial stocks, while underweight outperforming consumer discretionary stocks. This contributed to the equal-weighted index's outperformance for years after the recession.
- The market-cap weighted index has materially changed over time as the performance differentials across sectors has forced the reconstitution of the index. Chart 12 compares the sector exposures of a market-cap weighted index ETF today versus a decade ago. Chart 12 shows an increase in the concentration of the technology sector, mostly at the expense of the energy sector. As concentrated positions can potentially lead to significant drawdowns, we looked to prudently trim our exposure on strength. In June 2020, we crystallized some gains in our portfolio and sold the market-cap weighted index ETF as it had become increasingly top heavy, with the top five companies representing over 20% of the index. We used the proceeds to buy an equal-weighted index ETF which would allow the portfolio to benefit from the "catch-up" trade, as other members of the index closed the performance gap. The trade reduced the portfolio's exposure to the technology sector and increased its exposure to economically sensitive sectors such as industrials and materials, which we believed should benefit as the global economy reopens and economic activity resumes.
- We continue to support this trade as we believe the significant outperformance of the top five names and the concentration in the technology sector in the market-cap weighted index warranted a prudent approach that led us to trim the portfolio's exposures after an extended period of very strong performance (Chart 1 shows us nothing lasts forever). Moreover, the trade increased our exposure to value names as the equal-weighted ETF has an inherent value bias due to its rebalancing methodology (buy low, sell high). We believe value stocks amidst an environment of higher growth and inflation expectations, and subsequently higher yields, will support a continued rotation of growth into value (which we saw glimpses of over the last year).

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Source: Charts are sourced to Bloomberg L.P. and Richardson Wealth unless otherwise noted.

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