Monthly Market Matters

Summary for May 2022

Justin Truong, CFA
Senior Manager, Investment Strategy

Highlights

Stocks complete round trip in a volatile month of trading. The energy sector continues to lead the broader market.

Oil and natural gas prices climb higher, bringing more pain for consumers at the pump.

Growth scares percolate with warnings from Corporate America. However, economic data remains solid.

US inflation moderates on a year over year basis, but monthly prints remain elevated. Goods prices are easing, but services pick up.

Round trip for equities

For a month where global equity markets ended where they started, the price action in May was quite historic. The S&P 500 fell at least 3% on three separate days, marking the first time since March 2020. The swings were extreme, with an average daily trading range of 1.5% and a monthly range of 11.4%. The volatile month of trading speaks to the high levels of uncertainty facing markets. Chief among them is future US Federal Reserve (Fed) policy, with Fed 'speak' continuing to sway markets viciously. Increasing growth concerns are sparking the potential for a pause in the current rate hiking cycle sometime in the fall. The energy sector continues to lead the broader market as information technology names weaken further in the rising interest rate environment. US bond yields retreated after the US 10-year Treasury Yield reached the 3.2% level, providing some relief to fixed-income and growth investors – although the FTSE Canada Universe Bond Index and NASDAQ still ended the month lower. European stocks continue to be hampered by the war in Ukraine, while Chinese equities are showing some signs of life as lockdown measures begin to ease. The US dollar consolidated some of its hefty YTD gains. WTI crude oil (see chart comments for more) and US natural gas prices climbed another ~10%, bringing gasoline prices to record highs.

Peak inflation & bond yields?

The US April inflation report did little to quell inflation fears. Although both the headline and core inflation prints decelerated annually, both monthly figures came in hotter than expected. As we have raised in past commentaries, concerns will now shift towards price pressures from services, which accounted for the bulk of the monthly increase. A spike in airfares (+18% m/m) was particularly notable, corroborated by Delta Airlines reporting record flight bookings. Meanwhile, energy prices (-2.7%) cooled after a double-digit gain the previous month. Despite the higher than expected inflation print, in our view, the report is an encouraging sign that core inflation has peaked and will moderate towards the end of the year. Aside from significant base effects dragging down the annual figure, goods prices continue to downshift, essentially flat in April after declining in March. New vehicle prices (+1.1%) were up, but the poster child for pandemic-related inflation, used cars (-0.4% m/m), declined again. Regarding the spike in service prices, we see them normalizing after the initial wave of pent-up demand fades (e.g.

Canadian Fixed Income	Level	Month	YTD
FTSE Canada Universe Bond	1,068	-0.1%	-10.3%
FTSE Canada All Corporate Bond	1,246	-0.2%	-9.6%
Bloomberg Canada High Yield	158	-1.2%	-5.1%
Global Equities	**Level**	**Month**	**YTD**
S&P/TSX Composite	20,729	-0.2%	-2.3%
S&P/TSX Small Cap	762	-2.4%	-1.6%
S&P 500	4,132	0.0%	-13.3%
NASDAQ	12,081	-2.1%	-22.8%
Russell 2000	1,864	0.0%	-17.0%
UK FTSE 100	7,608	0.8%	3.0%
Euro Stoxx 50	3,789	-0.4%	-11.8%
Nikkei 225	27,280	1.6%	-5.3%
MSCI China (USD)	69	0.9%	-17.0%
MSCI EM Index (USD)	1,078	0.1%	-12.5%
Currencies and Commodities	**Level**	**Month**	**YTD**
CDN $	$0.791	1.7%	-0.1%
US Dollar Index	101.75	-1.2%	6.4%
Oil (West Texas)	$114.67	9.5%	48.9%
Natural Gas	$8.15	10.7%	123.9%
Gold	$1,837	-3.1%	0.4%
Copper	$4.30	-2.6%	-3.3%
Canadian Interest Rates	**Level**	**Month**	**YTD**
3-month T-bill	1.47	8	131
GOC bonds 2-yr	2.66	4	171
GOC bonds 10-yr	2.89	3	147
GOC bonds 30-yr	2.84	4	117
Canadian Sector Performance		**Month**	**YTD**
Energy		7.9%	41.1%
Materials		-6.0%	7.0%
Industrials		-4.2%	-8.7%
Cons. Disc.		-1.9%	-12.5%
Info Tech		-4.9%	-50.9%
Health Care		-25.5%	-44.1%
Financials		1.4%	-4.1%
Cons. Staples		-1.0%	4.4%
Comm. Services		-2.0%	4.0%
Utilities		0.3%	2.7%
Real Estate		-3.2%	-14.2%

Source: Bloomberg & FactSet May 31, 2022 – local currency unless noted, equity price only returns, bonds total return travel). The two significant concerns that can keep inflation elevated are shelter (a third of the CPI basket), which recorded a 0.5% m/m gain for the third straight month, and wages. However, housing demand has cooled significantly, with the US 30Y mortgage rate soaring 156 basis points YTD to 5.35%, the highest level since 2009. Although wages have risen over the past year, the May jobs report showed US average hourly earnings decelerating annually. April's inflation report essentially locks in another 50 basis point move from the Fed at its next meeting in June. Fed Chairman Powell, reaffirmed that 50 basis point moves were likely at the next two meetings.

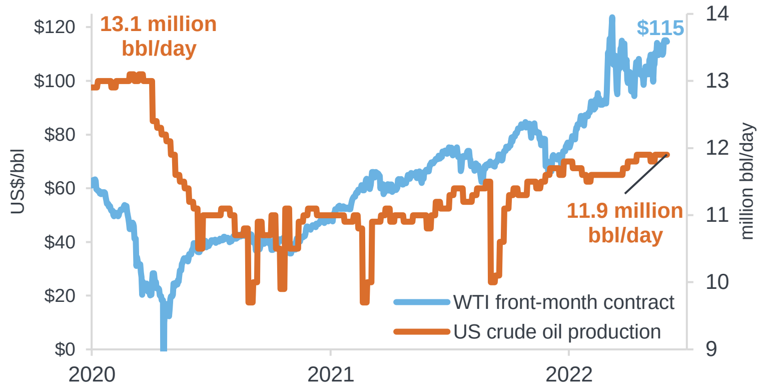
Corporate America's growth scare

This year has seen numerous share price reversals to many pandemic beneficiary names (Netflix, Peleton, Zoom, etc.). We can now add retailers to the list, as Walmart and Target plunged >20% overnight, the worst one-day loss since the infamous 1987 Black Monday stock market crash. On top of big Q1 earnings estimate misses, the sell-off was driven by significant downward revisions to future profits due to rising cost pressures (echoing those from Amazon earlier) and a shift in consumer spending in reaction to higher prices. Since the pandemic, many retailers saw their revenues bolstered by elevated consumer savings and pent-up demand. The favourable situation allowed them to pass on their higher costs to consumers, boosting profit margins to record highs. Despite another strong US retail sales report in April, given the warning from retailers, this trend appears to be reversing. In addition, with rising mortgage rates, higher prices for essential goods, and pent-up demand for travel and other services, consumers are left with less disposable income for higher-margin discretionary items that bolstered retailer profits last year. Outside of retailers, recent warnings from Corporate America leaders (Elon Musk and Jamie Dimon) have left investors unnerved about the economic outlook. Q2 earnings results and forward guidance will be parsed carefully to determine how serious to heed their dire outlooks. Notably, earnings estimates have not been revised lower despite these warnings. Potential downside revisions pose a significant risk to the outlook for equities.

China coming back online

With new Chinese Covid cases plunging, authorities officially ended the near two-month lockdown in Shanghai and are easing lockdown measures in Beijing. As a result, economic activity appears to be recovering after a disastrous start to the year. Chinese Purchasing Manager Indices remain in contraction territory, but the manufacturing and services surveys improved considerably in May. The relaxing of restrictions coincides with policymakers further loosening financial conditions. The People's Bank of China announced a larger than expected cut (0.15%) to their five-year loan prime rate to support a faltering property sector and boost loan demand. The additional stimulus is much-welcomed in a world where growth scares are abundant. Premier Li sounded the alarm on domestic economic growth and urged policymakers to provide more monetary support. Further easing of lockdown measures and more stimulus is imperative for policymakers to attain their 5.5% 2022 growth target. More broadly, China coming back online bodes well for a deteriorating global economic backdrop.

Chart in focus: Oil prices to continue climbing higher



After falling from the US$130/bbl level a few weeks after the initial invasion of Ukraine, oil prices have resumed their upward trajectory. WTI crude oil climbed ~10% to US$115/bbl, bringing prices over 50% higher YTD. We believe they can go higher for multiple reasons. First, oil prices are still being fueled by the commodity supply shock from the reopening of the global economy. As depicted in the chart, oil prices had been climbing well before the start of the Ukraine war. Second, Chinese demand is poised to come back online with the reopening of Shanghai and easing of restrictions in Beijing. The lockdowns removed over 1 million bbl/day (or ~10%) of Chinese demand. Finally, the downward pressure from the 180 million barrels released from the US Strategic Petroleum Reserve will conclude in the fall. Indeed for commodities, the cure for higher prices is higher prices. However, this famous saying is contingent on producers being *willing* to produce and sell more. So far, US oil production has barely budged from its pace at the start of the year, currently producing 1.2 million bbl/day less than pre-pandemic levels. This shows an inability on the part of producers to ramp up production, likely due to a whole host of reasons, including ESG concerns. Further, there is still an upside risk to prices if tensions between Europe and Russia escalate from this month's partial European embargo on Russian energy exports. The threats to our view will largely depend on how far the US administration is willing to go in arresting rising oil prices. With prices at the pump jumping to record highs, inflation is certainly top of mind heading into this year's mid-term elections – evidenced by Biden's recent endorsement of the Fed's inflation-fighting strategy. The other major factor that could thwart rising oil prices is OPEC+. After ignoring global pleas to increase production, the oil cartel announced that they would accelerate their pace of production increases by 50% to 648,000 bbl/day for June and July. Our base case remains that the structural upward trend is still intact, and oil prices will continue trending higher.

Source: Bloomberg & FactSet May 31, 2022 – local currency unless noted, equity price only returns, bonds total return