Desjardins
Financial Security
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Expert Opinion

CHANGES IN THE ECONOMY AND FINANCIAL MARKETS

Markets on steroids (dexamethasone?)

Another week, another decline of bond yields, new all-time highs for Apple and Microsoft, a further advance of stock markets. And a further advance of skepticism.

This week, we look at the uncertainties unlikely to dissipate this summer; at the new Democratic lead in voter intentions; at the possible effect of reversals of U.S. income-tax cuts; and at rising investor anxiety.

UNCERTAINTY – DEAL WITH IT!

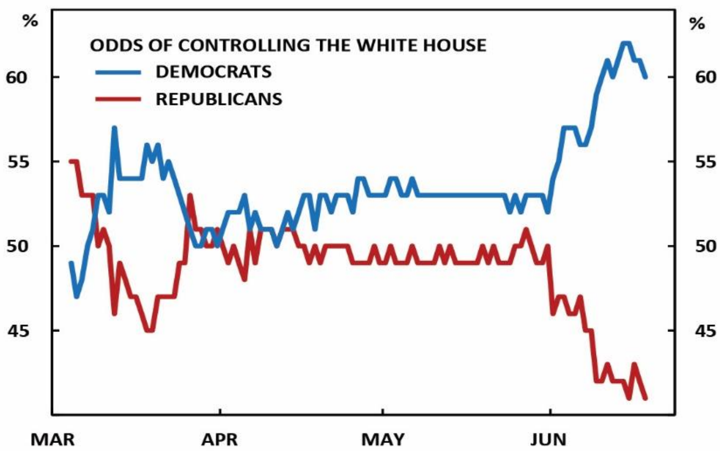
With summer finally here, minds may be tempted to relax and get away from it all, but the many sources of potentially market-roiling anxiety persist. Initial U.S. measures to assist households will soon run out and Republicans and Democrats have been slow to introduce their replacements. Trump, slipping in voter intentions, could become more unpredictable (if such a thing is possible) and more hostile to China and other trading partners. This stance bore him fruit in 2016 but turned out very badly for equity markets in the last quarter of 2018. Social and racial tensions remain high, and the pandemic has thrown new light on the burdens of inequality borne by certain groups.

Things are hardly quieter abroad. Britons and continental Europeans are proving slow to agree on their future trade relations, and Europe is struggling to negotiate a fiscal stimulus plan in the face of German dogmatism. In Asia, the Korean peninsula has been hit by a sudden deterioration of peace efforts. And finally, an old border dispute between China and India has just produced the first fatalities in more than 25 years. As if we needed a conflict between the two Asian giants. A quiet summer, did you say? Oh yes, and let's not forget COVID-19. While some U.S. states have made a great effort to flatten the curve by lockdowns, others have been moving hastily to unlock and are already seeing jumps in contamination and hospitalization (Arizona, California, Florida, Texas). Will new lockdowns be required? Apple has announced reclosing of some of its stores.

CHAOS FINALLY HELPING DEMOCRATS

Until recently, Trump's string of scandals and messes since his inauguration had done little to scratch his Teflon coating. If the bookmakers are right, the wind has changed. Not only is there no doubt the Democrats will win another majority in the House, but they could also take both the Senate, impregnable until just yesterday, and the presidency.

Betting Markets Now Expect Joe Biden To Become President



Yet a Trump defeat cannot be taken for granted. Remember, in 2016 almost everyone thought he would lose. He has since demonstrated, every time the pressure was on, that he would not back down and would become even more combative, if necessary, by igniting new tensions to divert attention. The buzz out of the China-U.S. talks in Hawaii seems promising, but a Trump slipping in the polls could very well turn more hostile to the Asian giant. Such hostility helped him in 2016 in states leaning very Democratic.

DEMOCRATS COULD CALM THINGS DOWN. AND RAISE TAXES

As the saying goes: Be careful what you wish for. Many are hoping for expulsion of the president. His departure might bring a little more order to the management of the world superpower but would probably mean tax increases. Joe Biden's platform would reverse almost half the income-tax cuts legislated by a Republican Congress in 2017. Businesses would be hit as well as some households. At this writing, Credit Suisse, Goldman Sachs and BCA Research all project a potential 12% to 15% reduction of S&P 500 earnings. Assuming a constant P/E ratio, a profit squeeze of that magnitude would crimp equity markets, with greater effect on companies that are mostly domestic.

A RALLY SHUNNED IS A RALLY WITH LEG

Despite the strong performance of equity markets in the last couple of months, the ranks of skeptics and pessimists are ever more numerous. In the Bank of America's latest survey of portfolio managers, 78% of respondents consider the market overbought, the highest percentage since 1998. Retail investors agree: the latest weekly survey by the American Association of Individual Investors reports strong growth of bearish sentiment and further erosion of bullish sentiment. Self-reported bears grew to 47.8% of respondents from 38% a week earlier. Still slightly less than the 52.66% of early May, but… Self-reported bulls shrank to 24.4% from 34.3% a week earlier. So, the bears are very much predominant.

But a rally shunned is a rally with legs! Historically, when bears have outnumbered bulls by more than 20 percentage points, the markets have been higher one month later and three months later.

Today, to doubt the market is to join the consensus, not the contrarians. Though P/E ratios may be saying this is not a time to maximize risk, excessive caution could also hurt. When in doubt, better to stick close to one's targets and stay well-balanced.

THE ECONOMY IN BRIEF

Growing evidence that a recovery began in May has tempered the darkness of some of the April numbers. U.S. retail sales jumped 18% in May, still down 6% from a year earlier but distinctly better than was expected at this point. Statistics Canada's preliminary estimate of May retail sales signals a similar increase of 19% for Canada. Existing-home sales were up 57% on the month and motor-vehicle sales more than doubled, though in each case activity is still down sharply from a year earlier. With a gradual lifting of lockdowns progressing in all regions, spending has probably continued to increase in June.

This cheering news follows a devastating April, when activity seems to have been even slower than expected. Retail, wholesale and manufacturing sales in Canada all slumped more than 20% – indicators tracking the likelihood of decline from Statistic Canada's previous estimate of a record 11% contraction in April after a 7% contraction in March.

The good news is that the initial rebound seems stronger than most observers were expecting a month ago.

EQUITY MARKETS IN BRIEF

The Dow Jones index ended last week up 1.28%, a showing bettered by Nasdaq (3.51%) and the S&P 500 (1.72%). The TSX was up 1.65% on the week.

BOND MARKET IN BRIEF

In parallel with a good volume of new issues, bond yields, influenced by Bank of Canada intervention, were mostly flat last week.

INVESTMENT STRATEGY

Absent a major change in your personal situation, we recommend that you stay with your present investment strategy, taking advantage of moments of turbulence to rebalance your portfolio. An appropriately diversified portfolio is designed to achieve your long-term objectives.

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