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Market Ethos

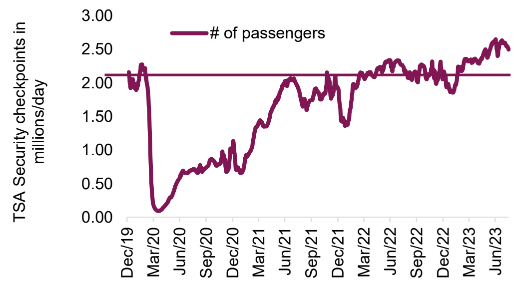
The latest market insights from Richardson Wealth

Craig Basinger

Sometimes good news isn't good after all

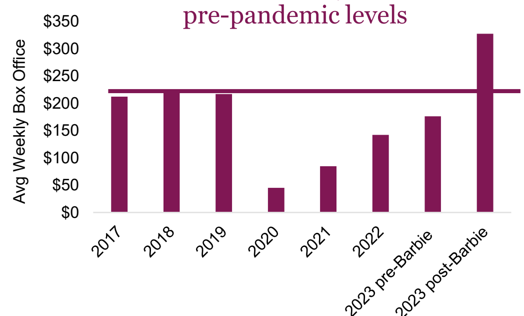
Markets enjoyed a great advance in June and July, thanks to a number of factors. Certainly, some hype around AI helped a few of the mega caps, but it was much more pervasive. During those two months, the S&P 500, NASDAQ, equal-weighted S&P (adjusts for concentration), TSX and Europe were all up about 10% (common currency USD). Perhaps some of this advance was fuelled by a sudden change in sentiment, but it would appear it was more likely driven by some firming in the global economic data.

Up, up and away



Source: Bloomberg, TSA, Purpose Investments

Movie box office finally breaks above pre-pandemic levels

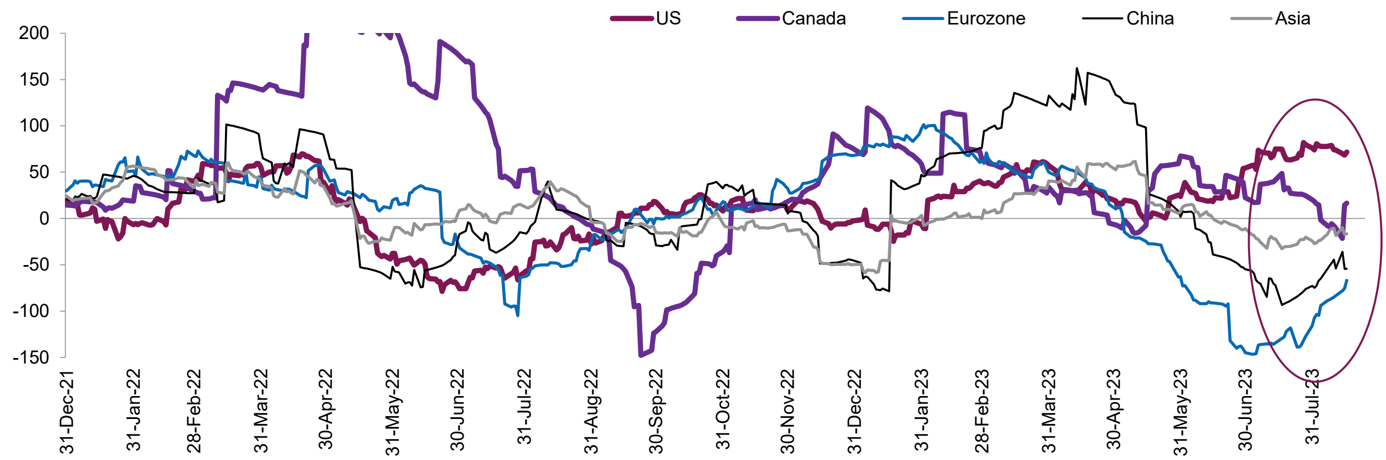


Source: Bloomberg, Purpose Investments

Of course, the star remains America! Housing is humming along, enduring higher financing costs. Sure, manufacturing is in the dumps, but nobody seems to care because of the consumer. Resilience would be an understatement. Whether thanks to some dwindling stockpiled pandemic savings, an uptick in wages, or continued ease to find a job, the U.S. consumer remains in spending mode. Anyone who has flown recently would agree the prices are on the high side, yet the volumes going through TSA security checkpoints are now well above pre-pandemic levels. And in the past few months, box office numbers have finally broken above pre-pandemic levels (thanks, Barbie!!). Maybe there is some truth that Swifties and Barbie have pushed off the recession.

There has been an improvement in economic data beyond just the U.S. consumer. European data, which had been deteriorating since the start of 2023, turned more encouraging over the past month or so. Based on the Citigroup Economic Surprise indices, even China has shown some improvement, albeit from depressed levels. Meanwhile, Canada and the U.S. remain in positive surprise territory.

Economic data in general has turned more positive during the past month



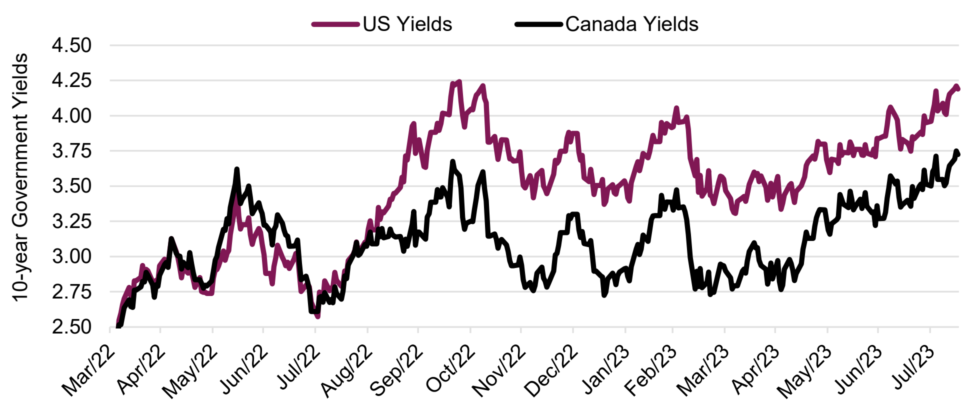
Source: Bloomberg, Citigroup, Purpose Investments

The improving economic data is generally a positive development as this helped alleviate concerns over near-term recession risk. Adding to this good news, the May and June inflation data, released with a one-month lag in June and July, showed continued cooling. Better economic data and cooling inflation are a great combination for markets. This lifted the S&P 500 to 4,600, a mere 5% below its all-time high set in back in January 2022. Global equity markets also rallied up to within 7% of their all-time high, set around the same time as the S&P.

Rising bond yields

Herein lies the rub. The good news of better economic data, which lifted markets for a while, has started to become a negative due to rising bond yields. It seems some good economic news is great, but too much good news is not. We could bring in the appropriate temperature of porridge, but not this time. 10-year yields in Canada and the U.S. have moved back up to previous highs set in late 2022.

Bond yields have climbed back to previous highs



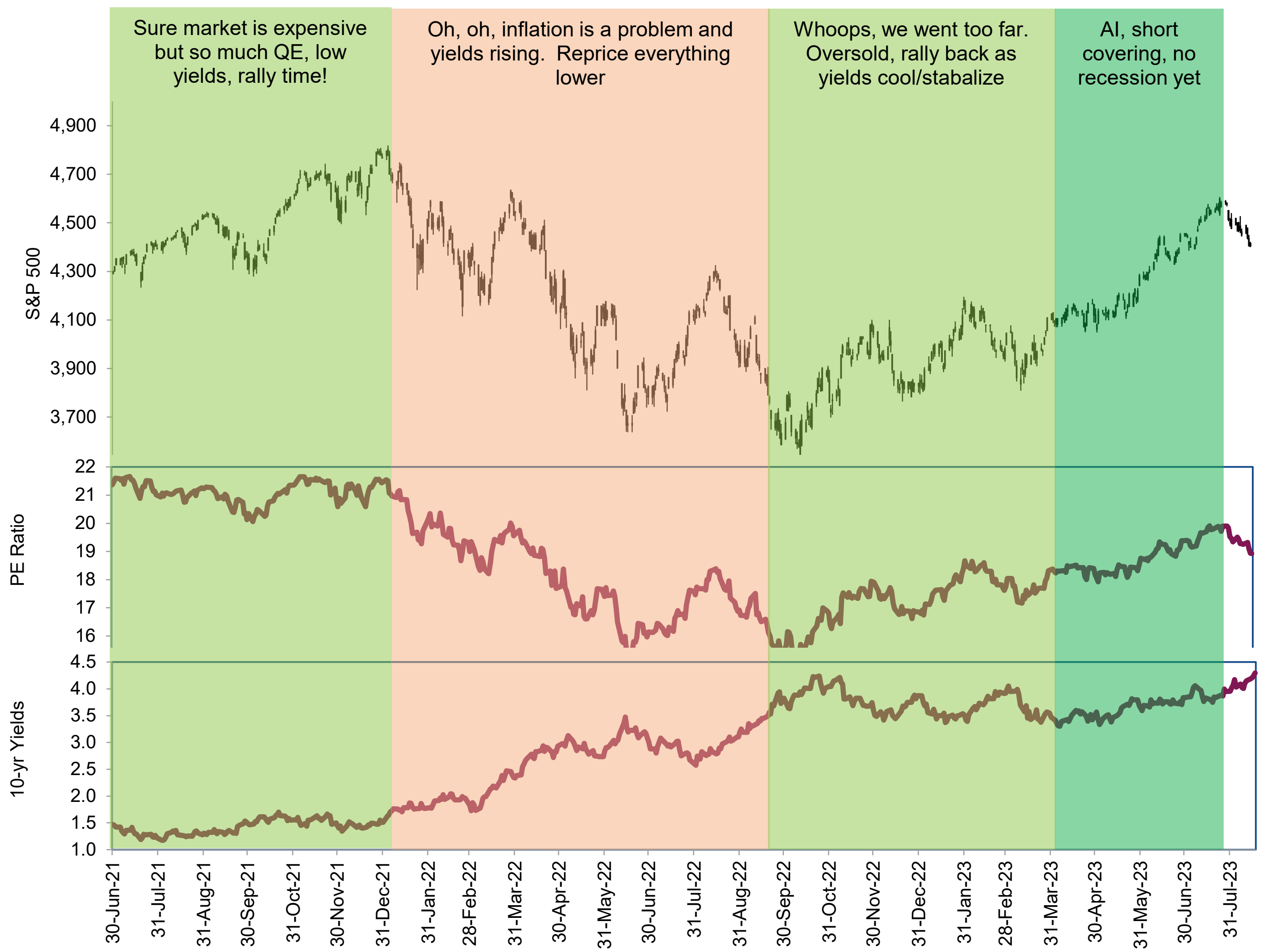
Source: Bloomberg, Purpose Investments

It is these higher yields that are weighing on equity markets in August, hence our need for some bad economic news. Compounding the yield situation is that the base rates on the inflation side are subsiding. Meaning that we could actually start to see CPI year-over-year measures tick up as the data from a year ago falls off.

With the benefit of hindsight, the market of the past two years has gone through a number of phases. In 2021, quantitative easing meant fiscal stimulus was flowing as the economy recovered and bond yields remained low. Put that into the market mixing bowl, and you get price appreciation. Then, inflation proved to be less transitory, eliciting a central bank tightening response and a rapid repricing of assets (repricing = lower).

But as the market always does, it went too far, especially given a recession had not begun. This led to a prolonged bounce back up. Then there was optimism around AI, short covering and improving sentiment – combined with some improving economic data pushing out the recession risk, and markets took another leg higher.

Market phases of the past 2 years - with the benefit of hindsight



Source: Bloomberg, Purpose Investments

The problem now becomes a market that moved higher on a lack of fundamentals. Earnings have held in but are certainly not growing or accelerating, which means the rally was all multiple expansion. And now that the good economic news is leading to higher yields, the market valuation multiple is under pressure to come down. You may notice a near-perfect inverse relationship between 10-year bond yields and the PE of the S&P 500 in the above graph.

Final thoughts

Good news is good news, but sometimes it isn't. The biggest risk for the market today is if yields continue to rise, the valuation multiple will likely continue to fall via lower prices. Some softer economic data may cool yields and provide a bit of a reprieve for the market, but that will bring recession fears back pretty quickly. The silver lining is maybe if you were thinking of adding to bonds but missed the higher yields of late 2022, well, it looks like there is another similar entry point. We would have to see better valuations than these to get us excited about adding to equities.

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

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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