Keeping Score

If you are keeping score, the S&P 500 Index started March off with five consecutive days of market gains. It is not the best stretch of consecutive gains this year, but it is the longest. This is the first time this year that the S&P 500 Index has gained for five days in a row. Asked last Friday morning if I thought this rally had legs my response was that while equity investors appear to be in a better mood heading into March, the economic data would not necessarily confirm their enthusiasm. In other words, while it is not all that bad, neither is it all that good and therefore we shouldn't get too excited by this rally. Before we get to that however, let's take a quick look at how markets have performed through to the end of February.

The S&P/TSX Composite Index gained 0.3% in February to bring its two month return to -1.2% on a price return basis. Canadian stocks outperformed US stocks as the S&P 500 Index fell 0.4% in February for a return of -5.5% in US dollar terms for the first two months. International stocks as measured by the MSCI EAFE Index, also fell in February by -2.1% and for the first two months by -9.2% (USD). Equities continued to swing in both directions in February while investors gaged the economic trade winds.

Among the individual sectors, standout performance came from the S&P/TSX Composite Materials sector which gained 15.5% year-to-date on the back of gold. The yellow metal advanced 16.7% in the first two months of the year as investors sought shelter from the equity volatility. Of note in the United States, the S&P 500 Financials sector fell -11.9% in the first two months led lower by the banks. Bank stocks, which fell 17.9%, were dragged down by a flattening US government yield curve. Counter to the historical norm, the US 10-Year yield fell following the Fed's first rate hike in nine years. When factoring in the rise in the short end of the curve, the spread between the US 10-Year yield and the 3-Month Yield tightened by 69 bps between the Fed's decision on December 16 and February 10. Bank stocks fell alongside the spread. Typically, following a Fed tightening the yield curve flattens from the short end and the 10-year yield moves higher albeit at a slower pace than the Fed Funds Rate.

As we have identified in commentary earlier this year, "Nobody Expects the Spanish Inquisition – January 25, 2016", we attribute the volatility largely to three factors: a US inventory correction, the glut of global crude supply, and China's economic slowdown/transition. When we examine each of these factors none look to have shown much improvement over the past month. Focusing specifically on US manufacturing activity, the Institute for Supply Management Manufacturing Purchasing Managers Index (PMI), continued to contract in February. The ISM PMI came in at 49.5 (a level below 50 indicated contraction), better than January's 48.2, but still below the break even level of 50. Further, global manufacturing growth stalled as measured by the JP Morgan Global PMI which was reported at an even 50 level. Global manufacturing activity has been in a slowing trend over the past two years particularly in Asia and more recently in the United States and Europe.

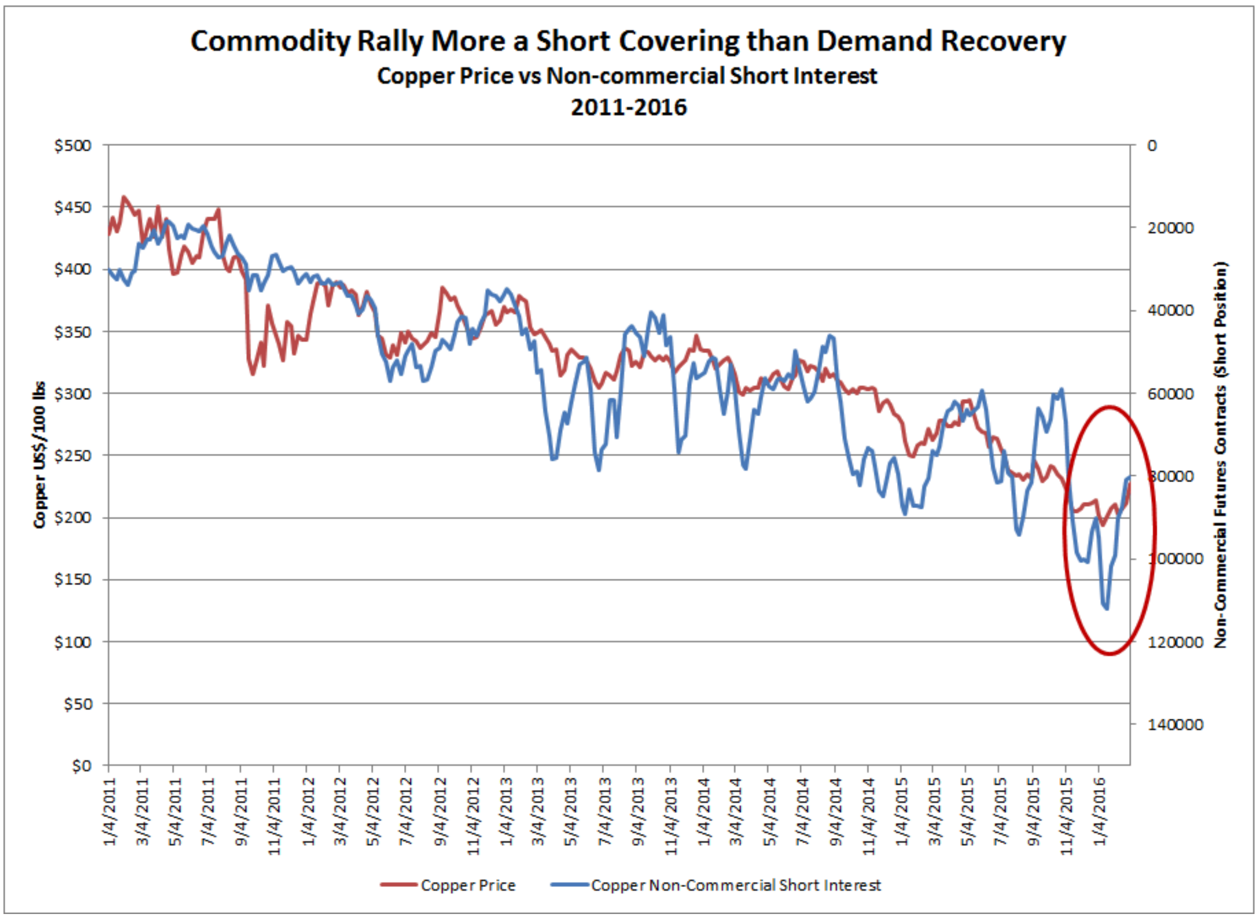
Despite a deceleration of global economic growth, investors have embraced a risk-on attitude pushing stocks, corporate bonds and commodities off their lows. In the United States, the S&P 500 Index has gained 9% from its near-term low of February 11. Oil has climbed 40% since its low of February 11. The S&P/TSX Composite has gained 11% since its low of January 20. And high yield bonds have recovered 6% also since February 11 as measured by the Merrill Lynch High Yield Constrained Index when spreads over treasuries reached 888 bps vs the current 717.

While the market's enthusiasm is refreshing, the economic trend is still somewhat muted, and as such, the market reprieve of the past couple of weeks may be classic of a dead-cat bounce. We continue to preach caution until signs of improvement emerge.

So, if nothing has changed fundamentally, what is the driving force behind the rally in stocks, credit and commodities? I am reluctant to look a gift horse in the mouth but in this case, I fear I must if only to rationalize whether these markets have reached an inflection point.

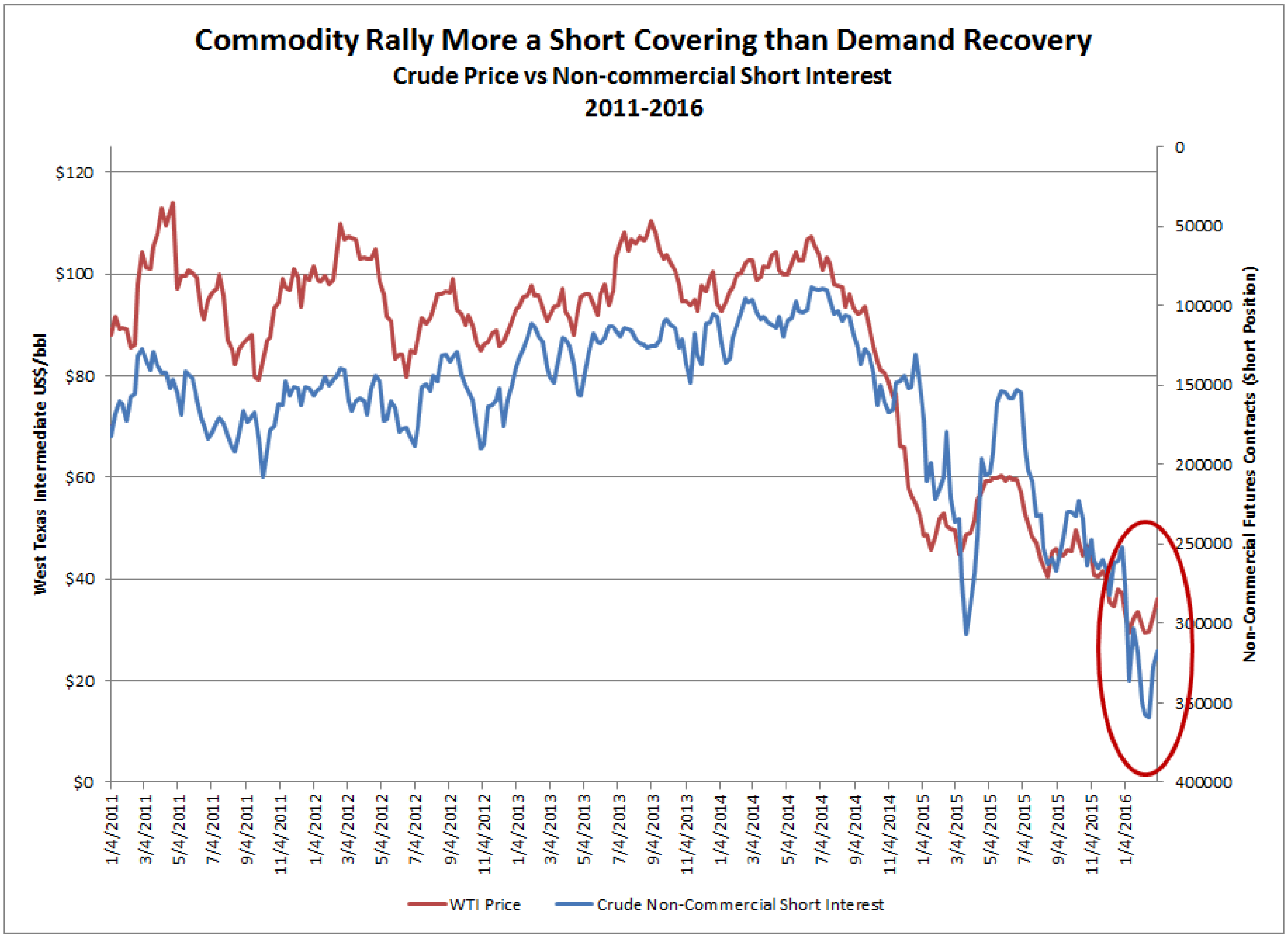
Looking specifically to the commodity markets, it is too difficult to attribute the recent gains to a shift in fundamentals – that is that the spread between supply and demand is narrowing. Rather, the recent run has been more a function of short covering. Charts 1 and 2 highlight the non-commercial short interest in each of copper and crude futures. Copper reached a low in January, coinciding with the largest short position of the red metal. Since then the short position has come down by 28% while copper prices have recovered 15% off their low. Similarly, crude prices reached their low in February, also coinciding with the peak in short interest of crude futures. Therefore, it is entirely reasonable to attribute the recent gains to a short covering and as such the rally, while welcome, may be short lived.

Chart 1



Source: Bloomberg, Manulife Asset Management as of March 2016

Chart 2



Source: Bloomberg, Manulife Asset Management as of March 2016

We have often said “fundamentals trump noise”. This case is no exception. With respect to oil, until we see global production abate we are unlikely to see a sustained increase in price. That may not be too far off into the future, but neither is it the case today. As such, our caution would extend to commodities as well as equities, until the fundamentals change in favour of investors.

Key Statistics (week-over-week) *Ending March 4, 2016*

	Weekly Change	YTD
MSCI World Index (USD)	3.4%	-3.3%
S&P 500 Index (USD)	2.7%	-2.2%
S&P/TSX Composite Index	3.2%	1.6%
MSCI Europe Index (EUR)	3.2%	-6.4%
MSCI Emerging Market Index (USD)	6.9%	-0.4%
Hang Seng (HKD)	4.2%	-7.9%
Topix Index (JPY)	4.9%	-11.1%
	Current Week	Last Week
CAD/USD	$0.7509	$0.7400
EUR/USD	$1.1005	$1.0934
USD/JPY	¥113.74	¥114.00
10-Year US Treasury Yield	1.87%	1.76%
10-Year GoC Yield	1.25%	1.18%
Gold USD/oz.	$1,259.25	$1,222.65
Oil USD/bbl.	$35.92	$32.78

Source: Bloomberg

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