Did we just get a year's worth of market movement in a quarter?

If you think (insert market dynamic here*) is over, think again. It has only just begun.

**reflation/rising inflation*
**rising interest rates*
**a steeper yield curve*
**the economic re-opening*
**the manufacturing boom*
**the jobs recovery*
**consumer pent-up demand*
**revenge/envy spending*
**the bull market*
…

"Did we just get a year's worth of market movement in a quarter? If so, then what's left? And if not, then where do we go from here?" By this, we point to the rapid rise in U.S. Treasury yields (and Canadian yields for that matter), the gains in oil and other commodity prices, and equity market returns. In short, no, the year hasn't been front-ended. In fact, while the speed of the market movement was faster than we anticipated, things have progressed directionally, as expected. Markets are merely responding to the improving economic and earnings environment that were expected and as suggested in my January 18th note as the thesis or idea of the Rapid Reopening of the economy continues to play out.

Equity markets performed well through the first quarter, extending the gains made since the market lows of March 2020. The S&P 500 Index gained 6.2% in U.S. dollar terms (4.9% CAD), including dividends. Gains were prevalent across most major equity indices with the MSCI EAFE Index up 3.6% in U.S. dollar terms (2.32% CAD) and the MSCI Emerging Markets Index returning 2.3% USD (1.1% CAD), both including dividends.

The expectation of Canadian equity outperformance against U.S. equities for 2021 appears to have materialized through the first quarter as the S&P/TSX Composite Index gained 8.1%, including dividends.

Perhaps the biggest surprise to the market was the increase in bond yields. The U.S. 10-year Treasury yield started the year at 0.91% and very quickly rose by 83 basis points to end the quarter at 1.74%. The rise in yields was right in line with where I suspected they may be over the entire calendar year in 2021. Although I suspected them to move higher than the market expected I don't think many would have guessed the speed they increased. The move in U.S. Treasury yields was met by similar movements in Canadian bond yields. The 10-year Government of Canada bond yield gained 88 basis points to finish the quarter at 1.56%. Bond yields rose across several categories. As a result, the FTSE Canadian Universe Bond Index, the benchmark for Canadian bonds, fell 5% during the quarter.

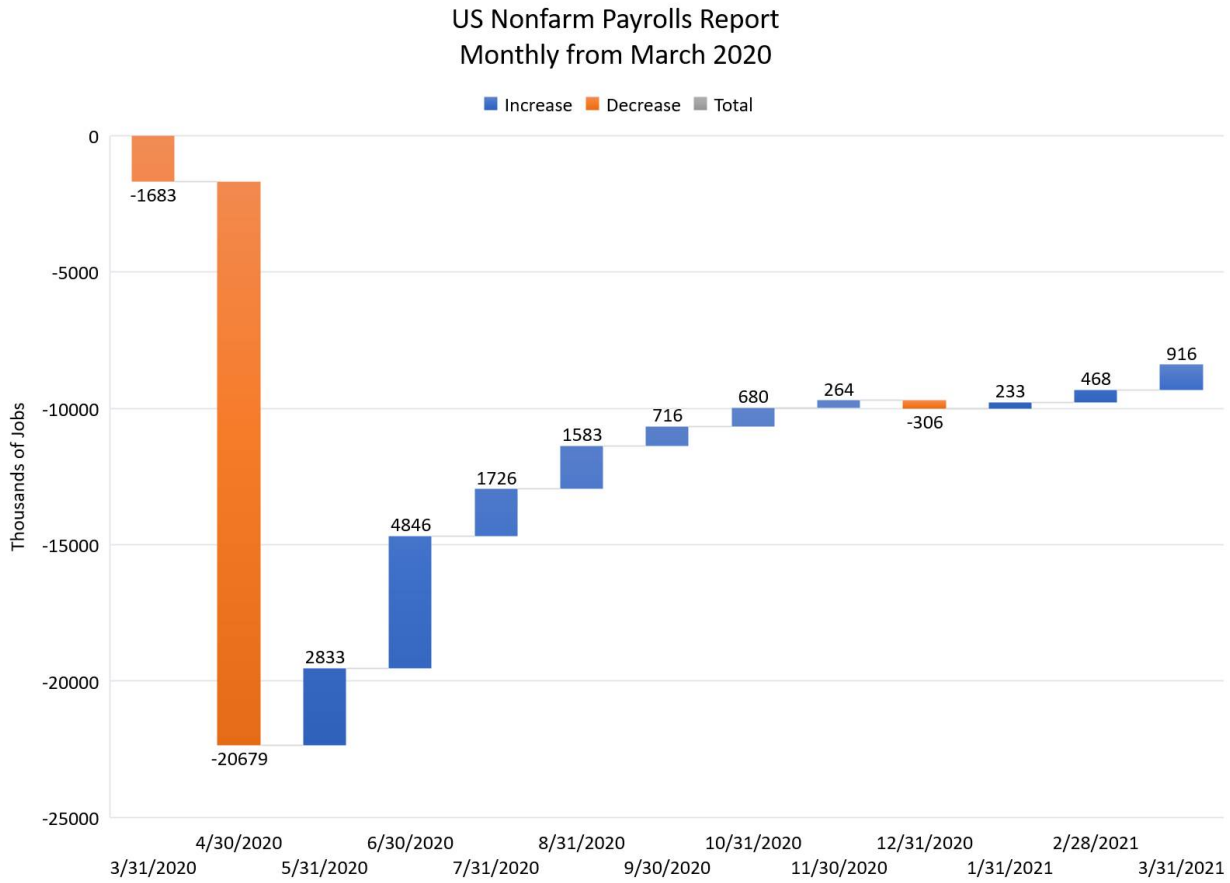
Back to the initial question though: "Where do we go from here?" Below I outline my views in three themes that I believe will define the economic and market environment through the remainder of 2021:

- Economic growth is set to surge — surprises to economic growth will skew to the upside.
- Higher inflation is the new norm — yields will continue to follow.
- Equity market gains will transition from multiple expansion to earnings growth.

Economic growth is set to surge

While countries around the world continue to face new waves of COVID-19 contagion and lockdowns, there is recent economic data and indicators which has surprised to the upside, emanating out of the United States for what a full reopen may look like. Both positive for economic expansion and jobs growth. The "U.S. Non-farm Payrolls" report showed 916,000 jobs were created in the month of March (with an additional 156,000 from revisions to the prior two months), the strongest job gains since last August.

Job gains are starting to reaccelerate.



Some economies, like the United States, have only just started to open up, while others (much of Europe and Canada) remain economically restrained. For example, the combined population of California, Illinois, Massachusetts, and New York is approximately 78.5 million people. These are states that had some of the more stringent lockdowns and are poised to reopen. The recent data, however, would

support the thesis from last year that the COVID-19 pandemic is more likely a disruptive event rather than a destructive event. As lockdowns lift, and in line with the rapid reopen thesis, the data would indicate we will see a surge in economic activity to come.

Higher inflation is the new norm

Evidence of higher inflation is already making its way through the economic data — the ISM PMI Report on Business Prices Index has surged to 85.6, the highest level since 2008. Lumber, one of the biggest costs in home-building after land and labour, has never been more expensive and is more than twice the typical price for this time of year. Crude oil, a starting point for paint, plastics, flooring, etc., has shot up more than 80% since October. Copper, which carries water and electricity, costs about a third more than it did in the autumn. Given the low levels of business inventories combined with the backlog of orders and potential release of pent-up demand, the direction for inflation is most likely higher, not lower.

Higher inflation expectations have led the U.S. 10-year yield to rise above the full-year target of 1.5% before the end of the first quarter. The out-of-consensus view of inflation led to a similar out-of-consensus view for yields. As the surge in yields has met the initial target, I've revised my expectations to 2.0%, with risk to the upside through the remainder of the year. This will continue to pose challenges for fixed-income investors when it comes to long-duration bonds.

Equity market gains will transition from multiple expansion to earnings growth

The optimistic economic outlook leads me to a favourable view towards equity markets. Research suggests that in an environment characterized by accelerating growth and accelerating inflation, major equity markets tend to perform well — in particular, those that are cyclically oriented or have higher exposure to commodities (e.g., emerging markets, Canada).

Over the past year, equity market returns have largely been driven by valuation, or price-to-earnings (P/E), expansion. This is typical of an equity market recovery following a recessionary bear market. This period is typically characterized by stellar equity gains as the market starts to price in a recovery.

It should be noted that in earnings-driven environments, market returns tend to be positive yet average to below-average. Therefore, investors would be well served to discount the outsized equity market gains over the past year and return to average expectations. However, I continue to believe that the risk is to the upside.

In closing, as we head into first quarter earnings results, I'll be interested and watching closely to full-year guidance. The expectation, given the recent economic data, is that earnings risks are to the upside through 2021 and will be the driver of continued market gains.

Stay safe. Stay sane. Although this pandemic has probably lasted much longer than anyone originally predicted there is a light at the end of the tunnel.

-Aaron Pedlar