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Commodities: Road to Redemption

With the view that things will get better, not worse, we believe there remains an opportunity in areas of the market that have lagged over the past nine months. It may be challenging to look past the present, but both equity and bond markets have picked up on the improving growth prospects. In the equity market, small caps and cyclical sectors are outperforming. In the fixed income market, the yield curve is steepening due to long-term yields rising. We view this as a positive for value stocks, many of which can be found in the energy, materials and financial sectors.

- Our commodity-centric market here in Canada should fair well in 2021. Still, as we've discussed in the past, sectors that are involved in the exploration and production of commodities are ones that should be rented, not owned, given they're inherently volatile. Not only that, investors that have been long commodity producers have generally suffered for much of the last decade due to slumping commodity prices. However, this underperformance appears overextended, particularly with the view that global economic activity will improve throughout the year. Perhaps 2021 is the year commodities get their groove back.
- Oil has made a remarkable recovery, considering futures contracts traded negative in March for the first time in their history. We believe oil faces many headwinds, but in the immediate future, the stars are aligning to push the commodity higher.
- The number of commodities in an uptrend far exceeds those that are declining in price, and many of these commodities are supply-constrained. Copper is a good example. It is trading at its highest level since 2013 on the back of positive economic data, particularly in China, which reinforces that the country's economic recovery is on track.
- As economic conditions improve and both fiscal and monetary stimulus measures remain in place, there is the potential for higher inflation. Broadly, developed world central banks have indicated they fully intend to allow inflation to run "hot" as the recovery takes hold.
- Banks have performed well amid a steepening yield curve – government 2yr10yr spreads have widened 70 bps since March. Central banks have committed to maintaining their key lending rate near zero for the foreseeable future. Still, the million-dollar question is, when will central banks step in to neutralize long-term rates (e.g. yield curve control)?

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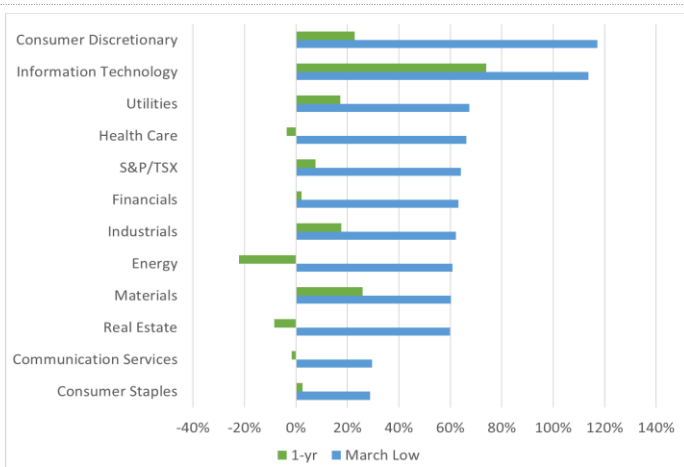
US politics has dominated the headlines since October. To remind readers, in October, many worried about what a Biden win would mean for the markets. He won, and the market went up. Then, there were worries about a contested election. After multiple lawsuits and Trump's attempts to overturn the outcome in key states, the market continued higher. Then, we worried about the "Blue Wave" if Democrats won two seats in the runoff election in Georgia. Both Democratic candidates won, giving their party the majority in the Senate, and the market went up still. A lot of ink was spilt on what these outcomes would mean for investments; not many predicted positive ones for the market. Surely, the storming of the Capitol would have had negative implications on the market. Nope, the market marched higher. These events underscore that markets beat to their own drum, and politics has limited impact on the markets' long-term direction. They are driven by factors like corporate earnings outlook, market liquidity, interest rates and overall sentiment.

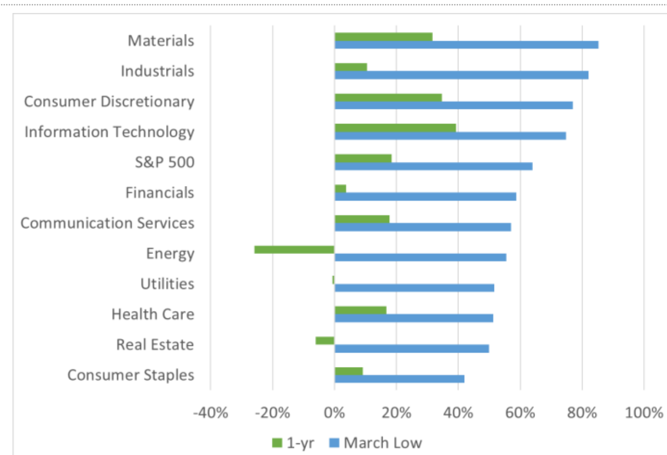
That said, one may be asking how the market hasn't skipped a beat during such a turbulent time. We must remind ourselves that markets look forwards, not backwards, and at the end of the day, the future seems a lot more certain than 12 months ago, even though there remains some difficult months ahead. In just a few months, we will likely have a surge in vaccine availability; shots in arms will allow for more economies reopening rather than locking down. After a chaotic few weeks on the political front, it appears we're moving into a period of greater political stability. If anything, confidence in our institutions and greater assurance on the policy front is critical for business sentiment. Corporations will find ways to generate profits as long as they know the rules aren't going to change.

With the view that things will get better, not worse, we believe there remains an opportunity in areas of the market that have lagged over the past nine months. It may be challenging to look past the present, but both equity and bond markets have picked up on the improving growth prospects. In the equity market, small caps and cyclical sectors are outperforming. In the fixed income market, the yield curve is steepening due to long-term yields rising. We view this as a positive for value stocks, many of which can be found in the energy, materials and financial sectors.

S&P/TSX Sectors – Cyclicals Lead the way



S&P 500 Sectors - Cyclicals Lead the way



Source: FactSet

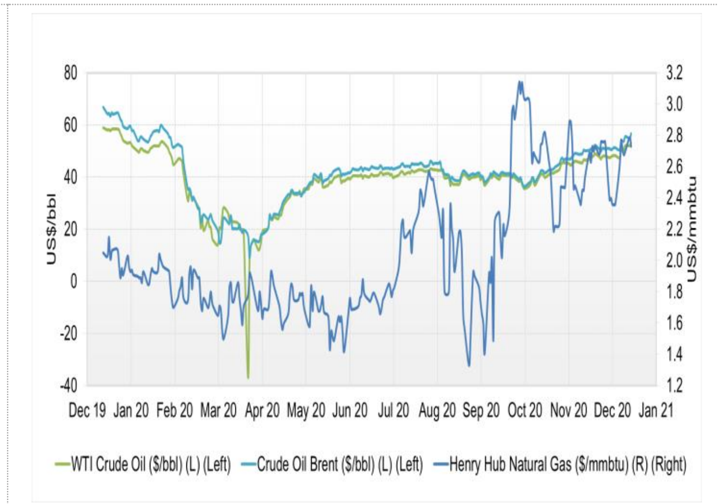
Our commodity-centric market here in Canada should fair well in 2021. Still, as we've discussed in the past, sectors that are involved in the exploration and production of commodities are ones that should be rented, not owned, given they're inherently volatile. Not only that, investors that have been long commodity producers have generally suffered for much of the last decade due to slumping commodity prices. However, this underperformance appears overextended, particularly with the view that global economic activity will improve throughout the year. Perhaps 2021 is the year commodities get their groove back.

Energy – Road to Redemption

Oil has made a remarkable recovery, considering futures contracts traded negative in March for the first time in their history. We believe oil faces many headwinds, but in the immediate future, the stars are aligning to push the commodity higher. Earlier this month, the world's largest oil producers decided not to turn on the spigots and flood the market in a rather dramatic fashion. Further, US shale producers appear to be in no rush to increase supply, rather focusing their attention on improving their balance sheets and returning cash to shareholders. Taken together, greater discipline and commitment to not flood the market should help the energy sector recovery in 2021.

Commodities Relative to Equities Overextended…

…Oil & Nat Gas Recovery Underway



Source: FactSet, Raymond James Ltd.

Materials - Improving Demand/Limited Supply

The number of commodities in an uptrend far exceeds those that are declining in price, and many of these commodities are supply-constrained. Copper is a good example. It is trading at its highest level since 2013 on the back of positive economic data, particularly in China, which reinforces that the country's economic recovery is on track. The increased odds of a large US infrastructure spending initiative also increases the prospects for an improved demand outlook for raw materials. As the demand outlook improves, supply has tightened. The most notable example is the decreased production in copper-rich regions, such as Latin America and Africa that continue to deal with the pandemic's adverse effects. With a more robust global consumption outlook, copper is forecast to slip into a supply deficit in 2021.

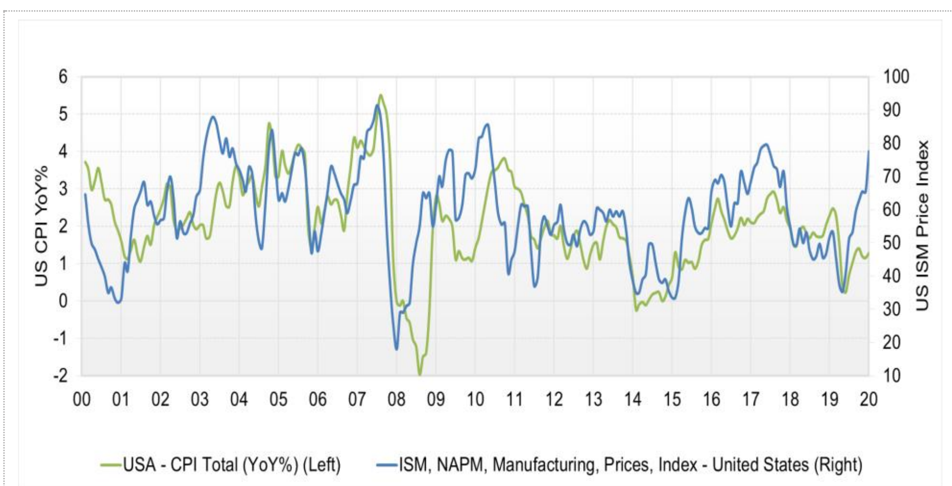
Dr. Copper Revisit 2013 Levels

Source: FactSet, Raymond James Ltd.

Inflation to Run "Hot"

As economic conditions improve and both fiscal and monetary stimulus measures remain in place, there is the potential for higher inflation. Broadly, developed world central banks have indicated they fully intend to allow inflation to run "hot" as the recovery takes hold. Thus, the ingredients are in place for higher inflation to become a dominant theme later this year. In the chart below, we can see the US ISM Price Index has shown a tendency to lead overall inflation; we think this divergence will narrow throughout 2021.

ISM Price Index Point to an Uptick in US CPI

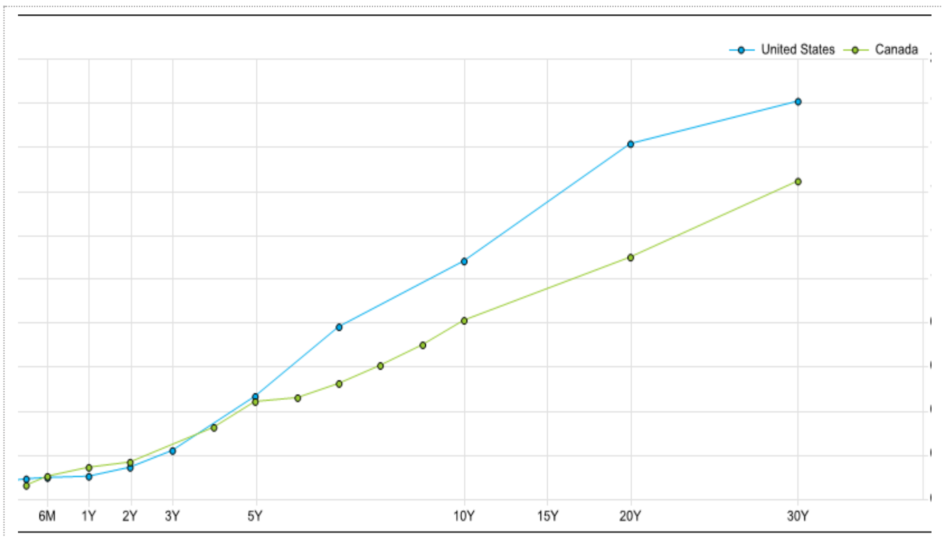


Source: FactSet, Raymond James Ltd.

Financials – Steeper Curve Benefits Banks

Banks have performed well amid a steepening yield curve – government 2yr10yr spreads have widened 70 bps since March. Central banks have committed to maintaining their key lending rate near zero for the foreseeable future. Still, the million-dollar question is, when will central banks step in to neutralize long-term rates (e.g. yield curve control)? While there has been no indication as to when this may happen, our assumption is central banks will wish to maintain a negative real rate environment. Thus, once the government 10-year bond yield approaches the annual inflation rate, we suspect action will be taken. This implies a US government 10-year bond yield at 1.13% would need to rise another 50-80bps. That that point, the spread between 2 year and 10 year will likely be as wide as the Fed is comfortable, and one may wish to lighten up on the banks.

US & Canadian Yield Curves Steepen



Source: FactSet, Raymond James Ltd.

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