The Madness of March Markets

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> *"Markets can remain irrational longer than you can remain solvent."*
> —JM Keynes

> *"Every once in a while, the market does something so stupid it takes your breath away."*
> —JJ Cramer

I seldom doubt the deep wisdom of financial markets, since it represents the weighted collective views of all participants. But, every so often, the market can do things that are tough to reconcile—to put a gentler spin on Mr. Cramer's quote—and even tougher to discern its underlying message. As a prime example, consider what has just transpired in Q1 and even for the month of March alone. **While the Treasury yield curve inversion and relentless rally in bonds revived recession chatter, almost all other financial markets simply refused to listen to that siren song.**

Which of these things doesn't belong? For all of Q1, the **S&P 500** was up almost 13% and the **MSCI World index** more than 11%. **CRB Futures** rose more than 8%, while the **GSCI** was up 16% on a blistering 30% gain in oil prices. **Corporate spreads**, from BBB to junk, tightened sharply. **Gold** was about the only commodity price that didn't rally forcefully. And, **government bond yields** plunged, with 5s and 10s leading the Treasury charge with declines of more than 25 bps, while GoCs plummeted more than 30 bps in the quarter. *Wait… what*—**a massive bond rally in the face of a uniform risk-on move everywhere else?** Making the move even more curious is the fact that the slide in yields was heavily concentrated in a steep drop in real yields, as the implied inflation component (not surprisingly) held up on the comeback in oil prices.

While much of the risk-on rally was concentrated in the first two months of the year, March didn't exactly break the spell. If anything, **the government bond rally gathered momentum**, even as each of stocks, credit and commodities firmed a bit further in the month. So, while much of the chattering class has focussed on the loud message that the bond market is sending, through the flat and occasionally inverted yield curve, almost all other markets are saying something quite different about the outlook.

Attempting to circle this Rubik's cube of contradictory messages, we can put some of the spirited rally in equities and commodities down to a rebound from the overly negative move in Q4. As well, the extreme dovish pivot by the Fed, the BoC, the ECB, and others, helped fuel some of the rally in both stocks and bonds. **However, the fact that the divergence in stocks and bond yields widened further in March is tougher to explain.** Broadly, the combined market message appears to be that growth globally will keep grinding ahead, but it has taken a big step down from above potential in the past two years to below potential, probably for a few years. In turn, underlying price pressures will ebb, even with the snap-back in oil prices. These combined forces suggest that **we are indeed looking at a long pause for policy interest rates**, possibly among all major central banks. See Michael Gregory's writeup in our weekly *Focus*, outlining our small revisions to our official rate call, but—*spoiler alert*—**we are removing the one rate hike we had in 2019/20 for both the Fed and the BoC**.

No central bank is going to rush to do anything with rates after a noisy first quarter, for both markets and the economy. The U.S., in particular, was whipped around by the government shutdown, wicked winter weather, and delayed data. Even something as straightforward as consumer confidence couldn't deliver an unambiguous message, as the Conference Board reported an unnerving pullback in March (notably on job prospects) while the University of Michigan told us sentiment hit a five-month high the same month. At the same time, housing starts retreated sharply in February even as new home sales roared back to life. Balancing out these diverging trends, we suspect GDP growth will do well to meet our 1.2% call in Q1, after the middling 2.2% pace in Q4.

In reality, we and policymakers likely **need to get a much better bead on how the economy fares in the spring**. By then, we should have a cleaner read on underlying growth. But, circling back to the opening quotes, let's bring in a real market legend himself for the final word. In a startling bout of clarity and simplicity, Warren Buffett opined on both the economic outlook and the stock/bond divergence this week, and may just have hit the nail on the head.

- *"It appears that the pace of U.S. economic growth has slowed down"*. While the use of the word "down" is redundant (can you slow up?), there are two key messages here: No doubt that, after a stimulus-fuelled spurt last year, growth is cooling, but also no talk of recession.
- *"The lower long bond yields go, the more attractive stocks are as a long-term investment."* And, thus, Mr. Buffett helps explain in one simple sentence the riddle of plunging yields and resilient stocks that we have seen through the first quarter.

In recent weeks, I must allow that thoughts of gloom and foreboding have swept in around the local outlook—and I am not just talking about the Leafs' playoff prospects or the next 161 Blue Jay games. Instead, it was the **seemingly darkening outlook for the Canadian economy**, what with the plunge in bond yields, the inverted curve, trade actions by China, the uncertain fate of the USMCA, a tired consumer, and a struggling housing market. But January's GDP report cut through this deepening fog like a high-powered beam, with a hearty 0.3% advance (0.349% to be precise). Instead of printing a third consecutive monthly decline as some (*ahem*) had expected, on mandated oil production cuts in Alberta, 18 of the other 19 sectors posted growth, led by towering gains in both construction and manufacturing.

This is one time when we are delighted to have been—let's not sugar-coat it—dead wrong on a monthly call. Given that it kicks off the quarter and the year, January is simply the most important month of the year for the annual estimate of GDP. Thus, the large high-side surprise prompted us to **revise up our GDP growth call for both Q1** (from zero to a 0.7% annualized gain) **and for 2019** (from 1.3% to 1.5%). Last week's stimulus in the federal budget added a bit of support for the upgrade, alongside the ongoing strength in oil prices, tempered somewhat by China blocking canola imports and the Fiat-Chrysler job losses in Windsor later this year.

To be sure, 1.5% GDP growth is only scraping the very low end of the range of the BoC's estimate of potential, is barely keeping up with Canada's population growth, and would still be step down from last year's 1.8% advance. But, it's a far cry from recession, it clipped talk of possible BoC rate cuts, and it's a nice break to actually be revising *up* a growth forecast. Now, if we can only do something about the Leafs' defence and the Jays' offence…