CIBC Asset Management

Market Spotlight

August 2017

Global Markets

Optimism over improving global economies kept global financial markets on the rise again in July. Global equities rose 2.4% in U.S. dollar terms, but fell -1.4% in Canadian dollar terms as the loonie rose. Global economic data continued to improve and major central banks, with the notable exception of Canada, kept interest rates unchanged.

The Canadian equity market fell fractionally, losing -0.06%. The Canadian dollar rose sharply as the Bank of Canada (BoC) raised interest rates and oil prices stabilized. The Canadian economy has created new jobs at an impressive rate over the past few months, but inflation remains low. This leaves the BoC with a justification to curtail any further immediate rate hikes. The next BoC rate increase is expected in October.

U.S. broad equity markets gained just over +2%, while the Nasdaq 100 was higher by over +4%. The U.S. jobs market continues to strengthen and manufacturing data remains strong. The improved economic picture was reflected in some fairly good corporate earnings results released in July. At the same time, inflation remains subdued, removing the immediate need for the U.S. Federal Reserve (Fed) to raise interest rates.

International equity markets rose about +2.9% (USD). European equity market gains (ex UK) registered +0.5% in local currency, with a stronger euro again boosting gains to +3.2% in USD. Japanese equities recorded a fractional gain in local currency, but yen appreciation lifted returns to +2% when viewed in USD.

Emerging markets gained +6% (USD), with China higher by almost +9% (USD). China recently reached an important milestone with the introduction of its domestic equities into several MSCI indices. Emerging markets continue to post the strongest global equity performance in 2017, up +25% (in USD).

Current Asset Allocation Outlook*

Asset Class	Weighting
Canadian Bonds	Overweight
International Bonds	Underweight
Canadian Equities	Market Weight
U.S. Equities	Underweight
International Equities	Overweight
Emerging Market Equities	Overweight

** For balanced portfolios, as at July 31, 2017.*

"Sound Bites"

Luc de la Durantaye

"Fuelled by the BoC's drastic change in views, the Canadian dollar gained substantial ground against the U.S. in the last few months. Previously concerned that Canada was stuck in a low-growth environment, the BoC is now convinced that the Canadian economy is on more solid footing. Currency-wise, whether Canadian monetary authorities actually hike rates once or twice before year end is of little relevance. The Canadian dollar has, to some extent, already priced in such policy actions.

From this point on, the relevant question to determine the Canadian dollar outlook is whether the BoC's projections for the Canadian economy and inflation will materialize or not. If they don't (as we suspect), the BoC will certainly strongly hesitate before actually delivering rate hikes. This is especially true given the strong appreciation of the Canadian currency and the prevailing weakness in oil prices. Given the forces at work, we see limited short-term upside for the Canadian dollar at current levels. Over the longer term, the Canadian dollar is expected to drift lower, owing to a BoC-led downshift in relative Canadian versus U.S. monetary policy expectations and more persistent oil price weakness."

Fixed Income

The Bank of Canada (BoC) delivered on the warning it gave in June by raising its interest rate 0.25%—the first increase in seven years. Bond yields rose in anticipation of the move, but continued to rise for the balance of the month as investors priced in further action in the fall and 2018. The BoC's actions came despite an inflation rate that remains well below the midpoint of its target. U.S. bond yields also rose, but to a lesser degree. Investors worried that the economic benefits expected to result from some of President Trump's signature policies would not be implemented in 2017. The Fed left its rate unchanged, but reiterated its intent to begin shrinking its balance sheet—perhaps as soon as September.

Canadian Equity

The Canadian equity market fell fractionally in July, losing -0.06%. The Canadian dollar rose sharply as the BoC raised interest rates and oil prices stabilized. The energy sector was the best performing sector (+2%) while materials recorded a similar gain. Financials, the other heavily weighted sector in the S&P/TSX Composite, rose fractionally, but most sectors posted negative returns for the month.

"Sound Bites"

Patrick O'Toole
Vice-President, Global Fixed Income

Rates are Rising but Still Chronically Low

"In July, we saw the Bank of Canada start to increase its interest rate. Some people are taking that to mean that there is going to be a full-blown interest rate hike cycle. However, I don't think the BoC was committing to anything—it's not in their self-interest at the moment. They're basically giving guidance saying, 'We're looking to remove some of that emergency 50 basis points of cuts that we did in 2015.' I think the media may be overhyping the belief that a full-blown interest rate hike cycle is coming up. That scares people because they remember that, in the past, you had the BoC raising rates three, four, five percentage points and then bond yields jump. This cycle is much different. This whole growth cycle has been subdued, with lower inflation. Inflation hasn't come close to what the central banks were expecting.

It's not a surprise that growth has been lower, as we've seen a drop in the labour force growth rate. We all know that demographic story—the baby boomers are aging. Higher trend growth is a challenge when the labour force is shrinking.

Even though inflation is below the BoC's target level, they are starting to hike interest rates a little bit believing inflation is coming back. We think the BoC is maybe going to hike once more in the next six or nine months. They may get away with two or three hikes in the next 18 months, but it will be a very different cycle than we've seen in the past.

Where Should Investors Turn?

We believe that corporate bonds are going to continue to outperform government bonds. Government bond yields can move up a little bit as the economy continues to be lukewarm (perhaps a little above trend growth) in the next year or so.

For some investors, one solution is to focus on those portfolios that are overweight corporate bonds and don't have as much exposure to government bonds. There's nothing wrong with having some government bonds in there for some insurance. Investors could also consider pure corporate bond funds that have a good mix of investment grade and high yield. This would be an attempt to keep portfolio yields higher than what you're getting with pure government bond portfolios."