CIBC Asset Management

Market Spotlight

December 2017

Global Markets

As we close in on year-end 2017, global equity markets continue the healthy performance they have demonstrated all year. In the current optimistic climate, global growth has picked up, but not to the extent that would generate rampant inflation and a sharp increase in interest rates. In November, global equities rose 2.2% in U.S. dollar terms, and 2.1% in Canadian dollar terms.

U.S. broad equity markets gained 3.1%, while the Nasdaq 100 was higher by 2.1%. Jerome Powell was announced as the new Federal Reserve (Fed) Board Chairperson, replacing current head Janet Yellen in 2018. The choice of Powell was met with calm, as his economic philosophy is not considered radically different from the outgoing Chairperson. Strong employment numbers for November increased speculation that another U.S. interest rate increase was coming in December—and the Fed did not disappoint. The Fed moved the fed funds rate to 1.50%, an increase of 25 basis points.

International developed equity markets gained 1.1 % (USD), with Japanese equities higher by 3% (USD). Investors welcomed stronger growth readings from Germany, France and Italy. The British pound rallied as investors become more convinced that Brexit negotiations will be more favourable for the U.K. than previously expected. Meanwhile in Germany, Chancellor Angela Merkel has been unable to form a coalition government following the election in September. Without a coaliton, the political alternatives are a new election or an unprecedented minority government. Talks between parties continue into December.

Emerging markets gained 0.2% (USD), with China higher by 1.6% (USD). Rating agency Moody's upgraded its sovereign rating on India, its first upgrade on this country in 14 years. The move is a vote of confidence in the ongoing policy changes being enacted by Prime Minister Modi. Among the changes, Modi has implemented a goods and services tax and is moving to address increasing numbers of bad loans in the banking sector. India's stock market has rallied almost 30% in 2017. While impressive, this still trails the greater-than-50% increase in China's equity market.

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 November 30, 2017.*

"Sound Bites"

Luc de la Durantaye

"In the U.S., the unemployment rate is at or below the level that signals full employment. Additional employment gains from here could create bottlenecks and wage pressure inflation. If this process takes place more quickly than expected, central banks would have no choice but to react by tightening more aggressively. The repricing of investors' expectations would have serious repercussions for most financial assets. Bond yields would spike and the resulting U.S. dollar rally would hit emerging markets and commodities. High equity valuations would become hard to justify and a correction would follow.

Keep in mind that equities have been rising without interruption since early 2016 and, year-to-date, are up double digits. This creates some concerns about "overbought" markets. Outside of inflation, there are a number of other issues creating uncertainty: North Korea, U.S. tax reforms, Italian banks… to name a few.

The two scenarios—a gradual or a sharp and swift rise in inflation— stand in opposition. The reality will most likely fall somewhere in between, while market expectations may shift back and forth from one scenario to the other. For the moment, inflation remains benign and we are leaning towards the "more gradual" scenario."

Fixed Income

The bond market put in a mixed performance in November as short-term yields posted a modest rise, while long-term yields moved slightly lower. Although there was little change in the odds that the Bank of Canada would hike rates any time soon, short-term yields felt the tug of higher bond yields in the U.S. The U.S. Treasury market priced in the near certainty that the Fed would raise its rate again in December. Long-term yields pushed lower on evidence that Canada's growth rate was slowing and that inflationary pressures remained muted. The rise in U.S. yields occurred as investors priced in stronger growth that is expected to result from revisions to the tax code that will see business taxes reduced.

Canadian Equity

The Canadian equity market rose 0.5%. Canadian quarterly bank earnings were strong, with record profits in many cases; strong performance by capital markets helped boost results. Oil continued to rally after the October 31 OPEC meeting, where participants agreed to extend production cuts for another year. NAFTA discussions continue without concrete results for the moment, as Trump and Trudeau publicly debate whether it is Canada or the U.S. that holds the trade deficit. At its last monetary policy meeting of the year, the Bank of Canada maintained interest rates at current levels.

"Sound Bites"

Éric Morin

Assistant Vice-President
Asset Allocation and Currency Management

U.S. Tax Reform

"The passage of the U.S. tax reform bill has been a very hot topic over the past month. Overall, we believe that its effect on the U.S. economic outlook will be somewhat muted. Despite the recent U.S. equity market strength, our models forecast that this initiative will add only about 0.3% to U.S. GDP growth—and we are not alone in this conclusion.

Here at home, we were not surprised that the Bank of Canada held rates steady at their December meeting. A closer look at recent Canadian economic data reveals that the picture here is not as robust as it initially appears. For example, let's look at the Canadian jobs number for November. While 80,000 jobs were added and the unemployment rate fell to 5.9% (lowest since October 2008), the number of hours worked was disappointing. Wage growth (increase in wages) however was a positive. It is worth noting that this wage growth did not result primarily from wage inflation. Rather, we are seeing more growth in higher paying jobs and a resulting change in compositon of the "job growth" universe.

There are still material risks in Canada, especially rising housing concerns. This will likely lead the Bank of Canada to be somewhat cautious about rate increases and create a growing divergence with U.S. monetary policy.

Update on Brexit

On a side note, a few thoughts on the Brexit talks currently underway in Europe. The U.K. pound sterling has strengthened in recent weeks as Brexit talks seem to moving along at a more optimistic pace than the most gloomy predictions. While financial markets seem to be discounting a "hard Brexit", keep in mind that the U.K. economy is still relatively weak."