CIBC Asset Management

December 2018

MARKET SPOTLIGHT

GLOBAL MARKETS

November's G20 meeting in Argentina produced political controversy but also a détente (perhaps temporary) in the trade war between the U.S. and China. While this development sparked a U.S. equity rally in late November, volatility has resumed with a vengeance in early December. In November, global equities rose 1.1% (USD), and 2.4% (CAD), as the Canadian dollar weakened.

U.S. broad equity markets gained 2%, with the Nasdaq 100 almost unchanged (-0.1%). U.S. midterm election results were not a surprise, as Democrats regained control of the U.S. Congress. But investors are acknowledging that Trump will be less likely to succeed with the introduction of further fiscal stimulus, and the U.S. economy is likely to slow. In addition, higher interest rates have subdued the housing market, with an impending additional hike in December likely to extend the lethargy.

International developed equity markets traded close to unchanged (in USD), with Japanese equities inching higher by 0.4% (USD). Brexit negotiations are coming to a head as Prime Minister May scrambles to engineer a deal acceptable to all parties. May was forced to delay a vote on the proposal to January, knowing the current draft would not pass. France is dealing with backlash from a proposed environmental fuel tax, as "yellow vest" protestors riot across France. President Macron has temporarily suspended the tax. Italy continues to negotiate the details of its deficit reduction with the European Commission.

Emerging markets rose 4.1% (USD), while China gained 7.3% (USD). Chinese equities have had a difficult year, reacting to an ongoing onslaught of U.S. trade tariffs and threats. Chinese government stimulus coming in 2019 could help improve the domestic economy, but Chinese equities, and emerging market equities as a group, will almost certainly produce negative returns for 2018.

The view from our Chief Investment Strategist:

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TRADE UNCERTAINTY MEETS LOWER DECEMBER TRADING VOLUMES

The market correction over the past weeks seems to be disconnected from the more balanced news over that time. We believe several developments should have been somewhat more supportive of financial markets.

- First, the U.S./China "truce" at the G20 meeting delayed additional tariffs. The tone between the U.S. and China was more constructive, despite the Huawei incident. This may indicate that the Trump administration's tolerance/appetite for market volatility is waning, with a view to a 2020 re-election. While trade uncertainty still exists, recent events could be interpreted as *not* increasing the downside risk to financial markets.
- Second, U.S. Federal Reserve (Fed) policy has been softening, at least in words, following Fed governors' speeches. U.S. data remains relatively healthy, albeit slowed—providing the Fed a window to consider slowing its pace of hiking. The market narrative around European monetary policy turned somewhat more dovish. This should continue following the soft November jobs report. Even Italian budget negotiations with the European Council have moved in the right direction, although at a glacial pace. Italian political objectives remain misaligned with European technocrats; however, consequences of not having a budget agreement should force the adoption of a compromise that could ease eurozone tensions.
- Lastly, the OPEC production cut agreement is both helping arrest the fall in oil prices and not producing a sharp price reversal that could jeopardize economic growth or create inflationary pressures.

These developments remain tentative and other financial market risks (e.g. Brexit) remain unresolved. Our main economic scenario is for continued growth over the coming 12 months. Monetary policy remains accommodative, and we don't see large economic imbalances that have traditionally led to the end of a period of expansion.

FIXED INCOME

The bond market rallied in November, taking yields lower across the yield curve. The rally was largely attributed to evidence that global growth is slowing and that the Federal Reserve (Fed) and Bank of Canada (BoC) may soon pause in their interest rate hike campaigns. Canada's economy has also struggled with soft commodity prices. That may shake the BoC's recent confidence that a resurgence in business spending will help offset softer consumer spending resulting from changes to mortgage qualification rules and higher interest rates.

CANADIAN EQUITY

Canadian equities gained 1.4% in November, bouncing back slightly from October declines, as volatility continues. Canadian financial companies (+2%) and information technology (+2.9) led the gains. Energy stocks (-2.4%) fell, mirroring November's sharp declines in the price of oil (-22%). Providing an additional challenge, Canadian energy prices continue to trade at a substantial discount to internationally quoted prices. Following an OPEC production cut in early December, oil has modestly rebounded.

SOUND BITES

TAKING STOCK OF TECH

Jonathan Mzengeza
Equity Analyst

Since the beginning of October, technology has underperformed the broader market, with major indices such as the tech-heavy Nasdaq declining by -13%. This outpaced declines in the broader market and was driven by several factors including the U.S./China trade dispute, fears of rising interest rates and decelerating economic growth. Technology has been particularly hard hit, as the trade dispute between the U.S. and China has an outsized impact on the technology sector, where global supply chains have significant China exposure. Additionally, several FAANG* stocks reported results or gave guidance that disappointed the market.

Despite missing market expectations when it reported quarterly earnings, we continue to believe that the fundamental story behind Amazon remains strong. Global e-commerce is still only 9% of global retail spending and Amazon is the leader in online retail. Furthermore, Amazon Web Services, its enterprise cloud business, is currently the clear leader in the segment.

Apple's results reflected uncertainty over the continued demand for its iconic product, the iPhone, which constitutes roughly 60% of its business. Smartphone demand is expected to be weak, given what many consumers believe to be limited innovation and a significant increase in price. Following a period of consolidation, we believe that Apple could eventually represent a compelling investment.

Internet services companies face an uncertain future—the impact of regulatory scrutiny and new regulations (such as the General Protection of Data Regulation) have not been fully realized. This should have an impact on the ability of these companies to drive revenue growth as well as on profitability, as companies spend more to comply.

Overall, we are most constructive on the software sector, given limited to no trade risk and underlying secular drivers of growth such as the move to cloud and digital transformation. We have a preference for Microsoft, ServiceNow and Salesforce.com in this space. We also see opportunities in data analysis and security.

We are most negative on the semiconductor sector, given the large trade risk and deteriorating fundamentals. Inventory levels across the supply chain remain above historical levels and demand in key end markets such as industrial, datacenter and automotive is declining. Additionally, the price correction in cryptocurrency assets has had an adverse effect on demand in this sector. The only bright spot is communications, where the rollout of 5G networks is leading to increased demand for semiconductor companies exposed to that end market.

*Facebook, Amazon, Apple, Netflix, Google