CIBC Asset Management

Market Spotlight

June 2017

Global Markets

Global financial markets were higher again in May. Global equities rose 2.1% in U.S. dollar terms, 0.9% in Canadian dollar terms. Political events again dominated global headlines, with attention turning from the French election to other global political events. The OPEC meeting and continued controvesy over actions by U.S. President Trump were issues of note. U.K. elections became a much closer race as voting day neared, with the Conservative party ultimately losing its parliamentary majority on June 8.

The Canadian equity market slipped, losing 1.3% in May. Oil prices briefly moved over $50 but dropped later in the month nearer to $45, a multi-month low, even as OPEC agreed to extend production cuts. The Bank of Canada left interest rates unchanged, commenting that it expects continued challenges for the sluggish export sector. The Canadian dollar gained over 1% against the U.S. dollar.

U.S. broad equity markets rose 1.4%, while the Nasdaq 100 jumped almost 4%. U.S. earnings season continued, with a majority of companies surpassing revenue estimates. Employment reports, however, have recently been weaker than many had hoped. Wage gains, which should be in evidence at this point in the recovery, have been notably disappointing.

International equity markets rose about 3.7% (USD). European equity market gains (ex U.K.) registered about 2% in local currency, with a stronger euro producing 5.2% gains in USD. Investors were relieved that the second round of voting in France served to confirm a win for Macron's centrist party. European economic data continues to improve, with unemployment falling and consumer confidence improving. The German business sentiment index recently reached the highest level since its creation in 1991.

Emerging markets gained about 3% (USD), 2.5% in local currency. A rating agency (Moody's) downgrade of Chinese sovereign debt (but a change in outlook to stable from negative) was no deterrent for equity investors. Chinese equity markets rose by over 5% (USD). Emerging markets remain the best-performing major global equity region in 2017.

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 May 31, 2017.*

"Sound Bites"

Luc de la Durantaye

U.S. Fed raises rates in June

"Nearly eight years after the Great Recession, the U.S. Federal Reserve (Fed) can finally breathe a little easier. Thanks to the colossal efforts it has deployed over a number of years, the U.S. labour market is in its best shape in over a decade. This is certainly good news and provides enough justification for the Fed to shift to the second phase of its tightening campaign—one where it could deliver rate hikes at a faster pace. However, this second phase should prove to be a critical one with much higher risk of a policy mistake. Why worry?

The challenge the Fed faces is to figure out the right dose of tightening to deliver. The U.S. debt load is at record levels (after accounting for households, government and corporations), roughly 300% of GDP. As a result, the U.S. economy is more vulnerable than ever to rising borrowing costs. Because of this unique feature, the Fed will have a difficult balancing act between renormalizing monetary policy and keeping an eye on the unusually high economic debt load."

Fixed Income

Bonds rallied as it became increasingly evident that some of President Trump's major policy changes are unlikely to be enacted this year or could be watered down. The rally was also helped by U.S. economic data releases that, on balance, were weaker than expected. That led many economists to reduce their expectations for a sharp rebound in second quarter U.S. growth after a disappointing start to the year. Despite the move lower in yields, the futures market remained priced for the Fed to increase the fed funds rate at its June 14 meeting.

Canadian Equity

The Canadian equity market fell 1.3% in May, bringing its year-to-date return to +1.5%. Canada's economy exceeded expectations in the first quarter with a 3.7% annualized GDP reading. Retail sales (March) were healthy, with a strong showing from auto sales, while inflation remains benign. Early economic data show the second quarter is also off to a strong start. During the month, rating agency Moody's downgraded Canadian banks over concerns related to an overheating housing market and high levels of consumer debt. However, Canadian financial institutions continue to demonstrate solid earnings power *(see below for detailed comments).*

"Sound Bites"

Bart Dziarski
Equities – Financials
Analyst

Canadian banks continue to deliver strong results

"Canadian banks reported a strong Q2/17, modestly exceeding analyst expectations. Year-over-year earnings growth of 14% beat consensus estimates by 3% on average— driven by strong capital markets, wealth management, expense control and a continued improvement in credit losses. The strong results generated robust capital levels. With the exception of capital markets earnings, which are highly volatile and market dependent, expense and credit improvement trends are expected to continue driving earnings growth in 2017.

Strong capital markets/wealth management results and expense improvement drive positive operating leverage

Canadian banks continued to benefit from increased market volatility, following the U.S. election, and higher assets under management, following a strong RRSP season. Strong trading revenue and wealth management results, combined with disciplined expense control, drove positive operating leverage (revenue growth outpaced expense growth) for the fifth consecutive quarter. While trading revenue can be volatile, we believe the theme of expense control will continue to play out over the next couple of years— Canadian banks have taken over $2 billion CAD in collective restructuring charges over the last two years. In our view, Bank of Nova Scotia will benefit the most from the expense control theme—it has been aggressive in managing costs, taking nearly $600 million CAD in restructuring charges. The bank is trending ahead of its 2017 targeted cost saving and our analysis indicates productivity can improve further as the gap with best-in-class peers narrows. CIBC should also benefit from productivity improvements; however, the bulk of the benefit should come in 2018 and beyond.

Credit metrics continue to improve

With energy-related losses likely having peaked in fiscal Q2/16, the market has shifted its focus to the Canadian consumer as a driver of potential credit deterioration. Macroeconomic factors such as elevated consumer debt levels and "overheated" housing markets drive this view. In early May, Moody's downgraded the "Big-6" banks on these concerns. However, Canada's housing market and its consumers have remained resilient. In Q2/17, banks reported a fourth consecutive quarter of declining credit costs while Canadian mortgage and consumer (including credit card) credit metrics remained strong. With no notable deterioration in consumer credit and energy companies continuing to improve their balance sheets, we believe provisions for credit losses have peaked in the near term. We expect credit stabilization to continue in 2017. In our view, CIBC stands to benefit most from the resilient credit trends, as the market remains concerned with CIBC's elevated mortgage growth relative to peers."