MARKET SPOTLIGHT

GLOBAL MARKETS

Geopolitical events continue to rattle global financial markets, especially because next moves from the U.S. have been so difficult to anticipate. An on-again/off-again peace summit with North Korea and back-on-again U.S. trade tariffs on steel and aluminum grabbed headlines. Italian political maneuvering added more uncertainty. Increased global anxiety pushed investors to the safety of the U.S. dollar, strengthening the greenback by 2% against a basket of foreign currencies. In May, global equities gained 0.6% in USD, and 1.8% in Canadian dollar terms, as the Canadian dollar declined.

U.S. broad equity markets rose 2.4% while the Nasdaq 100 rose 5.7%. The U.S. economic picture continues strong, with both consumer (consumer confidence, retail sales) and manufacturing reports improving. Trump's June 1 decision to impose steel and aluminum tariffs on its trading partners threatens to challenge the ongoing U.S. expansion with the possibility of a global trade war.

International developed equity markets declined by 2.3% (USD), with Japanese equities lower by 1% (USD). The changing political scene in Italy has raised fears that the country could exit the euro currency. However, the current coalition government makes any radical change less likely, at least in the short term. European economies continue to improve without generating strong inflation, reassuring investors that the European Central Bank will remain accommodative for now.

Emerging markets fell 3.5% (USD), with China higher by 1.8% (USD). Investors in emerging markets were spooked by USD strength in May—emerging markets can be negatively affected by a strong USD, especially if the country is holding USD-denominated debt. That said, even after the USD rally of the past five weeks, the USD is still lower than levels that prevailed through 2016 and early 2017.

CURRENT ASSET ALLOCATION OUTLOOK*

ASSET CLASS	WEIGHTING
Canadian Bonds	Underweight
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, 2018.

SOUND BITES

Luc de la Durantaye

"It's tempting to conclude that the undervaluation of the Canadian dollar will allow Canada to restore its competitiveness, as has often occurred in the past. This time around, however, there are a few caveats to consider. First, while the Canadian dollar does qualify as undervalued, it is not particularly cheap. Many other currencies are more undervalued than the Canadian dollar when compared to the U.S. dollar. Second, issues around competitiveness are numerous and becoming more and more problematic. In many sectors, the non-energy trade deficit has continued to widen and Canadian exporters have continued to lose U.S. market share. In the oil sector, despite higher oil prices, investment intentions for 2018 are more than 10% below last year, the fourth consecutive annual decline. Finally, the prospect for a deep reform of U.S. trade policy is certainly not good news for Canadian exporters."

FIXED INCOME

The bond market recovered previously lost ground in May, as yields declined across the yield curve. Long-term yields saw the biggest drop. The rally was largely driven by geopolitical events—these overwhelmed the evidence that the economy is doing better in the current quarter. Tame inflationary pressures were also supportive of lower yields. The Bank of Canada—which had cited trade tensions as a reason for keeping its policy rate unchanged—signaled that it intends to raise its interest rate on July 11. The Federal Reserve is also likely to hike at its next meeting, on June 13.

CANADIAN EQUITY

The Canadian equity market rose 3.1%. Gains were spread across most market sectors with materials, industrials and technology leading the way. The energy sector also moved higher (up 2.8%), adding to April's gain of almost 7%. Although trade troubles continue to make daily headlines, the Canadian jobs market is improving (part-time jobs declining, full-time jobs increasing) and wages are moving higher. February and March also showed decent monthly gains in GDP.

SOUND BITES

Catharine Sterritt

Associate Portfolio Manager

Trade Wars Escalate

The U.S. moved ahead with tariffs on aluminum and steel against Canada. There were a lot of expectations for another extension to facilitate the progress of NAFTA talks but, instead, it's clear those talks have broken down. In the meantime, our manufacturers have to deal with these tariffs. What makes it all the more critical is the fact that we have a new threat—tariffs against the import of automobiles. Those tariffs would probably be four times the value and impact of aluminum and steel, considering the extent and amount of trade between Canada and the U.S. Most auto production in Canada (85%) goes to the U.S.

Is NAFTA dead?

Many believed that if we can't come to an agreement on NAFTA, we would move to WTO[1] with 2-6% tariffs; the Canadian dollar would adjust and we would carry on. That would be preferable to onerous terms on NAFTA that don't make sense for Canada. We might see Canada or Mexico break and give concessions and have an early NAFTA, but that would likely be at terms that are not favourable to Canada.

Or we might take the risk that four months down the road the U.S. Department of Commerce exercise on national security comes back the same way it did for aluminum and steel and brings in auto tariffs. The 'national security' exercise is just the legal mechanism that allows the president to set tariffs instead of Congress.

It is a critical time for Canada because we are a trade nation. Manufacturing is very dependent on the U.S. market and we're already at a tax disadvantage because of U.S. tax reform and their accelerated depreciation that encourages capital expenditures (i.e. capex).

Potential impact for Canadian companies?

The impact will be greatest for companies that are vulnerable to a trade war and vulnerable to a weak Canadian dollar. Many retail stores stock a lot of imported goods and those goods will carry a pricing disadvantage because of our weaker dollar and tariffs. It's going to make it more difficult for the retail sector to perform. On the other hand, major Canadian banks that benefit from a rising interest rate environment and have made substantial U.S. investments over the past three to four years are very well positioned to perform in this environment.

[1]The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations.