

MARKET SPOTLIGHT

GLOBAL MARKETS

Trade issues grabbed financial news headlines over the past several weeks. New U.S. tariffs, both proposed and in effect, and retaliatory measures from its trading partners, seemed to change almost daily. Despite the anxiety this produces, most global equity markets produced gains for the month, as this trade backdrop becomes the “new normal”. In July, global equities gained 3.1% (USD), and 2.1% in Canadian dollar terms, as the Canadian dollar strengthened.

U.S. broad equity markets rose 3.7% while the Nasdaq 100 gained 2.8%. Evidence of a strong U.S. economy continues to mount. Corporate earnings results released during the month were robust, with almost 90% of companies surpassing expectations. GDP was reported at +4.1% (annualized), while data on jobs, retail sales and consumer confidence all continue to improve.

International developed equity markets rose by 2.5% (USD), with Japanese equities up 0.04% (USD). Growth is slowing in these regions (see comment at right) but seems to be stabilizing at lower levels. Although it produced no concrete results, the Washington meeting on trade relations between European Union President Juncker and President Trump appeared to ease some investor concerns—at least for the moment.

Emerging markets gained 2.2% (USD), with China lower by 2.5% (USD). Trade issues are weighing on China, where the economy had already been moderating. A trade war will also affect other Asian countries that are involved in the production supply chain. Some of the countries at risk include Taiwan, Malaysia, South Korea, Thailand, the Philippines and Singapore. This dispute is not just a headwind for China but for the whole Asian manufacturing hub.

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 July 31, 2018.

SOUND BITES



Luc de la Durantaye

“In international developed markets, economic growth is decelerating, and is unlikely to rebound as vigorously as in the U.S. However, inflation is still very contained, so central banks can afford to take their time

renormalizing monetary policies—this has been the recent message from the European Central Bank. This ongoing easing creates an environment where earnings can continue to grow nicely, although at a slower pace than last year, without facing headwinds from the labour and interest rate costs present in the U.S.

In Europe, the U.K., Sweden, Spain and France offer the best value. In Asia, the most attractive markets are Australia, Singapore and Hong Kong. Dividend yields are also attractive at 3.1%, and should contribute substantially to total returns.”

FIXED INCOME

The bond market posted negative returns as interest rates moved higher on stronger economic data. That raised the odds that the Bank of Canada (BoC) could raise its rates again in October, after a 0.25% increase in July. The increase in yields was exacerbated by speculation that the Bank of Japan may join other central banks in reducing its stimulus measures.

The U.S. 10-year Treasury yield moved close to 3%, a level that has proved to be tough to penetrate as inflationary pressures have remained muted. However, tariffs, tight labour markets and higher transportation costs are raising the risk that inflation could accelerate.

CANADIAN EQUITY

The Canadian equity market rose 1.2%. Financials and industrial stocks were the biggest gainers, while materials dropped 4%. NAFTA negotiations are still a big area of uncertainty for Canada, but Canada's economy is strengthening despite that backdrop. May retail sales and manufacturing reports were much better than expected and may translate to higher Q2 GDP than previously forecast. The July rate increase from the BoC demonstrated its confidence in Canada's continued growth. Markets are now indicating that the next BoC rate increase may come in October.

SOUND BITES



Vincent Lépine

Vice-President
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Britain is nearing the “home stretch” for Brexit, with the U.K. scheduled to leave the EU in only eight months. What deal, if any, will Britain end up with—a hard or a soft Brexit?

To avoid a hard Brexit, a full withdrawal agreement has to be reached between the British administration and the European Commission (EC). The European Council summit in October provides the most likely opportunity for a final agreement on the U.K. divorce. If the deadlock on Ireland continues in October, an emergency EU summit may be required in November to finalize the agreement. The last practical date for an Article 50 divorce deal would be mid-December at the last European Council summit of 2018. In any case, there is very little time left to strike a deal.

Progress has been made, and a resolution of remaining issues is coming into view. On the U.K. side, the question is whether the May administration will get the necessary political support to put it in place. The Conservative Party in the House of Commons is in a deadlock. Positions seem irreconcilable, and progress is unlikely unless Brussels tables a compromise plan of its own—this seems very unlikely. The goal for Brussels is not to reach a compromise, but to punish the U.K. for

leaving the EU. This explains why each successive British proposal has been rejected by EC negotiators—even though the last proposal resembled total capitulation by the British government.

Although a second referendum is possible, we don't see it as very likely. The lesson from the first Brexit referendum is that there is no guarantee on the final outcome. May also does not have enough votes in the parliamentary Conservative Party to call for it and would require Liberal and partial Labour Party votes to achieve a majority. Finally, a second referendum would take time to set up and time is exactly what the British government lacks.

It is still difficult to say what kind of deal will be signed. Dark clouds will continue to hang over Britain as long as the U.K.'s exit from the EU remains mired in uncertainty. This forces investors to delay plans and convinces more businesses to implement contingency plans. The closer we get to the Brexit date without an agreement, the more jittery investors will likely become, implying potential bouts of panic selling in U.K. financial assets (i.e. increased volatility). The Bank of England will have to stay on the sidelines and the British pound will most likely remain under pressure. Brexit adds another uncertainty to trade disputes between the U.S. and China, the Iranian dispute and its impact on oil prices, and the upcoming Italian budget negotiations. These should keep investors on edge about the direction of financial markets.

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