CIBC Asset Management

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MARKET SPOTLIGHT

GLOBAL MARKETS

October lived up to its reputation as a difficult month for stock investors. Declines in numerous global equity markets reflected trade battles, political uncertainty and, in some cases, interest rates on the rise. Global equities tumbled -7.3% (USD), and -5.9% (CAD), as the Canadian dollar weakened.

U.S. broad equity markets fell -6.8% while the Nasdaq 100 lost -8.6%. The U.S. economy continues to strengthen, with more job opportunities reflected in stronger consumer confidence and spending—but a better economy can also mean higher wage demands. This can reduce corporate profits by raising costs, already a risk as a result of trade tariffs. The bond market is reflecting inflation fears as well, and rising yields are providing some competition to equity dividends. Taken together with the uncertainty of November midterm elections and strong equity market performance for the first nine months of 2018, equity investors chose to back away from U.S. equities in October.

International developed equity markets declined -8% (USD), with Japanese equities lower by -8.5% (USD). Europe is dealing with a number of issues including the lack of a Brexit resolution, the announced departure of Merkel in Germany and concern over the large and growing Italian fiscal debt. On the positive side, rating agency Moody's downgraded Italian sovereign debt, but kept its rating in the investment grade category and called the country's outlook "stable".

Emerging markets fell -8.7% (USD), with China lower by -11.5% (USD). Investors are laser-focused on how the Chinese economy is coping with U.S.-imposed trade sanctions—any data that sheds light on that situation is heavily scrutinized. The decline in the Chinese renminbi has partly offset the negative effects of the sanctions. As a further boost, and for a fourth time in 2018, the People's Bank of China cut the bank reserve requirements in October to encourage Chinese banks to lend.

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 October 31, 2018.

SOUND BITES

Luc de la Durantaye - U.S. and Canada reach a trade agreement in October

"Moving from the old NAFTA to the new USMCA trade agreement is not likely to radically change the North American economic landscape. From an investor's perspective, however, this new trade agreement is a non-trivial development—it substantially alleviates the uncertainty relating to building trade tensions. For the Bank of Canada, NAFTA uncertainty has been one of the reasons that justified its unusually slow pace of policy renormalization (i.e. raising interest rates). This was limiting the Canadian dollar's upside. Less trade uncertainty means less reason for the Canadian monetary authorities to be gun shy. Looking forward, the Bank of Canada will likely be delivering rate hikes at a faster pace (or at least signal its intention to do so), providing more support to the Canadian dollar over the short term.

Having said that, trade uncertainties have not completely vanished. The new trade agreement between Canada and the United States is not yet a done deal and requires approval by the U.S. Congress."

(see page 2 for more on the U.S. midterm election result)

FIXED INCOME

After NAFTA renegotiations were resolved early in the month, bond yields moved higher, breaking out of a range that prevailed for the past six months. Yields continued to move higher after the Governors of the Bank of Canada and Federal Reserve stated they would continue to raise rates to their neutral targets of roughly 3% in both countries. The rise in yields was offset somewhat by a fall in equity markets that saw investors move to bonds. Investors have come to the realization that bond yields are increasingly competitive with dividend yields.

As expected, the Bank of Canada raised its rate and the futures market sees two more increases in the next twelve months with a similar rise in U.S. rates. That's a slower pace than the central banks are telegraphing.

CANADIAN EQUITY

Despite relief that Canada had reached a trade deal with the U.S., the Canadian equity market fell -6.3% in October, reflecting declines in other global markets. Every equity sector fell, as energy lost -9%, materials -5% and financials -6%. Marijuana stocks, which had climbed in the last few months as the legalization date approached, fell back to earth, contributing to an -18% loss in the healthcare sector. Data on Canadian economic growth is mixed, as the jobs market improves modestly while real estate and retail spending slow.

U.S. MIDTERM ELECTIONS - HAS ANYTHING CHANGED?

Luc de la Durantaye
Chief Investment Strategist

The Democrats regained control of the U.S. Congress, while Republicans expanded their Senate majority—this means the U.S. legislature is set for two years of gridlock. This was the most benign and widely expected result possible from this midterm election. Is this good or bad news for global investors? While largely expected, this is probably marginally positive for U.S. and global risk assets.

Historically, legislative gridlock has been modestly positive, for the simple reason that changes in regulation typically prove costly. Had the Democrats swept both houses, a flood of new rule-making would likely have occurred. Gridlock may also prove better for markets than a Republican clean sweep, which would have allowed for more large policy changes.

With midterms behind us and the outcome in line with market expectations, the attention of financial markets will likely refocus on the main investment theme of the year: global central bank policy normalization (which includes raising interest rates). After years of easy-money trading in an environment of abundant liquidity, global investors developed a strong dependence on central bank liquidity injections. At this late stage of the business cycle, global central banks must figure out the right pace to withdraw that liquidity.

This midterm outcome does not appear to be an impediment to Trump's trade agenda. Congressional Democrats, as compared to Republicans, are bigger supporters of Trump trade initiatives (and USMCA provides less free trade than NAFTA). Trade and tariffs were not key election issues, even those negatively affected by it continued to support Republicans. Trump still has the political support to tackle unfair trade practices from China and trade tensions between the two largest economies should continue to weigh on global growth.

The main fiscal policy consequence of a Democratic House is the considerably lower probability of fiscally conservative budgets that would negatively impact economic growth. Republican conservatives want government spending cuts that could finance more tax cuts. However, the positive spillovers of tax cuts would not be strong enough to outpace negative growth spillovers from spending cuts. Less potential economic drag from fiscal policy down the road is the main fiscal policy implication.

For equity markets, remember that U.S. stocks were up near double digits this year before the correction. The technology sector (the biggest in the S&P 500) was showing signs of euphoria, with many companies like Apple and Microsoft up 40% or more.

Given the starting point of near-zero interest rates, our view has long been that we would face an extended period of gradually rising yields and weak or negative returns on bonds. While this is still the case for Germany and Japan, U.S. bonds have already normalized significantly and are getting close to our range for fair value. The election outcome removes the prospect of another significant fiscal boost financed by more debt and, as a result, U.S. bonds are becoming more attractive.

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