CIBC Asset Management

Market Spotlight

March 2018

Global Markets

After very strong January performance for global equity markets, investors got a little 'spooked' in February and volatility returned. Facing the possibility of higher-than-expected inflation and interest rate hikes (see comment at right), equities tumbled dramatically in the first 10 days of February—returning to November levels, in some cases. A sharp rally then moved equities off their lowest monthly levels, although most world indices closed lower for the month. In February, global equities lost -4.1% in U.S. dollar terms (USD), but were close to unchanged (+0.1%) in Canadian dollar terms, as the Canadian dollar lost ground.

U.S. broad equity markets fell -3.7% while the Nasdaq 100 fell -1.2%. U.S. jobs numbers for January (released early February) surprised with their strength, especially for wage growth. As a result, and after strong equity performance for several consecutive months, investors took the markets lower on fears of inflation and higher interest rates. At the U.S. Federal Reserve (Fed), Jerome Powell stepped into the chairman's role, replacing Janet Yellen. Investors expect little change in strategic direction from Powell, but the Fed's moves continue to be data dependent.

International developed equity markets lost -4.5% (USD), with Japanese equities lower by -1.5% (USD), despite some improving economic data. Eurozone GDP growth showed a +2.7% broad-based gain while Japan also showed slight positive growth. In Germany, Angela Merkel was finally able to form a coalition government and to resume her role as Chancellor, something her party had been struggling to put in place since last September's election. The Italian election in March produced a hung parliament after no party was able to capture an outright majority. The banking situation in Italy is a concern to global investors, and the lack of strong political leadership to deal with the situation adds to investors' anxiety.

Emerging markets fell -4.6% (USD), with China losing -6.4% (USD). The Chinese market has recouped about half the losses incurred in the February decline (as of mid-March) and China continues to produce strong economic readings. Industrial production, fixed-asset investment and retail sales all surprised with their strength. U.S. President Trump's initiation of steel and aluminum tariffs in early March threatened to set off a trade war between the U.S. and China. Despite an uncertain trade picture, Chinese exports jumped +44.5% (year-over-year) in February.

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 February 28, 2018.*

"Sound Bites"

Luc de la Durantaye

"Why have investors suddenly turned so jittery? It relates to the recent turn of events in the U.S. economy. In February, there was a re-pricing of U.S. inflation expectations, with more and more market participants worrying about an overheating U.S. economy. This led to a move higher in both short-term and long-term interest rates. In terms of magnitude, this bond market pullback is comparable to the "taper tantrum" episode in the summer of 2013. This time around, however, it is the threat of higher cost-push inflation potentially leading to higher interest rates that is the main source of concern. Very tight labour conditions have been translating into faster wage inflation. If significant enough, the build-up in pressures could force the U.S. Federal Reserve to deliver more aggressive rate hikes, putting the U.S. economic expansion at risk. Higher inflation can also lead to lower profit margins and ultimately depress the revenue growth of S&P 500 companies.

Luckily, Europe and most emerging economies are well behind the U.S. in terms of the inflation dynamics, which leaves their respective central banks some leeway to remain gentle in their policy renormalization. Inflationary pressures also have less negative impact on corporate profitability in these regions, which leaves us more constructive on their financial market prospects."

Fixed Income

Concerns that inflation was finally rearing its ugly head dominated the headlines in the bond market in February. The U.S. employment report released early in the month showed a sharp rise in average hourly earnings, driving investors to expect higher inflation and a more aggressive pace of rate hikes from the Fed this year. As a result, U.S. bond yields rose during the month. However, Canadian yields—which initially kept pace with the rise in U.S. bond yields—ended the month little changed on evidence that Canada's economy was slowing. Headwinds from new mortgage rules, NAFTA renegotiations, higher minimum wages and impact from interest rate increases to date are taking a toll.

Canadian Equity

The Canadian equity market fell -3%. All Canadian equity sectors declined, with the exception of industrials (+1.3%) and information technology (IT, +5.8%). Shopify, a Canadian company that creates e-commerce platforms for online stores, helped boost the IT sector. Continuing its stellar performance of the past year, Shopify's stock has risen 40% year-to-date. The energy sector declined (-6.1%) following a sharp decline in oil prices in early February. The Canadian dollar also lost ground as NAFTA negotiations pushed ahead with no concrete outcome. U.S. President Trump's announcement on steel and aluminum tariffs (later exempting Canada and Mexico) added to the high uncertainty for the trade picture.

"Sound Bites"

Vincent Lépine

Vice-President
Asset Allocation and Currency Management

"Here are some of our recent observations on U.S. trade policy—a few thoughts that hopefully supply some insight that goes "beyond the tweets"…

Over the past year, White House staff has done a full reassessment on trade policy. It has come up with some very convincing arguments that the rest of the world has implemented some very unfair trade policies in relation to the U.S. Many areas were studied—including manufacturing, high tech and autos. The U.S. has large trade deficits with China, Europe and many other countries. So, despite the impression that President Trump may have made an impulsive decision to raise steel and aluminum tariffs, this issue has actually been under the microscope for some time.

We believe what is unfolding in the area of trade will have an impact on U.S. inflation. As a result, we have boosted our inflation estimates, assuming that trade barriers will add to inflationary pressures. The timing on these trade policy changes is not ideal, as they are coming at the same time as the U.S. economy is in danger of overheating (which in itself could trigger inflation).

Another issue to consider: which countries will retaliate for new U.S. trade barriers and how will they retaliate? Canada is at risk in a number of sectors and this also produces a risk for the Canadian dollar."

Éric Morin

Assistant Vice-President
Asset Allocation and Currency Management

"Since our last round of economic projections (three months ago), underlying growth in the U.S. has been somewhat stronger than we expected. In addition, the Bi-Partisan Budget Act, enacted by Congress in February, will likely boost the level of U.S. growth (GDP) by 0.7% by Q4 2019.

The U.S. employment numbers for February showed solid growth. Job creation was strong, broad-based and well above expectations. While wage inflation was slightly below the market's expectations, it was close (0.14% vs. 0.2% expected). We estimate wage inflation will probably reach +0.3% (average, month-over-month) in the second half of 2018.

We expect the U.S. Fed to continue to raise interest rates over the course of 2018. We are currently working with an estimate of one interest rate increase per quarter."

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