MARKET SPOTLIGHT

GLOBAL MARKETS

Global financial markets seemed ready to extend this year's gains as markets meandered higher for most of July. The U.S. Federal Reserve (Fed) delivered on its heavily hinted at 0.25% interest rate cut at the end of the month. But things went south in early August when President Trump announced new tariffs on Chinese goods and China retaliated by suspending purchases of U.S. farm products. (We look at some portfolio considerations on page 2.) In July, global equity markets rose 0.5% (USD), and 0.99% (CAD), as the Canadian dollar weakened slightly.

U.S. broad equity markets were higher by 1.4%, with the Nasdaq 100 up 2.4%. The month's main event took place in its last week, when the Fed lowered interest rates by 0.25% in a widely anticipated move. The cut was characterized as insurance against the economic drag of global trade wars. However, a healthy Q2 GDP reading of +2.1% underscored the fact that the U.S. economy is in fairly good shape and likely not in immediate need of more forceful stimulus.

International developed equity markets fell -1.3% (USD), with Japanese equities fractionally higher with a 0.14% gain (USD). European economies continue to limp along as the ECB contemplates a stimulus package. Manufacturing data from Germany revealed declining business sentiment, while the election of Boris Johnson in the U.K. highlighted his threat that Brexit would occur with or without a negotiated deal with the EU.

Emerging markets fell -1.2% (USD), while China lost -0.5% (USD). Trade negotiations continue to affect market sentiment for Chinese equities and the story took another turn in early August when Trump accused the country of currency manipulation. (See page 2 for additional insights on the Chinese currency picture.)

The view from our
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TRADE WARS AND THE GLOBAL SLOWDOWN

The Fed just delivered an "insurance policy" rate cut on heightened concerns about the world economy. The depth of the global downturn will determine how much additional Fed policy relief lies ahead. To a large extent, this will depend on the trade war and whether tensions between the U.S. and China intensify or abate.

Having said this, the global economic slowdown now underway cannot entirely be linked to the trade war. There is a lot more to the story. Over the last year, the Chinese economy has slowed substantially and dragged the rest of the world down with it, even before the trade war. This shouldn't be surprising as China now matches America in sheer economic size. Isolating the negative shocks hitting the world economy, we see nearly two-thirds (63%) of the -0.9% global growth slowdown that has already taken place is a result of the Chinese economic slowdown. Another 20% is attributable to the fact that the global monetary impulse (i.e. global monetary base) has turned into a drag and 17% can be directly related to the trade war.

As of last June, the trade war started to rise in importance as a factor dragging on global growth. The increase in tariffs from 10% to 25% on $200B of U.S. imports from China and the just-announced additional U.S. tariffs on 10% of the remaining $300B of U.S. imports from China (to be implemented on September 1) should reduce global growth by another -0.25%.

FIXED INCOME

Bond yields moved slightly higher in July although the Fed cut its interest rate for the first time since 2008. The increase in yields was largely due to the Fed's statement that it is not on the cusp of a full-blown easing cycle, but is taking out "insurance" against downside risks from trade frictions. The Fed also announced that it would halt the shrinking of its balance sheet. The Bank of Canada is not expected to immediately follow in the Fed's footsteps, as Canada has posted better-than-expected job growth and GDP in recent months.

CANADIAN EQUITY

Canadian equities gained 0.3% in July. The Canadian equity market benefited from renewed interest in gold stocks as well as surging performance from Canadian Internet star Shopify. Energy stocks were lower, following the price of oil to the downside.

SOUND BITES

HOW TO FORTIFY YOUR INVESTMENTS DURING A TRADE WAR

Global trade wars took centre stage last month, producing renewed market volatility (the volatility index, the VIX, spiked to a level not seen since January). Our ***Asset Allocation team*** looks at some issues that investors have raised this time around.

In this volatile environment, should gold be part of my asset mix?

Gold is typically a safe haven. In periods of economic and market turbulence, investors avoid risky and cyclical assets and look for shelter in safe assets. Given the ongoing and unpredictable trade war, the Brexit saga and Italian fiscal woes (to name just a few current variables), we are in a period of constant geopolitical uncertainty. In a balanced portfolio, the traditional safe asset, government bonds, looks somewhat expensive and gold becomes an attractive alternative. Here are several reasons why:

Central banks are back in easing mode as they attempt to stimulate their economies and relaunch the expansion. While monetary policy does not usually target currency depreciation, it follows as a consequence of easing. This is actually desirable, as a country facing a slowdown with limited policy tools will try to resist a rising currency. However, since all currencies are priced against other currencies, one currency's depreciation is another currency's appreciation. When all currencies are under downward pressure at the same time, something else has to absorb the opposite upward pressure and gold rises.

Another consideration—historically, central banks have mostly held their foreign currency reserves in U.S. dollars (USD). There is now a trend to diversify those reserves away from the USD and increase exposure to other currencies, as well as to gold. In the first six months of this year, central banks purchased a record amount of gold, continuing the trend from previous years.

Can bond prices still rise from here?

Global trade tensions in early August produced a big U.S. bond rally. Since further trade conflict escalation is possible, yields could move even lower. Bond prices will stop rising (i.e. yields will stop falling) once global economic data starts producing positive surprises (versus expectations). At this point, expectations are so depressed that it wouldn't take much to push yields higher. However, since there's little capacity or willingness from global policy-makers to significantly increase stimulus and boost growth, a rise in U.S. bond yields would likely be very gradual.

Why are financial markets reacting dramatically to Chinese currency movements?

The Chinese currency, the yuan, is not a freely traded currency. Instead, the People's Bank of China provides a daily mid-point price fix but allows the yuan to deviate up to 2% from that fix on any given day. Large deviations from the mid-point suggest there is pressure on the currency in a given direction—since early August the pressure has been to depreciate the yuan. In effect, the PBOC is "permitting" this depreciation by failing to intervene and support the currency.

Remember, a weaker yuan makes Chinese exports less expensive in foreign markets and helps offset the impact of U.S. tariffs on Chinese products. The fact that the yuan is now sitting at the lowest level of the past 10 years has raised speculation, and accusations from Trump, that China is manipulating its currency to gain a trade advantage.

Another important consideration—the yuan is the dominant currency in the Asian block. Its movements have significant impacts on many of the currency's Asian partners and often result in similar co-movements for this regional block.