

MARKET SPOTLIGHT

GLOBAL MARKETS

The fairly steady upward rise for stocks since the beginning of the year ended abruptly in May. Trade uncertainty escalated as U.S. President Trump brought in additional tariffs on China, while China hit back with its own tariffs. To further intensify the situation, Trump decided that new tariffs on Mexico could help to resolve his immigration issues with that country by forcing it to take some action. With investors unsure how tariffs will be used in future international disputes of many varieties, global investors sold equities and bought bonds. In May, global equity markets fell -5.8% (USD), and -5.3% (CAD), as the Canadian dollar weakened slightly.

U.S. broad equity markets were lower by -6.5%, with the Nasdaq 100 down -8.3%. Trade anxiety increased in May, but the U.S. central bank seemed reluctant to consider an interest rate cut to provide an economic boost. By early June, increasing evidence that the jobs market has been losing steam was seen as a positive, as it could give the Fed a rationale to cut rates. Combined with a resolution to the Mexican trade situation, the first week of June brought a rally as stocks retraced a good portion of May's declines.

International developed equity markets fell -4.8% (USD), with Japanese equities lower by -4% (USD). The resignation of Prime Minister Theresa May added to uncertainty over Brexit and the future of the European Union. On the trade front, the U.S. has postponed global auto tariff discussions and attention will now turn to the G20 summit at the end of June in Osaka, Japan.

Emerging markets fell -7.3% (USD), while China lost -13.1% (USD). Trade worries also hurt Chinese stocks, although a decline in the value of the Chinese yuan during the month partly offset the impact of tariff increases. In India, Prime Minister Modi and his BJP party were re-elected with a strong mandate in a landslide victory—seen as a positive for business by some market pundits.



*The view from our
Chief Investment Strategist:*

LUC DE LA
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In collaboration with Marco Lettieri, Senior Analyst

TRADE WARS AND THE INVESTMENT OUTLOOK FOR CHINA

Our outlook for Chinese GDP growth in 2019 is 6%, lower than the 6.6% growth in 2018 and at the low end of the Chinese government's GDP target band of 6% to 6.5% for 2019. We continue to expect a challenging trade environment due to a significant growth slowdown in Europe and the unresolved trade dispute with the U.S. The U.S. and China have yet to confirm an agreement and U.S. tariffs on Chinese goods remain in place. Given these external challenges, expectations for domestic growth ultimately rely on the domestic policy environment and whether or not it is promoting any growth acceleration.

In terms of fiscal and monetary policy impulses, we don't expect much—certainly no stimulus comparable to what was delivered in 2016. The one area where the PBOC* has become increasingly aggressive is a reduction in the reserve requirement rate (RRR); however, this is much more a liquidity management tool than a measure to boost credit. This has helped provide liquidity to commercial banks and alleviated liquidity stress due to the challenges associated with restrictive rules on the issuance of shadow banking credit—overall, promoting a healthier financial system.

*People's Bank of China

FIXED INCOME

Bond yields fell, as the lack of progress in trade talks between the U.S. and China saw many revising their global growth expectations lower. The situation was exacerbated by President Trump threatening further tariffs on Mexican imports. The rally left 10-year bond yields below 3-month Treasury bill yields in both Canada and the U.S. In the past, this has often signalled that recession is imminent. The rally in bonds also resulted in futures markets raising the odds that the Federal Reserve will cut its rate at least once by year-end. However, better-than-expected Canadian economic data could lower the odds that the Bank of Canada (BoC) will follow suit this year.

CANADIAN EQUITY

Canadian equities fell -3.1% in May. The financial sector dropped -4.9% as recent Canadian housing market sluggishness was one factor that exerted pressure on Canadian bank results. In early June, the release of May jobs numbers indicated a modest improvement, with the unemployment rate at 5.4%—the lowest since 1976. A pick-up in exports helped to improve the Canadian trade deficit and added to the positive news, although the improvements may be temporary. Global trade uncertainty is still weighing on our Canadian growth forecasts.

TRADE WAR FALLOUT: THE ECONOMY, EQUITIES AND BONDS



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The U.S. believes its trade relations with China are unfair. U.S. companies are subject to important trade barriers such as tariffs, deficient intellectual property laws in China, forced technology transfers. They are also competing with companies that benefit from State support. As a result, Chinese high-tech companies are accelerating their development at the expense of U.S. companies. Since the U.S. imports about four times more than it exports to China, it uses tariffs as a bargaining tool, aiming to force Beijing to change its commercial practices. While the U.S. currently imposes 25% tariffs on about 40% of Chinese imports, it has threatened tariffs on all Chinese goods. This risk has made financial markets nervous because the hit on both economies would be substantial, forcing the Fed and Chinese authorities to launch important stimulus.

While we expect China and the U.S. to resume negotiations after the G20 meeting, a comprehensive deal is unlikely in the near term and uncertain thereafter. China does not want its long-term development sacrificed by changing its domestic policies and in the U.S., there is no political appetite for a mediocre deal.

While trade tensions will likely remain, they will fluctuate in a countercyclical manner. If the economy is in bad (good) shape, a more (less) conciliatory stance is likely. Investors should keep this in mind, as, ironically, upcoming policy stimulus (i.e. rate cuts) could pave the way for further escalation down the road.



Pat O'Toole

Vice-President, Global Fixed Income

Bonds rallied in the past few quarters after interest rates peaked in October at the height of fears that the Federal Reserve's interest rate hikes program was on auto-pilot. The now famous "Powell Pivot" in January, where the Fed Chair put to rest fears of further rate increases, set the stage for a stabilization in bond yields and a rally in risk assets. The rally in bond yields has gathered steam in the past couple of months as evidence of slowing global growth was exacerbated by rising trade tensions. Those tensions ratcheted up when an imminent trade deal between the U.S. and China collapsed and Trump threatened new tariffs on imports from Mexico. While some of these tensions could be reduced with a couple of tweets, the slowdown in global growth and falling inflationary pressures were followed by a more dovish stance from the Federal Reserve. That may result in the Fed cutting its rate in the near term. Indeed, the futures market sees high odds of a Fed cut in July, with more action to follow in October and in early 2020. The rally in bond yields has been so strong that the benchmark 10-year Treasury yield is now lower than the yield on the 91-day Treasury bill, something that, in the past, has warned that a recession is imminent. Should the Fed cut its rate, the Bank of Canada is unlikely to respond in short order, unless the Canadian dollar were to rally. However, the futures market does see the BoC cutting its rate by year-end.

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