MARKET SPOTLIGHT

GLOBAL MARKETS

The investor mood improved last month as global economic uncertainty abated. U.S-China trade wars seemed closer to some resolution and a no-deal Brexit was averted. Meanwhile, central bank stance remains supportive as the U.S. Federal Reserve (Fed) cut rates again. In October, global equity markets gained 2.5% (USD) and 1.8% (CAD), as the Canadian dollar strengthened.

U.S. broad equity markets were higher by 2.1%, with the Nasdaq 100 up 4.4%. The increased likelihood of a first phase of a trade agreement with China and a Fed rate cut encouraged a risk-on stance and lifted U.S. stocks. Third quarter GDP numbers were a mild surprise to the upside, showing growth of 1.9% (annualized). At the same time, the picture is not all rosy. Consumer confidence slipped slightly and job growth, while positive, decelerated from the previous month.

International developed equity markets gained 4% (USD), with Japanese equities higher by 4.9% (USD). In the U.K., Boris Johnson was able to get the European Union (EU) to agree to a tentative Brexit deal but the British parliament needed more time to confirm it. The EU agreed to an extension to the end of January and a U.K. election will take place in December. As the ECB struggles to boost the European economy, Mario Draghi leaves the post of ECB[1] president to be replaced by Christine Lagarde, former IMF chair.

Emerging markets were higher by 4.2% (USD), while China gained 4% (USD). Chinese GDP growth continues to slow, falling to 6% (year-over-year) in the third quarter from a 6.2% reading in the second quarter. This is the slowest increase in over 25 years, but investors chose to focus instead on indications of some resolution in trade war disputes.

[1] European Central Bank

The view from our Chief Investment Strategist:

LUC DE LA DURANTAYE

In collaboration with Jean-Laurent Gagnon, Portfolio Manager, Global Bonds

DO INVESTORS STILL NEED THEIR SAFE HAVENS?

Bonds have filled their traditional role as safe haven investments this year, providing a refuge from volatile U.S./China trade-related news flow and weakening worldwide economic data. Subdued inflationary forces have also supported demand for bonds.

For the most part, this favourable environment for developed market (DM) bonds should remain for some time. Several of our most important signposts continue to signal that there is no recovery in sight. Global leading indicators are flashing red, global trade headwinds are blowing hard and business surveys offer little reassurance. Additionally, several idiosyncratic stories have combined to generate greater market concerns. Tightening liquidity conditions in U.S. money markets, an attack on oil fields in the Middle East and the beginning of proceedings to impeach the U.S. President have pressured global bond yields to the downside. We believe the U.S. Treasury 10-year yield will hover in a range of 1.35%-2.10% over the next 12 months. However, several factors will soften the downward pressure on DM bond yields going forward. First, dovish DM central banks, reflationary efforts by the People's Bank of China (PBOC) and synchronous rate cuts by most emerging market central banks should help stabilize global growth as we move further into 2020. Second, the trade war between the U.S. and Chinese administrations should proceed without further major escalation or de-escalation. The lack of surprises on that front should reduce the volatility in the bond market. While bond yields in developed markets might have already seen a bottom, they are still unlikely to march meaningfully higher.

FIXED INCOME

The bond market put in a mixed performance, with short-term yields falling in the month while longer-term yields rose. The divergence can be mainly attributed to rising expectations for more interest rate cuts. This allowed short-term yields to fall, while the expected positive impact from rate cuts and further balance sheet expansion by the Fed led to higher longer-term yields. The Fed met the market's expectations by cutting its rate to 1.50%-1.75%, but left the impression that it is now on hold, barring some material deterioration in the outlook. The Bank of Canada also turned more dovish, holding its rate at 1.75%, but downgrading its growth forecast for the second half of the year.

CANADIAN EQUITY

Canadian equities fell -0.9% in October, lagging most global equity markets. With the U.S. Fed's rate now below the Bank of Canada's (BoC) rate of 1.75%, the BoC now has the highest administered rate of any developed nation central bank. At its October meeting, the BoC commented on the resilience of the Canadian dollar in the face of lower commodity prices and heightened trade risks. That was received by market participants as an acknowledgement that a cut in the Bank's rate may be necessary to sanction a weaker Canadian dollar.

SOUND BITES

Bart Dziarski
Analyst, Equities–Financials

Why are Canadian banks outperforming the overall market?

Canadian bank stocks performed well in the last 3 months, up 9.5% vs. about 6% for the overall Canadian equity market. We believe a rebounding Canadian housing market, robust commercial lending and benign credit losses contributed to the strong performance.

In 2018, Canadian personal lending slowed to low-single digits, dampened by new B-20 housing regulation implementation, rising interest rates, and an overall cautious Canadian consumer. In 2019, the story improved as no new housing regulations were passed, interest rates remained flat, and strong employment numbers drove a turnaround in the Canadian housing market. Together, these factors led to an increase in personal lending. The acceleration is important because about 55% of the Canadian bank balance sheet is levered to the Canadian consumer. In 2020, we expect these themes to persist and consumer lending growth to continue accelerating into the mid-single digit range.

Since 2017, commercial loan growth has accelerated to low double-digits, above its historical range—this acted as a partial offset to slowing personal lending. Growth has been broad-based and banks continue to benefit as life insurance companies scale back their exposure to commercial mortgages. U.S./China trade tensions and rising geopolitical risks have led bank management to provide guidance that commercial lending growth will likely slow. We expect commercial lending growth to pull back to its historical high-single digit growth range in the near term.

Credit losses started normalizing in 2019—we believe that 2018 likely represented trough credit levels. In 2020, we expect losses to continue normalizing, driven by the energy sector. Our cautious view acknowledges the recent acceleration in energy-related bankruptcies in both Canada and the U.S. These were driven by sustained low oil prices, a lack of capital available to the sector, and continued poor capital structures and allocation decisions. Energy loans represent 2% of bank loan books, on average, which is a manageable exposure. Despite the uptick, we expect credit losses to remain benign overall.

Although we are in the later stage of the economic cycle, Canadian banks are well-capitalized, with capital ratios well above both regulatory minimums and pre-Global Financial Crisis levels. In May 2019, the Bank of Canada completed a comprehensive stress test on Canadian banking models assuming recessionary scenarios more severe than the prior three recessions we've experienced. The conclusion was that Canadian bank business models are resilient.