Market Commentary

Wake Me Up When September Ends

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"We are taught to understand, correctly, that courage is not the absence of fear, but the capacity for action despite our fears."
John McCain

September is historically among the most feared months for stock market performance. This is true when looking at the long-term returns for the S&P 500, Dow Jones Industrial Average and Nasdaq composite.

September 2018 was shaping up to be consistent with past seasonal patterns. Policy-setting meetings were on the docket for both the U.S. Federal Reserve and Bank of Canada, China-U.S. trade tensions were high, and the U.S. and Mexico reached a bilateral trade agreement that froze Canada out. And then, to the surprise of many, late on September 30 Canada signed an eleventh-hour pact (almost literally) with its largest trading partner, meeting the deadline the U.S. had imposed.

During the month, the Teflon market climbed, shrugging off bad news. Shareholders seemed to care only that corporate earnings again exceeded expectations. While U.S. hiring conditions are extremely tight, we have yet to see any evidence that inflation will dampen stock market optimism.

United States – Leaves Aren't Turning Yet

In a largely expected move, the U.S. Federal Reserve raised its benchmark interest rate 25 basis points to a range of 2% to 2.25%. Fed Chair Jerome Powell said he expected the trade war would have limited impact on the U.S. economy and does not anticipate that inflation will surprise to the upside. August inflation data supported his view. The core PCE (Personal Consumption Expenditures index, the Fed's favourite inflation gauge) stayed even with July's level and was consistent with a 2% inflation target. Consumer confidence levels reached an 18-year high, delivering more bullish news. This means that consumers are upbeat about spending and are not overly worried about trade and tariff risks.

President Donald Trump continued to make good on his election promise to correct the U.S. trade imbalance with China. Washington slapped 10% tariffs on over US$200 billion of Chinese imports. Tightening the screws, he threatened to raise these tariffs to 25% come January. He also promised to increase the value of goods subject to tariffs by another US$267 billion unless China makes an effort to level the trade playing field for these two economic superpowers.

The down-to-the-wire deal that replaced NAFTA with the new United States-Mexico-Canada agreement (USMCA) provided another opportunity for the U.S. to flex its economic muscle on trade. Ultimately, the impact on Canada and Mexico was less than had been feared.

Higher interest rates and trade tensions had little apparent impact on the stock market as U.S. stocks continued to shatter records in Q3. The S&P 500 rose over 7%, buoyed by strong corporate earnings and economic growth.

Canada – A Late Surprise

As September drew to a close, it appeared another NAFTA negotiation deadline would pass without a deal. But Canadian negotiators remained steadfast in their determination to fight for their various constituents. This calculated risk paid off. Based on early analysis of the USMCA, the terms seem largely neutral for Canada. The loonie greeted the news with enthusiasm and climbed higher against its U.S. counterpart.

Included in the new agreement is a compromise that will allow U.S. dairy farmers access to some of Canada's protected market. Offsetting this negative, automotive content rules favour higher-wage jurisdictions such as Canada. One of the more neutral terms was an increase in the duty-free threshold value from $20 to $150 for imported goods purchased online. While Canadian consumers will benefit, Canadian retailers may feel the pinch.

Canadian stocks took NAFTA uncertainties in stride. They turned in only a slightly negative performance this quarter – even though disappointments over negotiations flared up several times. Once the new agreement was announced, they barely reacted.

Healthcare, which includes cannabis companies, has been the top performing sector in Canada's stock market. Strong upward price momentum in these stocks was the primary driver as marijuana legalization quickly approaches. Because of its small size, healthcare has less impact on the overall market than larger sectors such as financials, which has benefited from improving margins due to rising interest rates. In the heavily weighted resource sectors, weakness in energy and materials has offset some strength in Canadian stocks.

Canadian bonds traded lower as interest rates continued to rise in recognition of the Bank of Canada's (BoC) inflation-fighting stance. The BoC's press release clearly stated that higher rates will be warranted to achieve its inflation target. This further reinforced the consensus view that our central bank will hike overnight rates in October at its next meeting. The BoC has been closely watching NAFTA developments; further rate hikes may be on the table in 2019 if current inflation trends persist.

Europe and the U.K. – The Winter of Discontent

The region continues to be mired in problems, most recently thanks to Italy's plans to run a huge budget deficit. Panic in the eurozone sent that currency lower in late September. The euro ought to have maintained its recent uptrend, especially since the European Central Bank is winding down asset purchases and ECB Chair Mario Draghi confirmed an end to easy money.

Tensions between Italy and neighbouring EU countries rose as the government released its budget proposal, which indicated the country's massive deficit had increased to a level scarily close to the EU's deficit guidelines. Italian stocks sold off sharply and Italian bond yields rose, setting off fears that rating agencies would downgrade Italian bonds. European banks with exposure to Italian debt also came under pressure.

Stalled Brexit talks are plaguing the U.K., weighing down U.K. equities. Although the British pound rallied over the quarter, the currency was on a downward trend for the year.

Japan – Open Season

The Japanese market is thriving on better-than-expected growth, a weaker yen and seemingly improved trade relations with the U.S. Weakness in the yen comes from the Japanese central bank's decision to stay firmly on the sidelines, despite the economy's strength. As a result, the Nikkei climbed to a near 27-year high in late September. Investors are buying into the domestic market's stronger fundamentals and an optimistic global outlook, despite unpredictable U.S. trade rhetoric. Overall, economic conditions are positive in Japan; the latest inflation reading is 1.3% and unemployment is low at 2.4%.

China – The Bigger They Are, The Harder They Fall

The Sino-U.S. relationship deteriorated further as President Trump openly accused China of interfering with America's midterm elections. Tensions between the two superpowers have led to a protectionist trade policy that has created headwinds for the Chinese market. Investor confidence in the Chinese stock market has dwindled; it has been the worst global performer so far in 2018.

The U.S. announced a long list of Chinese goods worth US$200 billion that are subject to an initial 10% tariff rate. In the short term, trade tensions appear to have widened the trade gap between the U.S. and China. As the Chinese yuan continues to slide, exporters are frontloading shipments on fears more tariffs are coming. It remains unclear how much long-term harm the escalating trade war will inflict.

Amidst this turbulence, China is making an effort to manage its economic slowdown and control the trade war's negative impact. Policymakers are planning to introduce a variety of measures, including tax cuts and infrastructure spending, to reduce reliance on external demand and increase domestic consumption. China is also looking to diversify its trading partners by promoting trade talks with countries in Asia and Africa, as well as Canada.

At this point, we can't know whether these stimulative measures will lessen the economic impact of a trade war with the globe's largest economy. It does seem, however, that the big performance differential between U.S. and Chinese equities is overly punitive to Chinese investors.

Emerging Markets – Leaves Are Still Falling

Emerging markets (EM) realized a slight reprieve from the downturn they have experienced during most of this year. Yet, major negative conditions continue to exist for most EM countries. Currencies in the developing world have been hit by global trade tensions, a strong U.S. dollar and rising interest rates. Soaring crude oil prices also have a negative impact on the inflation outlook for many regions that are net importers of this key commodity. For example, India – the world's third largest oil importer – is considering a temporary limit on its level of oil imports.

Our Strategy

The world's major economies continue to benefit from twin tailwinds of growth and new jobs. Companies are benefiting from their investment in intangibles, which is enhancing productivity and, in turn, profitability. This allows them to continue to grow profitability in the face of an extremely tight labour market. As central banks globally remove liquidity by phasing out quantitative easing and increasing interest rates, we continue to favour the outlook for risk assets such as equities across the globe over bonds.

The apparent disparity in growth and fundamentals between the U.S. and the rest of the world continues to underpin the strength of U.S. equities. This is especially noticeable when the performance of U.S. equities is compared to the performance of equities in regions such as Europe and Canada, which are facing headwinds of slower growth. Emerging markets continue to be held back by rising interest rates and weak currencies, making the current environment less conducive to higher equity returns for most of these regions.

The Last Word

As temperatures cool through the later stages of autumn, optimism that has fed the market for riskier assets may also diminish. For Canadians, NAFTA will no longer cast a chill. The U.S. will have to confront its own obstacles in the fourth quarter and grapple with contentious midterm elections. The European project will continue to be tested as it deals with the outcome of Brexit negotiations and Italy's need for fiscal reform.

As with the weather of the seasons, we can expect the unpredictable. We know that when it comes to investing, there is always a chance that things may get colder before they get warmer. But we can now breathe a sigh of relief as we bid September (and NAFTA negotiations) a not-so-fond farewell.