So much for the summer slowdown. Even significant primetime events did not shake investor confidence in July as most global stock markets sustained a strong uptrend. World economies started Q3 where they left off in Q2, fuelled by rising household spending and employment growth – although there was still no evidence of rising wages in response to these conditions.

Early in July, G20 leaders gathered in Hamburg for their first summit since Donald Trump moved into the White House. While the summit produced no big revelations, it re-confirmed that the U.S. is determined to exit the Paris climate accord and stick to President Trump’s “America First” agenda.

To add gasoline to the protectionist fire, the U.S. released its negotiating position on NAFTA. There were few surprises, but it did highlight the risks to Canadian manufacturing and the export outlook.

Amazingly, all the efforts to repeal and replace the Affordable Care Act (better known as Obamacare) died a slow death. On the other hand, no one was shocked at the ongoing drama and endless “breaking news” generated by the current administration in Washington.

In the area of market trends, the Canadian stock market prolonged its slump compared with the other major developed markets; U.S. stock markets kept climbing and European markets also exhibited strength, as did Hong Kong and India.

The greenback extended its slide against major currencies, but for Canadian investors its rapid decline versus the loonie was most important. Investors in all major economies became focused on whether higher interest rates would choke off economic growth. The U.S. currency has been well supported by the Federal Reserve’s stated intent to keep hiking interest rates. Other major central banks began signalling similar policy moves (Canada, the U.K. and Europe, for example). As a result, prime lending rates began to rise globally, taking the wind out of the sails of the strong U.S. currency.

We might as well face it – we’re all addicted to low prime rates. Historically low lending rates have enabled consumers to borrow more than they otherwise could afford. This has likely helped fuel
asset bubbles, such as in housing, which feed the addiction to low rates. A material rise in rates will reduce the affordability of things that consumers typically borrow for – like cars and homes.

Consumers have also found a different “prime” to feed their addiction. July 11 marked the third annual Amazon Prime Day, an event that offers exclusive discounts to Amazon Prime members. The key to this 24-hour blitz is not the high volume of sales (although it was the company’s biggest sales day ever). More significant is the sales impact of the estimated 80 million Prime members whose spending habits on Amazon are more than double those of non-Prime members. Online shopping is taking a huge bite from the profits of bricks-and-mortar retailers and their landlords. Back in the day, prime referred to the rate that the most credit-worthy borrowers would pay in interest. Today, this new kind of prime represents a growing disruptive force confronting our economies. In particular, it is challenging how goods and services are priced and is perhaps the root cause of lower-than-expected inflation.

U.S. – Buoyancy Prevails

For Canadians travelling south, the weakness in the U.S. dollar is a good thing. For Americans, however, this unexpected and steep drop in their currency is problematic. A weak greenback is positive for the trade balance: imports become more expensive and exports more attractive to foreign buyers. This supports President Trump’s “Buy American” mantra. He has said that he’d like a weaker dollar. Yet, large swings create problems. Mr. Trump’s pro-growth policies at first created optimism, which lifted the U.S. dollar to a 14-year high earlier this year. When reality set in, the dollar fell back to earth.

In the meantime, the Fed is pondering whether to raise rates again or take a break and wait for new economic data. June data confirmed the tight conditions of the U.S. job market, with an unemployment rate of 4.4%. On the other hand, inflation remained well below the Fed’s target rate of 2%. Although the Fed chose not to raise rates in July, it signalled that another rate hike is possible if job numbers are good. The central bank added that it might use other monetary policy tools such as reducing its bond portfolio, which would also make rates climb. The so-called Goldilocks environment of moderate growth and low inflation produced several record-breaking days for the U.S. stock market in July.

Although U.S. retail sales volume showed slight weakness, the record number of bankruptcies and store closures in the traditional retailing environment can only be explained by the disruptive forces of the “Amazon effect.”

On the political front, the Senate failed to repeal the Affordable Care Act (ACA). Senators can’t seem to agree on what should replace the ACA, which caused the impasse. The Trump administration will
now focus on the budget deficit, debt ceiling and tax reform, all of which pose potential risk to the strong stock market.

Since the U.S. election, U.S. stock prices have moved higher, even though the earnings forecast for the S&P 500 companies have not kept pace with these moves. This has caused investors to “climb the wall of worry” as valuations hit new, lofty levels with every price record the stock market breaks.

**Canada – Really Addicted to Prime**

In mid-July, the Bank of Canada increased its benchmark policy rate by 25 basis points to 0.75%, the first hike in almost seven years. As bond yields moved ahead of this rate increase, mortgage rates moved upward in concert, raising monthly expenses for Canadians with variable-rate mortgages. Although the rate hike was small, and lenders responded with minimal interest-rate increases, the average Canadian’s high level of indebtedness indicates that borrowers are addicted to low prime rates to fund their debt.

The central bank was reacting to an economy that appears to be approaching full capacity – with low unemployment and healthy economic growth (as measured by the country’s strong GDP growth rate). Although many thought the rate increase was premature, given that inflation is well below the 2% target, the central bankers believe inflation is set to rebound. The Monetary Policy Report also indicated we can expect more increases later in the year.

In July, longer-term rates started to rise faster than short-term rates, indicating that the bond market believes that there is greater staying power to the strength in the Canadian economy than previously expected. The loonie also responded to the rate hike, ending its downward slide. A country’s currency will typically respond positively and move higher when a central bank increases interest rates in response to strong economic growth, as was the case with the Bank of Canada’s move. Not only did the Canadian dollar climb higher but the move was also fast and furious, appreciating 10% from the lows reached in May of this year.

Investors have shown great interest in the Canadian urban housing market, thanks to the large price increases in 2017. In the Greater Toronto Area (GTA), several measures were introduced in April to cool the red-hot market. June GTA sales volumes plunged 37% compared with last June, according to the Toronto Real Estate Board. Although prices in the region kept climbing at a rate of 6% year over year, these price increases moderated substantially from April’s peak increases of almost 25%.

While Canadian stock markets are still underperforming most other global developed markets, the main culprits are no longer energy and financials. Shouldeering the blame now are sectors particularly sensitive to the higher Canadian dollar. That includes export-oriented companies in the tech sector,
for example, whose revenues may be priced in U.S. currency but whose costs are primarily Canadian. Other industries such as real estate and utilities (which are sensitive to interest rates) were also negatively impacted by the upward move.

**Europe – Recovering Nicely**

The eurozone stock market performed well, buoyed by the region’s Q2 robust GDP growth rate of 2.1%, surpassing both the U.S. and the U.K. This is also the region’s strongest GDP growth number since Q1 of 2011. Unemployment also maintained a downward trend, approaching its pre-recession low.

On balance, the picture in Europe remains quite positive, supported by a solid showing from the Purchasing Managers’ Index (PMIs are an indicator of the economic health of the manufacturing sector). It forecasts low inflation and strong future growth in jobs and, in turn, consumer spending. The eurozone is also benefiting from a political-risk environment that has grown much more relaxed. This is welcome relief from the tension of the last year when a number of countries seemed poised to exit the world’s largest trading block. A research report from Capital Economics (a leading independent economic research consultancy) says that this risk has substantially decreased. According to the report, a recent European Commission survey indicates that positive views of the European Union (EU) have improved from 34% to 40%; optimism about the EU’s future has gone up from 50% to 56%.

One potential risk to the bullish prospects for the eurozone are signals coming from the European Central Bank that it plans to reduce bond purchases. Interest rates will rise as a result, which could choke off the region’s growth.

**Japan – Doing Well**

The Bank of Japan lowered its inflation outlook, but said the economy could expand by 1.8% this year. In contrast to other major central banks, the Bank of Japan signalled its intent to stand pat on rates. It has now stretched the timeline for reaching its 2% inflation target to 2019.

**Emerging Markets – Still A Mixed Bag**

Emerging markets remain a mixed bag of economic data. Strength is evident in markets like Brazil, Russia and India, whose PMIs are all foreshadowing a growth recovery. Although retail sales volume has been weak in emerging markets, recent numbers indicate an upturn, likely due to the recovery in markets such as India and Brazil.
In China, economic data stayed mixed, with the official PMI numbers hinting at a softer third quarter; GDP growth came in at 6.9%, unchanged from Q1. Despite this muted trend, Chinese stocks extended the climb they began in May of this year.

**Our Strategy**

With the U.S. economy firing on all cylinders, stock market valuations have moved to reflect this strength. International markets have also done well year to date, but they have a better relative valuation picture and better fundamentals (such as low inflation, improving growth outlook and moderate valuation) than U.S. equity markets. Therefore, we continue to favour international equities.

While the recent strength in the Canadian dollar has negatively impacted returns for foreign investments (U.S. and international), we expect this currency strength to moderate from these levels.

Although central banks have become more unified in their intentions to tighten conditions (generally raising interest rates), we believe this will have greater impact on the outlook for fixed income investments than on equities (bond prices move in the opposite direction to interest rates). Our portfolio positioning continues to prefer equity markets over fixed income, supported by the persistent “Goldilocks” environment (not too hot, not too cold) where economic growth is fuelling earnings growth and, in turn, upward momentum for stocks.

**The Last Word**

The strong uptrend in stock markets, combined with primetime events on the geopolitical front, has encouraged investors to stick with global equities. The fundamental picture is still strong and supportive of higher stock prices, namely upward trends in earnings and low inflation rates. In this environment, we are staying the course. The central bankers have spoken. It’s now time for consumers to address their addiction to low prime rates. They must prepare for a future that will likely include interest rates higher than those we’ve enjoyed over the last few years.

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