Summer 2019

Following the first quarter's rebound, investors have experienced see-saw like returns since the end of March. A weak month of May was sandwiched by positive April and June periods. The May weakness was based on trade related concerns, specifically threats of additional tariffs between the United States and China. An agreement for the United States and China to reengage in trade talks at the G-20 Osaka summit and indications that central banks would be moving to be more accommodative have since provided the basis for a relief rally through June that brought markets back towards their year-to-date highs: S&P/TSX Composite Index 16.22%, S&P 500 13.71%, U.K. London FTSE 8.19%, German DAX 11.96%, MSCI Japan 3.57%, China Shanghai Comp 14.76%, MSCI EAFE 9.83%, MSCI Emerging Markets 6.27%, and MSCI World Index ex-USA 10.42%. These year-to-date returns as of June 20 are in Canadian dollars and reflect a stronger Loonie so far this year. For the Canadian benchmark index, S&P/TSX, there was strong sector breadth with double digit gains experienced by 9 of the 11 sectors. Even the weakest, energy and telecom, were in the green over the first six months. The best performers of the group, health care and technology, both doubled the index's return though had limited overall contribution given their low weightings, 1.78% and 5.3%, respectively, within the market cap based index. The S&P 500 experienced similarly broad gains, with just health care, affected by political uncertainty, not reaching double digit gain territory.

The evolution of the U.S. Federal Reserve's Federal Open Market Committee's (FOMC) stance on short-term rates has moved beyond their "watchful waiting" with a 0.25% cut of their benchmark Fed Funds rate to 2.00-2.25% on July 31st. In doing so, they appear to have adjusted their data-driven stance to become more forward looking by cutting rates as insurance against slower future growth expectations resulting from global trade tensions. There's also an argument that could be made where the cut is in defense of the longer-term treasury bonds given lower/negative sovereign interest rates oversees and the extremely accommodative stance of the European Central Bank. Following the July 31st meeting and additional tariff threats, the consensus expectation is projecting additional reductions at the FOMC's next two meetings (September and October), with more possible in 2020. While the official statement seemed consistent with this expectation, Chairman Powell's news conference threw some cold water on that being a foregone conclusion. While this hedging is likely to draw the ire of President Trump, we interpret this as providing coverage to not be locked in to a follow-up cut in September.

Following their early July meeting, the Bank of Canada (BoC) kept their benchmark overnight rate at 1.75%. The BoC continues to describe the current rate as "accommodative and appropriate." A stronger than expected Q2 GDP gave the BoC cover to wait and see how things play out over the summer. We believe that their commentary had a generally accommodative tone, as they described the bump in GDP as transitory with temporary gains from energy exports and a recapture of activity that was delayed due to inclement weather in Q1. Canada's central bank doesn't meet again until early September when they're not currently expected to move off 1.75%. Though with a yield of 1.44% on the two-year Canadian Treasury bond, the bond market is pricing cuts on the horizon.

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As mentioned, the bond market has gotten out ahead of the central banks and pushed rates lower so this year, though still above the 2016 lows in North America. The slope of the short to medium term portion of the yield curve has also flattened in both Canada and the U.S. In Canada, the two, five and ten year treasury yields are all within 0.10% of each other, while equivalent U.S. rates are carrying a spread of 0.27%, with the two and five-year rates trading right on top of each other. The move lower accelerated in late-May when Sino-U.S. trade tensions were worsening. Despite an agreement to restart talks, the yields have remained near their lows for the year. With little to no compensation for term, we favour short-duration though finding individual bonds that aren't trading with meaningful premiums has once again become a difficult task.

While the direction of the bond trade has been the same on both sides of the border, the depth of the move has been more significant in the U.S. The 2-year Canadian Treasury yield has declined by 11 basis points since the end of March, while the equivalent U.S. yield has declined by 43 basis points. This interest rate differential move combined with stronger commodity prices has sent the Canadian dollar higher in recent weeks. A 3% move since the end of May brings the Canadian dollar near the lower bound of the currency's range for last 12-months, relative to the U.S. dollar. We also are of the opinion that this is consistent with the direction that the U.S. would like their dollar to go relative to Canada and their other trading partners.

After trading back towards April's highs, equities have been moving sideways since the end of June. Seemingly waiting for a catalyst, which thus far, earnings season has failed to provide. Only a couple of weeks into the peak earnings period, early Q2 results have being slightly ahead of modest expectations. Looking deeper, there's been a divergence with companies connected to the consumer generally faring better than the more industrial focused companies. What the markets seem to be waiting for is some sort of development on the trade front. Filtering through the most recent news, we expect a deal between the U.S. and China later this year. That said, we expect any deal struck in the short-term to be more cease-fire than truce with the more difficult topics like intellectual property and technology transfer being punted into the future in favour of economic gains ahead the full ramp-up of the U.S. election cycle.

Sources:
Bloomberg Finance L.P. as at June 30, 2019. Total Index returns. Index returns calculated in C$.
bankofcanada.ca/rates/exchange/currency-converter/

Interest Rates as of July 31, 2019

Fixed Income Securities	1 year	2 years	3 years	5 years	10 years	20 Years	30 Years
GICs**	2.16%	2.22%	2.23%	2.31%			
Canadian Treasury Bonds*	1.71%	1.52%	1.49%	1.42%	1.47%	1.65%	1.67%
U.S. Treasury Bonds*	1.97%	1.85%	1.76%	1.83%	2.02%	2.23%	2.53%

* Rates provided by TD Securities
** Rates provided by TD Wealth

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