Canada Surprises as Global Markets Climb

By Ian M. Riach

Despite low trading volumes and geopolitical sabre rattling between the United States and North Korea, global equity markets continued their upward momentum (in local currency terms) during the summer months. Since the end of the second quarter, the S&P/TSX Composite Index is up 2.8% and the S&P 500 Index 3.5%.[1] Having led equity markets for the first half of the year, the MSCI EAFE Index lagged its developed market counterparts, rising 0.7%.[2]

However, Canada's strengthening economy and rising dollar proved to be one of the season's most surprising stories. Given the loonie's near 4% increase in the quarter, the S&P 500 Index actually declined when translated into Canadian dollars.[3] Likewise, in Canadian dollar terms, the MSCI EAFE Index dropped 0.8%.[4]

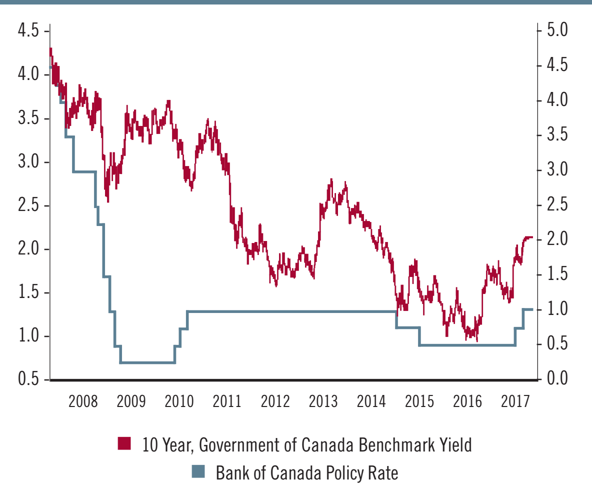
The loonie began gaining strength as it became clear the Bank of Canada was changing its view of the domestic economy from moribund growth to acceleration. As a result of this changing outlook, the Bank raised its overnight lending rate twice last summer. The rate increases helped propel the loonie to over US$0.82 before pulling back a bit in the last two weeks. Longer-term bonds also reacted to the change in the Bank of Canada's stance, as the yield on the 10-year Government of Canada bond rose above 2% for the first time since 2013.

The International Monetary Fund (IMF) shares the Bank of Canada's upbeat view. The IMF forecasts that Canada will lead the G7 in terms of growth for 2017 and revised its forecast upwards in July.[5] However, the IMF also points out that beyond the 2017-2018 period, certain risks could cause global growth to decelerate, which in turn would affect Canada. These risks include policy uncertainty surrounding trade (e.g., Brexit and NAFTA), the implementation of fiscal stimulus in the United States, and non-economic factors such as rising geopolitical tensions. Closer to home, record debt-to-income levels in a rising interest rate environment could dampen consumer sentiment, which has been a driver of growth in Canada. In addition, the higher Canadian dollar could affect exports and resource revenues, putting some pressure on growth.

The risks outlined above, together with North American equity valuations that are at, or slightly above longer-term averages, are causing us to be somewhat cautious. Equity prices at these levels are vulnerable to negative surprises. Therefore, we are being somewhat defensive in our equity positioning.

1. As of September 27, 2017; Source Bloomberg Finance L.P.
2. As of September 27, 2017; Source Bloomberg Finance L.P.
3. As of September 27, 2017; Source Bloomberg Finance L.P.
4. As of September 27, 2017; Source Bloomberg Finance L.P.
5. "World Economic Outlook Update: A Firming Recovery," International Monetary Fund, Washington, D.C., July 2017, https://www.imf.org/en/Publications/WEO/Issues/2017/07/07/world-economic-outlook-update-july-2017.

Interest Rates



Canadian/US Dollar Exchange Rate