

Geopolitical Fireworks Spark Late-Summer Volatility

Monthly Market Commentary

August 2019

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- Equity markets sold off around the globe in early August as the U.S.-China trade war appeared to enter a new phase characterized by much broader tariffs. Canadian stocks recovered from the sharp early-month selloff in mixed fashion, and yields declined for almost all Canadian government bonds.
- U.S. stocks vacillated throughout August—confined to a total range of about three percent—and finished the month toward the high end, partially recovering from the early-month selloff.
- We think there is still life in the global economic expansion. This may seem like a bold statement, but we would need to see a severe deterioration in financial and leading economic indicators before climbing onto the recession train.

Economic Backdrop

Equity markets sold off around the globe at the start of August as the U.S.-China trade war appeared to enter a newly heightened phase. With the promise of U.S. tariffs extending to virtually all imports from China by September, China allowed the yuan (its currency) to depreciate against the U.S. dollar to levels not seen since the 2008 financial crisis. This compounded concerns that the trade war would spill into a currency war. Volatility settled somewhat after spiking in early August, but remained elevated throughout the month.

Large-cap Canadian stocks recovered from the sharp early-month selloff for a small gain, while small caps ended August at a loss. Yields declined across all Canadian government bonds except those with the shortest maturities. Intermediate- and long-term bond yields declined by more than short-term bond yields, deepening an existing yield curve inversion.

U.S. stocks vacillated throughout August—confined to a total range of about three percent—and finished the period toward the high end, partially recovering from the early-month selloff. New tariffs went into effect on September 1, imposing a 15% levy on \$112 billion of Chinese exports to the U.S. that were previously unaffected.

The U.S. Treasury yield curve reached full inversion in August: The yield on the 30-year Treasury fell below the 1-month Treasury yield, settling at its bottommost level. The low-rate environment for long-term government bonds prompted U.S. Treasury Secretary Steve Mnuchin to assert the possibility of issuing 50- and 100-year Treasuries. Long-term government bond yields decreased more than short-term yields in the U.K. and Europe as well.

U.K. stock prices failed to recover from the early-month selloff as prospects of a reworked Brexit deal remained elusive. Prime Minister Boris Johnson made an effort to suspend Parliament until mid-October, leaving only two weeks for opponents of a no-deal departure to attempt to stop the U.K. from crashing out of the EU upon the planned departure date at the end of October. Sterling tumbled to multi-year lows versus the U.S. dollar at the beginning of September after Prime Minister Johnson threatened to call an election in mid-October; his parliamentary majority appeared to slip away as the House of Commons voted to block a no-deal departure.

European equities partially rebounded in the second half of August. A late-month Group of Seven (G-7) meeting of world leaders in France featured a notable unscheduled visit by Iran's foreign minister; his invitation by French President Emmanuel Macron showcased the gulf between European and U.S. leaders in terms of how to proceed in the wake of President Donald Trump deciding to exit the multi-party Iran denuclearization agreement last year.

Italy's coalition government collapsed on the resignation of Prime Minister Giuseppe Conte, who stepped down in a move to block Deputy Prime Minister (and leader of the nativist League party) Matteo Salvini's attempt to seize control through a snap election. At the request of President Sergio Mattarella, Mr. Conte has since agreed to help form a new coalition comprising the euroskeptic 5-Star Movement (the League's former senior coalition partner) and the pro-EU Democratic Party.

Elsewhere, Argentina revealed plans at the end of August to skip payments on more than \$100 billion of debt in favour of comprehensive restructuring, sending prices on Argentine bonds spiraling downward. The Argentine stock market dropped 48% on August 12—the largest single-day decline for a stock exchange since 1989¹—as primary election results indicated that President Mauricio Macri, a conservative reformer, would likely face pressure from populists in the upcoming general election. The government announced controls to restrict foreign purchases of Argentine pesos at the beginning of September.

India launched a wide-ranging occupation of Kashmir (a Muslim-majority region in the western Himalayas claimed by both India and Pakistan) in early August, which involved an expanded military presence, the imposition of curfews, targeted arrests, and a shuttered communications infrastructure. India's Prime Minister Narendra Modi revoked Kashmir's constitutionally guaranteed right to territorial autonomy on August 5, raising the prospect of conflict between India and Pakistan—both of which possess nuclear arms.

Protests in Hong Kong that begin in early June continued to escalate incrementally throughout August, increasing the risk of a heavy-handed crackdown by the mainland Chinese government.

Central Banks

- The Bank of Canada (BoC) held no meeting in August, but left the overnight rate unchanged at 1.75% following its meeting on September 4. If the U.S. Federal Open Market Committee (FOMC) cuts rates further—which it appears to be considering ahead of its mid-September meeting—the BoC may feel pressure to follow suit.
- The FOMC also did not meet in August, but communicated on July 31 its decisions to cut the federal-funds rate by 0.25% and conclude its balance-sheet reduction program sooner than expected.
- The Bank of England's Monetary Policy Committee announced on August 1 that it retained its preference for tighter monetary policy, contingent on Brexit and its impact on economic growth.
- Central Banks from New Zealand and a raft of emerging markets including India, Thailand, Mexico and Indonesia lowered their benchmark rates in August, collectively registering the greatest number of rate cuts in a single month since 2009². There was increased pressure on policymakers to ease monetary conditions due to the FOMC's decision to cut the federal-funds rate and China's allowing the yuan to depreciate.
- The European Central Bank (ECB) and Bank of Japan had no meetings in August.

Economic Data

- According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) jumped by 0.4% in July but remained steady at a 2.0% increase for the past 12 months. Producer prices were mixed—the Industrial Product Price Index (IPPI) declined by 0.3% in July while the Raw Materials Price Index (RMPI) bounced higher by 1.2%. Over the past 12 months, the IPPI and RMPI respectively declined by 1.7% and 9.0%. Similar to consumer prices, the weak data can be attributed to sliding energy prices. The unemployment rate was unchanged in August at 5.7% despite the addition of 81,000 new jobs as more people participated in the labour market.
- U.S. manufacturing activity slowed in August as export orders tumbled. Personal incomes gained 0.1% in July and consumer spending jumped by 0.6%, as prices for personal consumption expenditures increased at a 1.4% year-over-year pace (1.6% for core prices, which exclude food and energy products). Total economic growth was less than expected in the second quarter, but measured an annualized 2.0% on robust consumer spending.

¹ "Argentina's Stock Market Decline Is Among the World's Worst Since 1950" Hickey, C.K. Foreign Policy. August 13, 2019.

² "Down, down they go: Emerging central banks deliver most rate cuts in a decade" Strohecker, K. and Carvalho, R. Reuters. September 2, 2019.

- A survey of U.K. retail sales conditions found that orders to suppliers dropped in August at the fastest rate since December 2008.³ U.K. manufacturing activity continued to contract for the fourth consecutive month in August. The U.K. claimant count unemployment rate remained unchanged in July at 3.2%; the three-month average U.K. unemployment rate increased from 3.8% to 3.9% for the April-to-June period, while average year-over-year earnings growth jumped from 3.4% to 3.7%. The U.K. economy shrank by 0.2% during the second quarter, contracting for the first time since 2012, but expanded 1.2% year over year.
- The eurozone services sector continued to grow at a healthy pace in August according to a preliminary report. However, manufacturing activity declined for the seventh straight month. The eurozone unemployment rate held at 7.5% in July for the third consecutive month. Overall economic growth registered 0.2% during the second quarter and 1.1% year over year, unchanged from an earlier report.

Market Impact (in Canadian dollar terms)

Global equities slid in August, with emerging markets tumbling by more than developed markets. Large-cap domestic equities fared best, followed by Japan with a modest gain, and then the U.S. with a small loss. China and the U.K. delivered sizeable losses, but Brazil fared even worse. From a domestic sector perspective, information technology delivered August's best performance, followed by materials, utilities and consumer staples. Healthcare's sharp fall eclipsed the relatively restrained losses in other lagging sectors.

Domestic fixed-income markets delivered a healthy gain in August. Government bonds had the best performance, followed by real return bonds. Meanwhile, U.S. high-yield bonds lagged.

Index Data (August 2019)

- The S&P/TSX Composite Index was up by 0.43%.
- The FTSE Canada Universe Bond Index returned 1.88%.
- The S&P 500 Index, which measures U.S. equities, fell by 0.41%.
- The MSCI ACWI Index (Net), used to gauge global equity performance, declined by 1.21%.
- The ICE BofAML U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 0.33% (currency hedged) and 1.59% (unhedged).
- The Chicago Board Options Exchange Volatility Index—a measure of implied volatility in the S&P 500 Index also known as the “fear index”—moved from 16.12 to 18.98 during the full month, and peaked at 24.59 on August 5.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, fell from US\$58.58 on the last day of July to US\$55.10 at the end of August.
- The loonie weakened versus the U.S. dollar; it ended the month at C\$1.33 per U.S. dollar. Meanwhile, the U.S. dollar was modestly stronger relative to sterling and the euro, but weaker versus yen. It ended the month at US\$1.22 against sterling, US\$1.10 versus the euro and 106.15 yen.

³ Confederation of British Industry Distributive Trades Monthly Survey for August. Released August 22, 2019.

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