CIBC
Asset Management

Market Spotlight

September 2016

Global Markets

Global equities took a breather in August, following a strong post-Brexit rally in July. Speculation on central bank actions continues to dominate, with a particular focus on the timing of the next U.S. rate increase and possible unorthodox stimulative measures (e.g. quantitative easing) in other regions. Global equity markets gained 0.08% in U.S. dollar terms, 0.70% in Canadian dollar terms.

U.S. equity markets ended close to unchanged for the month. Investors paused after a strong July rally and turned their focus to employment data and other economic reports. Investors are trying to gauge the probability of a September, or possibly December, rate increase. July job numbers were surprisingly strong, but August numbers, which are often subject to later revision, were disappointing.

Canadian equities inched up, adding about 0.3%, as oil prices climbed; other commodities, such as copper and gold, declined. Gold's decline was partly a reaction to the prospect of a higher U.S. currency, as the probability of a U.S. interest rate increase moved up slightly. This followed comments from Janet Yellen and other U.S. Federal Reserve (Fed) members.

International equity market broad averages were close to unchanged in August, although individual countries were more volatile. The U.K.'s central bank resumed its quantitative easing policy, cut its rate, forecast further rate cuts and provided forward guidance for low rates for the next couple of years. These developments are not surprising given the uncertainty introduced by the Brexit vote.

Emerging markets had a solid gain, especially when compared to the rest of the world, ending 2.5% higher as a group (in USD). Chinese equities were higher by about 7.4%. One positive development was the announcement from the securities regulator that a long-delayed exchange link between Shenzhen and Hong Kong will be established this year. Some limits on the amounts foreigners can invest in the Chinese market will also be lifted.

Current Asset Allocation Outlook*

Asset Class	Weighting
Canadian Bonds	Overweight
International Bonds	Underweight
Canadian Equities	Market Weight
U.S. Equities	Underweight
International Equities	Overweight
Emerging Market Equities	Overweight

**For balanced portfolios, as at August 31, 2016.*

"Sound Bites"

Luc de la Durantaye

"Over the last year, fluctuations in the U.S. dollar have been heavily influenced by market expectations about U.S. monetary policy. The year started with a radical shift in expectations—from market participants thinking that the Fed's tightening cycle was just beginning, to thinking that the Fed would instead move to the sidelines for an extended period. This was enough to push the greenback lower against most other currencies. Since then, market participants have had trouble figuring out what the Fed will do next, resulting in increased U.S. dollar volatility.

Looking through this short-term volatility, one thing stands out: with the exception of the yen, the U.S. dollar remains strong against the currencies of most of its trading partners and this is hurting U.S. corporate profitability. U.S. corporate profits have been declining for three consecutive quarters—a profit recession. Under these conditions, it is very hard for the Fed to commit to further policy tightening. The more the Fed raises rates, the more ground the U.S. dollar gains and the bigger the negative impact on U.S. corporate profits. What we can say: under these conditions, heightened U.S. dollar volatility is most likely here to stay."

Fixed Income

Chairperson Yellen and several Fed governors cautioned that further interest rate increases are warranted, perhaps as soon as September. U.S. bond yields moved higher in response; however, yields remain close to record lows, as overall growth levels remain lower than expected at the start of the year. Canadian bond yields didn't follow their U.S. counterparts higher. This was due to a string of disappointing economic releases that were largely blamed on the impact of the Fort McMurray fires. However, the problems for Canada run deeper, as sluggish U.S. growth has hindered the expected rewards of a lower loonie.

Canadian Equity

The Canadian equity market reached a 52-week high and closed the month with a +0.3% return. This brings the S&P/TSX Composite Index's year-to-date return to +14.4%. There were pullbacks in gold stocks, as a stronger U.S. dollar contributed to a lower gold price. The best relative-performing sectors during the month were health care, consumer staples and industrials. The sectors with negative returns were materials, utilities and telecommunications. OPEC will hold an informal meeting in mid-September to discuss possible actions that could be implemented to stabilize oil prices. Agrium and Potash announced that they were having preliminary discussions on a potential merger.

"Sound Bites"

Natalie Taylor
Equities - Financials

"Canadian banks reported a strong quarter, exceeding muted analyst expectations. Earnings beats averaged 6%, driven by expense control, strong capital markets results and improving provisions for credit losses. With the exception of capital markets earnings, which are highly volatile and market dependent, the trends of expense improvement and credit cost improvement are expected to drive earnings growth into 2017.

Restructuring charges result in expense improvement and positive operating leverage

The Canadian banks have taken over $2 billion CAD in collective restructuring charges over the last two years. Initially, the expense savings were reinvested in technology and branch optimization; however, Q3/16 results showed that more of the recent expense savings are falling to the bottom line. After three years of negative operating leverage, revenue growth is finally outpacing expense growth, even in a muted growth environment. We believe the theme of expense control will continue to play out over the next couple of years. In our view, Bank of Nova Scotia will benefit the most—it has been aggressive in managing costs, taking nearly $600 million CAD in restructuring charges. Our analysis indicates that the bank has room to improve productivity as it narrows the gap with best-in-class peers. CIBC will also benefit from productivity improvements; however, the bulk of the benefit will come in 2018 and beyond. While Royal Bank has chosen not to take a restructuring charge, it will manage expenses on an ongoing basis. As such, meaningful progress on expenses in 2017 could surprise the market.

Energy related credit costs have likely peaked

Over the last two years, the market has been myopically focused on the deteriorating credit quality of energy companies and the potential for losses to the banks. While exposure to the energy sector is minimal at 2-3% of total loans, the 'loss given default' is high relative to other loan exposures. Bank fiscal Q2/16 (Feb-April) saw the WTI oil price touch $26 US, followed by a meaningful spike in energy-related provisions for credit losses. Since that time, oil prices have recovered and energy companies have improved their operating costs and balance sheets. As such, the third quarter results showed an improvement in credit costs related to energy. We believe provisions for credit losses have peaked in the near term and expect further stabilization in 2017. Again, we believe Bank of Nova Scotia is best positioned, as it is over-indexed to the energy sector."