September 3, 2019

Investor Strategy

Helping investors reach their long-term wealth goals

Late-summer volatility

Craig Basinger, Chris Kerlow, Derek Benedet, Alexander Tjiang, Gerald Cheng

Summary

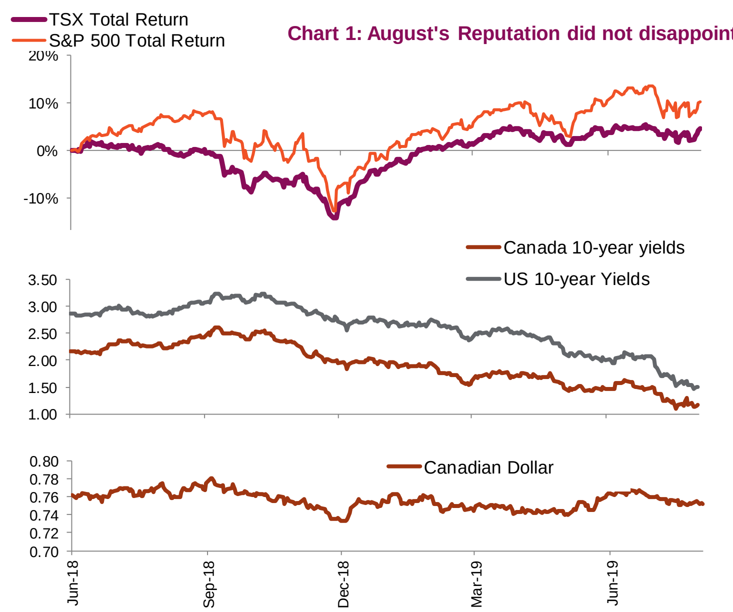


Chart 1: August's Reputation did not disappoint

I. Market recap – Late-summer volatility

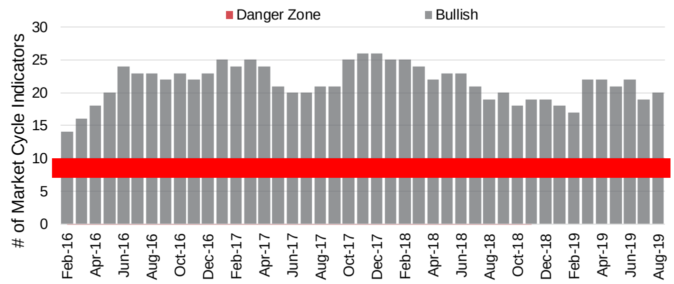
August is no stranger to volatility, and the weakness in late July carried over throughout the month. It was a choppy month, no doubt about it, with a quick sell-off to kick start the month followed by elevated levels of volatility as markets bounced to-and-fro amid the trade war twitter turmoil. New tariffs announced by both China and the U.S. escalated trade tensions as well as fears of economic contagion. The G7 meeting grabbed headlines for a period of time, as did the central bank summit in Jackson Hole, but the meetings concluded with no material announcements. The Brexit drama continues with the British Parliament set to get a long vacation ahead of the Halloween deadline, increasing the risk of a no-deal Brexit. The S&P 500 fell 1.6% in August. Meanwhile, the S&P/TSX Composite fared better: buttressed by a healthy gold weighing, it managed to rise 0.4%. Gold had a spectacular month reaching its highest level since 2013, topping out at $1,550/ounce. Almost long forgotten, gold is reaffirming its reputation as a portfolio stabilizer during uncertain times.

Volatility, measured by the VIX index, peaked early in the month at 25, and has remained elevated over the course of the month with the highest average VIX reading since January. There has been a clustering of abnormally large intraday swings, the likes of which we have not seen since the fourth quarter of 2018. The

S&P 500 has seen a total of eleven 1% moves this month (seven up and four down), the highest total since February 2018. With fear permeating the financial markets, we're seeing the typical flight to quality giving a boost to bonds, with yields falling. The 10-year Canadian bond yield dropped to 1.08% mid-month, and the U.S. 10-year fell to 1.44%. The U.S. dollar has also benefited as a risk-off trade with the U.S. dollar index remaining elevated and the Canadian dollar falling slightly over the course of the month. Looking ahead to September, the focus will remain on the direction of trade tensions, whether slowing economic growth in manufacturing spreads and how central banks respond. From a seasonality perspective, we're heading into a difficult period and with tensions already high, market anxiety remains elevated.

II. Market cycle

Chart 2: Market Cycle



Resilience

Our Market Cycle indicators have remained resilient during the market volatility of August and we have ticked slightly higher, with 20 signals bullish compared to 13 bearish. There was an uptick of only one signal, but given the market choppiness and continued soft economic data, one in the right direction is not inconsequential. It was oil that changed, as prices improved. With a score of 20, we believe there is a low probability that the cycle is coming to an end – even with an inverted yield curve, slowing economic growth and a volatile trade war. This does not imply that the recent period of market weakness is over. Encouragingly, it does suggest that given the current data, market weakness should be contained as a correction at the worst.

Market Momentum				
Canada				✓
US				✓
Consumer Model		✓		
HY Spreads			✓	
US Economy				
Leading Ind (3m)			✓	
Leading Ind (6m)			✓	
PMI			✓	
PMI New Orders			✓	
Cons Sentiment		✓		
Cars			✓	
Homes		✓		
Credit				✓
Chemical Activity		✓		
Rail		✓		
Energy Demand			✓	
Trucking		✓		
Phili Coinc				✓
US Unemployment			✓	
Rates				
Fed Funds				✓
Yield Curve	✓			
Yield Curve Change	✓			
Fundamentals				
Valuation Canada			✓	
Valuation US		✓		
Earnings Growth				✓
Sales Growth				✓
Margins				✓
Global Economy				
CRB		✓		
Oil			✓	
Copper	✓			
Baltic Freight				✓
KOSPI	✓			
Emerging Mkts		✓		
Global PMI			✓	
Total	4	9	11	9

There are a number of positives out there in the data at the moment. Despite the market weakness in August, our longer-term momentum models remain bullish. Leading indicators for the U.S. dipped, but have since started to rise again.The U.S. economy remains in pretty good shape and now with bond yields much lower, there may be further support. Valuations are slightly mixed, but growth continues and margins remain resilient.Globally, the situation is more challenging as Europe and Asia see strong headwinds.The global economy has slowed and the big question is how much more will it slow or will we see stabilization.

The next few months will likely be critical. It is safe to say we are currently experiencing a manufacturing recession, with slowing activity in most areas of the globe. Corporate spending is also seeing softness as companies cut back or put spending plans on pause due to slowing growth and trade uncertainty. So far, this has only marginally impacted other areas of the global economy, such as services and employment. But if this slowness spreads, that could be the tipping point that spells the end of this long 10+ year bull-market cycle. As a result, the next few months of economic data will be critical.

While we score all our indicators equally, there are times when we focus more on some signals over others. Currently, we are keenly focused on any softness in margins and U.S. consumer data. We have seen some softness in margins, notably in the smaller and mid-cap sized companies in the U.S. If this spreads to large caps, we could see companies cut back even more on spending which would create a bigger headwind for the economy. For the consumer, if we see delinquencies rising, employment softness or a drop in confidence, this could mean that soft economic growth is spreading throughout the economy.

For now though, these are on our radar and not evident enough to warrant changing allocations. One very interesting trend we have noticed over the past decade is that economic data has this tendency to fall short of consensus expectations during the first half of the year then beat expecatations in the second half. We may be seeing that trend play out again this year as the Citigroup economic surprise indices have turned up over the past few months in most major economic areas. Better economic data would go a long way to injecting some confidence back into these markets.

III. Trade wars: Lose, lose?

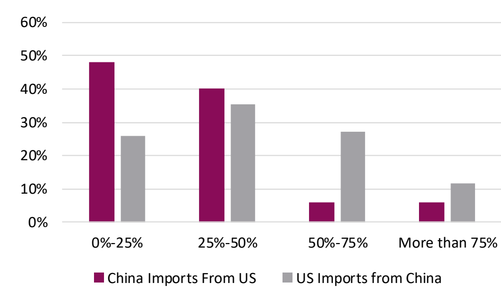
International trade raises living standards by providing greater access to goods and services at a lower price. Globalization has been arguably the greatest boon to economic growth since the industrial revolution. By that logic, we surmise that the goal of the trade war between the U.S. and China is not about who has more to gain but rather which country can lose the least. China seems well aware of this fact. After the G7 Summit, China's Minister of Commerce told reporters, "Escalation of the trade war won't benefit China, nor the U.S., nor the world."

Throughout August, both sides raised the stakes. The U.S. threatened an additional 5% tariffs on almost all imports from China in addition to the 10% tariffs on imports that were not impacted within previous tranches. Then China directly retaliated by halting agricultural purchases from the U.S. and allowing the Yuan to drift above 7:1 to the U.S. dollar. The last week of August, however, saw a more muted tone with China saying it would not retaliate against the latest round of tariffs. Still, Beijing did not rule out placing additional tariffs on U.S. imports.

China is the largest supplier of a variety of goods to the U.S.; many manufacturers are scrambling to source inputs and fill the gaps from other countries. The most notable beneficiaries of this move will be other southeast Asian economies such as Vietnam and Taiwan, whose supply channels China must rely upon to ship their products overseas. In a true war-like tactic, China increasingly appears to be flooding those markets with their products and relabelling them as domestic.

To recap events thus far, the U.S. has imposed tariffs on just over $350 billion worth of goods from China. Over the past year, as the "war" has escalated, those imports have fallen by 28%, according to Bloomberg. And it isn't as simple as re-sourcing many of these goods because China is the main supplier for many and, in some cases, the only supplier.

Chart 3: Share of China/U.S. Imports in Total Imports For a Given Category



But for China this virtue may also be a vice. It is a net-exporting nation and so if exports fall, so too will its gross domestic product.

The U.S. also exports to China. However, it isn't as dominant a player in China's market because these exports are more readily available elsewhere. Consequently, U.S. companies that import from China are going to be harder hit because it is easy for Chinese buyers to source imports from non-U.S. suppliers. For the U.S., the opportunity cost of losing a foreign buyer outweighs that of China's.

You needn't look past President Trump's Twitter account to know he watches closely the trade war's impact on the stock market. It's probably not a coincidence that when the White House announced the delay on tariffs to a certain list of items from September 1 to December 15, it came the day after the S&P 500 was down more than 3%, the worst day so far in 2019 since January 3. One can also infer from this move Trump's 'affection' for the consumer, or more specifically, his voter base given his bid for re-election in 2020. The list of impacted items includes laptops and toys and is conveniently timed for after the holiday shopping season. It also allows more time to potentially walk back announced tariffs.

Tranche	Import Volume (2018 $B)	Current Rate	Latest Proposed	Major Categories
List 1	30	**25% as of July 6, 2018**	*30% as of October 1, 2019*	Industrial machinery, capital goods
List 2	15	**25% as of August 23, 2018**	*30% as of October 1, 2019*	Electrical equipment, capital goods
List 3	222	**25% as of May 10, 2019**	*30% as of October 1, 2019*	Furniture, electronics, autos, leather goods, other int. and cap. goods
List 4A	104	**0% (Current)**	*15% as of September 1, 2019*	Apparel, footwear, electronics, TVs/monitor screens
List 4B	156	**0% (Current)**	*15% as of December 1, 2019*	Cell phones, computers, toys, electronics

Beyond letting the currency devalue, expectations are growing that China will make modest cuts to the medium-term lending facility (MLF)/open markets operations (OMO) rates and credit policy reserve requirement ratios (RRRs) cuts. The U.S. has already taken action by easing monetary policy and is expected to make two more rate cuts by the end of the year.

As mentioned above, cutting rates would help China defend its economy and likely escalate the feud. Yet on August 29, cooler heads appear to have prevailed when the Ministry of Commerce spokesman Gao Fend said, "China has ample means for retaliation, but thinks the question that should be discussed now is about removing the new tariffs to prevent escalation of the trade war." When asked pointedly if Beijing would retaliate to this most recent round, the ministry spokesman repeated the comment. This could be a sign of a change of course. Markets, in turn, responded positively.

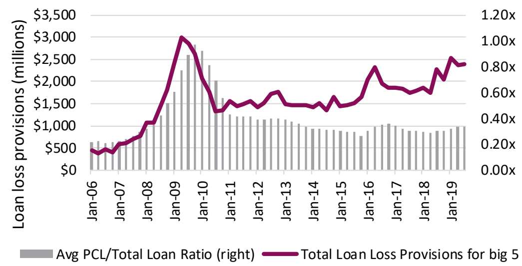
It is anyone's guess whether these trade issues will be resolved. The key issue for investors at this point is the degree to which this ongoing feud feeds corporate uncertainty and further slows global economic growth. Given the slowdown over the past year, the global economy isn't in the best shape to weather any further escalation in the trade dispute.

IV. Canada sees growing signs of credit risk

Among investors who follow Canada's banks there's a subtle, yet growing sense of nervousness and unrest. This quarter's earnings headlines were once again marked by a line-item that has long sat at the top of mind: the provision for credit losses, or PCLs. As a refresher, loan loss provisions are proxies for potential losses a bank might incur in the future due to loans that may not be repaid.

In aggregate, loan loss provision amounts recorded by Canadian banks have been rising for the past decade, implying credit risks are steadily increasing. Year-over-year, PCLs rose 37% across the Big Five banks. Most concerning among the peer group is BMO, which reported a 65% increase in its PCLs from the past year to $306 million. Moreover, we note that the ratio of PCLs to their total loan book – on average – has held relatively steady for the past five years (Chart 4). So, while PCLs have been rising so have the total amount of loans with the current average sitting at 0.33x.

Chart 4: Bigger loan book for big 5 but so far provisions remain proportionate

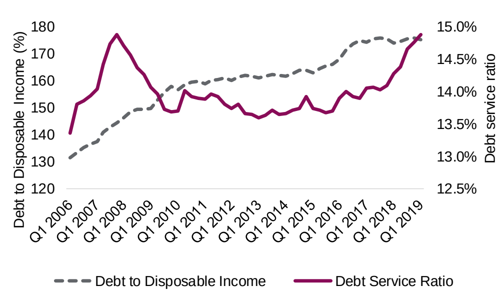


Digging a bit deep, it appears that loan loss provisions have started to rise faster than overall loan growth. What, then, is driving credit risk volumes higher? And further, when will credit losses peak?

Under new accounting standards (IFRS 9) implemented in 2018, PCLs have risen materially. Canadian banks must now revise their performing credit loss models using stricter economic data considerations. Hence, amid the current backdrop of mixed data, financial institutions across the board have been forced to allocate higher amounts of loss provisions. While this is an accounting technicality, we believe a truer, and more conservative depiction of credit risk is now being reflected in the market. Furthermore, it appears that risk has moved higher in both commercial and consumer lending, most notably in commercial real estate and construction loans.

On the consumer side, rising debt service costs and a softening real estate market continue to stress some Canadian households. The last reported Canadian debt service ratio has now reached its previous recessionary peak, at 14.9% (Chart 5). Add historically high debt to disposable income levels and the Canadian consumer appears stretched. Any hiccup in employment or wage growth would not be well received.

Chart 5: Canadian debt service ratios elevated, debt levels elevated



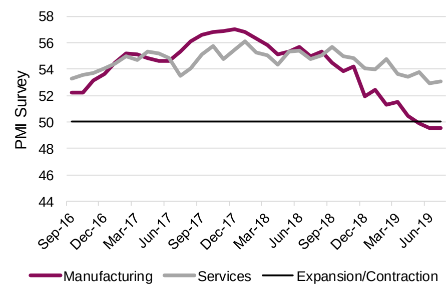
On the commercial side, notional default volumes in North America overall have risen to $36 billion and are on track to surpass yearly 2016 volumes. Notably, however, these delinquencies are heavily concentrated in energy issuers, suggesting that recent occurrences are idiosyncratic and not a result of a broader cyclical trend. Decent GDP growth is also helping on the commercial credit side.

Upon the foundation of the Canadian banks, cracks are undoubtedly beginning to grow wider as PCLs continue to climb slowly towards levels not seen in many years. Adding in slower loan growth, this has certainly contributed to the banking industry's recent underperformance and current low valuations. We continue to believe investors should be tilting more away from domestic Canadian credit exposure at this point in the cycle.

V. Consumer contagion?

It is safe to say that we are in the midst of a global manufacturing slowdown if not a manufacturing recession. Purchasing Managers Indices (PMIs), which are a proxy for manufacturing activity, are almost all pointing to slowing manufacturing activity around the world. And the slowness appears to have spread to corporate spending. If you dig just past the surface of Canada's latest quarterly GDP, which was up a healthy 3.7% annualized pace, you find all the good news came from a spike in exports. Non-residential structure, machinery & equipment, which represents a good chunk of corporate spending, dropped at a 16% annualized pace, making the third negative reading in the past four quarters. The trend in the U.S. has been in the same direction, albeit not nearly as dire. This is understandable: slowing global economic activity plus trade uncertainty naturally leads companies to pause or slow spending plans or output.

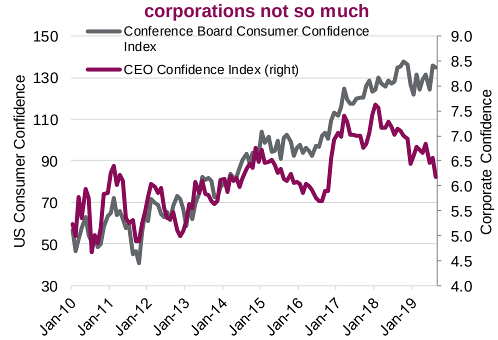
Chart 6: Soft manufacturing is starting to bleed over into services



The degree to which this isolated slowdown in manufacturing/corporate spending spreads to the consumer, in our view, will dictate whether we have a recession in the next year or this cycle marches onward. To date, the consumer appears to be doing well, after all economies are not as manufacturing based as decades past. But a loss of momentum appears to be starting to show itself beyond manufacturing. PMI data includes both manufacturing industries and service industries, and while services have held up better, the data is starting to soften there as well (Chart 6).

Corporations are becoming more cautious in response to slower economic growth and trade uncertainty. In our view, the trade tariffs only have a minor impact on economic growth and consumer prices. However, the daily news flow on trade which seems to oscillate between escalation and de-escalation, has eroded corporate confidence (Chart 7). This has led to the slowing of corporate spending, but so far this has not transgressed to hiring and employment, which would weigh on the consumer. Normally a company will cut back on travel and other spending before employment given the cost of finding and hiring people. Still, weakness has started to show up in temporary hiring and job openings. While these are minor dips at the moment, these are the areas that we would expect to see weakness first if a slowdown in labour is building.

Chart 7: Consumers remain confident, corporations not so much



The degree to which this contagion spreads to the consumer will be key. The good news so far is that consumer confidence remains healthy (Chart 7) as does spending. Second-quarter earnings posted by retailers held a number of surprises thanks to robust consumer spending. And let's not forget that we have near record-low unemployment, wages are rising, U.S. consumer debt is low, interest rates are super low, so there are plenty of reasons to go out and buy that big 'whatever'. For now, then, we are not overly concerned. But if we see continued weakness in temporary hiring or job openings or a rise in initial jobless claims, those could be the early warnings that this weakness has spread beyond the corporation to the consumer.

VI. Portfolio positioning

We have not made any changes to our asset or geographic allocations in August. We continue to believe this period of weakness, while not necessarily over, will prove to be a correction at worst. But the degree of the pullback is not enough to have us deploying any dry powder on a short-term trade basis.

We have a minor underweight in Canada with an overweight U.S. equities and market weight international. Our low duration stance has certainly been the wrong one this year. However, where yields sit today, inverted across much of the curve, we have no desire to add duration and remain shorter term focused with higher credit quality.

With Market Cycle indicators appearing healthy, we believe this cycle still has room to go. Central banks have pivoted to a more accomodative position, which is encouraging. Countering this is the continued uncertainty around the trade war and the implications for slower economic growth. There are certainly areas of concern in the market place, as there always are, but at this point we do not believe the negatives have flared up enough to spell the end of a market cycle.

Overall Asset Allocation	-				+
Equities				■	
Fixed Income		■			
Cash				■	
Global Equities	**-**				**+**
Canada		■			
U.S.				■	
Euro Area			■		
Japan			■		
Emerging Markets	■				
Fixed Income	**-**				**+**
Canada		■			
U.S.			■		
Government			■		
Investment Grade		■			
High Yield	■				
EM Debt	■				
Prefs		■			
Duration	■				
Credit		■			

Charts are sourced to Bloomberg L.P. unless otherwise noted