FP Wealth Management Monthly Letter – August 2017

Canada's Sizzling Economy Fails to Lift TSX as Wall Street Extends Record Run

July was a significant month for the global financial markets. Canada solidified its leadership pace on the recovery front, while Wall Street flexed its earning power. Politics and central bank decision-making have also factored into a season that has yet to deliver the so-called "summer doldrums."

Canada's Economy: Full Steam Ahead

If there was any debate about the strength of Canada's recovery, last month's data likely put it to rest – at least for the time being. Canada's gross domestic product (GDP) expanded 0.6% in May, the latest month for which there is available data.

The growth rate was not only three times bigger than expected, it translated into year-over-year growth of 4.6%. That's nearly one full percentage point higher than the first-quarter expansion, which was easily tops in the G7.

Although health was reported across nearly every industry, energy posted its fastest annual growth since October 2000.[1] The sector's strong performance came amid a global rebound in oil prices after Saudi Arabia announced fewer crude shipments about two months ago. The Organization of the Petroleum Exporting Countries (OPEC) appears to be ratcheting up its effort to stem the global supply glut, which could lead prices even higher in the short run.[2]

Against this backdrop, the Bank of Canada's decision to raise interest rates on July 12 was an easy one. The increase, which amounted to a quarter-point adjustment, was the first such move since 2010. It also put the Bank of Canada in the same company as the U.S. Federal Reserve in being one of only two major central banks to raise interest rates.

The BOC could be on track to hike again as early as October,[3] a move that could propel the Canadian dollar even higher than the two-year peak it saw this past month.

Economic Growth Fails to Lift Canadian Stocks

Unfortunately for stocks, GDP is a coincident indicator, not a leading one. In fact, it has often been described as a lagging indicator in the context of national output. This essentially means that GDP growth follows an event or occurs approximately at the same time as the conditions it signifies.[4]

That partly explains why Canadian stocks have failed to rally in the wake of stellar economic numbers. The S&P/TSX Composite Index rose just 0.5% in July. While much better than June's 1.1% drop, it pales in comparison to Wall Street, which is currently riding the longest bull market since 1900. To boot, U.S. GDP growth has been anything but impressive as of late.

Canadian stocks, as measured by the TSX, have traded virtually flat this year. When factoring in dividends, the growth rate is a little more flattering, but not enough to make Canadian equities an attractive option for passively managed portfolios.

Wall Street Diverges from the Pack

Volatility north of the border and across the Atlantic had little-to-no effect on U.S. stocks, which steamrolled to new record highs in July. All three benchmarks – the S&P 500, Dow Jones and Nasdaq – saw stellar returns for the month. The Nasdaq led the pack, growing 3.4%, as technology shares made a comeback.

Technology was subject to sector rotation just one month earlier, leading to a series of sharp declines and dragging the benchmark indices away from record territory. Capital flowed back into the sector in July as heavyweights Alphabet, Facebook and Intel posted strong quarterly earnings. More recently, Apple posted better than expected top and bottom line results during the quarter, sending the stock to new record highs.

Though difficult to justify for much of 2017, the latest equities rally on Wall Street is at least partly attributable to robust earnings. About 57% of S&P 500 companies reported earnings through July 28. Of them, 73% registered per share earnings that were higher than the median estimate, according to financial research firm FactSet. A further 73% said revenues also surpassed expectations.[5]

Trump Administration Sets NAFTA Negotiation Date

Negotiations over the future of the North American Free Trade Agreement (NAFTA) are set to begin August 16 in D.C. The Trump administration says it intends to mend trade imbalances with Mexico and Canada through the NAFTA revamp. This includes boosting exports of everything from farm goods to financial services.[6]

Trump hasn't shied away from playing hardball with his neighbour to the north. Earlier this year, the president reopened old wounds by announcing hefty import duties on Canadian softwood lumber. The tariffs, which range between 3% and 24%, are expected to add to the costs of U.S. homes by about $1,200, according to the U.S.-based National Association of Home Builders (NAHB).[7]

The Month Ahead

Politics will be at the top of investors' agenda for the month of August. In addition to NAFTA negotiations, Congress is locked in a bitter debate over healthcare reform at a time when President Trump is backing drastic changes on another front: immigration.

Aside from political wrangling in Washington and elsewhere, August could be a slower month for North American markets. Central banks are on holiday until September and earnings season is set to unwind in the coming weeks.

Sincerely,

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6 Andrew Mayeda, Josh Wingrove and Eric Martin (July 17, 2017). "U.S. Says It Aims to Cut Trade Deficits Through Nafta Revamp." Bloomberg Politics.
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