

## May Market Update: Wall Street Recovers from Politically-Charged Selloff; Canadian Economy Outshines Global Peers

Investors ran away from the G7's fastest-growing economy last month, as geopolitical risks and an uncertain domestic outlook caused the Toronto Stock Exchange to underperform its global peers. Political scandal in the White House triggered a sharp rise in volatility, leading North American markets to their biggest one-day drop in at least eight months. Although Wall Street recovered, Canadian stocks didn't fare nearly as well.

### Trump's Political Test

U.S. President Donald Trump dominated the headlines last month, first by firing F.B.I. Director James Comey over his handling of the investigation into Hillary Clinton's emails. By doing so, Trump became only the second president in U.S. history to dismiss his F.B.I. chief.

A memo written by Comey surfaced about a week later, where he alleges that Trump tried to end an investigation of former National Security Advisor Michael Flynn, who resigned in February on information he misled the administration about his interaction with Russian officials. Based on Comey's memo, Trump may have committed obstruction of justice, which is an impeachable offense under U.S. law.

Before the scandal could be resolved, the president boarded Air Force one for his first foreign tour with stops in Saudi Arabia, Israel and the Vatican.

### Volatility Rises

Political uncertainty in Washington triggered a sharp rise in implied volatility through the middle of the month. A measure of investor fear known as the CBOE VIX spiked more than 46% on May 17, which was the day after the Comey memo surfaced. The large-cap S&P 500 Index declined 1.8% during the session, while the Dow Jones Industrial Average sold off nearly 400 points. The S&P/TSX also shed 270 points.

Volatility left the scene as quickly as it arrived as U.S. stocks returned to record territory by the end of the month. The same could not be said about the TSX, which failed to break even for the month. The Toronto benchmark has returned approximately 1% this year, vastly underperforming Wall Street and European equities. The gauge has been dragged lower by outsized exposure to energy and financials – two sectors that have broadly underperformed.

### Canadian Economy Flexes Its Muscles

The Canadian economy outshined its G7 peers during the first quarter, with gross domestic product (GDP) accelerating at a 3.7% annual pace. That was the fastest expansion since 2010, when Canada was growing at a much faster rate than its American counterpart.<sup>1</sup> By comparison, the U.S. economy grew just 1.2% annually in January-March, and that was after an upward revision.

Domestic demand by way of consumer spending and real estate continued to underpin the economy. Household spending on goods rose 4.3% on the quarter. Business investment in residential properties and new construction activity were major contributors to GDP. Combined, these forces outweighed a slight drop in exports.

Since the financial crisis, consumer spending and housing have been the cornerstones of the Canadian economy. Although this has been a source of strength, it has also created systemic risk in the form of record home values and mounting consumer debt. Canada's household debt exceeded GDP last year for the first time ever.<sup>ii</sup> These vulnerabilities have been cited repeatedly by the Bank of Canada (BOC), which has maintained a cautious outlook on the domestic economy.

### **White House Triggers NAFTA Renegotiation Process**

The rise of protectionism under President Trump is another source of concern for Canadian and global policymakers. Last month, the president triggered a 90-day consultation period to begin renegotiating the North American Free Trade Agreement (NAFTA), which has governed bilateral trade relations between Canada, the United States and Mexico since 1994. This means negotiations can begin as early as August.

NAFTA's economic footprint exceeded \$1.1 trillion in 2016, a dramatic increase from the roughly \$290 billion in continental trade back in 1993.<sup>iii</sup> The United States is by far Canada's biggest export market, with bilateral trade between the countries valued at \$2 billion per day.<sup>iv</sup>

### **OPEC Extends Production Freeze**

Oil prices staged a dramatic relief rally through the middle of the month after Russia and Saudi Arabia agreed to extend a production cut agreement by nine months. The deal, which was originally intended to run for six months beginning in January, was ratified at a biannual meeting held by the Organization of the Petroleum Exporting Countries (OPEC) on May 25.

The meeting proved to be another "buy the rumour, sell the fact" event as oil prices declined sharply in its aftermath. The decline was partially attributed to disappointment that OPEC wasn't planning for deeper cuts through March 2018.

Though achieving record compliance with its pledge to reduce production,<sup>v</sup> OPEC has been unable to drain the global supply glut. Pressured by U.S. shale, crude prices are expected to have limited upside for the remainder of the year.

Active U.S. oil rigs – a proxy for production levels and shale-industry activity – has steadily increased in each of the past 20 weeks, reaching the highest level in over two years.

### **The Look Ahead**

The old adage "sell in May and walk away" wasn't nearly as relevant last month as it has been historically, possibility signaling above-average volatility through the summer. Geopolitics, monetary policy and economic data will continue to drive headlines over the course of June and beyond. The status of the Trump reflation trade is still up in the air as the new administration struggles to implement its highly sought-after growth agenda. In the meantime, evidence suggests portfolio managers are pivoting toward Europe to capitalize on easy monetary policy and a rebounding economy.

If you have any questions regarding this summary or your investment portfolio, please contact us.

Sincerely,

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#### Sources

- <sup>i</sup> Daniel Tencer (May 31, 2017). "Canada's Economic Growth Triples U.S.'s." Huffington Post Canada.
- <sup>ii</sup> Gordon Isfeld (September 15, 2016). "Canada's household debt is now bigger than its GDP, for the first time." Financial Post.
- <sup>iii</sup> Wharton University of Pennsylvania (September 6, 2016). NAFTA's Impact on the U.S. Economy: What Are the Facts?
- <sup>iv</sup> The Embassy of the United States of America. U.S.-Canada Economic Relations.
- <sup>v</sup> Benoit Faucon (February 10, 2017). "IEA Says OPEC Reaches Record Compliance With Agreed Cuts." The Wall Street Journal.