Selloff Scare Hits Markets Everywhere
Monthly Market Commentary
October 2018

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- Capital markets almost universally posted dismal performance in October (in U.S. dollar terms). Recent top performers such as U.S. growth shares suffered steep declines, while global fixed-income securities were also hurt by the selloff.
- Domestic assets shared in the pain across nearly all sectors and asset classes.
- While investors may feel uncomfortable maintaining exposure to risk assets amid such market declines and geopolitical uncertainty, mistiming entries and exits into and out of equities can be costly. We therefore believe, as always, that investors are best served by remaining focused on the long term.

Economic Backdrop

Capital markets almost universally posted dismal performance in October. The straightforward countercyclical environment meant that recent top performers such as U.S. growth shares suffered the steepest declines. The most cyclically-oriented sectors (consumer discretionary, energy and industrials) were hit the hardest, while classic defensive sectors (consumer staples and utilities) were positive. Asia Pacific stocks were sharply lower, particularly China. Latin American shares gained—presumably on ballot-box expectations for Jair Bolsonaro, Brazil's conservative pro-business president-elect.

Fixed income was not spared in October's selloff; higher-risk segments—like high yield and emerging-market debt—fared worst, but investment-grade bonds also struggled. Government bond yields declined in the U.K. and EU, but increased in the U.S. West Texas Intermediate crude-oil prices peaked at the beginning of October before descending more than 14% by the end of the month; the trend was largely similar in other commodities.

U.S. mid-term elections occupied the public's attention as healthcare and immigration became defining issues while the economic landscape remained broadly appealing. The country's trade policy was marked by worrying ultimatums (as President Donald Trump's administration continued to threaten tariffs on essentially all China imports) in addition to a hopeful outlook for interpersonal progress (with an end-of-month phone call between the leaders of these two major trading partners). Mexico committed to abstaining from signing the U.S.-Mexico-Canada Agreement (or USMCA, a revised trade deal intended to replace the North American Free Trade Agreement known as NAFTA) until the U.S. exempts Canada and Mexico from steel and aluminium tariffs.

Brexit negotiations continued past the October 17 deadline, days after Prime Minister Theresa May suggested at an EU summit to extend the post-divorce transition period. The proposal reportedly earned a warm reception; although EU leaders have since continued to develop no-deal contingency plans. Negotiations appear to hinge on the EU's insistence that the withdrawal agreement allow Northern Ireland to remain in its single market and customs union; the U.K. prefers a temporary customs arrangement during the transition period, while negotiating a more permanent customs union between the EU and the entire U.K.

A late-October report revealed that May had negotiated the right of U.K.-based financial services companies to continue operating in EU markets after Brexit (although the prime minister's office characterized the report as speculative). The deal would establish a relationship based on the principle of equivalence (that is, the premise that the financial regulatory frameworks of the two areas are in broad alignment)—which is what currently governs the EU-U.S. relationship, for example. German Chancellor Angela Merkel announced she would not stand for re-election as leader of the Christian Democratic Union later this year or as chancellor in 2021 amid poor regional election results for her governing coalition.

The Bank of Canada (BoC) continued to raise its policy interest rate with another 0.25% hike in October. Policy rates now stand at 1.75%, a level last reached in 2008. The BoC's final meeting of the year is scheduled for December 5; expectations are that the BoC may not raise rates at this meeting, but could accelerate its pace in 2019 due to strong growth and inflation expectations. The Federal Open Market Committee had no official meeting during October—but minutes released from its September meeting explained that the word "accommodative" was removed from its statement about monetary policy to avoid giving a "false sense of precision" regarding interest-rate expectations. The Federal Reserve (Fed) proposed rolling back banking regulations in late October, spurred by Congress' passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act earlier this year. The proposal sought more flexible capital requirements and less frequent stress tests for smaller and lower-risk firms; lower standardized requirements for medium-sized firms; and no relief for the largest and highest-risk firms. The Bank of England's Monetary Policy Committee announced no new actions following its meeting on November 1, and lowered economic growth expectations for 2018 and 2019. The European Central Bank and Bank of Japan made no changes at their respective late-October meetings.

According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) declined 0.1% in September but was up 2.2% for the past 12 months. Although both figures represent a substantial slowing from the prior period, the annual rate was well within the BoC's target range. The cost of alcoholic beverages and tobacco products continued to rise sharply; meanwhile transportation costs fell in September but remained well above year-ago levels. Producer prices were mixed: the Industrial Product Price Index (IPPI) ticked up 0.1% and the Raw Materials Price Index (RMPI) fell 0.9% in September. Price increases were more robust on a year-over-year basis, with the indexes up 6.2% and 14.6%, respectively, as energy prices continued to drive the longer-term increases. Unemployment remained at historically low levels after falling 0.1% in October, to 5.8%. The Canadian economy has added 206,000 new jobs over the past 12 months, with full-time employment gaining 173,000.

U.S. manufacturing was depicted in mixed reports as still healthy but modestly softer in October; services-sector growth appeared to accelerate in preliminary reporting. The core personal consumption expenditures price index held at 2.0% in September, remaining at the Fed's target inflation level. Payrolls expanded convincingly in October, and average hourly earnings grew by 3.1% year over year, contributing to the latest evidence of a trend toward higher wage growth. The U.S. economy grew at a slower but still-strong 3.5% annualized rate for the third quarter, according to preliminary reports.

U.K. manufacturing growth dropped in October from the prior month's downward-revised report, registering the slowest expansion in 27 months. Construction growth remained below its long-term average in October, but accelerated to its second-best growth rate since mid-2017. Labour-market conditions were nearly frozen in the latest report, with the claimant-count unemployment rate holding at 2.6% in September. The June-to-August unemployment rate was also unchanged from its prior reporting period, registering a rate of 4.0%, while average year-over-year earnings growth edged upward to 2.7% over the same three-month period.

The eurozone's manufacturing expansion cooled in October for the ninth time in the past 10 months, falling firmly into slow-growth territory. Services growth also moderated but remained at healthier levels. The unemployment rate held at 8.1% in September, with almost no net change across the eurozone; although Italy saw a sharp uptick in joblessness that was partially offset by gains in Spain. A preliminary report of overall economic conditions showed eurozone gross-domestic product expanding by 0.2% in the third quarter and 1.7% year over year, representing a deceleration over both periods and the slowest quarterly pace since the three-month period ending September 2014.

Market Impact (in Canadian dollar terms)

The BoC's rate hike created headwinds for Canadian bonds. Real-return bonds significantly underperformed the overall bond market. Inflation expectations appeared to move lower with the global stock market, while the FTSE TMX Canada Universe Overall Bond Index also contains longer-dated securities that are more sensitive to interest rates. There was little differentiation between government and corporate debt in performance terms. Residential mortgages and short-term bonds seemed to absorb the rate hike better and were nearly flat for the quarter. U.S. high-yield bonds performed much better on an unhedged (versus hedged) basis as the loonie weakened against the U.S. dollar.

Global equity markets were down on a nearly universal basis; Brazil was the only country of note to post gains as it benefited from election results that were viewed as pro-business. Despite Brazil's strong performance, emerging markets underperformed developed markets. Domestically, healthcare was easily the worst-performing sector, while small companies—along with cyclical and growth-oriented sectors (energy, information technology, consumer discretionary)—also underperformed. More defensive sectors (consumer staples, telecommunications, utilities) were among the top performers, but still suffered modest declines.

Index Data (October 2018)

- The S&P/TSX Composite Index was down 6.27%.
- The FTSE TMX Canada Universe Overall Bond Index returned -0.61%.
- The S&P 500 Index, which measures U.S. equities, fell 5.35%.
- The MSCI ACWI Index (Net), used to gauge global equity performance, dropped 6.02%.
- The ICE BofA Merrill Lynch U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned -1.73% (currency hedged) and -0.07% (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”, spiked higher in October moving from 12.12 to 21.23.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, slumped from US$73.25 a barrel at the end of September to US$65.31 on the last day of October.
- The loonie was generally stronger versus most of the world’s major currencies, but slipped to C$1.31 per U.S. dollar. The U.S. dollar strengthened as investors reduced their appetite for risk. It ended the month at U.S.$1.28 against sterling, U.S.$1.13 versus the euro and 112.86 yen.