Wary of a perfect storm

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Key Takeaways

- A peak in global growth and rising trade tensions is likely to hurt Canada
- These risks do not appear to be fully appreciated by markets
- We remain underweight Canadian assets and have reduced our Emerging Market equity position

The growing drumbeat of protectionist rhetoric from the United States represents a clear downside risk to Canada's small, trade-reliant economy. At the same time, Canada's overextended household sector is finally being brought to heel by the combination of tighter mortgage regulations and rising interest rates. Either of these headwinds, which we do not believe are fully appreciated by markets, could justify our longstanding underweight to Canadian assets in our multi-asset class funds. But the risk that they combine into a sort of perfect storm for the Canadian economy suggests an even more defensive positioning in the Canadian assets and currency could be warranted.

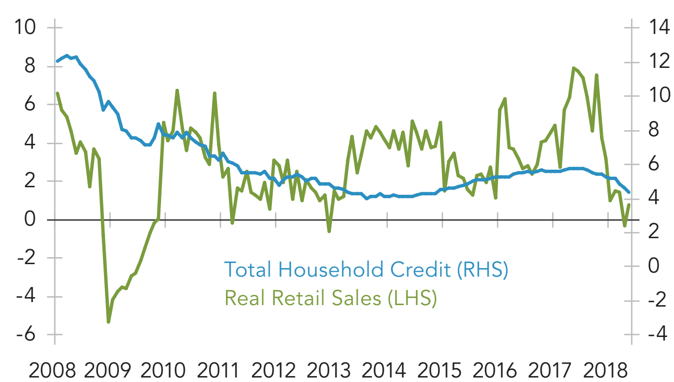
Benign Rotation

We have long expressed concern over Canada's economic imbalances. Over the last decade, too many economic resources have been directed to consumer spending and the housing market at the expense of more productive sectors such as business investment and exports. Absent a catalyst for correction, these imbalances have steadily grown and increased the vulnerability of household balance sheets. But now that interest rates have begun to increase, the household sector can no longer be counted on to effectively carry the entire economy. Indeed, that engine is already sputtering – after accounting for 98% of total Canadian economic growth between 2015 and 2017, consumer spending and housing investment accounted for only 5% of growth in the first quarter of this year. Retail sales and household credit have also decelerated sharply in recent months (see Exhibit 1).

To bring the Canadian economy back into balance, the engine of growth must now rotate *away* from the household sector and *towards* exports and business

EXHIBIT 1: Canadian Credit and Retail Sales Cooling

Year-over-year percent growth



Source: Statistics Canada, Haver Analytics, FMR Co as of July 20, 2018 investment. For this rotation to be successful the global economy must remain robust and the Canadian dollar needs to fall in order to make our exports of goods and services more competitive globally. In other words, a lot needs to go right for the Canadian economy to achieve a benign rotation and avoid a period of prolonged economic weakness and heightened vulnerability.

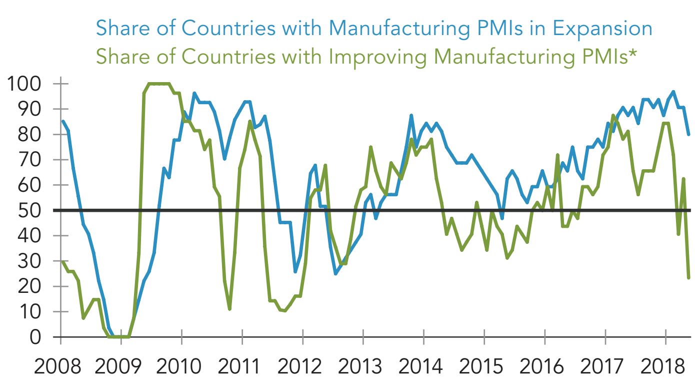
Rotation Interrupted

In recent months two impediments to the benign rotation narrative have emerged. The first is evidence that global economic growth appears to have peaked, which reduces overall demand for Canadian exports. High frequency measures of economic activity revealed a retrenchment in growth through the first quarter of the year (see Exhibit 2). This pullback was not entirely unexpected. It followed a period of exceptional and ultimately unsustainable strength in much of the global economy and coincides with central banks around the world gradually tightening financial conditions. While we are comforted by our analysis that shows recession probabilities remain low in most major economies and acknowledge a recent stabilization in some economic indicators at reasonably robust levels, the incremental tailwind from global growth that could further support Canadian exports has dissipated.

The second, and potentially more significant, impediment is the increasingly hostile rhetoric towards international trade. For a small open economy like Canada, any barrier to international trade represents a negative shock. Already Canadian exporters have struggled with shifts in global production chains to relatively low-cost emerging market economies, resulting in a loss of market share in the U.S. in particular (see Exhibit 3). This challenge has been exacerbated more recently by the uncertainty surrounding what now appear to be stalled NAFTA negotiations and the economic hit from the tit-for-tat tariffs on a host of U.S. consumer goods in response to the tariffs on Canadian steel and aluminum. While these goods represent a small proportion of total trade between Canada and the United States, the impact on overall business and household confidence could prove to be more significant. If the U.S. were to follow through on proposed tariffs on the automotive industry, the direct and indirect effects on the Canadian economy would yet be far more severe.

EXHIBIT 2: Peak Growth for the Cycle?

Percent Share

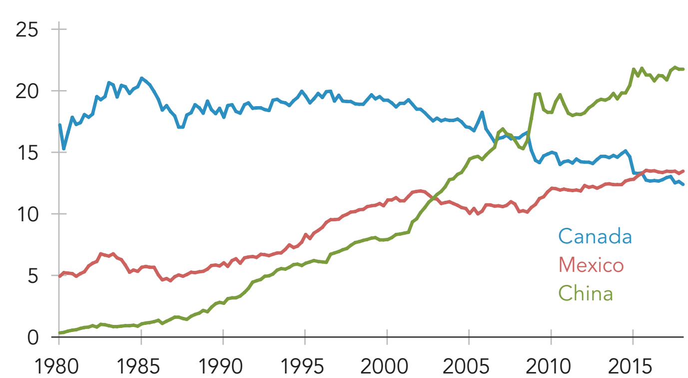


* Over the past six months. PMI: Purchasing Managers' Index. Shares shown include 30 countries, representing the world's largest economies.

Source: Markit, ISM, Haver Analytics, FMR Co as of May 31/2018

EXHIBIT 3: Canada Losing US Market Share

Percent Share Goods Imports into the US



Source: Census Bureau, Haver Analytics, FMR Co as of May 31, 2018

We acknowledge that it is very difficult to predict the path – let alone the outcome – of international trade negotiations. But in assessing the range of potential outcomes, even the best case scenario where the trade tensions fade still requires a rebalancing of the Canadian economy that is likely to be marked by a period of slower economic growth and a heighted vulnerability to future shocks. The worst case scenario – where the domestic headwind from household deleveraging is joined by a significant deterioration in the trade environment – would put a Canadian recession into view. We can't know where on this spectrum the actual outcome will lie. But why take the risk, when there are myriad foreign markets not subject to the same degree of household or trade vulnerabilities as Canada? Thus we are comfortable to remain underweight Canadian assets and by extension the Canadian dollar.

Finding the Appropriate Balance

Canada is not alone in facing the downside risk of increased global trade tensions. Emerging market (EM) economies also derive an important share of their economic activity from export activity and are vulnerable to both a peak in global economic growth and a stronger U.S. dollar. In our multi-asset class funds, we have long balanced an underweight to Canadian equities with an overweight to emerging market equities, seeing similar investment characteristics in the two while preferring the valuations, growth prospects and sector diversification in EM. But in a world of rising trade tensions, both legs of this pair trade will be challenged (as they indeed have been already). As a result, earlier this year we pared back our overweight to emerging market equities and diverted the proceeds to the following:

- U.S. Equities: By virtue of being less reliant on international trade, the economy of the United States offers relative safety amid rising trade tensions. Moreover, domestic activity remains upbeat as the benefit of the tax cuts introduced late last year has supported growth and reinforced household and corporate confidence.
- Short-term assets / cash: Pairing the increase in trade tensions with a global cycle that has likely hit its peak amid a gradual withdrawal of monetary stimulus by central banks argues for a more defensive allocation between equities and bonds. Within the bond allocation, our concern about rising interest rates reveals a preference for shorter-term bonds and/or cash holdings.

To conclude, it is difficult to evaluate the probability that the combination of a fading household sector, trade actions and weaker global growth combine into a perfect storm for Canada. But we have taken steps to guard against the clear risk of such an outcome, as part of the active risk management process in our multi-asset class funds.

David Wolf and David Tulk, July 24, 2018

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