An Ill Wind

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It’s volatile, and can cause havoc in previously placid places. It dominates headlines, pushing aside all other news and events. Its predominant feature is brutal gusts of warm air. And it leaves chaos and destruction in its wake after making landfall, even unsettling some financial markets. Hurricane Harvey? Oh, that works too, but we were thinking more of a certain speech in Arizona this past week.

President Trump managed a rare two-fer in his remarks on Tuesday, causing anxiety on two separate economic issues with just a few casual asides. First, less than a week after negotiations began, he declared that he thinks “we will end up terminating NAFTA at some point”. While this mildly rattled the peso, and even the previously perky loonie, the concern faded fast as both Mexican and Canadian diplomats played down the remarks as a rather transparent negotiating tactic. (Apparently, Trump advises in his 1987 book “The Art of the Deal”, that the worst thing you can do is let the other side know you need to make a deal.) Indeed, some Canadian trade experts are suggesting that Canada should prepare for the possibility of life without NAFTA, with the view that no deal would be better than a bad deal. There is also the small matter that Congress will ultimately have a big say in the fate of NAFTA, and there appears to be limited appetite for “terminating” the deal in those halls. In any event, the Canadian dollar took it all in stride and resumed its march back to 80 cents, up almost 2% in the past two weeks.

The other issue that Hurricane Donald tore into on Tuesday was the delicate matter of funding the federal government. The President declared that if financing for a border wall with Mexico wasn’t forthcoming, Washington would be headed for a shutdown by the end of September. This is a separate, but clearly related, issue from the debt ceiling, which also happens to be coming to a head at the end of September. While a government shutdown is potentially dramatic, and can cause some mild economic harm over the short-term, we’ve been there before and it’s not really a major market event. The lead-up to the latest shutdown, in October 2013, and threats of similar moves in other recent years have caused a short-term dip in Treasury yields. But, again, it’s a minor event for markets, and we have seen it all before—the longest such shutdown was in Bill Clinton’s days in late 1995. And, yes, there have been prior shutdowns when the Administration and both the Senate and House were all controlled by the same party; it happened a few times under Jimmy Carter and a firmly Democratic Congress in the late 1970s.

The much more serious issue for the market is the threat of Washington hitting the debt ceiling, and President Trump launched into this terrain as well this week. But, in contrast to a possible shutdown, the tone was much less combative. He railed against Congress for not tying a debt limit increase to another, easier to pass, item, to avoid a mess. The last time the debt ceiling was a truly serious concern was in the summer of 2011, and financial markets were broadly put through the wringer in that episode (which coincided with the deepening Euro area debt crisis). S&P eventually downgraded the U.S. credit rating that year in the wake of the flirtation with default.
On cue, Fitch Ratings warned this week that it could review the rating as well, should the debt limit be pressed. On the other side, soothing words were heard from both Mitch McConnell ("zero chance, no chance") and Paul Ryan ("not worried") on the possibility of even a limited default. For markets, this is the much more important issue of the two, and while investors and analysts generally share the optimism of the Congressional leaders, the Treasury bill market is flagging that default odds are more than "zero".

All this comes after a relative summer of calm for most financial markets, a calm that was not the least disturbed by Yellen’s remarks in Jackson Hole today (which avoided monetary policy). Despite all the drama in the geopolitical world, U.S. markets barely budged, on net, over the past three months. Looking back to just before Memorial Day, the S&P 500 is up slightly, 10-year Treasury yields have dipped a few basis points to just under 2.2%, and oil and gold are almost flat on net. In stark contrast, Canadian markets have seen some major moves, driven largely by the hawkish turn at the central bank. To wit, 2-year GoC yields are up 55 bps in three months, 10s have jumped 43 bps, the loonie has rocketed almost 8%, and the TSX has sagged 2%, back into the red for the year.

As we fast approach the end of August, 2017 is almost two-thirds through, and many Canadian investors don’t have much to show for their efforts so far this year. Between a lacklustre domestic equity market (the TSX trails the global pack at down 1% this year), a recent sag in the broader bond market (the total return is now up less than 2%), sub-1% yields on cash (even with a BoC rate hike), and a typical balanced investor has barely been in the green in 2017. Adding insult, solid gains on U.S. equities have been blunted in unhedged portfolios by a 7% pop in the Canadian dollar this year. The one rare bright spot has been even better advances in EAFE markets, where currencies have largely kept pace, or even topped, the loonie and equities have mostly turned in hefty gains. We estimate that a hypothetical balanced investor (with 5% cash, 40% bonds, 55% equities—20% in Canada, 20% in U.S. and 15% in EAFE) has seen a total return of a bit less than 3% so far this year.

While no doubt modest, there are a few points. One, even with a dead-calm domestic stock market and a BoC rate hike, balanced investors can still manage to grind out gains a bit above inflation. Two, the fact that EAFE has saved the day reinforces the importance of balanced investing—you just never know where the good gains are going to come from in any given year. Third, most pension funds have done just fine even with sluggish returns on assets, because the moderate back-up in bond yields has helped clip liabilities this year, for a change. Finally, this year is ringing proof that a strong economy does not necessarily equate to strong investor returns—if only it were that straightforward!
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