Myles Zyblock - Market Commentary

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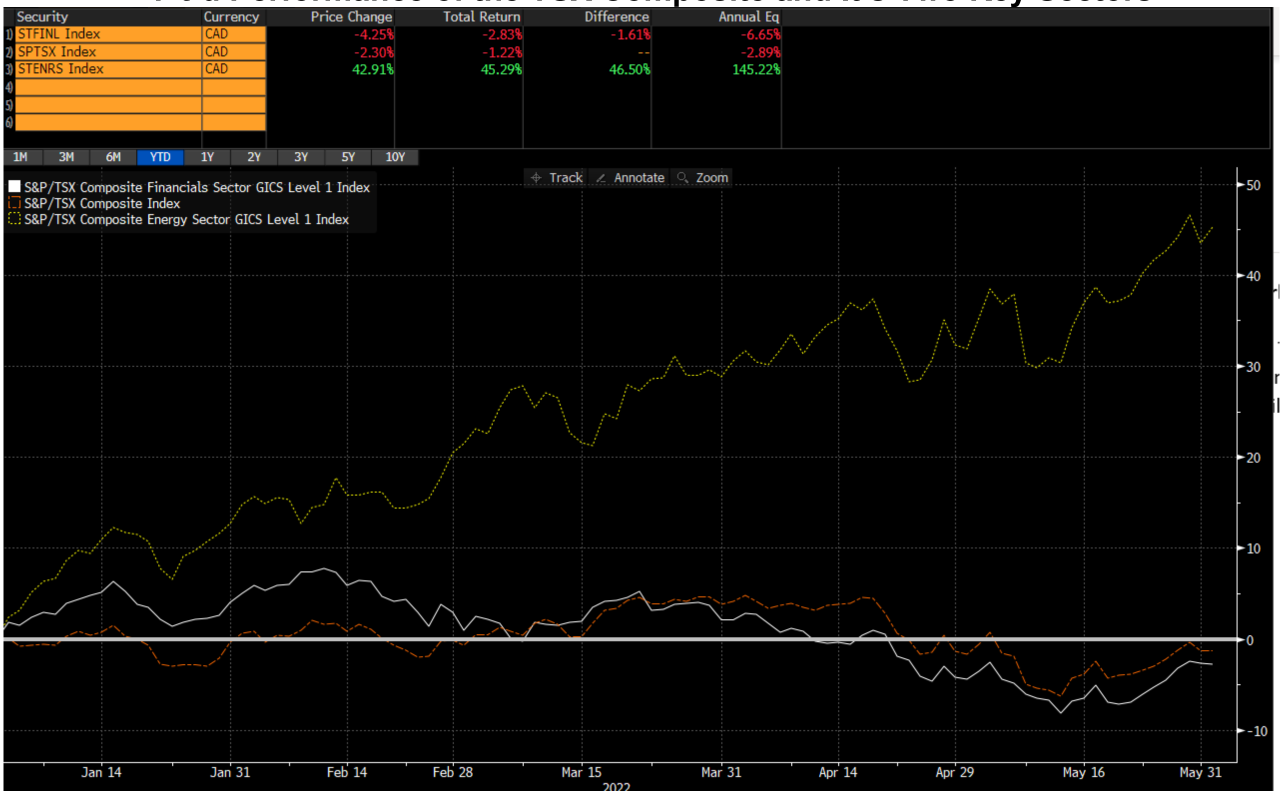
Market Volatility: +50 Bps from the Bank of Canada with more to follow

The TSX has held in reasonably well, only down by 1.2% while global equities are 13% lower this year. The TSX's outsized market capitalization weighting in Energy and Materials has been somewhat of a saving grace. These two resource sectors, a combined 31.5% of the index's total weight, have risen by 29.6%. The other big TSX weighting is Financials, representing 31.6% of the index's market capitalization. While these stocks are down by 2.8%, they have been holding in much better than their U.S. counterparts which are off by closer to 11% during the same period.

Y-t-d Performance of the TSX Composite and It's Two Key Sectors



(Source: Bloomberg)

The investment environment could become more challenging from here. The Bank of Canada raised interest rates by 0.5% earlier today and this has moved the overnight policy rate up to 1.5%. This is the second consecutive half-point increase from the Bank and the first time anything like this has happened since 1998. The Bank's message immediately following its action was that the economy is "clearly operating in excess demand" and that "the Governing Council judges that interest rates will need to rise further". Their message was focused on elevated inflation, not the potential knock on effects of an aggressive tightening cycle.

Bond markets now believe that another 50 basis points, perhaps even 75 basis points, of tightening is likely at the July 13 meeting followed by an ongoing series of increases until the policy rate reaches 3.25% in a year's time. This encourages us to closely monitor the health of the most interest-sensitive areas of the economy, particularly the housing market. Household balance sheets are already stretched while home affordability has moved to its worst level since the late 1980s. RBC's economists last estimated in March that 49.7% of Canadian household income was needed to cover ownership costs, a measure that has surely risen from there given recent interest rate action.

A more serious downturn in the residential property market would weigh on mortgage origination and bank company earnings. And, as mentioned, the bank stocks comprise a significant share of TSX market capitalization. It would be mathematically difficult for the TSX Index to find significantly higher ground riding on the back of energy stocks alone.

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