Looking back on 2016, a year that contained its share of far-reaching geopolitical events—the U.K. vote to leave the European Union (EU) and the election of Donald Trump as U.S. president, to name two—it's extraordinary that the financial markets remained relatively calm and, in the end, generated substantial year-over-year gains.

Trump unleashes market's animal spirits

As many predicted would happen, investors welcomed Trump's November victory in the election polls. North American equities rose sharply the next day and a number of U.S. indices soon posted record highs.

Investors in the energy and materials sectors, previously undercut by world events, saw particularly strong returns. In February, oil had declined to its lowest point in 12 years, weighed down by sizeable inventories. But the price subsequently rallied, driven by increasing demand and lower production.

In the materials sector, rising prices were driven by resurgent growth in China, along with strengthening global industrial activity, reduced concerns about deflation and continued U.S. economic expansion.

TSX performance

Here at home, the TSX delivered its strongest returns since 2009. The top-performing sector in 2016 was materials, up 39 percent, followed closely by energy, up 36.47 percent.

Health Care, which declined 44.43% percent, was the only negative TSX sector for the year. The decline was caused mostly by Valeant Pharmaceuticals, which lost a whopping 86 percent of its stock value. Remarkably, Valeant suffered more market cap loss in 2016 than the other 59 declining stocks in the TSX Composite combined.

U.S. Interest rates

Looking ahead, a major headwind for equities in 2017 could come from rising interest rates. As rates climb, borrowing becomes more expensive, potentially leaving companies with less discretionary money to spend on growth. Over time, less growth can lead to a decrease in profits. Eventually, investors, whose discretionary spending power also drops as rates rise, may begin to view stock ownership as undesirable.

In December, U.S. Federal Reserve Chairwoman Janet Yellen raised the federal funds rate for the first time in a year, and only the second time since the 2008 financial collapse. During a press conference held earlier this month, she confirmed the widely held market view that further hikes were coming. According to Yellen, the central bank expects to increase rates "a few times a year" until the end of 2019.

The central bank's perspective on rates stems from the fact that the U.S. economy is at close to full employment and inflation is approaching the Federal Reserve's two percent target. By raising rates and signaling that more increases can be expected, the bank is expressing confidence in the economy.

In contrast, Trump has argued on the campaign trail and since election day that the economy is weak. He claims it needs a strong boost, hence his promise of big tax cuts and a $1 trillion infrastructure spending blitz.

Lower interest rates encourage growth, so Trump would prefer to keep rates low and has made his view known. Yellen, however, is concerned, as she told Congress in November, that Trump's spending plan could cause the economy to overheat and trigger inflation—leaving the Fed with little choice but to raise rates.

The two are at loggerheads, and it will be some time before Trump rolls out his economic agenda showing how he will move forward. For now, investors are left wondering what's to come, making it difficult to predict future market moves.

Once scenario is that Trump pushes ahead with his stimulus. If the economy accelerates, rising corporate profits could partially offset the inhibiting effect that climbing interest rates might have on stock values. Another possibility is that Republican party fiscal hawks reject the parts of Trump's economic strategy that would increase the deficit. This could include cutting back on his infrastructure spending plan, lessening the chance of the economy overheating.

Impact of Fed rate hikes on Canada

Rising interest rates in the U.S. are likely to drive up some borrowing costs in Canada, particularly for fixed mortgages. Why? Because in a rising rate environment, 5- and 10-year U.S. bonds will probably trend higher, and matching Canadian bonds will tend to follow suit.

As well, consumer spending levels may fall in the future because rising rates will make it more expensive to carry consumer debt, which is already at record levels in Canada.

If these potential developments were to occur, the Bank of Canada might put rate cuts back on the table. A decrease in Canadian interest rates could help prevent the housing sector from experiencing a hard landing in 2017. Further, by lowering Canadian rates at a time when the U.S. is increasing rates, the BoC would further weaken the loonie against the greenback, thereby giving a helping hand to Canada's export sector.

Summary

Over the next few months, investors will have a front-row seat as the Fed's interest rate strategy makes contact with Trump's economic vision. It's possible that Trump achieves his growth goals, while the Fed maintains control of the economy through slow, steady rate hikes. That would please the markets. Of course, Trump's unpredictability could easily lead to a political crisis at home or abroad. If that happens, more of the market volatility we saw in 2016 could be in store for 2017.

Getting Advice

Are you looking for additional perspective on the financial markets and how they might affect your portfolio?

We encourage you to talk to us. Speak to your Financial Advisor or contact investor services at 1 800 608 7707.