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INVESTMENT REVIEW

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MARKET COMMENT

The turbulent start for financial markets so far in 2018 has left few places to hide. Investors have had a lot thrown at them; escalating tensions over global trade, major tech sector wobbles, increasing turmoil at the White House and an onslaught of stock volatility. Certainly, the markets were overly greedy and downturns are normal but what has investors in a tizzy is the abrupt and perhaps savageness of the swings. However, while the ride was bumpy the final outcome was not overly hideous or cataclysmic.

Last year the Canadian economy expanded at a much stronger pace in comparison to the previous year and the outlook for 2018 remains positive. However, it is likely to march along at a slower pace due to increasingly uncertainty. As there are ominous signs ahead due to U.S. trade and tax policy as well as weakening investment fears related to the unknowns of U.S. corporate tax cuts and NAFTA's renegotiation. None of which is expected to overcome the steadily rising employment, cool inflation and manufacturing and service industries expansion at their highest pace of growth since 2011. What is particularly positive is the fact that the biggest contribution to growth in 2017 came from the natural resources extraction sector, which has been in the doldrums for years.

The U.S. economy has been like a tortoise; slow but steady. Last year was the ninth year of this expansion, the third longest since 1900. Near term risks to the economic outlook appear roughly balanced. Corporate earnings have been quietly spectacular and the future impact of corporate tax cuts will only boost them further. Inflation has picked up slightly last year while interest rates remain low and stable despite the sixth hike since the credit tightening cycle began in December 2015. The Fed is trying to keep a tight labour market from overheating without raising borrowing costs so fast that it would stifle the economy. While the tax cuts could lead to rising budget deficits and ultimately even higher interest rates, growth is expected to remain on an upward trajectory in the coming years.

As central banks around the world slowly withdraw policy support and raise interest rates, economic growth should accelerate and stabilize. Europe is growing particularly fast thanks to a still undervalued currency, rising confidence and considerable pent up demand. The U.K. appears to be weathering the impact of Brexit better than many had feared. Rebounding demand for commodities continues to be positive for Latin America and Australia, while Chinese growth has ebbed slightly as authorities try to restrain financial speculation. Japan's economy expanded for the eighth straight quarter, its longest consecutive period of expansion in 28 years. All-in-all, the global economy is growing everywhere but booming nowhere adding a welcomed level of stability.

Clearly, the markets have been more volatile this year versus last year, which were all calm seas and blue skies. But markets run on fundamentals and the fundamentals look very, very solid. After a surge in stock markets in January, most of the returns were given back in the latter half of the quarter, such that without the appreciation of the Canadian dollar (up 2.5% for the quarter) most foreign markets would have been negative. Emerging markets were the best performers, climbing 3.6% (all returns in Canadian dollar terms); while other International stocks were up 1.1%; and U.S. stocks rose 1.7%. The worst market was Canada where stocks declined 4.5%. Surprisingly, Canadian bonds managed to eke out a small gain on the quarter at 0.1%.

With Europe coming off a stellar year, Japan maintaining its longest expansion in years, the U.S. growth still on solid footing and the emerging economies in good shape, the synchronized global growth acceleration appears to be shifting into another gear. Of course, this business cycle is relatively mature but global monetary conditions should remain accommodating enough to leave plenty of room for future gains.

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Canadian Equities

Global economies and markets started the year with plenty of optimism that the synchronized momentum exhibited in 2017 should continue in 2018. Though optimistic, there were concerns over rising protectionism from the U.S. along with its disruption to global free trade. There was also some concern for the upward trajectory of interest rates. Some of these fears materialized as cracks erupted in February and March with the VIX (an index that measures market volatility) more than doubling from its level in 2017. The double digit returns that markets around the world posted in 2017 quickly evaporated in the first quarter as almost all major global indices ended with negative returns despite the fact that most economies are still growing.

Canada, in particular, saw its economy expanding for most of 2017 with 3% GDP growth (highest of the G7 countries), but it unexpectedly shrank in January coinciding with the biggest job decline since 2009. Though the outlook remained positive as the economy entered the "sweet spot of the business cycle" according to Bank of Canada, the cumulative effect of these interim shifts may continue to pull the Canadian market down. The S&P/TSX composite index had no reprieve in any of the months during the quarter as each one ended in negative territory. Overall the index returned -4.5% in the first quarter on a total return basis, making it one of the worst performing major global indices.

Although the Canadian economy started slowly for the year, it is still slated to record decent GDP growth in 2018. The relatively good shape of the economy has even pushed up the inflation rate a little over Bank of Canada's target 2% rate; the highest since 2012. Additionally, the 5.8% unemployment rate is close to a 40 year low. Despite some 88,000 job losses in January, the job market added an impressive 283,000 positions over a twelve month period. Nevertheless the Canadian equity market and corporations are still exhibiting price/earnings (P/E) compression. The lower ratio is not because of business fundamentals but rather due to NAFTA uncertainties as well as household indebtedness. Current pessimism appears overdone and the TSX should rebound to its fundamental value once these concerns abate.

The succession of impactful events was very swift in the first quarter. Although a correction was expected and overdue since the beginning of the bull market in 2009, especially in the U.S., investors' reactions appear to be overdone. For instance, February, the most tumultuous month of the quarter, contributed to the biggest loss for the TSX amid a volatility surge that pushed the VIX past 35. This is a situation that has occurred only ten times since 1988. Yet 60% of the TSX companies' results were positive on their top and bottom lines with upbeat outlooks for earnings revisions. This evidence seems to infer that continued underperformance of the Canadian stock market is not consistent with the true valuation of the underlying stocks.

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Fixed Income

During the first quarter of 2018 the Canadian FTSE TMX Universe Bond Index gained 0.1%. The Bank of Canada raised its key lending rate in July and September of 2017 and again in January by a quarter point to 1.25%. Interest rates are recovering from the once record lows of last summer in response to signs of an improving economy. The central bank has taken a cautious stance on rate adjustments but investors are pricing in at least two more hikes by the end of this year. The recent increases overwhelm the two rate cuts introduced in 2015 which were to help cushion and stimulate the economy from the collapse in oil prices. In the U.S. the Federal Reserve raised interest rates in March for the sixth time since the financial crisis and signaled that at least two additional rate hikes are coming in 2018. The U.S. central bank increased its benchmark interest rate target range by 0.25% to a new band of 1.5% to 1.75%.

At a speech in early March, the Bank of Canada's Deputy Governor Timothy Lane made a number of comments as to why the central bank decided earlier that month to put any rate changes on hold for the time being. The decision was grounded on their assessment of developments in the Canadian economy and what that meant for the outlook for inflation which is key to their decision. In that regard, global and Canadian economic data had been coming in as expected which gave them greater confidence that inflation will remain sustainably near their 2% target.

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FIXED INCOME

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The decision was also grounded on a number of factors. The first was that their policy rate remains appropriately below what they refer to as the normal or neutral rate, which is the policy rate that would balance the economy in the longer run. Mr. Lane estimated that the neutral rate is in the region of 2.5 to 3.5%. He further noted that it was “appropriately below because accommodative monetary policy is working to offset several factors weighing on demand: persistent competitiveness challenges facing Canadian exports, the chilling effect of heightened uncertainty about future U.S. trade policies, and the burden of high household debt levels.” The second factor was that they have increased their policy interest rate three times recently. With these moves the central bank has been balancing the risk of undermining the economic expansion by moving too quickly against the risk of delaying too long and later needing to raise rates sharply to rein in inflation. By moving gradually they have been able to take in new data and analyze four key issues. The first is that when an economy is running at close to full capacity, it can create more capacity as firms invest and discouraged workers are drawn back into employment. A second issue is that inflation dynamics could be changing in the new economy and it is important to understand how those dynamics would be affected by rising interest rates. A third item is that despite strong employment gains and an economy that is operating close to capacity, wage growth had been slower than expected. Finally it was noted that with household debt at high levels, the economic effects of interest rate increases could be significant for the housing market.

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U.S. EQUITIES

The Standard & Poor's 500 index fell 0.8% in U.S. dollars but rose 2.0% in Canadian dollar terms over the first quarter of 2018. The loonie finished the first quarter with a 2.8% loss after gaining almost 6.6% in 2017. The first quarter of the year injected a spike of volatility into the nine year bull market as fears regarding protectionist trade policies from the White House, tightening monetary policy and heightened regulation on the tech sector, including President Donald Trump's desire to take on Amazon and its founder Jeff Bezos, have dragged the market down.

The U.S. market correction began on January 26 with the selloff reaching 10% on February 8. It has since been followed by heightened volatility as equity markets again struggled at the end of the quarter with ongoing weakness in technology weighing on broader market sentiment. The wave of selling brought the U.S. indices down near their 200 day moving averages, levels that held during the early February selloff. The setback seemed to be particularly unsettling, largely because it was sudden, deep and followed a long period of low volatility.

Stocks have been pulled down by a number of factors, including growing fears of a global trade war following weeks of heated rhetoric and threats between the world’s two biggest economies, the U.S. and China. Beijing imposed tariffs of up to 25% on 128 U.S. imports worth $3 billion a year, including fruits and pork, in retaliation to U.S. duties on steel and aluminium. President Trump has repeatedly railed against China’s massive trade surplus over the United States, promising during the U.S. election campaign to slash the U.S. deficit.

Republicans are pouring government stimulus into a steadily strengthening economy, adding economic fuel at a moment when unemployment is at a 17 year low and wages are beginning to rise. The $1.5 trillion tax cut that President Trump signed into law late last year is likely to lift growth in 2018, though the Fed and most analysts see little long-term boost, if any, to the economy. Nevertheless the agreement to increase federal spending by hundreds of billions of dollars should deliver a large short term fiscal boost.

There are many reasons why the U.S. equity market underwent a setback lately but the health of the U.S. economy isn’t one of them. Despite a five year running tradition of consumers pulling back on their spending in the first quarter, the U.S. economy looks to be doing just fine and should strengthen this year thanks to the brisk fiscal tailwind. The concern for investors is not that the U.S. economy will slow this year but that it will grow too fast thanks to the fiscal expansion. At this stage it appears that this correction may well turn out to be just another dip in the long running bull market.

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International Equities

The global economic expansion looks to be on track for some pretty impressive gains going forward as the world becomes more synchronized despite escalating trade tensions. Trade wars are aimed more at punishing other countries than protecting domestic producers and they will inevitably cause pain for domestic consumers and import consuming industries. While collateral damage could be widespread, likely in the form of more volatility being unleased on stock markets around the world; eventually saner heads should prevail and co-operation will likely unfold. We can only hope, anyway.

Europe finished off last year with robust economic growth while confidence among businesses and households suggests there is no slowdown in sight. After years of suffering from the consequences of a sovereign debt crisis, unprecedented stimulus by the European Central Bank has turned Europe into a pillar of the global economy, recording its fastest rate of growth since 2008. Yet, despite this economic upswing, inflation remains muted. Employment is expanding at a vibrant pace. The Euro has recently climbed to a 3 year high against the U.S. dollar. However this is threatening to throw a spanner in the works and will likely force the Central Bank to wait until the year end before ending its asset purchase program or meaningfully contemplating raising interest rates.

Japan, the world's third largest economy, saw manufacturing activity expand at its fastest pace in almost 4 years. Stock prices are at their highest in 26 years and corporate profits are near an all time high. Japan is seeing strong export growth, which could be impaired by a strengthening currency and simmering fears of a trade war. Add in the fact that labour shortages and a dwindling working age population have pushed the jobless rate to a near 25 year low, concerns remain about the future of the country's economic turnaround. Still, with domestic demand accelerating and inflation remaining low there is little sign that any sort of correction will happen in the short term.

China has been experiencing unexpectedly robust growth in the first part of the year. The trade situation with the U.S. is obviously a rising risk and a relatively new challenge. While the risk of increasing trade tensions exist, the overall economic damage is likely to stay contained. Still, China's growth will be moderate this year weighed down by a cooling property market and the government's clampdown on riskier lending practices. While infrastructure remains a main engine behind China's investment growth, high tech manufacturing has also expanded rapidly and now accounts for 43% of the total exports to the U.S., so it could be vulnerable to punitive U.S. trade measures.

In many cases the world stock markets reached new highs in January. Unfortunately, volatility swept over the global stock markets and they have since retreated 6.1% (all returns in U.S. dollar terms), at least temporarily from their highs. Collectively, all international stock markets declined 1.4% in the first quarter. Outside of Emerging Markets which gained 1.1%, all other regions generated negative returns; European stocks fell 2.6% and Asian stocks dropped 1.4%.

Concerns over a potential trade war are beginning to weigh on confidence around the world and could potentially slow the economic dynamic during the coming year. However, this increasing uncertainty will likely strengthen central bank resolve to hold the line in future interest rate hikes and take a more cautious approach to exiting most of the extraordinary fiscal measures that are still in place. This should be enough to allow the world's economies to withstand most of the tit-for-tat gamesmanship that appears to be unfolding.

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