Quarterly Commentary

January | 2018

Climbing the wall of worry or a false sense of security?

"Strong returns for most risk assets combined with the advanced age of the U.S. economic expansion have many investors wondering to what extent dangers are building. Many, if not most, will acknowledge that the global economy is in its best shape since the 2008-2009 recession, with growth reasonably firm and synchronized. The threat of deflation has faded, yet inflation remains sufficiently low to forestall an aggressive unwinding of monetary accommodation. Monetary conditions are highly accommodative and supportive of risk assets, although there is widespread uncertainty about how sensitive asset prices and the global economy will be to even modestly higher interest rates.

At root the issue is whether investors are climbing the normal wall of worry or have been lulled into a false sense of security. Elevated asset prices, including U.S. equities, high-yield corporate debt, commercial real estate and even cryptocurrencies, imply to some that markets are setting up for a steep fall.

The flattening U.S. yield curve has been increasingly cited as a clear warning sign that the end is nigh for stocks and other risk assets. We explore this below, but front-run our analysis by stressing that such a conclusion is misplaced or at least premature, based on the historical evidence. Other signs, ranging from U.S. recession probability gauges, credit spreads, financial stress measures and private-sector balance sheets, also are not flashing "yellow" let alone "red". Close attention to economic and capital market behavior is warranted, heightened anxiety is not." – MRB Partners, December 1, 2017

We are in the midst of one of the lengthiest economic expansions in the post-World War II period, aided by the easy money policies of global central banks. We've repeatedly coined the phrase "lower for longer" to describe interest rate trends. One of the consequences of the low rates policy has been slim returns on lower risk investments such as high quality bonds and bank term deposits. This creates a dilemma for more conservative investors and in particular those who are in, or are approaching, their retirement either here in Canada and throughout most of the world. Low returns in low risk investments led to a boost in demand for stocks. Investors either accepted the reality of making little return on their savings, or took on more risk to generate a return on investment after tax and inflation. Coupled with solid global economic growth, and healthy corporate earnings growth, it's no surprise that many global stock indexes are near or at all-time highs.

The U.S. Federal Reserve, which was the most aggressive in cutting rates to stimulate and support the economy during the recession, is now leading the way in raising rates back to more "normal" levels. Strength in employment, consumer spending, manufacturing and global trade has buoyed U.S. economic strength, providing the Fed an opportunity to raise rates without impairing the expansion. In the absence of material inflation, we believe the pace of rate hikes in the U.S. will be slow enough to remain very supportive of the stock market. We are also seeing similar action by the Bank of Canada on this side of the border. Stronger economic data in Canada led to two rate hikes since summer. The global economy is also doing well, with most major regions participating in this economic expansion. There is little inflation in sight, and reduced risk of deflation. Global stock markets are in the sweet spot of this expansionary cycle. Central banks have been slow to raise rates throughout the world, and would rather err on the side of caution by hiking rates at a gradual pace, and are closely monitoring the impact of the rate increases to avoid a dramatic downshift in economic growth.

With all this positive economic momentum, stock market valuations have moved above historical norms. The U.S. market, which has led the way on the upside, is amongst the priciest in the world. U.S. tax reform and deregulation have added to investor bullishness. We have held a positive viewpoint towards U.S. equities, and believe there are still opportunities in that market on a stock specific basis, however in general, their high valuations gives us some caution as we enter 2018. U.S. stock price performance will be highly dependent on continuing strong corporate earnings growth, with any signs of moderating growth a challenge.

Our focus on opportunities shifts to non-U.S. markets, and in particular European equities. Although the U.S. markets have historically commanded premium pricing, the valuation difference suggests that some closing of that pricing gap is likely on the horizon. Chart 1 shows that the U.S. S&P 500 traded at a valuation that is not only well above its 20 year average, but also much higher than stocks from rest of the world. This gap has in fact widened in the past month. We see an eventual narrowing of this valuation differential to the benefit of stocks from outside the U.S.

Diversification

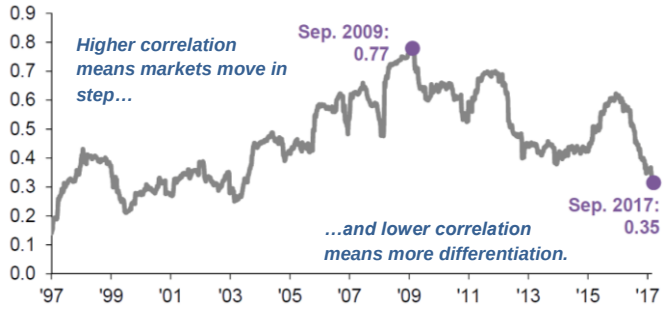
We've all heard the term "don't put all your eggs in one basket". It is a concept that was alluded to in Shakespeare's Merchant of Venice, *"…Believe me, no; I thank my fortune for it, My ventures are not in one bottom trusted, Nor to one place; nor is my whole estate Upon the fortune of this present year: Therefore my merchandise makes me not sad."* This is a line from Antonio, the title character who speaks of diversifying his cargo shipments using not just one vessel, but multiple ships through various routes. This simple risk management technique is just as important in investing, from diversifying between different asset classes (cash, bonds, stocks), regions (Canada, U.S., Europe, Asia), sectors (financials, technology, healthcare, utilities, resources), company size (large, mid, or small capitalization), and individual companies. It is effective in reducing the unsystematic risk within an investment portfolio, particularly when the correlations between different assets are low (Chart 2).

Chart 1: U.S. Equities are expensive compared to non-U.S. Equities (S&P 500 Index versus MSCI All Country World ex-U.S.)

Source: JP Morgan Asset Management

At present, the benefits from diversifying over different regions in the world are high, given that the global market correlations are low, and declining. Chart 2 shows the rolling one year correlations of 30 different countries' equity markets. The correlation is currently less than half of what it was during the height of the financial crisis. Differentiation is good, and means that proper diversification will lead to effective risk reduction in investment portfolios. One major reason for the high

Chart 2: Global market correlations have declined (Rolling one year correlations, 30 countries)



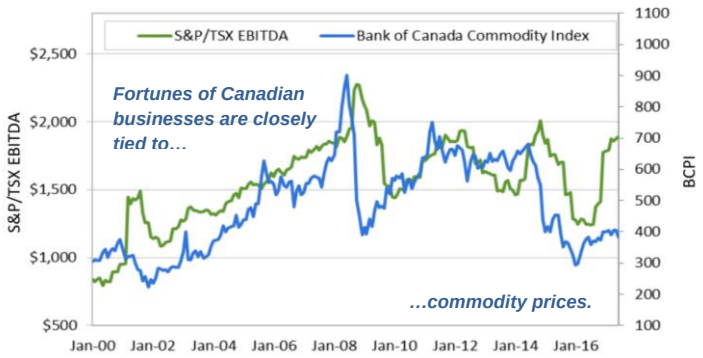
Countries included in global correlations include Argentina, South Africa, Japan, UK, Canada, France, Germany, Italy, Australia, Austria, Brazil, China, Colombia, Denmark, Finland, Hong Kong, India, Malaysia, Mexico, Netherlands, New Zealand, Peru, Philippines, Portugal, Korea, Spain, Taiwan, Thailand, Turkey, United States.

Source: JP Morgan Asset Management

correlation of markets in 2009, which rendered diversification less effective, was systematic risk, which was not specific to any sector, or country. The nature of the crisis had more to do with the ability of the global financial system to continue to function properly. Although the catalyst for the crisis originated in the U.S., the risk was to the global economy, and as a result regional diversification provided little benefit mitigating downside risk. Perhaps a current source of systemic risk is geopolitics, but to date this risk has been relatively well contained.

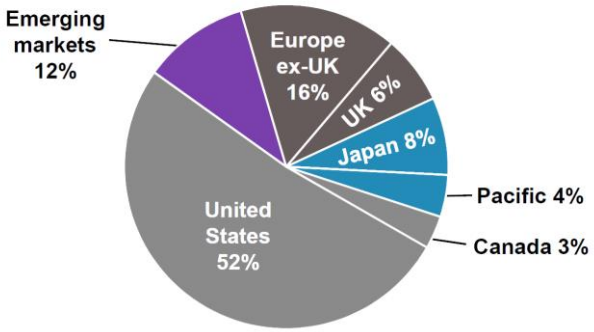
For Canadian investors, the long term benefits of diversification are substantial. Canadian corporate earnings are closely linked to commodity prices (Chart 3). Also, the value of Canada's stock market is a mere 3% of the total global market (Chart 4). Finally, key components of the global economy such as technology and healthcare, are a combined 4% sector representation within Canada versus 37% of the S&P 500. Investors must go outside Canada to get meaningful exposure to these important sectors.

Chart 3: Canadian stock earnings are highly dependent on commodities



Source: Raymond James, Bloomberg

Chart 4: Global market weights – Canada is only 3%!



Source: JPM Morgan Asset Management

High valuations do not mean the market is overvalued

During Janet Yellen's last press brief as Federal Reserve chairperson, she addressed current high stock market valuations stating "…..valuations are high, doesn't mean that they are necessarily overvalued", and added that the low-rate environment is supportive of higher valuations, and the risks to the global economy look more balanced than they have in many years.

High valuations do mean, however, that there may be a lower potential return on an asset for the level of risk taken. By adjusting portfolio exposure to markets with a better potential reward to risk relationship, the potential upside is enhanced without increasing portfolio risk.

Just like Antonio we continue to diversify, across regions, countries and sectors in an effort to improve returns while mitigating risk.

We at the Worth Allaye-Chan Investment Counsel would like to wish you all a happy, healthy, and prosperous 2018.

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