Quarterly Commentary

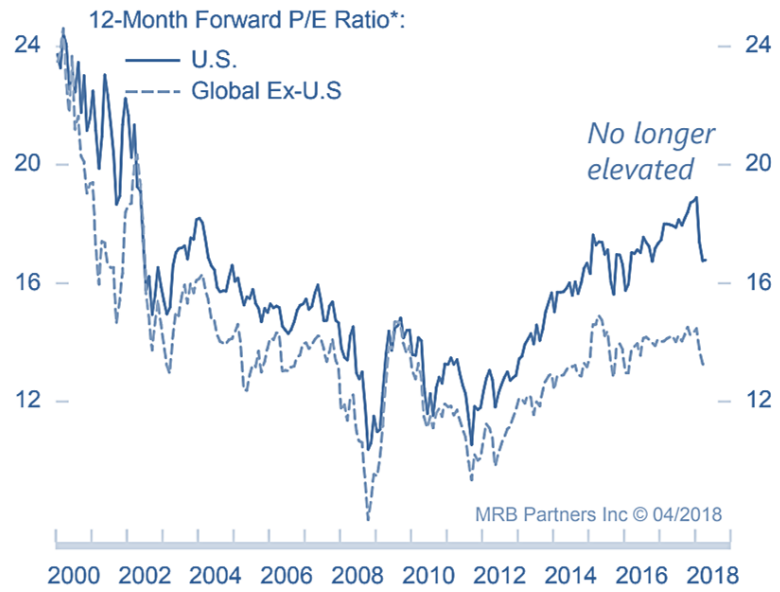
April | 2018

Volatility makes a comeback

The recent volatility and correction in stock prices has made investors uneasy. The early February swoon was due to concerns about the possibility of higher inflation, and rising bond yields. The ensuing equity market recovery was short lived on Trump's plans to put a tariff on steel and aluminum imports. Global stock markets rallied again given the continuing positive profit growth outlook, and relief that the impact from the tariffs would likely be much less than originally feared. This subsequent rebound was then derailed by new Trump's tariff announcements targeting China. The Facebook privacy scandal added further uncertainty, particularly in the technology sector. All of this has occurred within the past two months.

Conditions, however, remain quite favourable for global stock markets. The U.S. stock market has retreated, and although not cheap by historical measures, valuations are no longer stretched (chart 1). The benefits of lower corporate taxes on post tax profits remain in place. Inflation is still low, and global economic growth is solid. Global corporate earnings continue to improve and companies are increasing stock buybacks and dividend payments, both benefits for shareholders. During these more volatile periods, and in the midst of all of Trump's tariff talk, it's easy to forget such underlying positives. That's not to say that all is clear, since there are emerging concerns about the growth outlook. We've previously discussed the strength in the global economy, and how we have been in a period of synchronized global growth. Even though this has not changed, growth momentum is bound to moderate. Global interest rates are likely to remain at low levels, even though we have now exited the period requiring extraordinarily low rates to support the economy. But the biggest risks to global growth are U.S. protectionist policies and rhetoric.

Chart 1: Valuations are no longer stretched

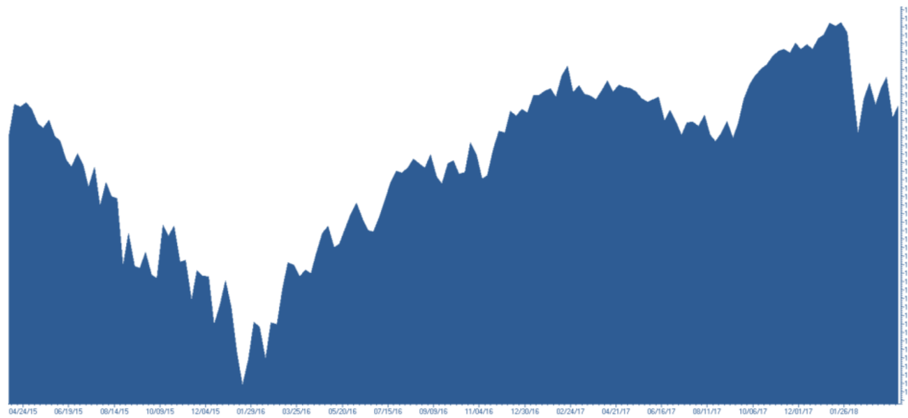


Source: MRB Partners, MSCI

Short term volatility could remain until growth worries subside, but should eventually give way to market upside as the year progresses. This economic expansion looks quite durable and the end of this economic cycle is still a while away. Confidence in our expectations of this positive trend will be further supported by a cooling of trade tensions. We look at a number of economic factors that signal the end of the economic cycle and onset of recession, but there are no major warnings signs at this point in time.

Canada's stock market underperformed, hampered by its larger exposure to the energy sector. The problems of "land locked oil" continue to weigh on sentiment. Depending on the mandate, our portfolios have zero to marginal exposure to the Canadian oil sector, helping us avoid a large part of the impact from Canadian equity underperformance. For the quarter, the S&P/TSX composite posted a total return of -4.52%, the worst quarterly showing since 2015. In fact, Canadian equities posted a total return of only +1.7% over one year, and the S&P TSX Composite Index is actually at about the same level after three years (chart 2)!

Chart 2: Canadian Stocks (S&P TSX Composite) – 3 years



Source: Thomson Reuters

U.S. equities fared better, though for the quarter they were still down -0.77% in U.S. dollar terms. International stocks were also dragged lower, with the MSCI EAFE Index posting a -1.71% return for the same period. The emerging markets bucked the trend, with a +1.15% return year to date. The Canadian bond market staged a slight recovery towards the end of the quarter, with the Canada Universe Bond Index edging up +0.08% for the period, after having been in negative territory for most of the quarter. Bonds benefited from renewed buying interest towards the end of the quarter as tariff talk led to some flight to safety buying.

Trade war or merely posturing?

Despite Trump making outlandish initial remarks on the trade front, there's been pattern of him making large "over the top" threats at the onset, followed by a progressively softening tone. Consider this series of headlines on Trump steel and aluminum tariffs.

March 1, 2018: Trump says US will impose steel and aluminum tariffs – *CNN*

March 2, 2018: Donald Trump announces big tariffs on metal imports, experts fear a trade war – *The Straits Times*

March 4, 2018: White House: No exemptions from steel, aluminum tariffs - U.S. President Donald Trump's administration appears unbowed by broad domestic and international criticism of his planned import tariffs on steel and aluminum, saying Sunday that the president is not planning on exempting any countries from the stiff duties. – *Associated Press*

March 5, 2018: Donald Trump warns Canada won't get a break on steel tariffs without 'fair' NAFTA deal – *Global News*

March 7, 2018: Trump plans to announce steel tariffs, but may allow exemptions for U.S allies after all – *LA Times*

March 22, 2018: Trump exempts EU, 4 other allies from steel, aluminum tariffs – *Politco*

March 26, 2018: South Korea agrees to open auto market in return for exemption from steel tariffs – *Washington Post*

The bark has been shown repeatedly to be worse than the bite, but global stock markets continue to react to his administration's every remark.

Headlines versus Reality

A trade war would be a significant negative for the global economy and global stock markets. So far, cooler heads appeared to have prevailed as foreign leaders' responses to Trump's opening salvos have been quite benign. Trump's initial US$60 billion tariff on select China imports has been initially met with a US$3 billion tariff on US pork, fruit, and steel pipe exports to China. This response by China will have very little impact on U.S. economic growth, but specifically targeted these industries to negatively impact rural America, a region where Trump has many supporters.

One of the key Trump election campaign promises was to level the trade playing field. The protectionist headlines give Trump supporters the impression that he is indeed fulfilling these promises, though the economic reality has much less impact. If all of the Chinese tariffs were implemented, they would represent about 3% of the total goods imported into the United States, and would increase import prices of such products by only about 1%. The impact on the economy and inflation would be marginal. The steel and aluminum tariffs represented about 2% of all imported goods, but with 77% of the exporting nations getting tariff exemptions, this becomes more of a rounding error to economic growth.

A tit-for-tat response cumulating into a full blown trade war would be a large negative for the global economy and the stock market. No one wins under that scenario, not even Trump. A trade war would put the U.S. economy at risk, and U.S. jobs at risk, not likely a path Trump will likely pursue just ahead of the mid-term elections.

Outlook

Global stock markets are likely to remain choppy in the short term as investors digest the impact of these protectionist threats. This current protectionist induced growth scare is uncomfortable near term, but we believe it is short term in nature and will give way to market upside in the medium term. As it becomes more apparent that the protectionist threats are more bark than bite, cyclical growth areas of the market should regain their footing. In particular global financial and technology stocks should benefit. We continue to watch for signs of an eventual peak of the current economic expansion, but we see this as highly unlikely through 2018. The underlying growth backdrop remains very positive for investors.

Worth Allaye-Chan Investment Counsel | www.worthallayechan.com | worthallayechan@raymondjames.ca
Suite 2100-925 West Georgia Street, Vancouver, B.C., Canada V6C 3L2 | T: 604.659.8066 TF: 1.855.659.8066 F: 604.659.8449

WORTH ALLAYE-CHAN
INVESTMENT COUNSEL

RAYMOND JAMES®