Less uncertainty for this late stage bull market November 11, 2018

"Too many positives to be negative"

There is no longer any need to "hunt for Red October". It came and went! The 10% correction in the U.S. stock market has let the steam out of what was an overheating rally at a time when other stock markets in the world were already struggling. A source of near term investor anxiety was the U.S. mid-term elections, which are now completed with no real surprises. This current bull market started at the end of the Great Recession in 2009, and is one of the longest in history, so what happens next?

As discussed in our last commentary, the U.S. economy and corporate earnings continue to be very strong, with some expected moderation next year. Still, expectations are for very good growth. The Canadian economy has also performed well, despite long and drawn out NAFTA negotiations. The resiliency in Canada has actually been quite remarkable given the numerous challenges (weak oil, high taxes, and elevated levels of household debt).

We do not see the U.S. midterm election results having a meaningful impact on stock markets. With the Democrats retaking the House and the Republicans retaining Senate control, this gridlocked government should lead to little change in economic policies, which means little change in the outlook for corporate earnings growth and the economy. This is a good thing. Gridlock actually means less uncertainty, and the surge in stock prices the day after the election results reflects this. Historically, stock market performance post the U.S. midterm elections has been overwhelmingly positive.

The positive economic outlook is largely due to strength in consumption. Consumer spending is a huge part of our economies. In Canada, it represents about 58% of our GDP, whereas in the U.S. it's up to 68%. With the unemployment rates in both countries at decade lows and no signs of weakening, it is no wonder that economic growth is now solid, and should remain so in 2019. We are also seeing some wage growth, and families with more money in their pockets will tend to spend more. Recent U.S. consumer sentiment numbers remain steady at high levels, and reflect improving income and employment growth expectations. Canadian consumer confidence has rebounded from lower levels in the summer as trade worries with the U.S. have diminished. The impact of higher interest rates on spending will be something to monitor, but rates are still low and are far from a level that is likely to put a damper on U.S. spending. High Canadian household debt levels means our consumers are more susceptible to increased borrowing costs, and as such, the Bank of Canada will likely take more time between rate hikes.

As positive as we are on the economic outlook, this does not necessarily mean positive stock returns. An overpriced market would lead to disappointment. Since markets are not overpriced (U.S. stock markets are now back to 2015/2016 valuation levels), the outlook for stock returns, particularly post the correction is very positive. Concern about peaking of corporate profits is completely unwarranted. Although the profit growth rate will undoubtedly moderate from an unsustainable 25% (highest since 2010), it is still likely to improve by another 9% in 2019. Significant declines in the stock market (bear markets) usually require declines in corporate earnings, not just decelerating growth. This rarely occurs outside of recessions. Even in non-US markets, corporate earnings are continuing to rise. We see near term outperformance by U.S. equity markets on strong corporate earnings momentum, but we also see much more upside in non-U.S. markets over a longer term horizon given their undervalued metrics.

For several years now we have projected more modest returns for balanced portfolios relative to historical experience. As we approach the end of 2018, returns for the calendar year have been disappointing. Bond markets have been a drag for the balanced investor and will continue to be for likely another year or so. Non-U.S. equities have also been negative for most of the year. Positive market returns for 2019 will help the average annual return to reach this more modest level.

Undemanding stock prices, solid corporate earnings growth and a strong underlying economy all provide a good foundation for this bull market to continue in 2019. What is sorely needed is for an improvement in sentiment. Trade concerns remain, but with the U.S. midterm election now behind us, the removal of this source of uncertainty should help.

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