Quarterly Commentary January | 2019

A year of many worries

Chart 1: Canadian stocks (S&P/TSX Composite) – 10 Years

2018 was a most disappointing year in the investment markets, with all major asset classes mired in losses for the year. December, which is usually a strong period for stock markets, was decidedly negative. U.S. markets in particular posted their worst December performance since the Great Depression in 1931, and worst annual performance in a decade. Various stock markets in the world were down 10%-25% from their peaks. Global markets buckled under the worries about the global economy. From worries about trade war to rising interest rates, investor sentiment sank to its lowest levels in years. The U.S. equity market had been the only major market to post positive returns through most of the year, only to succumb to these worries at the close of 2018. Canadian equity markets were negative for the year, with the Canadian bond market only recovering to slightly positive territory in the last months. Canadian stock markets are below the index level eleven years ago. NAFTA worries along with continuing difficulties with oil exports have hurt Canadian asset prices. International markets have also been negative in 2018, as the rest of the world has had to contend with trade tariffs and U.S. protectionism, and Brexit in the U.K. This is despite very strong corporate profit growth in 2018 and a much more modest, but still positive corporate profit growth outlook for 2019.

As strong as the U.S. economy has been, concerns about a dramatic slowdown in the global economy have weighed on stock markets. Talk of the risk of a U.S. recession has become more frequent, though the likelihood of such an occurrence in 2019 is lower than feared. The economy, though slowing, remains on a growth path. Trade, which has been the biggest source of uncertainty throughout 2018, is likely a key factor for the coming year. The risk of an escalation of tariffs has been a big worry, hurting investor sentiment particularly in recent months. The agreement to extend trade talks by ninety days before the possibility of more tariffs on China imports by the Trump Administration has merely prolonged this period of uncertainty. The establishment of a new NAFTA was an important step in the right direction, but a further thawing of trade relations between the U.S. and China, the world's two largest economies, would provide a much needed improvement in sentiment. <u>Any</u> progress on this front would be a welcome development.

Concerns over correctness of the U.S. Federal Reserve's positive viewpoint on the economy, and thus the possibility of more rate increases than warranted, has further hurt sentiment. The stock market has been pricing in a recession, fearing that the U.S. central bank will raise rates too much, stifling the economy. During such periods of worry, it's easy to forget that one of the goals of the central bank is to pro-long the economic expansion for as long possible.

During these periods of fear, sellers tend to pay no attention to fundamentals. It is also important to remember that, as difficult as it may be during these periods, fundamentals will dictate pricing again. We see numerous opportunities in the markets today, but we are awaiting some stabilization in the markets before making any new commitments. Evidence that the economy, though slowing, is still growing, and companies are likely to report improving profits. This should be very helpful in turning around investor sentiment, and the global stock markets. Stock valuations reflect a significant slowdown and profit recession, and do not reflect the upside from the most likely economic outcome.

We went into the end of the year slightly underinvested in stocks, shorter duration in bonds (we held short term bonds) and overweight in cash but intend to increase equity holdings once the fear driven volatility subsides.

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