The U.S. versus the world?

The Trump administration's trade battles have dominated the headlines in 2018. A year of negotiations finally culminated in a new United States Mexico Canada Agreement (USMCA) in place of the prior North America Free Trade Agreement (NAFTA). The USMCA will still need to be approved by the lawmakers. On the surface one might wonder why there was even so much difficulty in reaching such a deal. Headline trade numbers show that in fact the U.S. had a small trade surplus with Canada. However, selecting specific data can make it appear that that surplus is in fact a deficit. Regardless, any trade imbalance between the two countries is small compared to the trade deficit the U.S. has with other countries. It's about politics. Trump needs to declare victory to his electorate on the trade front, and Trudeau needs to show Canadians that we got a good deal. For Canada, getting a trade deal with the U.S. was crucial to our economy as the total value of trade with the U.S. is over eight times the value of trade with our second largest trade partner, China. Canada is also important to the U.S. since we are their second largest trade partner.

Among the key items that were resolved included auto and other tariffs, expanded U.S. dairy imports to the Canadian market, dispute settlement mechanisms, the removal of the U.S. demand for a sunset clause, and higher thresholds for cross-border purchases. The threat of U.S. auto tariffs was a key issue and was used to pressure Canada into a deal. Our automotive sector employs more than 125,000 people directly and another 400,000 in auto related service roles, and is a significant contributor to our GDP. The economic damage to Canada would have been severe. The U.S. demand for an increase in Canadian imports of U.S. dairy products was a challenging demand from a political standpoint since about 70% of Canadian dairy production is in Quebec and Ontario, two key provinces for the Trudeau government. An initial U.S. request for a sunset clause was scrapped. It would have essentially ended any new NAFTA deal after five years unless an extension was agreed upon by the three countries. The new USMCA provides trade certainty for 16 years and has a review process to fix issues which may arise. Of most interest for cross border shoppers are the higher exemptions from sales tax and duties on goods brought in from the U.S. and Mexico.

The continuing trade skirmishes have been a challenge for global stock markets this year. Sentiment has played a large role in short term equity market returns, and stock markets around the world are reflecting the perceived U.S. position of strength. Strong economic growth in Canada has not translated into strong returns for Canadian stocks *(Chart 1).* The S&P/TSX Composite has returned only 1.36% year to date, essentially all in the form of dividends. With the USMCA agreed upon in principal, removal of the trade dispute overhang

should improve sentiment towards Canadian assets.

Even more challenging for Canadian investors has been the bond market. Strength in the underlying economy has led to a retreat in bond prices this year as yields have moved higher. Canada's main benchmark bond index has a total return of -0.35% in 2018. We do, however, see opportunities to increase portfolio yield within the bond segment of the portfolio in the coming 12-18 months.

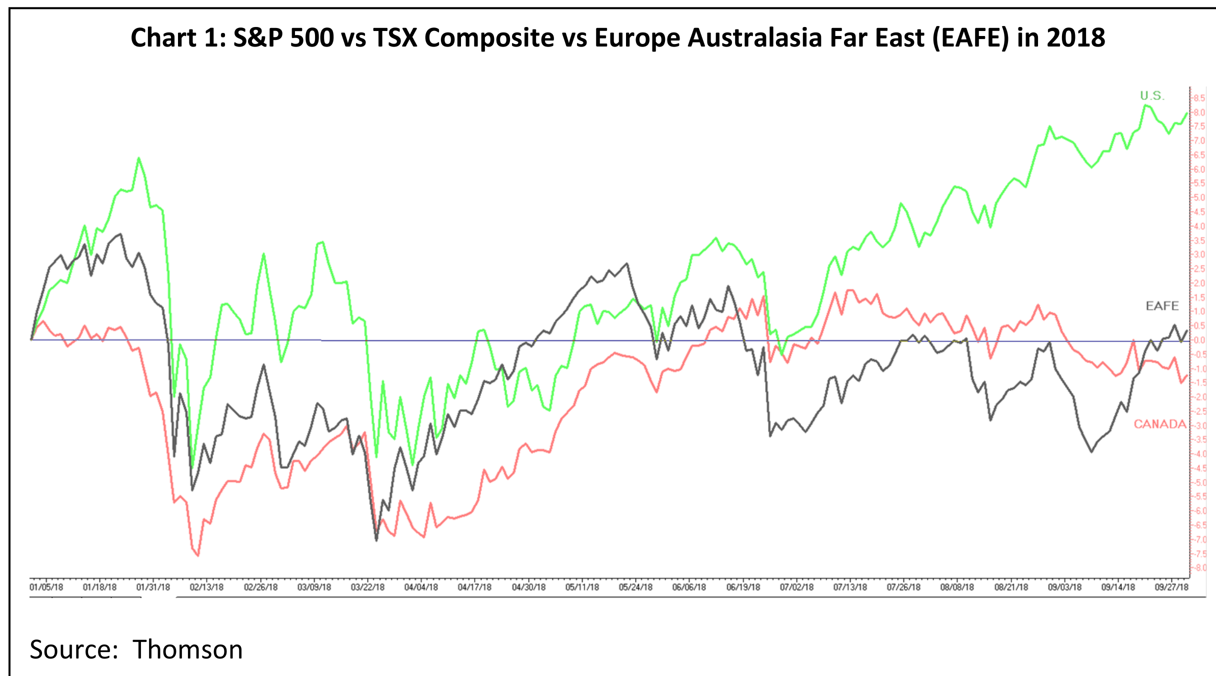

Chart 1: S&P 500 vs TSX Composite vs Europe Australasia Far East (EAFE) in 2018

Source: Thomson

Foreign markets have also struggled. Most major European markets are in negative territory this year as is the case for emerging markets and China. The decline in China's market is largely due to the trade rhetoric, but for longer term investors, a number of factors should be a positive for that market. Fundamentals are actually solid in the region, as valuations are in-expensive. Chinese domestic consumption, which is overwhelmingly a key driver of the economy, continues to expand, trade battle or not. In the short term, sentiment which is influenced by the trade dispute is likely to continue to weigh on the appetite for non-U.S. equities, despite the much more favourable long term rewards in those markets.

FANGMA craze

The U.S. stock market has been an outlier in terms of performance this year, with the S&P 500 index posting and impressive 10.6% return year to date. Investors have flocked to the U.S. as earnings growth and economic growth, spurred by corporate tax cuts, has been strongest in the U.S. At the same time U.S. equities are also the most expensive in the world. Looking under the hood it has not been a broad rally. The top 10 performing stocks represented half of the entire gain in 2018. This was even more skewed at the end of June, with the top 10 performing stocks accounting for more than 100% of the gain *(Table 1). The* remainder of the market generated a negative return. The rush into FANGMA (Facebook, Amazon, Netflix, Google/Alphabet, Microsoft, Apple) leaves the group quite overextended and it has become one of the most over owned groups in the market. These stocks are now very expensive!

Table 1: 10 stocks represented more than 100% of S&P 500 Return to June 30, 2018!			
Company	**2019 Sales Growth Estimate**	**% of S&P 500 Return**	**P/E Ratio Sep 30, 2018**
Amazon.com Inc.	23%	36%	205
Microsoft Corp.	10%	18%	32
Apple Inc.	4%	15%	21
Netfllix Inc.	24%	15%	95
Facebook Inc.	27%	8%	23
Alphabet Inc. (Google)	18%	7%	22
Mastercard Inc.	12%	7%	39
Visa Inc.	11%	6%	35
Adobe Systems Inc.	19%	5%	56
NVIDIA Corp.	14%	5%	41
Top 10 contributors	**16%**	**122%**	**S&P 500: 21**

Source: Bloomberg, Factset, Goldman Sachs Global Investment Research

Where are bond yields headed?

A three decades long bull market in bonds came to end in 2016. The ten year Canadian benchmark yield fell below 1% for the first time. At about the same time, the U.S. ten year Treasury bond benchmark yield fell to a low of 1.37%. The current 10 year yields for Canada and the U.S. are at 2.42% and 3.06% respectively, a pretty significant rate of change in the two years since. We continue to expect U.S. bond yields to rise, and bonds yields in the developed world to follow in the same direction, however on a much more muted path. Inflation remains contained, but over time, rising wages and the prospect of more tariffs should put upwards pressure on the inflation numbers, and subsequently the bond yields.

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