Asset class commentary

Heightened trade tensions between the United States and China, rising interest rates and a stronger U.S. dollar have weighed on stocks, particularly emerging-market equities. Support for the market going forward will most likely have to come from sustained earnings growth as valuations may continue to face headwinds from rising interest rates and firming inflation. We believe equities can still deliver attractive and above-average returns from current levels if earnings materialize as analysts expect. While rising rates would continue to act as a headwind for fixed-income investors, government bond yields are now sufficiently high in some regions (i.e. North America) that they offer buoyancy in a balanced portfolio. We continue to look for relatively low returns from fixed income, but expect that bonds would provide a cushion in a scenario where the economy falters.

Fixed income

Major fixed-income markets declined during the quarter ended November 30, 2018 in U.S.-dollar terms, mostly as a result of a stronger U.S. dollar, widening credit spreads and a modest rise in yields in the United States and Canada. Bond yields surged to multi-year highs earlier in the quarter and then tumbled as the outlook for global growth diminished and falling oil prices dampened inflation. The U.S. Federal Reserve (Fed) raised its benchmark rate by 25 basis points in December on concerns over weakness in the global economy and financial markets.

The Bank of Canada (BoC) raised its policy rate to 1.75% on October 24, which was expected, but the central bank unexpectedly dropped its “gradual pace” wording, and that was taken by the market as a sign that it plans to return rates to neutral. The United States-Mexico-Canada Agreement (USMCA) has taken one of the BoC’s main worries off the table, but elevated levels of household debt and restraints on consumer spending caused by higher interest rates are now taking centre stage. The recent decline in oil prices adds an unwelcome risk to the outlook.

Regional outlook for equities

Canada

While the Canadian economy continued to expand, concerns about Canada’s competitiveness, trade uncertainty, falling energy prices, and high levels of property-related debt weighed on Canadian stocks. The S&P/TSX Composite Index declined 7.5% during the three-month period ended November 30, 2018.

We have upgraded our Canadian growth forecast slightly, due largely to the new USMCA deal. While the deal is slightly worse for Canada than the previous NAFTA agreement, it turned out to be better than the market feared. Business conditions have become slightly less favourable within Canada at the same time that U.S. business policies have become friendlier in the areas of tax, regulation and labour costs. A considerable wedge has thus opened up between the two countries. Canadian companies will likely remain at a substantial disadvantage relative to the United States.

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United States

Although the U.S. economy continues to expand, the pace of activity appears to be slowing somewhat. The S&P 500 Index, which had been resilient earlier in the year and hit a record high in September, was not exempt from recent volatility, as tighter financial conditions, rising trade protectionism and slowing global growth continued to make investors nervous. The Index declined 4.4% in U.S.-dollar terms during the three-month period ended November 30, 2018. Value stocks outperformed growth stocks.

“It is our belief that the recent decline in stocks has pulled the S&P 500 Index back into a valuation zone that typically bodes well for stock-market performance.”

Defensive sectors such as Consumer Staples, Utilities and Health Care also outperformed. The lagging sectors were all economically sensitive, reflecting the general belief that economic growth is likely to slow next year. The Energy sector was the worst performer, driven by a roughly 25% decline in oil prices during the period. Also weighing on the overall market was the fact that two of the largest companies, Apple and Amazon, dropped significantly, contributing to the underperformance of the Information Technology and Consumer Discretionary sectors. It is our belief that the recent decline in stocks has pulled the S&P 500 Index back into a valuation zone that typically bodes well for stock-market performance.

Europe

Having begun 2018 with ‘risk-on’ vigour, European equities quickly conceded gains this autumn as U.S.-led trade wars and monetary tightening became realities, and concerns over European politics and the business cycle returned, ending a long period of low volatility. On a 12-month view, the European stock market is likely to continue underperforming the real economy, while displaying elevated volatility as is typical in “mature” cycle behaviour.

The official date for Brexit to take effect (March 29, 2019) is fast approaching. Negotiations on the terms under which the U.K. will split with the EU have been nothing short of chaos, with the unprecedented nature of the situation and fragile U.K. politics adding to the complexity. In all negative exit scenarios, the costs are likely to accrue quickly, before currency depreciation helps to restore economic growth in the coming years.

Asia

Asia-Pacific financial markets have generally underperformed developed markets in 2018 amid a confluence of challenging macroeconomic conditions, none bigger than escalating trade tensions between the United States and China. Other worries for investors in 2018 have been rate hikes by the Fed, leading to capital outflows, and, until recently, higher energy prices as many countries in the region are net importers of crude oil.

The MSCI China Index was one of the worst performers in the region, with sentiment dampened by trade uncertainty, slowing economic activity and tighter regulation of the online gaming industry. Japan’s equity markets fared better than the rest of the region as the country’s economy remains sound. The yen has been steady throughout 2018, strengthening to the 105 level in March before returning to its current 112 level. North Asian markets including South Korea and Taiwan declined due to weaker global sales of smartphones and auto demand, as well as the softening outlook for Chinese industrial activity. Indonesia and Thailand were regional outperformers during the past year as Southeast Asia is less affected by escalating trade tensions.

Across the region, the best-performing sectors over the three-month period were Utilities, Industrials and Financials, while Information Technology and Consumer Discretionary underperformed. We expect market volatility to remain elevated in the near term because the financial risks will escalate if the United States and China cannot resolve their dispute.

Emerging markets

Slowing global economic growth, heightened trade tensions between the United States and China, rising interest rates and a stronger U.S. dollar weighed on emerging-market equities over the past quarter. The MSCI Emerging Markets Index declined 5.5% over the three-month period ended November 30, 2018.

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Faster economic growth has historically been the key reason for investing in emerging markets and has driven long-term performance. For much of the last seven years, however, the emerging-market index has traded in a relatively tight range. We believe the key reason behind this has been a slowdown in the relative growth of emerging markets compared with developed markets, and the change in relative growth rates has been the crucial driver of emerging-market cycles during the period. Over the long term, emerging-market performance relative to developed markets appears to be cyclical with a strong upward trend.

Global Asset Management

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