Asset class commentary

Economies are advancing in all regions and, while growth slowed a bit in the first half of the year, the rate of global growth remains fairly good by post-crisis standards. Fixed-income investments are unlikely to deliver attractive returns in an environment of moderate growth, firming inflation and gradual central-bank tightening. Rising rates will act as a headwind to bond returns and could lead to low or even negative returns for bonds for many years. While forecasts don't look for meaningfully higher bond yields over the next year, sovereign bonds are likely to generate low single-digit returns over the longer term. Equities offer a much more attractive proposition for investors. Although stocks have been volatile in the past quarter amid protectionism, rising interest rates and firming inflation, equities continue to offer decent upside potential as long as rapid corporate profit growth is sustained. While stocks are likely to outperform over the longer term, it may be prudent to maintain a smaller allocation to risk assets in the shorter term given the maturation of the business cycle.

Fixed income

Global bond yields paused in the past quarter after having risen steadily since mid-2016 on the back of an improving economy and firming inflation. Our models continue to suggest an upward bias to yields over the long term, but also that adjustments can be gradual and distributed over an extended period and that they will be practically unchanged in a year's time. A sustained rise in bond yields, even if gradual, would act as a headwind for sovereign-bond investments and lead to low or even negative total returns. Our forecast for the U.S. 10-year yield is 3.00% over the next year with risks tilted to the upside.

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Meanwhile, Canadian yields have traded at historically low levels since the financial crisis due in part to huge demand from foreign investors, which seems to have hit a wall earlier this year as investors sold a net $3.1 billion of Canadian bonds in the first quarter, compared with an influx of $25.5 billion during the same period of 2017. The Bank of Canada (BoC) has been sidelined since January, but it indicated that "higher interest rates will be warranted over time," which may push yields higher.

Regional outlook for equities

Canada

Volatility in equity markets remained elevated in the three-month period ended May 31, 2018, as investors digested the impact of firming inflation expectations and rising bond yields on the economy, earnings outlook and valuations. U.S. President Trump's focus on imposing trade restrictions stoked investor anxiety. During the three-month period ended May 31, 2018, higher prices for crude oil and the solid global economic backdrop underpinned a 5.2% total return for the S&P/TSX Composite Index, outperforming the 0.4% gain in the S&P 500 Index. So far in 2018, the S&P/TSX Composite Index has been essentially flat, while the S&P 500 Index has risen 2.4% and the MSCI World Index is up 0.8%.

Canadian consumption is expected to ebb in 2018 as consumers feel the effects of a slowing housing market and rising interest rates. Continued labour-market strength and minimum-wage increases could act as offsets. In May, the BOC maintained the benchmark interest rate at 1.25% and slightly lowered its GDP growth forecasts, reflecting the housing-market softness and faltering energy exports. Even with inflation running at close to 2%, the BOC remains cautious about hiking interest rates amid uncertainty regarding NAFTA negotiations and Trump's recent imposition of tariffs on Canadian steel. As a result, the pace of interest-rate increases in Canada is likely to continue lagging the U.S.

S&P/TSX Composite Index earnings expectations are for $1,010 in 2018 and about $1,140 in 2019, representing annual increases of 13% in each of the next two years. The earnings outlook has been upgraded to reflect higher crude-oil prices, underpinning Energy sector earnings, as well as earnings momentum in the Financials sector. The global economic backdrop supports continued momentum in commodity prices as the global economy appears to be entering the later part of the cycle.

United States

The S&P 500 Index was flat in U.S.-dollar terms during the three-month period ended May 31, 2018, as concerns regarding trade, rising inflation and interest rates, and increasing geopolitical turmoil outweighed the positive impact of strong corporate earnings. The S&P 500 Index has risen over 12% during the past year, driven primarily by solid corporate fundamentals and the recent passage of legislation that lowered the corporate-tax rate. Profitability remains exceptional as net-profit margins were roughly 13%, near all-time highs, and the incremental margin on each dollar of new sales was 19%, similar to the percentage of the prior five quarters.

The U.S. economic backdrop remained solid, as real GDP growth has been roughly 3% in the last three quarters compared with the 2% trend seen since the global financial crisis. Growth appears to have had decent momentum heading into the last part of the second quarter. Surveys of economic activity, which correlate well with GDP, have been coming in at high levels and exceeding already high expectations.

While our base case is for U.S. stocks to rise modestly over the next year, there are several scenarios that could lead to different outcomes. On the downside, a policy mistake by the Fed or escalation of protectionist trade moves by the Trump administration are the most likely causes of a downturn given the potential for both to crimp the expansion. The market could also experience a downturn if the euro-skeptic parties in control of Italy push the case for exiting the euro and thereby cause a credit crisis. On the upside, if investors become convinced that the business cycle is likely to remain intact through 2021, then earnings for 2020 could be roughly USD 190 and the market would likely trade near 3000 sometime in 2019. The key point is that as long as U.S. growth remains positive and the Fed raises rates at a slow and measured pace, stocks should make some headway this year, but investors should continue to expect returns ranging in the high single digits to low double digits.

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Europe

On a political level, Italy has become the first major European country in recent history to experiment with a populist government after far-left and far-right parties cobbled together a coalition earlier this month. The coalition eliminated the need for new elections but raised the possibility that dissatisfaction with the euro will become a bigger political issue. We also are in the midst of Brexit negotiations. Progress has certainly been made, but the one big hurdle is whether a trade-hindering, politically sensitive border will be drawn between Ireland and Northern Ireland, which is part of the U.K.

Focusing on business fundamentals, we still see a relatively robust backdrop. Europe's earnings base remains depressed relative to other major markets and we see significant medium-term upside potential; credit conditions are supportive with real interest rates remaining low; and relative valuations in Europe versus other equity regions sit at a discount and are also discounted versus the bond market. However, this positive outlook is challenged by a number of factors. The euro has been robust, particularly leading up to the Italian election; this is a headwind for exporters, but has become less so since the election. Plans by the European Central Bank and the Bank of England to tighten monetary policy could also have a negative impact on equities given elevated price-to-earnings multiples.

Asia

Asian equities, in line with global stocks, sold off for much of March and April. However, they had pared most of the losses by the end of May, as investor sentiment improved on hopes for advancement in the U.S.-China trade dispute and a better-than-expected earnings outlook for the region's Information Technology and Health Care sectors. Asian equity markets excluding Japan have been a major beneficiary of global economic growth over the past year.

President Trump has started to deliver on his protectionist threats and continues to up the ante against China. Trump's view is benefiting from the fact that the U.S. trade deficit with China has increased over his presidency to its highest ever – USD 386 billion at the end of February 2018. U.S. protectionism clearly has global and regional ramifications in Asia. Chinese

President Xi Jinping appears to have opened the door to trade negotiations with the U.S., and China has reinforced its desire to further open up its economy and become more involved in global cooperation.

Emerging markets

The case for emerging markets to continue outperforming is largely predicated on the view that these markets are relatively early in their growth cycle. The MSCI Emerging Markets Index returned 38% in 2017 and 12% in 2016, making it the best-performing major global benchmark by some margin over this period. However, there was severe underperformance between 2010 and 2015, creating the potential for further catch-up in the years ahead. The gap in economic growth favouring emerging markets over developed markets, so instrumental in driving equity returns over the past few decades, continues to accelerate.

After a period of acceleration, we are seeing a moderation in emerging-market growth surprises, and it is a similar story with earnings expectations, which have begun to moderate after last year's consistent upgrades. We believe that emerging-market profit margins will continue to expand from a low base, but earnings growth could be put at risk with any change in the emerging-market reform agenda spurring productivity improvements, such as backtracking on supply-side reform in China.

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Global Asset Management

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