Global Asset Management

For more on our current view and outlook, consult **The Global Investment Outlook**.

FALL 2018

Asset class commentary

Led by the U.S., the global economy is growing at its fastest pace in several years and, while the list of challenges is always evolving, we don't foresee a recession over our forecast horizon. Economic growth is solid, inflation is no longer too low, and central banks are dialing back policy accommodation. Rising interest rates represent a risk, but should be manageable if their upward trajectory is gradual and well telegraphed as it has been so far this cycle. Prospective returns for sovereign bonds are particularly unexciting as even a small rise in yields will be a headwind to fixed-income returns. Equities look far more appealing relative to bonds and, while our total-return expectations for stocks are lower than they have been at previous points in the cycle, they remain positive and continue to exceed those for sovereign fixed income.

Fixed income

Key global fixed-income markets outside of North America declined in the past quarter, mostly caused by continued U.S.-dollar strength and, to a lesser extent, moderate yield increases in some markets. Yields on North American bonds fluctuated within narrow bands all summer. Concerns over potentially slowing economic growth, additional tariffs and emerging-market woes counteracted upward pressure on yields caused by firming inflation. We don't expect a significant near-term increase in the U.S. 10-year yield. However, our model assumes that real rates revert to their historical norm over the next half-decade and that the increase is distributed evenly over time. The Bank of Canada (BoC) raised its policy rate as expected in July by 25 basis points to 1.50%. The BoC reiterated its intention to continue gradually tightening monetary policy, highlighting trade uncertainty and sluggish wage growth. Central-bank tightening has led to a flattening of the yield curve, as short-term interest rates have been increasing at a faster pace than long-term bond yields. The gap between 10-year and 30-year benchmark bonds has essentially closed, with some of this flattening attributable to a relative shortage of longer-term Government of Canada bonds.

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Regional outlook for equities

Canada

The Canadian equity market hit an all-time high in mid-July, but has since retreated on uncertainty about the impact of the Trump administration's focus on global trade in general, and NAFTA in particular. The S&P/TSX Composite Index returned 2.7% between January 1, 2018, and August 31, 2018. The Canadian benchmark continues to underperform the S&P 500 Index, which is up almost 10% so far in 2018, and the MSCI World Index, which has gained 4.9% in U.S.-dollar terms. For the three-month period ending August 31, 2018, the S&P/TSX gained 2.0%, while the S&P 500 and MSCI World added 7.8% and 4.3%, respectively.

Meanwhile, the Canadian economy continues to soar. Economic data so far this year has reflected a rebound in exports and capital investment, reducing the reliance on growth driven by consumption and housing. The unemployment rate is at its lowest level in four decades and economic surprises are again positive. Given that the Canadian economy spends most of its time closely tracking the performance of its U.S. neighbour, it doesn't make sense to forecast pallid health for Canada at a time when the U.S. economy is doing well. For that matter, Canada has strung together a few promising policy developments, including the prospect of a constructive NAFTA resolution and the possibility of business-tax cuts in the next federal budget.

The S&P/TSX is trading at 15 times the consensus estimate for 2018 earnings per share, while the S&P 500 trades at a 17.5 multiple. The consensus forecast calls for S&P/ TSX earnings-per-share growth of 15% in 2018 and 12% in 2019. The earnings outlook has improved over 2018, driven largely by the Energy and Financials sectors. However, weak prices for commodities including gold, copper and aluminum could put pressure on earnings. A stabilization in commodity prices, clarity on the outcome for NAFTA and stability in the housing market may be necessary before we can expect S&P/TSX valuations to rise sustainably.

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United States

The S&P 500 Index rose strongly during the past three months as U.S. earnings growth eclipsed trade concerns, rising interest rates and emerging-market weakness. The market was led by the Health Care sector, which has outperformed since early May. Other leading sectors included the economically sensitive Consumer Discretionary and Information Technology, followed by the more defensive Real Estate and Consumer Staples sectors.

The U.S. economic backdrop remained solid, with real GDP growth coming in at 4.2% in the second quarter, compared with the 2% trend seen since the global financial crisis. Surveys of economic activity that correlate well with GDP have been coming in at high levels, though slightly lower than in the recent past.

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. For example, a policy mistake by the U.S. Federal Reserve (Fed) or escalation of protectionist moves by the Trump administration would be the most likely causes of a downturn given the potential for both to truncate the business cycle.

Europe

Leading economic indicators in Europe have flat-lined, monetary policy is beginning to tighten and global trade threats are slowly crystallizing. We do not believe that there is a short-term threat to earnings, but some trends are worrisome.

We continue to monitor Italy's populist government, whose election promise of increased fiscal spending is likely to place the country at odds with Brussels and potentially expose further division at the highest echelons of the Eurozone. GDP growth in the U.K. recently fell to its lowest in six years, business investment continues to fall and political angst is poised to worsen into the end of the year. Investors are also paying attention to rising trade frictions between the U.S., China and Europe. The magnitude, timing, composition and spillover effects are both uncertain and difficult to estimate.

Profits have been a key driver of European equity markets over the past few years, and earnings momentum is still positive and rising. A pick-up in capital expenditures, mergers and acquisitions, and buybacks has also provided a lift for stocks. However, business confidence is falling. Cyclical stocks have been bolstering earnings, but over the past six months there is evidence that investors are forsaking cyclical stocks for the relative safety of defensive sectors.

From a valuation perspective, the market P/E is marginally richer than its long-term average. On a price-to-book basis, Europe continues to look cheap relative to the U.S., though only some of this gap can be explained by lower returns on equity in Europe. Yields on European equities also continue to be attractive relative to long-term investment-grade corporate bonds and to other stock markets.

Asia

Asia-Pacific equity markets declined during the three-month period ended August 31, 2018, on fears of an escalating trade war between China and the U.S., interest-rate hikes by the Fed and reduced fund flows into emerging markets. Other areas of concern for investors included the weakening Chinese economy and the negative impact of the U.S.-China trade standoff on smaller Asian economies. India and Australia were among the economies less affected by Asia's economic slowdown.

In China, real GDP growth declined slightly to 6.7% in the second quarter from the year-earlier period, after staying at 6.8% for three consecutive quarters. In response, Beijing appears to be shifting from tentative policy easing toward more robust stimulus measures including increased credit, lower financing costs for smaller companies and accelerated fiscal spending on urban infrastructure.

Economists forecast that the Japanese economy will expand 0.8% in 2018. We believe that accommodative monetary and fiscal policies will offset the negative impact of global economic trends and softening external demand. Moreover, Japanese business investment continues to rise, with capacity expanding in manufacturing sectors.

Emerging markets

After a strong start to 2018, the MSCI Emerging Markets Index has underperformed developed-market equities, losing 4.7% in the three months ended August 31, 2018 in U.S. dollar terms. Concern about U.S. monetary tightening, U.S.-dollar strength and protectionism have combined to push down emerging-market stocks.

Looking beyond 2018, one of the most important questions to answer in terms of the outlook for emerging market equities is where we are in the economic cycle. The growth phase of the emerging-market economic and profit expansion is only in its second year at 22 months, while developed markets have been in recovery for about 8 1/2 years. The current decline in emerging-market stocks seems to have imposed only limited damage on the overall economy.

We consider the stability in corporate-earnings forecasts to be the most important sign of limited damage from the recent turmoil. The consensus forecast for emerging market earnings growth in 2018 has edged up to 15.9% at mid-year from 13.1% at the end of 2017. Other trends favouring emerging markets are improving operating leverage and rising returns on equity. Capital expenditures have also begun to turn up after three years of declines.

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