



## Asset class commentary

After enjoying solid and accelerating global growth in 2017 and through the first half of 2018, we saw momentum wane last quarter, and we expect this trend to continue in 2019. We therefore budget for a mild deceleration in growth going forward, but to rates that remain quite good by post-crisis standards.

### Fixed income

Global sovereign bonds rallied in the past quarter, reflecting the downshift in economic growth expectations, slightly lower inflation and, perhaps most importantly, the fact that central banks are no longer set to raise rates. Yields on 10-year government bonds are now below our estimates of equilibrium in all major regions, particularly in markets outside of North America. While our models continue to suggest that interest rates are unsustainably low and that the long-term direction for yields is likely higher, we also recognize that slowing economic growth and tame inflation could limit upside pressure in the near term. As a result, we have lowered our forecasts for 10-year sovereign bond yields in 2019 across major regions versus last quarter.

We expect that the U.S. Federal Reserve Board (Fed) will keep interest rates on hold in 2019; we also believe that the Bank of Canada (BOC) is likely finished raising policy rates and could be on hold into 2020. In this environment in which central banks probably won't raise interest rates, bond yields are unlikely to rise in the near term, which suggests that bond investors are more likely to keep their coupon. Should the economy downshift, bonds would provide a cushion in a balanced portfolio.

### Regional outlook for equities

#### Canada

Over the last three-month period, the S&P/TSX Composite Index soared 7% after underperforming most major global equity markets in 2018. A healthy labour market and consumer spending were the main drivers of domestic growth, while declining investment in housing and energy, as well as slowing global commodity demand tempered growth.

Following last quarter's equity rally, investors are paying 13.5 times S&P/TSX forward earnings, slightly lower than the long-term average of 14.5 times, which may be warranted given the cautious global economic backdrop. The S&P/TSX continues to trade at a discount to the S&P 500, the result of the Canadian benchmark's high exposure to the Financials, Energy and Materials sectors.

"A healthy labour market and consumer spending were the main drivers of domestic growth."

We see four key macroeconomic challenges for the Canadian economy: (1) slowing U.S. growth; (2) a weakening domestic housing market; (3) poor competitiveness versus the United States; and (4) a challenging domestic environment for the production and transport of crude oil.

#### United States

The S&P 500 Index experienced a strong rally in the past quarter that extended through February. Led by the Industrials and Energy sectors, the S&P 500 retraced most of the plunge it experienced in the fourth quarter of 2018. Within sectors, economically-sensitive segments of the market are gaining leadership. Since December, Industrials have outperformed, while defensive sectors such as Consumer staples have lagged.

We recognize that the profit outlook for 2019 is less rosy than last year, given the absence of another round of tax cuts and slower economic growth, but against a backdrop of moderate inflation and accommodative monetary policy, there is plenty of room for stocks to move up.

**“Long-term price momentum helps to place the current bull market for stocks in perspective.”**

Should the S&P 500 Index trade at the equilibrium P/E ratio and generate earnings of US\$167 per share in 2019, as the consensus of bottom-up estimates suggests, the Index would reach 3,155 by the end of

the year. Such an increase would represent a total return of roughly 15% from the close on February 28, 2019.

Long-term price momentum helps to place the current bull market for stocks in perspective. Following nearly a decade of poor returns resulting from the Tech Wreck and the Global Financial Crisis, stocks appear to have entered a new super-cycle bull market. We can see nothing in the market's tea leaves that signals an imminent end to the business cycle or the bull market. In our view, economic growth should be sufficient to support stocks in 2019.

### Europe

The European equity market fell 7% in December 2018, and a counter-trend rally was to be expected in January 2019. Given that all of the components of the European composite leading indicator are currently in decline, we believe that the risk of renewed weakness is fairly high. However, our belief is that the market should bottom by the second quarter of 2019. Investors have begun to detect that the risk of a “hard Brexit” – the departure of the U.K. from the EU without an exit pact – has diminished and a stabilization of share prices for domestically oriented U.K. companies now appears to be under way.

### Asia

Asian-Pacific equity markets rallied in the three-month period ended February 28, 2019, as the region outperformed the broad MSCI World Index. The rally continued into 2019 amid optimism that the U.S. and China would succeed in resolving their trade dispute. Also aiding markets was China's use of increased monetary stimulus to support the country's slowing economy. The strongest-performing Asia-Pacific markets during the period were China, Hong Kong and Australia. India and Malaysia underperformed.

### Emerging Markets

The three-month period ended February 28, 2019, was an eventful time for emerging-market equities as the benchmark stock index rebounded more than 10% following a large sell-off in October. Emerging-market equities were seen as oversold, and the rotation away from U.S. equities magnified the large rebound in January 2019 after volatility led to a further round of global equity losses in December.

We are cautiously optimistic about emerging-market equities and do not believe that the performance pattern witnessed in 2018, when the market peaked at the end of January and collapsed for much of the rest of the year, will be repeated in 2019. There are three main reasons for our guarded optimism: 1) valuations are more attractive after the MSCI Emerging Markets Index dropped 15% in 2018 while earnings per share rose about 10%; 2) emerging-market currencies are much cheaper than they were a year ago; and 3) investment inflows have started to increase as investors sell U.S. equities and shift the proceeds to emerging markets. We expect some of the worst-performing emerging-market countries, such as Turkey, China and South Africa, and sectors such as Consumer Discretionary and Real Estate, to perform better. We are also encouraged by progress in trade talks between China and the U.S. on tariffs.

**“Emerging-market currencies are much cheaper than they were a year ago.”**

The emerging-market stock index remains very attractive in terms of valuations, even after the recent gains, as last year's stock decline collapsed the price-to-earnings ratio to just above 12 from 16 – well below the long-term average. Emerging-market stocks are also more attractive on a price-to-book-value basis than they were a year ago, given a recovery in returns on equity.

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