# INVESTMENT OUTLOOK
Q2 2018

## HIGHLIGHTS

### Economic Review

- Economic momentum slowed during the first half of 2018 and leading indicators point to further slowing in the second half of the year.
- The Bank of Canada remained sidelined since its January interest rate hike although it strongly suggested that an early third quarter increase is likely.
- Bilateral trade agreements are being negotiated —while the U.S. is shutting down its trade borders, China has been opening them with its Asia Pacific Trade Agreement.

### Investment Outlook

- Rising trade tariffs and protectionism will impact the global supply chain which now dominates international trade.
- Continued economic and currency strength in the U.S. will lead to increased funding concerns for emerging economies.
- The environment for financial assets is becoming more uncertain, a carefully selected portfolio of high quality stocks and bonds will provide the necessary ballast for the potentially more turbulent environment ahead.

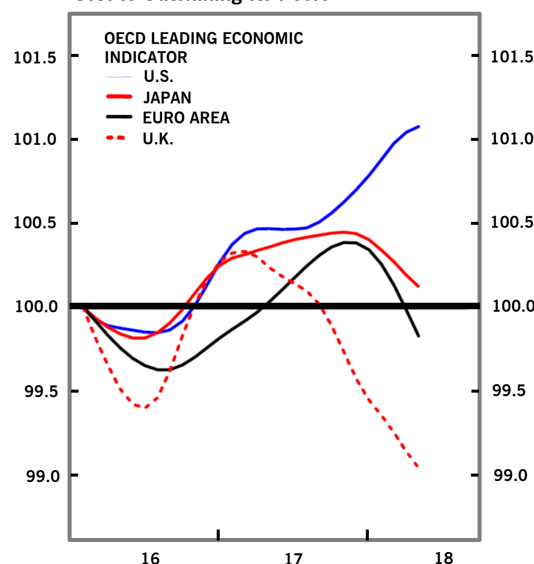
## ECONOMIC REVIEW

Following the brief period last quarter in which cash outperformed, equities came back with positive returns in the second quarter, except for the notable weakness in emerging markets. Economic momentum slowed and leading indicators point to further slowing in the second half of the year. Continued withdrawal of central bank liquidity and the increased threat of trade tariffs contributed to the uncertainty. There is, however, an expectation by investors that weaker growth and increased uncertainty will be offset by pauses or even reversals in the central banks' efforts to unwind years of accommodative policies. Among global markets, the Canadian equity market posted strong returns while emerging markets were the worst performing. Bond market gains were held back by continued interest rate increases by the U.S. Federal Reserve which pushed short-term interest rates higher.

Global growth has become less synchronized— the U.S. is the only major economy that continues to experience rising leading economic indicators. Emerging markets, in particular, are feeling the pressure from rising U.S. interest rates, a rising US dollar and trade tariffs, with the addition of a collapse of the World Trade Organization being an outside threat. China's economic growth rate has weakened recently and, unlike in previous downturns, the bar to further stimulus is placed high as the government is now more focused on reducing debt levels, excess capacity and pollution than on obtaining growth at any cost. We hesitate to group all emerging markets together as some of their constituents have economies that are driven by country-specific decisions, such as China (now the second largest economy in the world), whose prospects are no longer dictated by commodity prices. Mexico, for example, is an importer of oil and exporter of refined oil products. However, with 80% of emerging market foreign currency debt denominated in USD, continued strength in the US dollar will lead to increased funding concerns for some emerging economies

European growth has also turned weaker with a level of uncertainty being induced by the new Italian government coalition, resurrecting concerns about the frailty of the eurozone structure. Italy continues to be weighed down by an ageing population, excessive debt and an uncompetitive economy. Germany, on the other hand, is very competitive at the current exchange rate and, as a result, is one of the largest net exporters in the world. Without exports the prospects for European growth would be much more modest. This structure limits the ability of the European Central Bank (ECB) to tighten, much like the Bank of Japan in the last 30 years. If the ECB raises interest rates, the currency strengthens and hurts exports on which the European Union (EU) is much more dependent than most countries. The problem could be mitigated by easier fiscal policy, but Germany is notoriously conservative on that front. Germany has an incredible 8% current account surplus, and as long as problems with immigration, Italian solvency and President Trump's bellicose trade pronouncements continue, there will be persistent pressure for it to loosen policy. Naturally, the Canadian economy is very exposed to trade tariff risks, with exports at 30% of GDP and three quarters of that with the United States. Bilateral trade agreements are being negotiated, particularly with China, and the recently signed agreement with the EU was timely. More broadly, while the U.S. is shutting down trade borders, China has been opening them with its Asia Pacific Trade Agreement signed in 2017.

**U.S. Is Outshining Its Peers**




Source: OECD (Organization for Economic Co-operation and Development)

## BOND MARKETS

Bond market returns were modest as the rise in interest rates offset much of the interest income. Central banks' continued push to normalize interest rates weighed on sentiment particularly as the weaker economic data out of China and Europe surfaced. The bulk of the rising interest rate pressure was felt in the short maturities where the central banks' influence is the strongest. Long maturities were more focused on the weakening economic momentum and therefore saw very small yield increases and, in some cases, like Canada, even small declines. The Bank of Canada remained sidelined since its January interest rate hike although it strongly suggested that an early third quarter increase was likely. The U.S. Federal Reserve (the Fed) continued its methodical campaign to raise interest rates, adding another 0.25%. There were some expectations that with the difference between the 2-year and 10-year Treasury below 0.5% the Fed may pause so as not to create an inversion in the yield curve. We doubt this will occur as the Fed is very close to achieving its mandated inflation target and the unemployment rate is near 50-year lows. German and French yields declined as the uncertainty surrounding the impact of the new Italian coalition government and its fiscal policy intentions re-instilled a risk premium to the market.

Corporate bonds continued their more recent trend of underperforming federal government bonds. Valuations have been at the high end of historical levels, and with the increased uncertainty for global growth there was very little cushion to absorb increased investor uncertainty. Strong new issuance supply also weighed on the market as corporate issuers continue to take advantage of historically low interest rates to lock in long-term funding.

**Market Returns (as at June 30, 2018)**

| (%) | 3M | 1 Yr | 5 Yrs | 10 Yrs | 15 Yrs |
|---|---|---|---|---|---|
| S&P/TSX | 6.8 | 10.4 | 9.2 | 4.2 | 8.7 |
| S&P 500 (C$) | 5.5 | 15.8 | 18.5 | 13.1 | 9.1 |
| S&P 500 (US$) | 3.4 | 14.4 | 13.4 | 10.2 | 9.3 |
| Russell 2000 (US$) | 7.8 | 17.6 | 12.5 | 10.6 | 10.5 |
| DJIA (C$) | 2.7 | 15.1 | 15.2 | 10.7 | 6.6 |
| DJIA (US$) | 0.7 | 13.7 | 10.2 | 7.9 | 6.9 |
| MSCI EAFE Net (C$) | 0.7 | 8.1 | 11.2 | 5.5 | 7.0 |
| MSCI EAFE Net (US$) | -1.2 | 6.8 | 6.4 | 2.8 | 7.3 |
| MSCI Emerging Mkts (US$) | -7.9 | 8.6 | 5.4 | 2.6 | 11.1 |
| FTSE TMX Canada Universe | 0.5 | 0.8 | 3.5 | 4.5 | 4.7 |
| FTSE TMX Canada 91 Day T-Bills | 0.3 | 1.0 | 0.8 | 0.9 | 1.7 |
| C$/US$ | -2.0 | -1.3 | -4.3 | -2.6 | 0.2 |

Converted to CAD using London 4pm rates. Returns are annualized for periods greater than one year.

## EQUITY MARKETS

The rally in energy prices pushed energy stocks to double-digit gains in the quarter. Canada benefitted disproportionately, being one of the heaviest energy-weighted indexes in the world with the S&P/TSX at 20%. The 2% decline of the Canadian dollar against the U.S. dollar also boosted foreign equity market returns for Canadian investors. The Health Care and Technology sectors were also strong performers with biopharma stocks rallying on relief that some of the U.S. drug pricing changes were not as bad as feared. Trade tariffs and overall political uncertainty surrounding long-standing world trade structures contributed to a change in sentiment for emerging market stocks. Emerging markets declined by almost 10%, albeit following the recent period of strong absolute performance. Financials and Utilities were the weakest sectors as concerns about rising interest rates negatively impacted investor sentiment.

## INVESTMENT STRATEGY

Many countries are facing increasing societal pressure to move from an environment that encourages wealth accumulation to one that encourages wealth distribution. The impact on financial markets can be seen in many ways but broadly speaking it tends to be negative for overall corporate profits. Rising trade tariffs, or protectionism, will impact the global supply chain which now dominates international trade. A smartphone may be designed in the U.S., manufactured in any number of countries, with the software coded from sources around the world before it shows up in our stores. Almost half of the S&P 500 company revenues come from overseas markets. If the trend for global trade turns negative we will have lost one of the secular drivers for disinflation and increased corporate profits over the past few decades. Even the Fed's willingness to come to the rescue of financial markets may be tinged with an element of addressing inequality as the Fed's stimulus actions tend to favour the largest owners of financial assets, i.e. the wealthy. In addition, the Fed is now facing an environment where it is very close to having reached its inflation target, which makes further easing measures difficult to justify even if financial markets turn down. On the positive side of the liquidity ledger, the instability in Europe, owing to the uncertainty with Italy, suggests that the ECB will be reluctant to raise interest rates even though it announced the end of its Quantitative Easing program by early 2019. As mentioned in our previous Investment Outlooks, the environment for financial assets is becoming more uncertain, and the ability of policymakers to help is less obvious. A carefully selected portfolio of high quality stocks and bonds will provide the necessary ballast for the more turbulent environment that we expect.

All returns are expressed in Canadian dollars unless otherwise indicated.

Sources: TD Securities, S&P and Bloomberg. This document is prepared for general circulation to clients of Jarislowsky, Fraser Limited (JFL) and is provided for information purposes only, it is not intended to convey investment, legal, tax or individually tailored investment advice. All opinions and estimates contained in this report constitute JFL's judgment as of the time of writing and are provided in good faith. All data, facts and opinions presented in this document may change without notification. This is not a solicitation for business. Past performance is not a guide to future performance. Future returns are not guaranteed. No use of the Jarislowsky, Fraser Limited name or any information contained in this report may be copied or redistributed without the prior written approval of JFL.