HIGHLIGHTS

Economic Review

- Despite strong economic fundamentals market volatility persisted in 2018.
- Global equity markets tumbled and government bond markets rallied in the fourth quarter.
- Most countries are seeing declining leading economic indicators, which suggests a further slowdown in global growth next year.

Investment Outlook

- We expect positive equity market returns in 2019, albeit within the context of an environment that is showing increasing signs of being late cycle in character, and therefore volatile.
- A conservative, high-quality, sustainable investing philosophy should prove to be increasingly more valuable.

ECONOMIC REVIEW

US economic growth was an outlier in 2018, improving on 2017's pace, and in contrast to other developed economies. This likely gave its politicians the confidence to more aggressively challenge its trade relationship with China, and the Federal Reserve (Fed) the support to continue to raise interest rates. In the short term, markets can trade more on investor confidence than on underlying business fundamentals. Shake that confidence with talk of trade wars, yield curve inversions, central bank policy missteps, oil price declines and Chinese debt bubbles, and markets often temporarily ignore the economic fundamentals. Indeed, global equity markets tumbled and government bond markets rallied in the fourth quarter, without a material change in our outlook for economic growth.

Although US economic growth has slowed from the 4% peak reached earlier in 2018, we are still seeing solid employment growth, strong projections for the manufacturing and service sectors and generally easy financial conditions. A pullback in growth is to be expected, however, as fiscal stimulus is removed. Nonetheless, growth in 2018 should approximate 3%, up from 2.2% in 2017. This also compares favourably with the widely estimated 2% trend growth rate. Canada's growth rate, on the other hand, looks more similar to that of the global economy as a whole, which saw weaker growth in 2018. Canada is likely to register close to 2% growth for 2018, compared to 3% in 2017. Weakness was concentrated in the energy sector, which suffered from a decline in both global and Canadian oil prices as transportation bottlenecks continue to restrict Canadian supply from getting to international markets. Outside North America, growth was also weaker with the euro-zone likely to post 2% (down 0.4%) and China 6.6% (down 0.3%) growth in real GDP. China's goal of deleveraging its financial system and moving towards a consumption-based economy is not favourable for the global growth outlook, and much hinges on its ability to carefully manage the process. Most countries are now experiencing declining leading economic indicators, which suggests a further slowdown in global growth next year.

Outside of economic fundamentals, markets were buffeted by the ongoing China-US trade war and the approaching denouement of the Brexit saga. The Fed and, to a lesser extent, the Bank of Canada, contributed to heightened volatility as they backtracked from the hawkish path they were on early in the quarter. US financial conditions, i.e. the combination of interest rates, credit spreads, equity market and exchange rate movements, progressed notably higher (tighter) in the quarter. If the tightening in financial conditions persists, it could knock US growth down by 0.75-1% in 2019. The fact that the Fed pushed ahead with another interest rate increase in the quarter, seemingly ignoring the fact that financial conditions in the aggregate may have already done the tightening for them, only added to the equity market uncertainty.

One of the most reliable leading indicators, the yield curve, continued to flatten its slope, although we would point out that most of the move was due to the decline in the bond market's term premium. This is the extra yield that investors demand for locking in their investment for a longer period of time, as opposed to rolling short-term fixed income investments over the same time period. Historically, the extra yield offered to investors for buying a long-term government bond, instead of a series of short-term bonds, has been positive, whereas today it is -0.6%. Since 1950, the only time an inverted yield curve gave a false recession signal was in the mid-1960s, when the term premium was also at historically low levels. Flattening and flat yield curves have been associated with positive equity market returns in the past, as shown in the table below.

S&P 500 Price Performance

Yield curve broke below 50 bps	Date of inversion	Date of trough	From 50 bps to inversion	From 50 bps to trough
October 1977	August 1978	March 1980	12%	11%
August 1980	September 1980	December 1980	3%	11%
September 1988	January 1989	March 1989	9%	8%
December 1994	June 1998	April 2000	147%	216%
May 2005	January 2006	November 2006	7%	18%

Source: Charles Schwab

BOND MARKETS

Bond markets rebounded strongly from the negative third quarter, posting a return of 2.0% in Canada and 7.4% in the United States (both denominated in CAD). The Fed and the Bank of Canada continued to raise the overnight rate to 2.5% and 1.75%, respectively. The impact of these interest rate hikes was overshadowed by the weaker financial market environment and the obvious change in tone to the central bankers' communications. The Fed went from suggesting that interest rates were "far from" to "near to" the neutral range, while Bank of Canada Governor Stephen Poloz was forced to temper his earlier hawkish comments. The European Central Bank announced the previously telegraphed end to its asset purchase program but maintained its dovish tone by keeping the overnight rate at -0.4%.

The 10-year Canadian government yield declined by approximately 0.46% in the quarter while the 2–year equivalent yield was only 0.35% lower, flattening the yield curve as equity markets sold off. Corporate bonds significantly underperformed federal government bonds globally as investor confidence was shaken. It is becoming more evident that we are late in the credit cycle, as we can now add increased market volatility to a backdrop of deteriorating credit fundamentals.

Market Returns (as at December 31, 2018)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	-9.9	-8.9	4.1	7.9	6.7
S&P 500 (C$)	-8.7	4.2	14.1	14.3	8.2
S&P 500 (US$)	-13.5	-4.4	8.5	13.1	7.8
Russell 2000 (US$)	-20.2	-11.0	4.4	12.0	7.5
DJIA (C$)	-6.9	2.9	12.6	11.5	5.9
DJIA (US$)	-11.8	-5.6	7.1	10.3	5.5
MSCI EAFE Net (C$)	-7.7	-6.0	5.7	7.4	5.1
MSCI EAFE Net (US$)	-12.5	-13.8	0.5	6.3	4.7
MSCI Emerging Mkts (US$)	-7.4	-14.2	2.0	8.4	8.3
FTSE TMX Canada Universe	2.0	1.6	3.6	4.2	4.6
FTSE TMX Canada 91 Day T-Bills	0.5	1.4	0.8	0.8	1.6
C$/US$	-5.4	-8.3	-4.9	-1.0	0.3

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

EQUITY MARKETS

Equities had one of their worst quarters in recent years as investor confidence exhibited its fragile nature. Markets were hit with the sinking realization that reshaping trade relationships with a rising political and military power such as China will be a long and tortuous affair. This dynamic hurt technology companies in particular, as most have some linkage with China from an end-demand or component manufacturing perspective. Calls for enforcement of antitrust legislation and issues surrounding data privacy also weighed on the technology sector. Declining oil prices were feared to be a sign of slowing global growth, although that relationship is spotty. Much was also made about an inversion of the 2- to 5-year section of the US yield curve as a signal of rising recessionary risk. However, the 3-month to 10-year yield curve is the gold standard for forecasting recessions. Even if it were inverted —it currently stands at roughly 0.28%— it would only project a recession about two years hence, based on modern standards.

Emerging markets stabilized, and in some cases, such as Brazil, strongly outperformed developed markets**.** Emerging markets continued to face a more challenging external environment with higher interest rates and trade tensions. However, the decline in oil prices provided some relief to energy importing countries.

Recession Period	Going below, and staying below, 50 bps	Inversion Date	Time to Recession
Jan.1980 - July 1980	4/17/1978	8/18/1978	16 months
July 1981 - November 1982	8/18/1980	9/12/1980	10 months
July 1990 - March 1991	9/26/1988	12/13/1988	19 months
March 2001 - November 2001	3/20/1997	5/26/1998	22 months
Dec. 2007 - June 2009	5/19/2005	12/27/2005	24 months

Source: NBER

INVESTMENT OUTLOOK

Central bank tightening actions are usually late cycle moves, and the risk of overtightening, causing a recession, is ever present. Typically there are imbalances that have built up during the low interest rate environment, and they are exposed when interest rates rise. Warren Buffett's quip that "you only find out who is swimming naked when the tide goes out" is appropriate for this late cycle environment. Elevated profit margins, market valuations, leverage and consumer confidence are signs that we are late into the business cycle, in addition to the flattening yield curve, rising credit spreads and low unemployment rates.

Currently, the Fed believes that two more interest rate increases of 0.25% will be necessary in 2019 while fixed income markets are pricing in almost no chance of an increase, partly in response to stumbling equity markets. In the Fed members' minds, the current economic momentum suggests that the unemployment rate will fall further and contribute to rising wage pressures in 2019. The pace of Fed rate hikes has been gradual, but now that the Fed Funds rate is close to the neutral range of 2.5-3.5%, the Fed has become "data dependent", which means less predictable. Equity markets are typically somewhat insulated from this risk, as stronger than expected growth should boost confidence in profits. Today's markets, however, are exhibiting an unusual lack of confidence, with the US market having reached the official definition of a bear market —a 20% decline— during the fourth quarter. This contrasts with the typical end-of-cycle environment where we have historically seen second quintile performance for equity bull markets.

There is no doubt that the stakes have risen for central banks, and consequently for financial markets, as we enter the latter stages of the business cycle. Central banks have enjoyed the hard fought benefits of having anchored inflation expectations over the past four decades. Those expectations are likely to be tested as the US unemployment rate drives further below its estimated non-inflationary level and US politicians talk of more fiscal largesse. China continues to represent a substantial risk to the global economy, and its willingness to stimulate demand will be closely monitored. We expect positive equity market returns in 2019, albeit within the context of an environment that is showing increasing signs of being late cycle in character, and therefore volatile. A conservative, high quality, sustainable investing philosophy should prove to be increasingly more valuable within this context.

All returns are expressed in Canadian dollars unless otherwise indicated.