JARISLOWSKY FRASER

GLOBAL INVESTMENT MANAGEMENT

INVESTMENT OUTLOOK
Q1 2019

HIGHLIGHTS

Economic Review

- Stock markets rebounded sharply during the first quarter of 2019 as central banks shifted to a market-friendly policy stance and corporate earnings were generally stronger.
- Growth stocks shifted back into favour during the quarter with technology and other pro-cyclical sectors leading the way.
- The yield curve inverted which tends to be a leading indicator for an economic slowdown. However, we are skeptical of this signal for the current business cycle due to the distortion in longer term yields caused by central bank purchases.

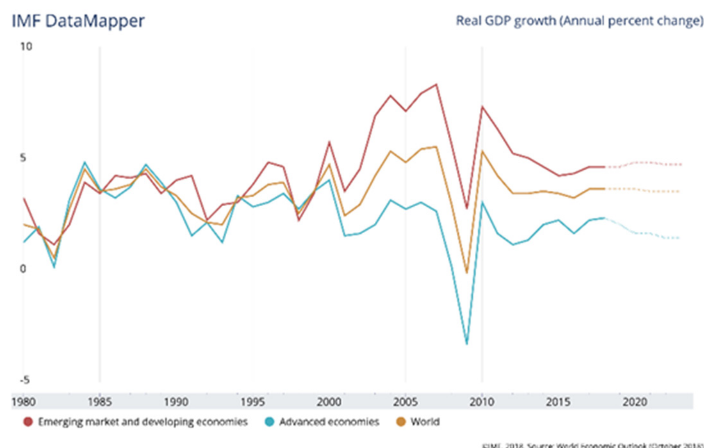
Investment Outlook

- Central banks are signaling their intention to keep short-term interest rates lower which leads us to remain optimistic on the likelihood of global growth surpassing expectations.
- Geopolitical risks remain top of mind looking forward with China's continued debt expansion, ongoing Brexit hearings, and trade negotiations between China and the U.S.
- Constructing a conservative top-quality portfolio should prove to be progressively valuable during these continued uncertain global conditions.

ECONOMIC REVIEW

Financial markets proved yet again that they are more volatile than underlying economic fundamentals. How else can we reconcile the magnitude of the strong gains in stock and bond markets against the continued weakness in global growth? The International Monetary Fund estimates that after rising 2.3% in 2018, the developed economies will grow by 2.0% in 2019, primarily due to a tightening in financial conditions. The U.S. Federal Reserve (the Fed) and Bank of Canada were both on the path toward interest rate normalization, while the European Central Bank (ECB) was attempting to get itself out of the asset purchasing business. In addition, China was slowing its unhealthy debt expansion and heightened geopolitical risks related to the U.S.-China trade negotiations and the Brexit process further raised concerns for economic growth. The United States also suffered from a temporary federal government shutdown and a bout of colder than normal weather.

Some of these negative influences are temporary, such as the government shutdown, the end of which will contribute to a bounce-back in activity, while others are more structural.

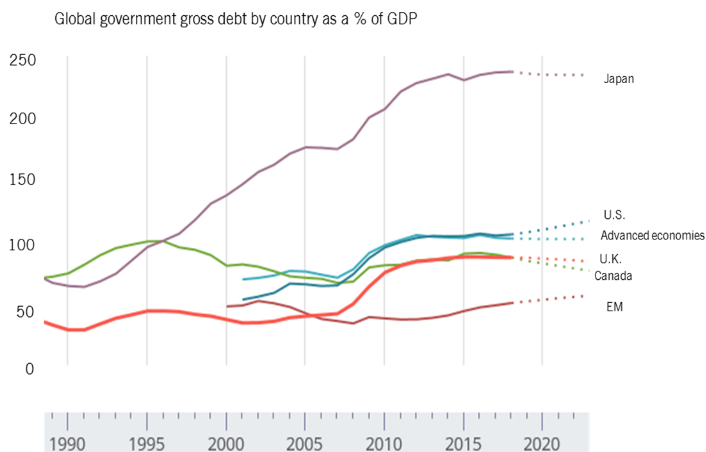


One of these is the growing level of government debt. How can interest rates on U.S. federal bonds remain so low while the U.S. government keeps growing its debt at a rate of more than $1 trillion per year? How can we have 0% interest rates for Japanese federal bonds compared to 3% in Italy, when the Japanese government has a 250% debt to GDP level while Italy's is below 150%? The big difference between the U.S. and Japanese situation and that of Italy is that all of the borrowing that the U.S. and Japanese governments do is in their own currency while the Italian government must borrow and repay its debt in euros. In addition, the U.S. and Japanese governments control the printing press while Italy does not. However, if the Japanese government is borrowing at such high levels shouldn't investors demand higher interest rates, given the increased supply and default risk? Not if the government gets its central bank to buy the debt, i.e. monetizes it, and also if there is no default risk. As to the second point, technically there is no default risk for a sovereign country borrowing in its own currency. They may choose to default but that is purely a political decision. Italy gave up the right to print liras when it joined the European monetary union and could therefore default if no longer able to finance themselves. Italy does not control the ECB and cannot borrow in liras any more.

For now the ECB is facilitating Italy's ability to borrow at relatively low rates. If they do not cut spending, a vicious cycle of higher rates, higher borrowing costs and higher debts could occur. The ECB's incentive is to make sure the whole euro-zone project stays afloat; if the cost of remaining in the euro-zone rises, you will get more countries that will attempt to leave. For now Italy is at the mercy of Brussels and the ECB, if it wants to make sure its borrowing costs do not spiral out of control it has to live by the euro-zone budget rules.

The U.S. and Japanese central banks are part of the same government apparatus. This does not mean they get a "free lunch", as their ability to spend is capped by inflation expectations. Spend beyond the economy's resource capacity and you will get inflation. Using that framework in Canada, we don't worry about the federal government's ability to spend as they do not have a balance sheet

constraint like normal individuals do. However, we do focus on the risk of rising inflation when its spending is excessive relative to the economy's potential. In addition, we do worry about provincial spending excesses as the provinces do not control the printing press and could end up defaulting on their own debt. Currently those risks are modest for Canada.



BOND MARKETS

Interest rates continued to decline in the first quarter. The main influence was the pivot to a more dovish stance by most central banks in response to continued weakness in global growth. The Bank of Canada and the Fed had previously stated, in their justification for interest rate increases last year, that they had become more data dependent. The impact on the bond market from the relatively abrupt shift from stronger to weaker economic data has been amplified by the central banks' data dependency policy framework. We now have the potential for central banks to abruptly shift policy direction and thereby accentuate asset price volatility. Implicit in the shift by the Fed is a prioritization of economic growth over inflation in terms of policy goals. The ECB backed away from previous intentions to normalize policy and even took a step further, extending its bank loan facility for another two years.

With central banks signaling their intention to keep short-term interest rates lower, longer investors moved into longer maturities as well as corporate bonds, grabbing whatever yield they could. During the quarter, the Canadian 10-year government yield declined by 0.34% while BBB-rated 10-year bonds declined even more and thereby outperformed government bonds. Provincial bonds also outperformed government bonds. The yield curve inverted during the quarter which, if maintained for three months, historically would suggest a recession in 12 to 18 months. The track record as a leading recession indicator is more robust in the U.S. than Canada. Our analysis has caused us to somewhat downplay the importance of the indicator in this business cycle due to the distortion in longer term yields caused by central bond purchases over the last ten years.

Market Returns (as at March 31, 2019)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	13.3	8.1	5.4	9.5	7.2
S&P 500 (C$)	11.2	13.5	15.2	16.6	8.7
S&P 500 (US$)	13.7	9.5	10.9	15.9	8.6
Russell 2000 (US$)	14.6	2.0	7.0	15.4	8.0
DJIA (C$)	8.7	11.5	13.8	13.7	6.5
DJIA (US$)	11.2	7.6	9.5	13.0	6.3
MSCI EAFE Net (C$)	7.6	-0.2	6.3	9.6	5.2
MSCI EAFE Net (US$)	10.0	-3.7	2.3	9.0	5.1
MSCI Emerging Mkts (US$)	10.0	-7.1	4.1	9.3	8.3
FTSE TMX Canada Universe	3.9	5.3	3.8	4.4	4.7
FTSE TMX Canada 91 Day T-Bills	0.4	1.5	0.8	0.8	1.6
C$/US$	2.2	-3.5	-3.8	-0.6	-0.1

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

EQUITY MARKETS

Equity markets rebounded strongly from one of their worst quarters in recent years. Growth stocks were in favour, with the technology sector leading in most global markets along with other typically pro cyclical areas. Given a somewhat mixed economic picture, the strength of the rally had some scratching their heads as to what provided the impetus. A more dovish tilt from the Fed was a key factor, and, as we have increasingly seen, monetary policy has tended to be a key determinant in aggregate equity market sentiment and performance. Optimism around a U.S.-China trade deal also served to boost confidence, with the market seemingly hanging on every "tweet" around progress. Corporate earnings, while perhaps not overly robust, were generally stronger than expectations rebased lower in the previous period. Oil prices also recovered, with a renewed commitment on supply discipline from OPEC and its partners. While not always consistent, equity markets and oil prices tend to move in similar fashion, except at the very extreme. Geopolitical noise also lessened, with the fears of a "hard Brexit" receding. All of these factors seemingly paved the way for a broad-based risk-on quarter.

Technology was a standout sector in most markets, with the NASDAQ (+14%) and other tech-heavy indexes leading globally. The S&P/TSX also posted solid returns (+13%), with the Energy sector following a strong move upwards in global crude oil prices (+27%). Europe also posted a reasonable recovery, while Japanese stocks were laggards in a global context. Emerging market returns were varied, though Chinese indexes rallied strongly on the back of notable moves in the Consumer Discretionary and Technology sectors. Conversely, the Financial sector was a laggard in most markets given the decline in benchmark rates and a flattening of the U.S. yield curve.

Consensus thinking now seems to accept that a U.S.-China trade deal will come easily, that neither inflation nor deflation is of major concern, that rates will likely stay low and range bound for a significant period of time and that it will likely be a significant

amount of time before we see a recession. We see a good portion of this thinking reflected in equity market valuations, and as such there could be some vulnerability if any of these factors fail to materialize.

INVESTMENT OUTLOOK

Markets experienced an unusual occurrence as all financial assets have rallied, i.e. equities and corporate and government bonds all posted gains for the quarter. Equity markets have moved from what was quite pessimistic to somewhat optimistic sentiment. In these instances the underlying driver tends to be more technical than fundamental.

The central banks' shift back to a market-friendly policy stance was the technical driver that explained the concurrent rally in stock and bonds. The central banks have essentially extended the business cycle at the risk of a longer-term inflation overshoot. Global growth should therefore beat expectations in light of easier financial conditions. China's credit growth slowdown has stabilized, the euro-zone will benefit from increased fiscal stimulus, and more countries are seeing improving leading economic indicators than not.

The central banks have already tipped their hand, showing that they will be in no rush to resume policy tightening should growth pick up. Whereas they were previously seen as preempting a future rise in inflation, now they are suggesting that they will need to see the "whites" of inflation's eyes before tightening policy. In effect they have traded in short-term gain for possible long-term pain, as historically the inflation cycle lagged the growth cycle. However, we do not believe that they can extend easier financial conditions for long because by the time inflation problems surface, the economy is already slowing and the central banks would be forced into tightening in order to maintain their inflation fighting chops. They fought very hard to anchor inflation expectations at relatively low levels over the last four decades and would not want to lose that credibility.

As previously mentioned, the environment is becoming more volatile and expectations for future returns should be adjusted accordingly. Our strength in identifying and selecting top-quality business at attractive valuations should help our clients withstand the short-term uncertainties, protect portfolios on the downside, and add value over the long-term.

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.