2019 Second Quarter Review

"Keep On Keepin' On." - Bob Dylan

After four months of consecutive gains, most stock markets slipped in May, only to stage an impressive comeback in June. Concerns over protectionism and global growth lingered but, at June's end, the expectation of lower US interest rates as soon as July, which would boost growth, outweighed other concerns - at least in the near term. Given ongoing uncertainties surrounding trade wars**,** however, not to mention rising geopolitical risks**, we remain cautious heading into the second half of 2019**.

Canadian equities, as measured by the S&P/TSX Composite, were up an impressive 2.6% last quarter and 16.2% year-to-date. **Trade worries remained, specifically with Canada's main trading partners - the US and China**. Whereas progress with the US led to tariffs coming off our steel and aluminum exports, relations with China deteriorated further, resulting in a punitive ban on all Canadian meat and canola shipments. Still, the latest GDP report (April) was up 0.3%, leading the Bank of Canada (BoC) to hold interest rates steady at 1.75% - a neutral stance for now.

The US equity market rally resumed after its May hiccup in the face of some mixed economic signals: home sales and consumer confidence fell in May; consumer spending was stronger. Notably, in their June comments, the Federal Reserve (the Fed) cited **subdued global growth and deteriorating business sentiment** as issues to monitor. With that, the prospect of a July interest rate cut became more likely. And, even though a US/China trade deal is not imminent, investors were encouraged that both sides agreed not to implement additional tariffs. The US stock market, as represented by the S&P 500, was up 2.2% (CAD) for the quarter and 13.7% (CAD) year-to-date.

On the international front, **political disarray in the UK continued**: **with no Brexit deal** happening, Theresa May resigned. Her likely successor as prime minister is Boris Johnson, who casually entertains the threat of a no-deal Brexit - an outcome most experts believe could be devastating. **China's trade truce with the US** led most analysts to stick with their 6% Chinese growth target, **calming investor sentiment**. International developed markets rose 1.6% (CAD) last quarter; emerging markets declined 1.4% (CAD).

With some global interest rates hovering near 0% (in major markets) and more about to move lower, bond yields have fallen (prices have risen) this year. Investors seeking yield have been turning to riskier corporate debt. Also, in the environment of inverted yield curves (short rates higher than long rates), the **incentive to hold longer maturities has weakened**. For example, the 10-year US Treasury bond currently yields approximately 2.1% compared to the 3-month US T-bill at about 2.2%. Short-term Canadian bonds fared well, with the FTSE Short-Term Bond Index returning 2.7% year-to-date.

Following are the returns for major indices for the period ended June 30th, 2019:

	2nd quarter actual	YTD actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.4	0.8	1.6	1.0	0.9	0.8
Canadian Bonds (FTSE Short Term Bond)	0.9	2.7	4.1	1.5	1.9	2.5
Canadian Stocks (S&P/TSX Comp.)	2.6	16.2	3.9	8.4	4.7	7.8
U.S. Stocks (S&P 500)	2.2	13.7	10.0	14.4	15.3	16.1
Non-North American Dev. Stocks (EAFE)	1.6	9.4	0.7	9.2	6.5	8.2
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-1.4	7.3	2.3	9.6	6.5	7.1

* 2nd quarter, YTD, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard

Outlook

"For the times they are a-changin'" - Bob Dylan

For many months now, it's clear that the Fed's stance on US monetary policy, along with US-related trade concerns, have been the **two main factors influencing the direction of global stock markets**. As we enter the second half of 2019, it's no surprise that we expect US interest rate policy to continue as a major market influencer, with investors engaging in perpetual "Fed watch". Likewise, there is no doubt much-hoped-for progress on US/China trade negotiations will remain on the radar screen as well. A more recent worry surrounds the escalating tense rhetoric between the US and Iran, which is currently making headlines. Any flare-up could certainly lead to some near-term market volatility.

Regarding the Fed, in June they said they'd "act as appropriate" to ensure that the US economic expansion, now the longest in history, would continue. After their having **raised rates four times in 2018**, economists anticipate the Fed **will cut rates as soon as this month**, with more to follow in the months ahead and possibly into next year. The timing and magnitude of any cuts will depend on the most current economic data, which have been mixed so far in Q3.

Despite the expected benefit of lower interest rates, there is a worry that the current stock market rally may peter out in the back half of 2019. That's because, due to the weakening economic backdrop, the **current outlook for earnings is generally poor**. It is no secret that corporate earnings and stock prices tend to be positively related over the long term. With that in mind, there is only so much lower interest rates can do to boost stock prices. Ultimately what is needed is a remedy to the harmful trade barriers which continue to hamper corporate profitability globally.

Typically when the Fed lowers interest rates, the BoC follows suit. However, somewhat rosy Canadian data on business sentiment, employment and GDP growth suggest that a **corresponding BoC cut in rates may not be in the cards until later this year**. In the oil patch, Albertans are cautiously optimistic that June's federal approval of the Trans Mountain pipeline expansion is a step in the right direction for our oil industry. The US/Iran situation may impact energy markets too. That said, the Canadian economy is still battling a slowdown in the housing market and exporters are dealing with the fallout from the ongoing trade dispute with China, not to mention a stronger CAD. And the upcoming federal election will garner plenty of media attention this summer, although we do not expect its outcome to have any lasting impact on domestic markets.

In Europe, conditions this year have improved, with household spending higher as a result of falling unemployment and a welcome uptick in the pace of wage growth. However, trade relations with the US remain sour and Brexit is still undecided, both of which are contributing to a slowdown in exports, manufacturing and investment. The European Central Bank (ECB) is working through its process of replacing retiring president Mario Draghi, most probably with Christine Lagarde, currently head of the International Monetary Fund (IMF). This appointment would signal the **likelihood of more monetary easing for the euro zone** as it deals with slow global growth, the prolonged Brexit saga and protectionism.

With central banks poised to reduce rates and investors seeking opportunities with higher return potential, **the outlook for emerging markets stocks appears to be enhanced**, it being an asset class where yields are not so depressed.

Portfolio Strategy

As discussed, declining interest rates and increasingly dovish comments from central banks have been the primary catalysts for the strong stock market returns year-to-date. Equity investors are clearly hoping for a return of the **“Goldilocks” scenario**, whereby the global economy continues to grow at a modest pace without the prospect of rising interest rates or inflation.

While this scenario is favourable for stocks, it may be less so for fixed income investments going forward. Five-year Government of Canada bonds now yield only 1.5%. This presents a challenging environment for conservative investors who cannot tolerate much volatility in their portfolios but who also need to generate cash flow and return. In order to accomplish this and, only if their individual circumstances warrant it, we may **modestly increase exposure to high-dividend-paying Canadian companies**, either through individual stock holdings or dividend exchange-traded funds (ETFs), as an **alternative to fixed income**. Such holdings are high quality with below-average volatility compared to the overall Canadian stock market, and the objective is to provide a higher rate of return than bonds and GICs will over time, rather than necessarily outperforming the broad Canadian market.

For fixed income holdings themselves, we continue to **focus on shorter-term issues** in the one-to three-year range, given the decline in yields. We may also use proceeds from maturities to add to a new **DFA Global Fixed Income Fund**. Within the equity component, we continue to rebalance when needed, which often involves a reduction in US equity holdings, given their strong outperformance over the past several years.

In summary, short-term market volatility may well be a factor in the months ahead. Much like the first half of 2019, it is likely to be **connected to two factors**. First, changing **US interest rate policy** - when, and by how much, will the Fed cut rates? The current consensus is for two rate cuts in 2019: any deviation could unsettle markets in the short term. Second, is a meaningful change, at least in tone, to be achieved in **ongoing trade disputes**? This question is specific, but not limited, to the US and China. Markets will be very sensitive to any progress, or lack thereof, in global trade negotiations.

As always, our advice to investors is a familiar one: holding a well-diversified, global portfolio is the most effective way to not only survive, but to thrive in a world of inevitable uncertainties.