## 2019 Third Quarter Review

**"Clowns to the left of me, Jokers to the right…." - J. Egan G. Rafferty**

**Global markets continued to experience volatility throughout the third quarter**, primarily due to renewed recessionary fears and flare-ups in the US-China trade negotiations which impact many economies. In the month of August alone, the S&P500 moved more than 1% (up or down) 11 times in 22 trading sessions. At quarter end, most markets finished in positive territory with investors being somewhat mollified by two factors: the US and China agreed to delay additional tariffs and, in mid-September, the US Federal Reserve (the Fed) lowered interest rates for a second time in less than three months.

Canadian stocks fared well with the S&P/TSX Composite Index returning 2.5% for the quarter and 19.1% year-to-date because the **Canadian economy seemed quite resilient in view of the weakening global landscape**. Some recent data was stronger than anticipated with better wage growth and improving housing markets. On the other hand, consumer and business spending softened, resulting in somewhat mixed economic signals. The Bank of Canada held interest rates steady but noted they stand ready to adjust if necessary.

In the US, controversy regarding President Trump's contact with Ukraine prompted the Democrat-held House to start an "impeachment inquiry", a first step in the impeachment process. Even though the Republican-held Senate would probably not convict him (i.e., remove him from office), these proceedings introduced another element of **uncertainty to markets - and more volatility**. At the same time, a US-China trade deal was not imminent, although talks were reportedly ongoing. These factors prompted the Fed to cut interest rates (twice) for the first time since 2008, helping US equities, as measured by the S&P500, to finish up 2.9% (CAD) for the quarter and 17.0% (CAD) year-to-date.

In Europe, the focus was mainly on the negative effects of the Brexit intransigence. With a month to go before the October 31st deadline, few thought UK Prime Minister Boris Johnson's latest proposal would pass muster with the EU, let alone his parliament, making a further Brexit extension of Article 50 almost inevitable. In Asia, Chinese stocks slipped over the deadlocked US-China trade dispute even as both sides claimed to be "optimistic" about a resolution. Meanwhile, **punitive tariffs continued to weigh down global trade**. International developed markets were up only 0.1% (CAD), and emerging markets declined 2.4% (CAD) last quarter.

As interest rates kept falling, bond investors sought shorter maturities. We must note that for the first time in 12 years, the US 10-year yield fell below the 2-year yield, resulting in a so-called **"inverted" yield curve**. Historically, this has often foreshadowed a recession. Only time will tell if this is a false signal or not, but investors holding bonds have already done well as a basket of short-term Canadian government issues have returned 3.0% year-to-date.

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

| | 3rd 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 | 1.2 | 1.7 | 1.1 | 0.9 | 0.8 |
| Canadian Bonds (FTSE Short Term Bond) | 0.3 | 3.0 | 4.4 | 1.5 | 1.9 | 2.4 |
| Canadian Stocks (S&P/TSX Comp.) | 2.5 | 19.1 | 7.1 | 7.4 | 5.3 | 7.0 |
| U.S. Stocks (S&P 500) | 2.9 | 17.0 | 6.8 | 13.8 | 14.6 | 15.7 |
| Non-North American Dev. Stocks (EAFE) | 0.1 | 9.5 | 1.1 | 6.8 | 6.8 | 7.2 |
| Emerging Markets Stocks (FTSE / MSCI Emerging)* | -2.4 | 4.8 | 3.6 | 5.7 | 5.5 | 5.6 |

* 3rd 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

### "…Here I am, stuck in the middle with you." - J. Egan G. Rafferty

Markets head into the end of the year against a complicated landscape of US impeachment proceedings, major trade disputes, Brexit pain and anxiety, tepid economic data around the globe and slowing corporate earnings growth. For investors who daily tune into business media, it is not a pretty picture. No wonder **equity markets are more volatile** lately and, as long as these headlines persist, we'd expect it will continue.

However, through all this daily "noise", **global equity markets continue to find welcome support**. Remember, last fall it was the fear of *rising* interest rates that precipitated the significant market sell-off in December 2018. Today, the Fed and other central banks sing a different tune, *lowering* interest rates in the face of troubling headwinds. Their accommodative policies are providing some help for equity valuations.

The US economy has seemed to chug along despite Trump's trade battle with China, but new decade-low manufacturing data shows that its resilience is being tested. After having cut interest rates twice last quarter, the Fed's path forward seems less clear. The market is anticipating three more cuts by mid-2021, but policymakers are not yet giving much guidance on their actual roadmap. Investors are also watchful of the impeachment proceedings on Capitol Hill, not to mention whether trade negotiations with China make real progress. Certainly, **positive developments on trade would provide some optimism** - far beyond the US and China.

At this point, **US stock valuations appear high** relative to near-term earnings expectations (P/Es), which have been sluggish. It is likely that valuations have already been propped up by looser monetary policy and that is somewhat worrisome. We would prefer market prices to be buoyed by strong company fundamentals instead. With that in mind and looking out to the second half of 2020, analysts expect overall earnings to improve dramatically, providing the rationale for their current constructive outlook on valuation levels.

**Canada's economy is expected to deliver modest growth** through next year but, like others, we are exposed to trade wars and geopolitical tensions beyond the control of Ottawa. There is concern about high household debt and a worry of a stalling housing market, but the risks emanating from beyond our borders overshadow domestic issues. For example, the strong 3.7% GDP growth recorded for the second quarter was driven by trade, which is susceptible to shocks from abroad. This means that Canada's economy may be on somewhat shaky ground if the global economy weakens further. For this reason, we do not expect the upcoming federal election to be particularly impactful on markets; rather it will be how international events unfold over the next several months that will most likely determine Canada's economic trajectory.

In Europe, business and consumer confidence recently hit a four-and-a-half-year low, as measured by the European Commission's Economic Sentiment Indicator. **Prospects for the eurozone remain dim** as long as it struggles with Brexit uncertainty and other trade tensions, which are causing slower growth. Industrial production in Germany, the EUs largest economy, is very weak, prompting a reduction in GDP forecasts. In September, the European Central Bank took action by further cutting interest rates and reintroducing quantitative easing (i.e., increasing the money supply, thereby encouraging growth). Their policy is likely to stay accommodative. And, even if the UKs anticipated Article-50 extension request (to January 31st) is granted, Brexit doldrums will remain, leaving all the players in a miserable state of uncertainty until some concrete plan can be delivered. Sadly, no one is holding their breath.

For emerging markets countries, lower US interest rates are beneficial since many companies have significant debt owed in US dollars. However, they too are negatively affected by the US-China trade war so, until that is settled, their **stock valuations are not likely to improve.**

## Portfolio Strategy

Every economic cycle has risks and uncertainties which add to market volatility: it is a **normal phenomenon for stock markets to continually climb a "wall of worry"**. The current cycle is no exception. While there are legitimate concerns about a possible recession next year, it is also true that central banks are continuing to act in a coordinated, proactive manner to support stability in the global economy. The fact that they have done so since the financial crisis of 2008 is one of the main reasons we remain in the longest economic expansion ever recorded.

We doubt that market volatility will abate much in the months ahead, **making portfolio diversification vital**. Recently, equity returns have been dominated by large technology companies, but their valuations now seem stretched given the backdrop of slower growth. We emphasize the advantages of a global equity portfolio "tilted" toward value-oriented stocks, which trade at better valuations. And, we continue to rebalance portfolios accordingly, which usually means trimming back US equities which have had stronger returns over this long cycle. By contrast, Canadian stocks have only enjoyed higher returns for about the past year. We are also modestly increasing exposure to real estate in portfolios to enhance diversification and to provide increased cash flow, given the current low interest-rate environment.

In fixed income portfolios, the **deteriorating economic outlook has led to bond yields declining** significantly this year. To balance risk in this environment, we are reinvesting maturities in shorter-term GICs and the DFA Global Fixed Income Fund. A declining rate environment favours bonds but, if/when interest rates begin rising again, shorter-term GICs provide both capital stability and the opportunity to reinvest sooner at higher rates.

As always, investment success comes with discounting the short-term "noise" in the marketplace and **focusing on one's longer-term objectives**. At Milestone, we structure portfolios with the appropriate asset mix not only to reflect each client's risk tolerance profile, but also to weather periods of market uncertainty.