2018 Third Quarter Review

"Reacting in anger or annoyance will not advance one's ability to persuade."
- Ruth Bader Ginsburg, Associate Justice, Supreme Court of the United States

After 13 months of negotiations that were often characterized as dramatic and tense, **the quarter ended with a trilateral deal being struck just before the US-imposed October 1st deadline for a new NAFTA**, **now known as the USMCA (United States-Mexico-Canada Agreement)**. Canadian businesses, consumers and investors alike breathed a sigh of relief. However, testy trade relations between the US and China deteriorated further over the summer with new tariffs being imposed by both countries. And President Trump's trade negotiations with the EU, UK, South Korea and Japan all made little progress, leaving investors watching the global landscape with some concern.

The issue of US tariffs has impacted the Canadian S&P/TSX Index all year, with tepid returns of -0.6% last quarter and 1.4% year to date. A notable exception to the trend has been cannabis stock prices, which have exploded in a fashion much like cryptocurrency did in late 2017. As Canada embarks on legalization, only time will tell if their summer "high" was justified. **Overall, our economy has demonstrated enough strength that investors should be prepared for another interest rate hike, probably in late October**.

The US has been the best-performing market so far in 2018, with year-to-date gains of 14.2% CAD (10.6% USD) for the S&P 500. Given the strength of the US economy, the Federal Reserve (the Fed) hiked its key lending rate again in September by 0.25% to a range of 2.00%-2.25%. Although business and consumer sentiment remained high thanks to low unemployment, growing wages and 2% inflation, **some analysts cautioned that rising interest rates and ongoing trade barriers may dampen future growth.**

Unlike 2017, **international developed markets have languished in 2018**, up only 1.8% (CAD) year to date, held back by punitive US tariffs and the threat of more to come. British Prime Minister May faced renewed Brexit difficulties within her own party, let alone with other EU members. **Emerging-markets (EM) countries faced headwinds too**: the US/China trade war hurt China's Asian suppliers, the strong greenback posed a problem for borrowers of USD and the economic crises in Argentina and Turkey negatively affected the broad EM index. It was down 6% (CAD) year to date.

As short-term interest rates continued to rise last quarter, **the incentive to hold longer-dated bonds diminished in what is commonly known as a "flat" interest-rate environment**. For example, the spread between 2-year and 10-year government bonds in Canada and the US shrank to about 20 basis points or 0.2%. The rule: when bond yields go up, by definition, bond prices will fall - and long bonds fall the most. Short-term bonds fared the best, returning 0.5% year to date as measured by the FTSE Short-Term Bond Index.

Following are the returns for major indices for the period ended September 30th, 2018:

	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)	0.3	0.9	1.1	0.7	0.7	0.8
Canadian Bonds (FTSE Short Term Bond)	0.0	0.5	0.8	0.7	1.6	2.8
Canadian Stocks (S&P/TSX Comp.)	-0.6	1.4	5.9	9.7	7.8	6.3
U.S. Stocks (S&P 500)	5.9	14.2	21.8	15.9	19.3	14.2
Non-North American Dev. Stocks (EAFE)	-0.3	1.8	6.2	8.0	9.3	7.5
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-3.6	-6.0	0.5	8.9	7.9	7.5

* 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

“I have never, ever focused on the negative of things. I always look at the positive.”
- Sonia Sotomayor, Associate Justice, Supreme Court of the United States

As mentioned, the new USMCA provides some much needed clarity on the trade front in North America, with President Trump declaring it an important achievement in his ongoing campaign to reshape global trade. With his threat of additional tariffs on Japan, South Korea and the EU, each are either making concessions or joining the US at the negotiating table. **Investors will be watching closely to see if China, America’s largest trading partner, begins to bend as well**. The pressure is on: the US recently hit them with $200 billion in new tariffs on top of the original $50 billion, claiming China uses unfair tactics in an effort to supplant the US as the global leader in technology.

Despite trade-related headwinds however, the US economy is humming along. It is poised to grow at a steady pace of 3% this year, with unemployment at historical lows and long-awaited wage growth becoming more evident. In response, the Fed, having hiked rates three times so far this year, plans to keep gradually “tightening” to maintain healthy, but moderate growth. Some forecasters are predicting a fourth rate hike this quarter, three in 2019 and one in 2020. **Critics think the Fed’s policy should be more accommodative in the face of trade barriers and the diminishing benefits of recent tax cuts**, both of which may dampen US growth and US stock valuations in 2019. China, for example, has hit back with tariffs against US agricultural producers and consumers, who now face higher prices on Chinese goods and even those with Chinese components. As for lower US corporate tax rates, the main benefit of its boost of “cash” is being enjoyed this year; business investment and demand for imports may wane going forward.

Very soon, investors may be better able to gauge the Trump administration’s ability to advance its trade agenda, not to mention its many other contentious policies. **With mid-term elections looming on November 6th, President Trump faces a significant test**. Close attention will be paid to the results, where any shift in the balance of power in Congress could have far-reaching implications - much beyond US borders.

Of course, that includes us in Canada. The USMCA is not yet a “done deal”; Congress must approve it. Assuming it remains largely intact, however, here is a quick summary: Canada stood pat on most of the headline-grabbing issues, avoiding debilitating tariffs on autos while managing to retain the so-called “Chapter 19” independent trade-resolution mechanism. But the US got concessions on dairy products, on auto-export quotas and in the extension of drug patents.

Even with the NAFTA saga behind us (hopefully), **Canadian investors have other worries, including the impact of higher interest rates** - not only on corporations but also on overextended households. We face competitive challenges with the US as well as persistent frustrations in moving crude oil to international markets. Yet, even though Canada’s economy is projected to grow at a very modest 2% next year, the Bank of Canada (BoC) seems laser-focused on managing inflation, which registered 2.8% in August. The USMCA will likely cause an uptick in economic activity, providing the BoC further justification for more tightening. Suffice to say, the near-term prospect of higher interest rates is not ideal for an already subdued Canadian economy.

Further afield in Europe, stalled Brexit talks are unhelpful to decision-makers on both sides. **Consumer spending is being dampened by rising inflation and weakening consumer sentiment**. Exports are falling in the face of US-incited tariffs. If these conditions persist, only modest growth can be expected next year. Political turmoil is once again an issue too: Italy, the third-largest mainland economy after Germany and France, is grabbing the latest headlines. Its newly formed coalition government is struggling with a long-standing fiscal mess. As new, inexperienced politicians waffle over how to deal with Italy’s massive debt, bond investors recently sent them a loud message, resulting in soaring bond yields and prompting a bond-ratings downgrade.

The landscape for EM countries is not cheerful either. As mentioned, the US/China trade war is damaging. Those who borrow in USD find rising US interest rates and related USD strength as punitive. Elsewhere, there are no clear solutions to the ongoing crises in either Turkey or Argentina. These distinct situations are all contributing to the collapse of EM stock prices this year. However, for contrarian thinkers among us who see the long-term potential of the EM asset class and who can “look through” short-term trouble, **EM valuations are nearing levels that must be viewed as increasingly compelling.**

Portfolio Strategy

For globally diversified portfolios, 2018 is turning into a year when major markets, except the US, are experiencing a pause in their long upward trajectory, thereby moderating returns. In the context of long-term investing and, especially after several years of uninterrupted positive performance, **we view this “normalizing” process as healthy**. We would rather see stock prices pause and take a breath than become overvalued and suffer more upsetting consequences. Also, the uneven results around the globe provide the opportunity to rebalance equity positions. If appropriate, we can pare back US-market exposure where prices have been strong, and reallocate to those where valuations are becoming relatively more attractive.

In fixed income, the long-awaited transition from a low to a rising interest-rate environment is holding back bond returns. During the past few years of falling rates, GICs outperformed the short-term bond index because, unlike bonds, their prices are fixed and do not change as market rates do (up or down). Now, with a cycle of rising rates underway in North America, bond yields are becoming more attractive relative to GIC rates. **There is renewed opportunity in liquid, short-term fixed income securities.**

Overall, and considering the tone of headline news these days, perhaps what is most surprising about 2018 is that **markets have remained resilient in spite of some pretty difficult challenges**. We hope it stays that way but, regardless, short-term market upsets need not be a concern for investors with a well-considered, long-term plan. It is designed to see them through the good times and the not-so-good times too.