Market Commentary

Another One Bites the Dust

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"Another one bites the dust
Another one bites the dust
And another one gone, and another one gone
Another one bites the dust."
Queen, *Another One Bites the Dust*

As 2018 came to a difficult close, many investors were glad to see the end of it. Trade tensions, fears about slowing global growth and geopolitical concerns continued to drive market performance. Softening economic data and falling oil prices impacted returns for riskier assets. Inflation worries moved firmly to the backburner, allowing safe-haven government bonds to rise as interest rates dropped.

Cryptocurrency began a rolling correction in early 2018 as Bitcoin's bubble deflated. One by one, returns in many other markets essentially bit the dust. Trade-war fears started an equities correction in China. A growth slowdown in Europe caused equities there to correct. Prices for industrial commodities such as copper nosedived last summer. Oil prices dropped last fall, pulling Canadian stocks down with them. For most of 2018, U.S. equities climbed, but started to correct in October. In the final months of the trading year, they were one of the weakest major markets.

United States – *We Will Rock You*

In December, volatility returned to U.S. markets. In their worst week since 2008's Great Recession, U.S. stocks plummeted. Following their worst-ever Christmas Eve, they staged a miraculous comeback as the Dow Jones increased by its largest point move on record.

Markets are worried about slowing U.S. economic growth, a looming trade war with China and chaos in Washington.

At its December meeting, the U.S. Federal Reserve ignored pressure from President Donald Trump and raised its benchmark interest rate a quarter point to its highest level in more than a decade. After four hikes in 2018, the Fed indicated it would raise rates twice in 2019, one less time than expected. When President Trump tweeted criticism of U.S. Federal Reserve Chair Jerome Powell, Wall Street became anxious that he was attacking the Fed's independence.

Investors also worried about the murky temporary truce in U.S.–China tariff disputes. Both sides face a three-month deadline to reach a deal.

Investors fretted when three-year government bonds were paying higher interest rates than five-year bonds. Longer-term bonds usually have higher interest rates. When the reverse occurs, as happened in mid-December, it is called an inversion of the yield curve. Many investors see that partial yield-curve inversion as declining confidence in the economy and a sign that a recession is coming.

In December, President Trump demanded $5 billion to build a southern border wall. Congress refused and adjourned for Christmas. More than 800,000 federal employees, out of a workforce of 2.1 million, were adversely affected by this third government shutdown of 2018.

All these factors and more shoved three major U.S indices firmly into correction territory (defined as a drop of greater than 10% from recent highs). In late December, the Nasdaq Composite slid into bear-market territory (a decline of more than 20% from a 52-week high). This steep descent caused U.S. stocks to significantly underperform most major developed world markets in the latter part of the year.

Meanwhile, U.S. economy fundamentals remained strong. The Commerce Department announced 3.5% GDP growth in Q3. In November, U.S. labour also showed continued strength. Unemployment held at 3.7%, its lowest level since 1969, and the economy added 155,000 jobs. Business investment and consumer spending are also rising. Right now, there is a disconnect between the gloom-and-doom reaction of financial markets and the strong economy that is prompting central bankers to raise rates.

Canada – *Under Pressure*

Bank of Canada (BoC) Governor Stephen Poloz warned that China–U.S. trade tensions could create a stagflationary environment. Stagflation, which is characterized by low growth and rising inflation, would be very bad news for all asset classes. He is particularly concerned about President Trump's threat to impose 25% tariffs on China.

At December's policy meeting, the BoC maintained its target overnight rate at 1.75%. It gave no indication that it has moved off its goal of raising the policy rate toward a neutral range of 2.5% to 3.5%. Our central bank expects business investment to strengthen once the USMCA trade deal is signed and Ottawa's tax incentives take effect.

The market did not share this optimism, choosing instead to focus on risks to the Canadian economy from trade wars and a steep decline in oil prices. Alberta's decision to cut production, plus OPEC's announced production cuts, did not stop oil prices from sliding.

Interest rates declined across the yield curve (both short-term and long-term bonds) as inflation concerns subsided. This caused bond prices to rally. Our dollar also sold off thanks to expectations that 2019 will bring just two rate increases instead of three. If the U.S. Federal Reserve follows through on hints that it might be less aggressive in raising rates in 2019, the loonie could get a boost. It closed 2018 at its lowest level for the year.

After Canadian authorities arrested Huawei chief financial officer Meng Wanzhou on a U.S. extradition request, we were dragged into the China–U.S. trade clash. China detained three Canadians in retaliation (one has been released). Diplomatic tensions between Ottawa and Beijing are high, with potential for significant escalation.

Canadian stocks did not escape the negativity that dragged down stock markets globally; they fell almost right across the board in December. While they did not sink as much as U.S. equities, Canadian stocks did not experience the same strength as U.S. stocks, either. Thus, they ended 2018 registering double-digit declines.

Looking ahead, our central bank's decisions on interest rates and the oil-patch crisis could hurt Canadian equities. The BoC might err by increasing interest rates faster than Canada's weakening economy can digest. A relentless sell-off dinged oil prices, despite recent positive news. Sustained weak oil prices will cause downward revisions in earnings for Canadian companies. This will make the valuation of the benchmark S&P/TSX Composite less compelling than its current level of 12 times 2019 estimated earnings.

Europe and the U.K. – *I Want to Break Free*

Rather than suffer a humiliating defeat in Parliament, Prime Minister Theresa May postponed the vote on a Brexit withdrawal agreement. After surviving a confidence vote in her leadership, she is expected to go back to Brussels seeking concessions. The House of Commons is scheduled to vote on her widely criticized Brexit deal in mid-January as the U.K. prepares to leave the European Union on March 29.

Italy's crisis continued thanks to its weak economic prospects and high government debt. Recent data suggest that Italy's economy slipped into recession late in 2018 as Q3 GDP shrunk by 0.1%, the first contraction in four years. Italy's government made progress when it agreed to reduce its big-spending budget and not add to its huge deficit forecast for next year.

European despair spread to France as President Emmanuel Macron's approval rating nose-dived over a proposed fuel-tax hike. French citizens formed a protest group called the Yellow Vests and rioted in anti-government demonstrations on the Champs-Élysées. President Macron then offered concessions through tax breaks that may push France to the brink of violating EU budget rules.

The European Central Bank (ECB) showed increasing caution when it decided to end its quantitative easing policy (a bond-buying program to keep a lid on interest rates) at yearend. It sees ongoing risks to the outlook for global growth and European economies. The ECB also said it would delay rate increases until at least summer 2019.

U.K. and European stocks continued to slide as a “hard Brexit” (exit from the EU without a negotiated deal) seemed more likely, Italy’s fiscal troubles lingered and Paris protests spread. The euro and British pound both declined, but stabilized as the U.S. greenback began to retreat from its persistent strength.

China – *The Show Must Go On*

China’s unprecedented trade war with the U.S. has almost become synonymous with China’s economic slowdown. Investors suffered greatly when Shanghai’s stock market ended 2018 as the world’s worst performer, off almost 25%. The Hong Kong equity market was slightly more insulated, but still landed firmly in negative territory to close out 2018. Nevertheless, Chinese equities experienced significantly less damage than those of other major world markets in the final weeks of the year. China’s price-to-earnings multiple contracted almost 30% in 2018, making valuations relatively attractive versus other markets.

Official GDP data came in around 6.5%, revealing slower growth compared to 2017; however, underlying trends have begun to show weakness. For example, a decline in electricity production (a proxy for heavy industry activity) signalled a slump in the nation’s manufacturing hubs. Chinese exports are getting a temporary boost as U.S. companies race to stockpile goods before January’s potential tariff increases of 25%. Yet, today’s export frenzy will likely reduce demand for tomorrow’s orders.

China clearly wants to contain tariff tensions and has made efforts to neutralize hostilities. At the G20 summit in November, China negotiated a 90-day grace period with the U.S. The world’s second largest economy subsequently purchased large amounts of soybeans in good faith to reduce the trade imbalance. In December, Beijing also announced measures to protect overseas firms operating in China against intellectual property theft, which will address a key sticking point for Mr. Trump.

Japan – *It’s a Hard Life*

At year’s end, the Bank of Japan (BoJ) maintained its accommodative monetary policy, causing short-term Japanese interest rates to remain slightly negative. Faced with weaker global growth, sliding oil prices and Sino–U.S. trade tensions, the BoJ warned that it is open to boosting monetary stimulus. It will be needed to ensure that modest economic growth is not hampered when Japan raises its sales tax in October.

In 2018, Japan's economy expanded moderately against a backdrop of close-to-record low unemployment, a low fiscal deficit and high labour force participation. Although the economy gained momentum, inflation stayed below the central bank target of 2%.

Business confidence remained strong despite the prospect of weaker global growth. According to a business sentiment survey, most Japanese businesses believe the Sino–U.S. trade war will have little impact on growth and they continue to expect a double-digit increase in capital spending next year. Japanese equities were less enthusiastic, suffering a 10% correction in December.

Our Strategy

We keep a resolute focus on the fundamental attributes of markets. Despite the market's correction, in our view many of the reasons for maintaining an overweight position in equities are still valid. The U.S. economy has a strong earnings outlook, job creation is robust and inflation is within an acceptable range. We do not expect that a growth slowdown in 2019 will lead to a Canadian or U.S. recession. With high levels of pessimism now priced into these markets, opportunities will unfold at attractive valuations.

The Last Word

There were few places to hide in 2018. Global markets entered the year enthusiastic about the sugar rush of tax cuts doled out by U.S. tax reform. They ended 2018 suffering from a nasty hangover caused by economic disruption around the world, an ongoing Brexit crisis and a U.S.–China trade war. Even though uncertainty remains elevated, we expect many of these problems will be resolved. It's quite likely that anxiety and gloom will give way to calm. To paraphrase Queen's lyrics – markets, this is us, under pressure.