Striking a delicate balance

2019 Capital Market Outlook

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The World at Large: All things in moderation

Step back from the edge. Big corporate earnings and bull market gains have lured some investors to believe it will be different this time and to move toward, and beyond, the edge of their normal investing comfort zone. Others have been more sensitive to the recent market volatility, with 2008 flashbacks tempting them to bail on long-term investment plans. Our advice to both is the same: step back from the edge – away from the emotional extremes of risk aversion, or over-confidence. A fact-based and reasoned look at current market conditions leads us to our 2019 Capital Market Outlook. Using our analysis, we outline ways to de-risk your portfolio AND remain invested toward your long-term goals.

"Excessive sorrow laughs. Excessive joy weeps."
– William Blake, English poet, painter and printmaker, 1757-1827.

Shifts in corporate earnings, bond yields and equity valuations are changing the opportunity costs of all asset classes, resulting in narrowed expected outcome differentials between asset classes. On the macro-economic side, all manner of politics, geopolitical risks, trade and inflation are creating unique concerns for various regions and industry sectors around the globe. All these factors combine to increase today’s complex task of finding a path forward.

From a top-down asset class level, we recommend a neutral stance (risk-tolerance aligned); this is neither overweight in bonds or equities. Under the current climate of increased volatility, slowing economic growth and rising interest rates (i.e., the tell-tale signs of progress through the later-stage of a market cycle), we believe a balance between risks and opportunities can best be achieved by fine-tuning portfolio positions within asset classes.

The general theme underpinning our outlook is moderation.

For market cycles, we believe acceleration is followed by moderation, before eventually giving way to decline, with moderation being a normal, albeit less desirable stage. Importantly, this means growth has peaked, but that does not immediately give way to economic or corporate earnings decline, rather just lower growth. Today’s debate is around how much global economies and corporate earnings will grow and, importantly, not how much will they shrink.
Moving through 2019, we believe the winds of moderation will be evident in the following key capital market factors: global growth; geopolitical issues; central bank policy; 2018 price corrections; corporate earnings; and, equity valuations.

a) Global growth
For most regions, we expect global GDP growth to moderate from the recent above-potential levels, toward long-run sustainable levels with China remaining a key driver of global economic growth. We believe the pace of decline in Chinese GDP growth will slow with their GDP firming-up in the later-half of 2019, providing support for overall global growth (see Exhibit 1.1).

1.1  Real GDP growth, year-over-year percent change

Moderating global GDP growth

b) Geopolitical issues
We expect the 2018 uncertainty around North American free-trade, Brexit, Italian politics and U.S. electioneering to eventually (largely) be behind us, and the lingering effects and concerns on these fronts to taper off throughout 2019.
c) Central bank policy

We expect the central banks to be less divergent in terms of overall policy direction. North American central banks are closer to the end of their tightening campaigns than the beginning. The U.S. Federal Reserve (the Fed) may continue to raise rates, but they have already raised rates eight times since 2015 (see Exhibit 1.2). The debate is whether they will increase the Fed Funds rate two, three or four more times this cycle, with our expectation leaning towards the lower end of that range. Similarly, we see the Bank of Canada stopping their rate-hiking cycle at the lower bound of their stated 2.5 to 3.5% neutral range. Many emerging market central banks have their tightening policy programs already underway, while the European Central Bank is headed toward a tighter stance, even if only slightly (or just in language). Our base case calls for rising sovereign bond yields to moderate from the torrid pace of the past three years (Government of Canada 2-year bonds yields have increase 8-fold in 3 years from a low of 0.29% to a high of 2.35%). For Canadian bond investors, we would be more constructive on the outlook for fixed income should the Bank of Canada raise rates two more times and/or we see the Canadian 10-year bond yield hit 2.5% (see Exhibit 1.3).

1.2 North American central bank overnight rates

Central bank interest rate hiking cycle is closer to the end than the beginning

Source: Bloomberg | Dec. 7, 2018
1.3 | Government of Canada 2- and 10-year bond yield
Sovereign bond yields to increase, but at a more moderate pace

![Graph showing the Government of Canada 2- and 10-year bond yield trends from 2007 to 2018.]

Source: Bloomberg | Dec. 7, 2018

d) 2018 price corrections
Significant price corrections in 2018 reset oil prices, base metal prices, Canadian and emerging market equities, bond values and currencies. We caution against straight-line extrapolation of these trends. Instead, we expect downward pressures to ease. We see the discounts between U.S. and Canadian oil prices set to narrow from record wide levels.

e) Corporate earnings
The past two years have been marked by accelerating earnings growth. Globally, earnings have been rebounding from the 2015-2016 slump and, in the U.S., 2018 earnings have been boosted by tax reform. Going forward, we expect a slower, ‘foot-off-the gas’ coasting period before a full stop, or decline, in global earnings growth. We expect to see more normalized 5 to 8% earnings growth rates in 2019 (see Exhibit 1.4). For example, in the U.S., the experience would be similar to earnings growth rates in 2012, 2013 and 2014 (see Exhibit 1.5).
1.4 | Global earnings growth expectations
Earnings growth year-over-year per cent change (consensus forecasts)

Source: Bloomberg | Dec. 7, 2018

1.5 | S&P 500 earnings growth
S&P 500 Index year-over-year earnings per share growth

Source: Bloomberg | Dec. 7, 2018
f) Equity valuations
Price-to-earnings (P/E) multiples in most markets have fallen from their very elevated levels of early 2018. Some markets have experienced the largest downward adjustment to P/E ratios of the past two decades. We believe the pace of retreat in price-to-earnings ratios is set to slow.

Furthermore, we see the strength of the following market trends moderating next year:

- Smaller relative gains for the U.S. dollar (DXY Index).
- No U.S. equity market outperformance versus the rest-of-the-world.
- Less outperformance of growth over value equity style.
- Little outperformance of high-yield and floating-rate fixed income over investment grade corporate and government bonds.

Some of the investment implications include a narrower risk/reward trade-off between stocks and bonds, enhancing the appeal of bonds as an attractive diversifier to mitigate equity market volatility. Within both equities and fixed-income asset classes, this signals a time to be more defensively positioned.

**Despite all this moderation, we do not anticipate volatility to slow.** The transition from accelerating growth to slowing growth will continue to be choppy. When metrics are slowing, investors remain sensitive that “slowing” turns into an outright decline. This sensitivity is more acute given the generally held belief that things have been exceptionally good for too long and this must ultimately give way to pain. Indeed, should the current U.S. economic expansion last through July 2019, it will become the longest on record, surpassing that of the 1990s. Due to unprecedented global central bank intervention, the current expansion has been characterized by a long period of cheap money. Cheap money fuels rising leverage, financial speculation and misallocation of human, physical and capital resources. Historically, the cumulative effect of these misallocations has ultimately led to financial calamity. We are not naïve in thinking “this time” will be completely different. We remain on high alert for when moderation begins to give way to outright decline. As of now, these risks remain on the horizon (beyond our 2019 outlook), and we see a neutral position, with a defensive bias, as most appropriate.

**Bottom line:** We believe a neutral stance (within one’s personal risk tolerance) with a defensive bias is most appropriate for today’s investors. Our 2019 Capital Market Outlook calls for North American equity price gains between 9 and 12%; we suggest continued exposure to participate in equity market growth without stretching one’s risk tolerance. **Within equities, we recommend broad and diversified geographic and sector allocations – with a slight overweight to Canadian and U.S. equities, and neutral non-North American developed market equities with an underweight in emerging markets. For fixed income investors, we see a 1 to 2% total return in 2019 for the Canadian asset class as a whole, with an overweight in investment grade corporate and government bonds.**
Canadian Equity

Canadian equities look more attractive to us than a year ago, and we continue to recommend a slight overweight position.

Our views toward Canadian equities continue to be driven based on fundamental data (i.e., earnings and valuations). On paper, Canadian equities look good, in part because they are relatively cheap for the corporate earnings expected in 2019. Unfortunately, just because something is cheap, doesn’t mean it will go up in value. Canadian equities need a catalyst to unlock their value.

Valuations in the near term are as much about sentiment as anything else. The negative sentiment toward Canadian equities is summed up by the lack of appetite on the part of investors. Domestic and foreign investor flows to Canadian equities have been moribund and we believe they’re at overly pessimistic levels. Consider that on the domestic front, as measured by investment funds’ industry flows, Canadian equity is on pace to complete its sixth consecutive year of net investment outflows. As for foreign investors, being mindful this is a broad measure of investment flows (not just publicly traded equities), Statistics Canada’s measure of net foreign direct investment has recorded net outflows from Canada in 11 of the last 12 quarters.

Where will we find the catalyst to unlock the value in Canadian equities? We see several developments that could spark a revival of interest in Canadian equities. Just as negativity in our bellwether sectors (such as financials, energy and materials) has generally been contagious, we feel a positive development in any one of these sectors could also spread, and we outline a case for each in our sector insights (page 10).

2.1 | S&P/TSX Composite return scenarios

2019 earnings per share growth using 5 per cent growth rate

<table>
<thead>
<tr>
<th>Implied trailing multiple</th>
<th>S&amp;P/TSX Composite</th>
<th>% change from Dec. 7 level of 14,795</th>
</tr>
</thead>
<tbody>
<tr>
<td>13X</td>
<td>14,359</td>
<td>- 3%</td>
</tr>
<tr>
<td>14X</td>
<td>15,463</td>
<td>5%</td>
</tr>
<tr>
<td>base case</td>
<td>16,568</td>
<td>12%</td>
</tr>
</tbody>
</table>

Source: Bloomberg | Dec. 7, 2018 | Price only returns.

a) Corporate earnings

Companies in the S&P/TSX Composite are delivering solid earnings, on track for 15% growth in 2018 and consensus estimates calling for 12% in 2019. In a testament to how fundamentals still work, Canadian earnings growth has been well above international and emerging markets, and Canadian equities have posted better performance than these markets. Going forward, we disagree with the consensus earnings growth estimate and expect a more conservative 5% growth rate (see Exhibit 2.1). One potential positive for earnings is the impact of the recently announced business capital expenditures tax reform.
2.2 North American equity valuations
S&P/TSX Composite valuations are attractive, providing a margin of safety

Outside of P/E, other valuation metrics are not as discounted, but they remain reasonable:

- Price-to-cash flow sits at the 10-year average;
- Price-to-book is one standard deviation below the 10-year average;
- EV-to-EBITDA* is off its two-standard deviation peak, but remains elevated, owing to the significant debt loads on Canadian corporate balance sheets; and
- Return on equity appears to have peaked, but sits on the 10-year average of 9% even though earnings are forecasted to continue to grow.

Why not upgrade our Canadian equity view beyond a slight overweight?

1. The patience that may be required for a potential catalyst to unfold and spark investor confidence;
2. Improvement in the relative outlook for non-Canadian equities; and
3. The over-arching recognition that Canadian equities are higher-beta assets, which are less attractive historically at this late stage of the market cycle when de-risking strategies are favoured.

Bottom line: On a fundamental basis (earnings and valuations), Canadian equities look more attractive than a year ago, but we acknowledge they need a catalyst. We don’t believe Canadian equities are broken; we see it as more of a case of being misunderstood. We see several catalysts that have the potential to deliver in 2019 and we continue to recommend a slight overweight position in Canadian equities. Our base case scenario for the S&P/TSX Composite is a 12% price return; when coupled with a 3% dividend yield, we expect a total return of 15% for 2019.

*EV is an abbreviation for enterprise value and EBITDA represents earnings before interest, taxes, depreciation and amortization.

b) Valuations
Canada continues to look attractive on both a relative basis to U.S. equities, and on an absolute basis (see Exhibit 2.2). We see current valuations as attractive and providing a margin of safety against further downside risk. Given rising earnings and falling prices in 2018, the P/E multiples on both a 12-month trailing and forward basis are at their lowest levels since 2013. Of course, valuation compression is to be expected under a rising yield environment, and our forecast continues to factor in further trailing P/E multiple compression in 2019 (albeit at a moderating pace).
Sector insights

a) Financials
The Canadian banks make up 24% of the total S&P/TSX Composite and given their cross-border listings, liquidity and options availability, they generally serve as a proxy for “all-things Canada” when it comes to foreign investors. The banks have been under their own negative cloud due to a slowing housing market, credit exposure to the energy sector (or perceptions thereof), and a flattening yield curve. We expect some reprieve in the negative sentiment on these fronts, even without seeing huge positive developments in any given one.

- Housing markets are adjusting, but we are a year or more past the beginning of the slowdown and close to a full year operating under the tighter financial lending environment. For the banks, mortgage lending growth has moderated, but continues to grow.
- We believe pessimism toward the Canadian energy sector is nearing extremes and see modest relief ahead (see energy comments for more), which in turn would be positive for the banks.
- The yield curve has been flattening, largely unabated for two years. We expect the yield curve to bottom out and move sideways for a period, before completely inverting as has been the case in the past. This brings little relief to lenders, but does remove the most bearish scenario amongst those who see yield curve inversion as an imminent threat.

The financials sector remains inexpensive and boasts a solid and growing dividend yield of approximately 4%. Under a scenario where the financials turn around their -9.5% price drag in 2018 to a modest +5% to +6% price gain, the 10% total return goes a long way to getting the S&P/TSX Composite to our base case return scenario.

b) Energy
The Canadian energy sector has faced a litany of negative news in 2018. Heading into 2019, we see little downside to global oil prices from current levels, having corrected by approximately 35% in a matter of eight weeks.

We are calling for a combination of growing demand and one or more of the following supply side developments:

- The return of a production cap by OPEC/Russia and partners.
- Ebbing U.S. shale production. U.S. shale output is very flexible and price responsive. So as much as $75USD oil prices brought rising output, $50USD should curb some of the drilling enthusiasm, especially when labour is tight and capacity pressures remain.
- Should oil prices stay low, the end (or pause) of exemptions to Iranian oil exports is a possibility. The surprise exemptions to the U.S. sanctions were handed out to eight of Iran’s major oil importers. These are only 180-day exemptions (ending May 3, 2019). The announcement of these exemptions, coinciding with the U.S. mid-term elections, appears to be very politically convenient for the U.S. President. Should oil prices stay low, this will bring about the opportunity to remove some, or all these exemptions, potentially removing millions of barrels a day of supply.

Our base case scenario for West Texas Intermediate (WTI) oil prices is a return to the mid-$60USD/bbl range (see Exhibit 2.3).

2.3 WTI crude oil prices per barrel
Forecast of $65USD per barrel for 2019

Source: Bloomberg | Dec. 7, 2018
For Canadian oil producers exposed to Canadian oil pricing, the problem lies in access to markets impacting prices, rather than demand (otherwise known as Canada’s egress problem). The price discount reflects market forces bringing the egress issues to the fore, and we believe the ‘pain’ inflicted by the low prices will bring a partial solution. The ‘pain’ of the low prices bolsters the necessity for increased pipeline capacity. Additionally, Canada’s oil companies have been reluctant to enter into long-term crude-by-rail (CBR) contracts, holding onto expectations that the cheaper (and safer) pipelines would soon come on board. There are three new pipelines that have a chance at moving crude in the future: Trans-Mountain (TMX), Keystone XL and Enbridge Line 3. Unfortunately, political delays have hampered the arrival dates for two of these projects, but Enbridge Line 3 is forecast to be operational late in 2019; Keystone XL has a chance to follow later. In the meantime, given the uncertainty around pipelines, Canadian oil production is being shut-in. We expect CBR negotiations to happen with a greater motivation. Also, the Alberta government is now stepping into the mix in a more deliberate fashion, providing rail capacity on its own and mandating production cuts (à la OPEC). All these egress options require business capital expenditures, and the recent tax reform initiative only improves their viability.

On several valuation metrics, the Canadian Energy sector looks cheap. On a price basis, the sector is down 26% from early 2017 levels and 44% below the heady high oil price days of 2014. Four years of forced discipline, innovation and technology adoption has resulted in a leaner, stronger industry. The sector also currently sports an attractive 4.5% dividend yield (though we suggest never getting overly attached to an energy company’s dividend stream). Marginal abatement of the egress issues should bring some relief. Energy stocks are volatile by nature, and upward moves for the sector are typically sharp and steep (consider that 2018 saw a +20% move between March and July). The Canadian energy sector continues to face a competitive environment, but we feel pessimism is currently ruling the day. We see enough potential developments on the horizon to believe that an abatement in the negative sentiment is due, thus allowing the energy sector to become a net contributor to overall performance (versus the -16.7% drag thus far in 2018).

c) Materials
Here too, valuations are not the problem. All main valuation metrics are attractive versus the past 10-year average: price-to-earnings is below average; and EV-to-EBITDA, price-to-cash flow and price-to-book are all one standard deviation below average. The price index has gone sideways for 10-years, despite the 2009 to 2010 180% rebound on the back of skyrocketing gold prices. Gold equities are leveraged plays on the price of gold, so moves in the share prices are magnified compared to moves for bullion alone. Shares of gold miners today are out of favour and undervalued versus current gold spot prices. Even if gold prices don’t move up, there is an argument the share prices will move up to narrow this current discount gap. If the price for gold bullion moves higher, the tug toward higher share prices will be even stronger. Any downward movement in the U.S. dollar, decline in global bond yields, rise in geopolitical tensions, or combination thereof, could push gold prices higher, providing a boost to oversold gold equities. Precious metals exposure in the S&P/TSX Composite isn’t what it used to be, but it still represents roughly 6% of the index. A strong move for gold equities in and of itself may only move the needle slightly for the index; we see it as a possible catalyst that can shine a more positive light on Canadian equities.
The Canadian economy

The perennial obsession for Canadian investors (and arguably part of our national psyche) is to compare ourselves to the United States. Here, our naturally modest tendencies may deceive us. The gap in economic and stock market fundamentals is narrower than many may perceive.

The U.S. economy is exceptionally strong but the Canadian economy has been no slouch either. We expect growth to moderate in 2019 for both economies, but in Canada the headlines have focused squarely on the negatives, such as high household debt, inflated housing prices, low oil prices, resource export bottlenecks, trade frictions and business competitiveness issues.

Canada has a long list of economic ‘wins’ to be proud of:

- Real GDP is on track to grow at an above potential 2.1%;
- 219,000 net jobs have been created in the 12-months ended November;
- A U.S.-Mexico-Canada trade deal appears likely;
- The too-hot housing market is moderating;
- Our central bank is moving toward normalizing interest rates and remains free of political intervention and social media shaming;
- We have exceptionally stable inflation;
- Exports hit a record $151 billion in Q3 2018; and
- A $40 billion liquified natural gas export facility in B.C. is moving forward, as is Imperial Oil’s $2.6-billion Aspen oil sands project in Alberta.

Despite high profile woes in the energy patch, aerospace and auto sectors, consider that Canada continues to offer an open economy with a flexible exchange rate, a well-educated and skilled workforce, significant infrastructure and a wealth of ingenuity and entrepreneurship. Our government is stable and in a strong fiscal position (certainly relative to most of the industrialized world). Changes to business taxation have levelled the competitive playing field with the U.S., our largest competitor (and customer). Ask yourself, “how many other countries can boast a similarly long list of fundamental, long-term positives?”
Our views toward U.S. equities remain cautiously optimistic. Consistent with our theme of moderation, we expect S&P 500 corporate earnings to progress from accelerating growth to a period of moderating growth, but not decline. Slowing global and U.S. economic growth, tighter financial conditions and the impact of trade frictions are key reasons earnings growth will moderate. Importantly, the question to be answered is how much will earnings grow, rather than how much they will shrink.

You can only count on one-time tax cuts to boost earnings growth... once, and that happened in 2018. However, we still expect some of the 2018 glow from a profitable corporate America to shine on into 2019. The powerful 19.4% return for the S&P 500 in 2017 was pulling forward some of the good news set to arrive in 2018; and ‘2017-like’ returns are always vulnerable to mean-reversion. We believe there is still room for corporate earnings to grow in 2019, owing to less intense headwinds from politics, trade and tightening financial conditions (including U.S. dollar strength). We see the opportunity for each of these headwinds to moderate enough to allow U.S. equities to grow in line with what we see as a normalized earnings growth rate of 5%.

a) Politics
The U.S. political system is, by design, in a state of perpetual electioneering. However, in a post-U.S. midterm elections period with a grid-locked Congress and 2020 presidential elections still a way off, we expect the volume of political rhetoric around policy decisions to turn down a notch or two. The political drama of the personas involved is likely to remain headline news; however, markets care about taxes, trade and regulations, and much less about investigations and scandal. We see the impact of taxes and regulation as less of a distraction in 2019. Congressional gridlock does increase concerns over threats to shut down the government and wrangling over the debt ceiling, but outside of short-term, knee-jerk reactions, we expect capital markets to continue to turn a blind eye.

b) Trade
Although trade frictions with China remain an open question, battles between the U.S. and Europe, Canada, Mexico and Japan should be much quieter in 2019. We believe China has always been the main target of the Trump administration’s protectionist tendencies. While it would be nice, we do not expect a complete resolution of trade tensions between the two nations. In this regard, we expect U.S.-China trade tensions to simmer in 2019 with periodic flare-ups. We believe both parties are feeling enough discomfort under the current situation to avoid an all-out escalation. Ultimately, we need to judge the impact of tariffs and trade frictions on earnings growth. For the near term, a ceasefire is all that is required for U.S. earnings growth to deliver the 5% built-in to our base case scenario.

3.1 U.S. Dollar Index
Holds 2018 gains, but upward trajectory set to moderate

<table>
<thead>
<tr>
<th>Composition of DXY</th>
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<tbody>
<tr>
<td>Euro</td>
</tr>
<tr>
<td>Japanese yen</td>
</tr>
<tr>
<td>Pound sterling</td>
</tr>
<tr>
<td>Canadian dollar</td>
</tr>
<tr>
<td>Swedish krona</td>
</tr>
<tr>
<td>Swiss franc</td>
</tr>
</tbody>
</table>

Source: Bloomberg | Dec. 7, 2018
Financial conditions
Higher bond yields, wider credit spreads and a strong U.S. dollar (see Exhibit 3.1) all factor into earnings growth and valuations. A stronger U.S. dollar is a negative for American corporate earnings growth as it leads to weaker exports and lower repatriated foreign currency earnings. The greenback has moved higher on global central bank policy divergence (the U.S. Fed leading the way on tighter monetary policy), firmer U.S. inflation, higher U.S. economic growth and the American imposition of tariffs. We expect the rate of change and extent of each of these factors to moderate in 2019, leading to an arrest of the upward trajectory of the U.S. dollar, and thus ameliorating this drag on earnings growth.

Earnings and valuations
From a valuation perspective, we expect the pace of decline for U.S. equity valuations to moderate. As part of our over-arching strategy to err on the side of risk-mitigation, we’ve chosen to be more conservative, calling for 5% earnings growth in 2019. That view provides some margin of safety compared to the consensus view of 9% growth. Similarly, we believe we’re being conservative with our expectation for valuations. U.S. price-to-earnings multiples have contracted sharply in 2018, experiencing their largest post-financial crisis contraction (i.e., S&P 500 12-month trailing P/E has fallen from 23.3X in January to 18X in early November – see Exhibit 2.2). We expect the trailing P/E multiple to continue to contract, consistent with the increase in bond yields, but both at a moderating pace. Our base case scenario sets the 5% earnings growth against a trailing P/E of 16.75X (down from the current 18X), driving a 9% price gain (see Exhibit 3.2).

S&P 500 return scenarios
2019 earnings per share growth using 5 per cent growth rate

<table>
<thead>
<tr>
<th>2019 EPS Growth @ 5%</th>
<th>$172</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Implied Trailing Multiple</th>
<th>S&amp;P 500</th>
<th>% change from Dec. 7 level of 2,633</th>
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</thead>
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<tr>
<td>15X</td>
<td>2,579</td>
<td>-2%</td>
</tr>
<tr>
<td>16X</td>
<td>2,751</td>
<td>4%</td>
</tr>
<tr>
<td>base case</td>
<td>2,880</td>
<td>9%</td>
</tr>
</tbody>
</table>

Source: Bloomberg | Dec. 7, 2018 | Price only return.

Bottom line: Despite significant P/E multiple contraction, U.S. equities remain relatively expensive compared to their global counterparts (and outright expensive on most valuation measures outside of forward P/E, which is subject to earnings uncertainty). A conservative approach continues to drive a high-single digit price gain. In a ‘risk-off’ market scenario, U.S. equities typically outperform other equity markets. For Canadian investors, this defensive quality in a ‘risk-off’ scenario is enhanced as the Canadian dollar would be expected to decline vis-à-vis the American dollar. We recommend a slight overweight position in U.S. equities. Our base case scenario for the S&P 500 is an 11% total return, 9% price return with a 2% dividend yield.
International Equity (EAFE)

International equities represent non-North American, developed market equities, commonly benchmarked against the MSCI Europe, Australasia and the Far East Index (MSCI EAFE Index).¹ We hold a constructive view toward international equities. We believe the divergence between U.S. and EAFE equity market performance is set to narrow. EAFE 2019 earnings growth expectations are much closer to those in the U.S., but EAFE equities come at a valuation discount. We see a narrowing valuation gap as the impetus for EAFE equities to outpace U.S. equity performance in 2019.

As we enter 2019, we will carry some of 2018’s political and central bank uncertainty with us, but as we move through the new year, we expect the uncertainty to abate.

- The Brexit situation is fraught with great uncertainty in the very near term, but must come to a head before March 2019. Regardless of the outcome, the deadline ensures reduced uncertainty, even if it is a ‘kick the can down the road’ extension of the March deadline.
- As for Italy, the real fight is not with the European Commission, but with the bond market. Rising Italian government bond yields will eventually force the populist leadership to compromise and submit an acceptable budget. Notable in this drama is the fact that while the Italian government is heavily indebted, the household sector is not. Also encouraging is the lack of rising bond yield contagion to other periphery economies such as Spain or Greece (where there are similar anti-euro populist movements to fear).
- The monetary policy divergence between the European Central Bank (ECB) and the U.S. Federal Reserve is set to narrow. At the margin, the ECB is moving toward a tighter monetary policy stance, and the Fed is getting closer to the end of its tightening campaign. This shift for the ECB should allow for some relief from the oppressive negative and zero interest rate policy that has hammered share prices of European banks (a 25% sector weight in the EuroStoxx 50 Index and they are down -29.8% year to date).
- In contrast to Europe, Japan’s political and monetary policy backdrop is remarkably stable due to the fresh mandates of Prime Minister Abe and Bank of Japan Governor Kuroda.
- The EAFE equity benchmark is heavily populated with export-oriented companies. On the trade file, given U.S. political gridlock (Democratic majority in the House, Republicans kept the Senate) and U.S. trade concerns increasingly focused on China, we expect a détente/status quo, or even a better scenario, to unfold as it relates to U.S. trade with Europe and Asian nations other than China.

a) Corporate earnings
Heading into 2019, EAFE earnings growth expectations are converging toward similar estimates as the U.S. (see Exhibit 1.4). For the U.K. and European component of EAFE, the sector composition, yield backdrop and prior and expected currency movement all build confidence in the 2019 earnings estimates. Japanese earnings growth expectations of ~4% are modest, but won’t stand out as such laggards when compared to earnings growth in the rest of the world, which we believe will be closer to 5 to 8%.
b) Valuations

European equities are not outright cheap, but the valuation discount between European and U.S. equities remains large, especially on an equity/risk premium basis given the extraordinarily low yield environment in Europe (and Japan) (see Exhibit 4.1). **We believe there will be marginal improvement in the European risk backdrop that will unlock outperformance for European equities over the U.S.** The main attraction of Japanese equities are their extremely depressed valuation levels. The forward price-earnings ratio (off low earnings growth expectations) sits at 12.5X (more than one standard deviation below the post-crisis average) and significantly cheaper than most other major indices.

4.1 | Equity valuations (Europe versus U.S.)

European risks abating, potentially unlocks equity performance

Bottom line: Given the extent of the 2018 performance diversion between EAFE and the U.S., and based on current valuations, the rest of the world has an edge on the U.S. when it comes to return potential. We will need the U.S. equity market to set the tone, but in our base case scenario, where global earnings growth moves from acceleration to moderation (resulting in a positive risk environment), we expect EAFE equities to outperform. However, given that our view is contingent on a number of factors, including an elevated level of uncertainty and risks unique to Europe, we are only prepared to neutral weight EAFE equities in our asset mix recommendation. This also gives heed to the fact that we continue to believe that we are in the late stage of the market cycle, where a more defensive shift is appropriate. At this stage, lower beta assets are more desirable, whereas EAFE equities would be expected to suffer more under a risk-off scenario versus their U.S. counterparts.

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*Note: The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Market countries around the world, excluding the U.S. and Canada. Developed Markets countries in the MSCI EAFE Index include: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.*
Emerging Markets

We continue to recommend an underweight to emerging markets (EM), but we are more sanguine on the path ahead. The risk profile of EM equities and our late-cycle preference for risk-control are preventing us from upgrading our recommended asset allocation. The risk/reward tradeoff has improved since our Mid-Year Capital Market Outlook. The extent of the selloff in this asset class means a lot of risk has already been priced in and we feel further downside from here is limited (see Exhibit 5.1). In addition, some of the headwinds from a firmer U.S. dollar, global bond yields trending higher and moderating Chinese growth are set to abate, but not disappear. Consistent with our moderation theme, EM are an area where the move toward moderating economic growth is well under way.

Emerging markets have entered ‘bear’ market territory. Historically, when emerging markets enter this territory, the typical duration is eight to 10 months, with a median decline in the MSCI EM Index of 45% (though there is a wide dispersion amongst EM equity bear markets and declines have ranged from 31% to 67%). The current selloff is already more than nine months old, and the 2018 drawdown hit 26.5% in late October. So, the risk/reward tradeoff has improved, but we are still inclined to tread lightly.

Emerging markets have faced a number of fundamental headwinds; while risks remain in each of these areas, our EM equity outlook has improved.

"Emerging markets come with an elevated risk profile.” – Brent Joyce

5.1 | MSCI Emerging Markets Index
Higher risk profile tempers our outlook

Source: Bloomberg | Dec. 7, 2018

a) Trade
Frictions with the U.S. remain an important risk to all global markets but the U.S.-China trade frictions are acutely important to EM. The difference between now and six months ago is the U.S. stock market is no longer ‘going it alone’ and powering higher. Trade tensions are now penalizing both regions’ stock markets. We believe this improves the chances for a near-term détente between the two global economic powerhouses. Longer term, the developed world is rightly concerned with China’s state-sponsored industrial and innovation strategies, uncompetitive/non-free market practices in a variety of economic matters (along with forced technology transfer) and weakness in patent protections and intellectual property rights. While these issues are related to trade imbalances, they are more structural and strategic; areas where much of the developed world takes issue and would like to see change. These issues are long term in nature and threaten to dampen overall global economic growth, but sentiment in the near term is very pessimistic and equity markets will welcome any hint of a ‘less bad’ scenario. We expect such a thaw to spark a bigger rally in EM assets versus their developed market counterparts.
5.2 | Forward price-to-earnings ratio
Emerging markets valuations

The recent strength of the U.S. dollar has hurt emerging markets. However, with a pause (or completion) of U.S. monetary policy tightening now on the table, and the attendant stability of the U.S. dollar, we believe we are past the point of peak stress for these conditions. This paves the way for EM equities to stage a recovery from their depressed level.

c) Financial conditions
The value of the U.S. dollar and tightening financial conditions globally are important metrics for emerging markets. The recent strength of the U.S. dollar has hurt emerging markets. However, with a pause (or completion) of U.S. monetary policy tightening now on the table, and the attendant stability of the U.S. dollar, we believe we are past the point of peak stress for these conditions. This paves the way for EM equities to stage a recovery from their depressed level.

d) Earnings and valuations
Emerging markets offer respectable earnings growth estimates (see Exhibit 1.4), and earnings growth has the potential to accelerate, after having recently slumped. On a valuation basis, EM equities are cheap compared to developed markets, and relative to their own valuation history (see Exhibit 5.2).

Bottom line: Emerging markets come with an elevated risk profile and EM equities could suffer as much, or more, should developed market equities come under further pressure and/or global growth slow precipitously. Under our base case scenario, there is a positive tone for risk assets, and emerging market equities are poised to outperform their developed market counterparts. However, we reiterate our expectation for increased global equity volatility. In recognition of the delicate timing of the late stage of the market cycle, EM equities remain a riskier asset class most appropriate for those with a higher risk tolerance and longer time horizon. Weighing the risk factors against the ability for EM equities to outperform developed market equities, we conclude that an underweight recommendation is most appropriate.

b) Global growth
Emerging markets are highly levered to global growth and we expect to see global growth slow in 2019. However, the slowdown is not a contraction; the extent of the slowdown is weighted more heavily to the developed world than emerging markets. Many emerging markets have been forced to tighten monetary policy and economic growth has already slowed, or begun to slow. So, unlike the developed world, the EM’s rate of decline in economic growth is set to abate, with the prospect of a small acceleration late in 2019.

In China, for example, the impact of previous tightening is working its way through the economy to the point where the authorities are now in easing mode, using a variety of tools to gently stimulate the economy and engineer a business cycle upturn. Although a composite of China’s leading economic indicators (LEI) is in contraction territory, it appears to have bottomed and started to climb back up. These changes in direction at the margin occurred in 2012 and 2016, and they preceded a bottom in Chinese companies’ earnings growth expectations and augured better future performance in EM equities.
Fixed Income

We have been warning of very low-to-negative fixed income returns for the past two years as interest rates were rising from ultra-low levels (see Exhibit 6.1). Finally, in 2018, some income returned to fixed income. Government bond yields have moved up from their 2016 lows, but remain unchanged in 2018. Credit spreads widened somewhat. As a result, income flowing through to investors is now better than what it has been for the past two years. We expect further increases in bond yields from current levels, which will erode some of the income component, but our forecasted yield increases will leave a small positive total return. We see returns in the 1 to 2% range for Canadian fixed income. Furthermore, the risk mitigation qualities of fixed income are ever more powerful, and never more necessary. Fixed income is poised to offer many benefits to a well-diversified portfolio in what we expect will be a volatile year.

“When stocks fall out of bed, it’s bonds that save your bacon.” – Brent Joyce

Most importantly, the good news for bond investors is the bond market has slowly been putting the “income” back into fixed income (see Exhibit 6.2). A steadily rising yield environment can be painful for fixed-income investors, but like diet and exercise, it’s leading to a better place. We believe bond price volatility will remain, but we see the greater probability that the Bank of Canada and/or the Fed will pause sooner than expected, and therefore yields remaining lower than expected, versus central banks accelerating hikes and yields spiking.

Central bank policy
Our base case calls for the Bank of Canada to raise the overnight rate to 2.25% (currently at 1.75%) at which point they will pause or stop. A further (and final) 0.25% could come in 2020, bringing the rate to neutral. We see the Fed raising rates to a maximum of 3.00%, abandoning their quarter-point-per-quarter cadence (see Exhibit 1.2).

6.1 | FTSE Canada Universe Bond Index returns
Year-to-date as of November 2018

Source: Bloomberg | FTSE Canada | Dec. 7, 2018
Sensitivity to higher interest rates, owing to elevated debt levels across the board (i.e., household, corporate and public-sector debt), necessitates a lower overall yield environment in Canada. Canadian economic growth is expected to moderate from current levels. Inflation pressures stemming from an overheating economy may be present in the U.S. but we do not see these being as acute an issue for Canada. Canada’s slowing housing market, productivity and competitiveness challenges and impediments to resource extraction that weigh on business investment are further reasons to believe interest rates and bond yields won’t head much higher in Canada.

The majority of our fixed-income return scenarios deliver a positive total return outcome. If yields move up by more than we expect (e.g., a 50 basis point parallel shift in the yield curve), we model a slightly negative return (-0.34%). In a risk-off environment (a parallel shift down by 50 basis points), we model a return in the 6% range.

**Bottom line:** High-quality fixed income’s value as a risk-mitigation tool has increased and continues to increase the longer we go in the cycle (i.e., the greater the likelihood of an equity ‘bear market’). Our asset allocation recommendation remains at a neutral weighting in fixed income with a move toward higher credit quality. We have upgraded our allocation to government bonds; remain overweight, but less so, in investment-grade corporate bonds; and underweight in high-yield bonds. Our base case scenario calls for a total bond market return in 2019 between 1 and 2%.
Sector insights

a) Government bonds
Federal and provincial government bonds are attractive for their superior risk-mitigation qualities. Mid-term and longer sovereign bond yields have risen enough that they can provide an income component while delivering the highest level of upside in the event of a risk-off scenario.

b) Investment-grade corporate bonds
We continue to see these as attractive for their mix of yield pickup and modest safety, but risks have risen since mid-year. Spreads remain narrow, offering little ability for investors to make gains on further spread contraction. Rather, should economic growth slow precipitously and/or corporate profitability be pinched, credit spread widening is the greater risk, which would then erode some of the yield premium offered by investment grade bonds relative to their government bond peers.

We do not see government bond yields falling, nor do we see spreads widening sufficiently, or soon enough, to negate the attraction of the higher-running yield available from investment-grade corporate bonds. As such, we continue to recommend an overweight position. However, our enthusiasm for investment-grade corporate bonds has come down and we favour the higher credit quality spectrum at the expense of the lowest BBB tranche (see Exhibit 6.3).

c) High-yield bonds
Given the very narrow spread levels in high-yield bonds in aggregate (see exhibit 6.4), and their lack of risk-mitigation characteristics as an asset class, the risk/reward tradeoff in high yield is unattractive. High-yield bonds in a risk-off scenario should not be relied upon for risk-mitigation qualities — they generally experience negative returns in ‘risk-off’ markets (see Exhibit 6.5). As such, the attraction lies in the higher yield and greater potential for capital appreciation as spreads decline. At the asset class level, neither of these metrics (yield offered, nor capital appreciation potential) appear very attractive to us at present.

6.3 | Investment-grade corporate bonds
A mix of yield pick-up and modest safety

Source: BMO Capital Markets | Dec. 7, 2018

“High-yield bonds in a risk-off scenario should not be relied upon for risk-mitigation qualities.” – Brent Joyce

However, high-yield bond issuers are not a homogeneous group. Where the risk/return tradeoffs of an individual security are appealing, our active fixed-income managers continue to uncover, select and monitor individual holdings that can augment the overall opportunity within the fixed-income portfolios we manage.
## 6.4 Canadian high-yield bond spreads

Narrow spread levels unattractive

![Graph showing Bloomberg Canadian High Yield Bond Index (spread)](image)

Source: Bloomberg | Dec. 7, 2018

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## 6.5 Fixed income performance during turmoil

**What’s inside your bond fund?**

<table>
<thead>
<tr>
<th>Worst decline periods for Canadian equity</th>
<th>S&amp;P/TSX Composite Index TR</th>
<th>FTSE TMX Canada Universe Bond Index TR</th>
<th>FTSE TMX Canada Corporate Bond Index TR</th>
<th>FTSE TMX Canada High Yield Bond Index TR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep 1, 2000 – Dec 21, 2000</td>
<td>-24.2%</td>
<td>3.1%</td>
<td>2.5%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Jan 30, 2001 – Apr 4, 2001</td>
<td>-20.4%</td>
<td>1.3%</td>
<td>1.5%</td>
<td>2.0%</td>
</tr>
<tr>
<td>May 22, 2001 – Sep 21, 2001</td>
<td>-22.0%</td>
<td>5.0%</td>
<td>4.7%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Mar 7, 2002 – Jul 23, 2002</td>
<td>-22.1%</td>
<td>4.5%</td>
<td>3.4%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Jun 18, 2008 – Mar 9, 2009</td>
<td>-48.5%</td>
<td>4.7%</td>
<td>0.3%</td>
<td>-10.3%</td>
</tr>
<tr>
<td>Apr 5, 2011 – Oct 4, 2011</td>
<td>-20.6%</td>
<td>8.3%</td>
<td>6.5%</td>
<td>-7.8%</td>
</tr>
<tr>
<td>Apr 15, 2015 – Jan 20, 2016</td>
<td>-21.5%</td>
<td>0.1%</td>
<td>-0.3%</td>
<td>-6.6%</td>
</tr>
</tbody>
</table>

Source: Bloomberg | Dec. 7, 2018

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**Two other considerations for credit investors**

The presumption that, going forward, liquidity will remain as ample as it has been is an errant one and we see typical, late-cycle erosion of credit quality. When liquidity does become a problem, the reality of the shifting landscape within the credit spectrum will become a negative. The past several years have been marked by a dramatic increase in leveraged loans, covenant-light bond issuance and bond indices populated by larger percentage weights in lower grade credit. The massive amount of money that has flowed into passive ETF products is likely in for a rude awakening versus the disciplined credit research and risk controls that are hallmarks of active fixed-income management.
GLC Outlook Summary

Fixed income

Fixed income’s value as a risk-mitigation tool has increased, and continues to increase, the longer we go in the cycle. Bond yields have moved up such that income flowing is now better than it has been for the past two years. We expect further increases in bond yields, which will erode some of the income component, but the yield increases we forecast will leave a small positive total return. Maintain a neutral weighting in fixed income, with a move toward higher credit quality. Our base case scenario calls for a total bond market return in 2019 between 1 and 2%.

Government bonds

Government bonds are attractive for their superior risk-mitigation qualities. Sovereign bond yields have risen enough that they can provide an income component while delivering the highest level of upside in the event of a risk-off scenario.

Investment grade corporate bonds

We see investment-grade corporate bonds as most attractive given their mix of yield pickup and modest safety. We expect investment-grade corporate bonds to outperform governments. Spreads have limited room for further tightening. Their generally shorter duration and higher running yield is a benefit in a rising rate environment.

High-yield corporate bonds

High yield spreads remain low. Given the very narrow spread levels and their lack of risk-mitigation characteristics, we see the risk/reward trade-off in high yield as unattractive.

Equity

We believe that the global economy and corporate earnings growth are shifting from acceleration to moderation (not decline), keeping our near-term outlook for equities constructive. Our expected return outcomes between equities and bonds, and amongst regional equity allocations, have narrowed. On a risk-adjusted basis, a neutral stance is most appropriate.

Canada

Canada is a favoured market due to its significant expected earnings growth and attractive valuations. These factors have existed for some time, with little appreciation. Canadian equities require a positive shift in sentiment to unlock their value.

U.S.

We hold a constructive view on U.S. equities based on reasonable valuations and earnings growth potential. Past peak, but a shift to a period of normalized earnings growth and improved valuations will help them post a high single-digit return. The return outlook, lower risk profile and diversification benefits lead us to maintain a slight overweight.

International

We hold a neutral view toward EAFE equities as the group offers a combination of reasonable earnings growth and valuations. Risks remain, but we see a moderation in many of the key risks through 2019 that allows EAFE equities to narrow the performance gap that has opened up against U.S. equities.

Emerging markets

We recommend an underweight to emerging markets, although some of the headwinds from a firmer U.S. dollar, global bond yields trending higher and moderating Chinese growth are set to abate (not disappear). The risk profile of this asset class tempers any enthusiasm at this stage of the market cycle.

Change in view

<table>
<thead>
<tr>
<th>Under</th>
<th>Neutral</th>
<th>Over</th>
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<tbody>
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1 From June 2018.
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