

GLC Insights

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2018 Year in Review

Nowhere to hide

After an unprecedented year of calm in 2017, where investors made money in virtually every asset class, investors were brought back down to earth during 2018.

Corporate earnings growth remained robust, but the ongoing monetary policy tightening cycle in the U.S. and increasing trade tensions (most notably between the U.S. and China) pushed up equity risk premiums and placed downward pressure on valuation multiples. Equity market returns were weighed down by commentary around the length of the current economic cycle (the U.S. economy is on track to mark a record in 2019) and the potential of a slowdown in global growth. Severe equity and bond market volatility was particularly notable throughout December; U.S. equity markets retreated sharply to narrow their year-long outperformance gap with non-U.S. equities. The S&P 500 narrowly averted entering 'bear market' territory, with a peak-to-trough decline of 19.8%, before recovering by 6.6% into the end of the year. North American bond yields witnessed wide swings; Canadian two-year bond yields ended the year higher on the back of three Bank of Canada rate hikes, while 10-year bond yields ended the year lower. The outcome was a modest positive return for bond investors. Importantly, bonds also provided the necessary offset balanced investors rely on, with a near 3% jump for the FTSE Canada Universe Bond Index coinciding with the fourth quarter swoon for equities.

U.S. equities finished in the red but continued to outperform relative to their developed market peers. Robust corporate earnings, boosted by tax cuts, provided fundamental support for U.S. stocks. Multiple contraction offset much of the earnings growth tailwind, resulting in negative returns – a significant downward shift following the ~20% returns achieved in 2017. Much of the damage came in the fourth quarter, which wiped out decent gains up to that point.

2018 Market Summary

Year (%)

| Canadian Fixed Income | | | CAD |
|--------------------------------------|----------|-------|------------------------|
| FTSE Canada Universe Bond Index | 1,051 ▲ | | 1.4 |
| FTSE Canada All Corporate Bond Index | 1,189 ▲ | | 1.1 |
| Canadian Equities | | | |
| S&P/TSX Composite | 14,323 ▼ | | -11.6 |
| S&P/TSX Small Cap | 528 ▼ | | -20.1 |
| Currency | | | |
| Canadian Dollar (CADUSD) | \$0.73 ▼ | | -7.8 |
| Global Equities | | | Local ¹ CAD |
| S&P 500 | 2,507 ▼ | -6.2 | 2.0 |
| NASDAQ | 6,635 ▼ | -3.9 | 4.5 |
| EURO STOXX 50 | 3,001 ▼ | -14.3 | -11.3 |
| FTSE 100 | 6,728 ▼ | -12.5 | -10.3 |
| Nikkei | 20,015 ▼ | -12.1 | -2.4 |
| Shanghai Composite | 2,494 ▼ | -24.6 | -22.3 |
| MSCI Emerging Markets (USD) | 966 ▼ | -16.6 | -9.3 |

Price only equity returns | 1. Local currency unless otherwise specified
| Source: Bloomberg | 31 Dec. 2018

Canadian equities struggled, weighed down by weaker commodity prices and some Canada-centric issues around high household debt, inflated housing prices, low oil prices, resource export bottlenecks, trade frictions and business competitiveness. Across the ocean, political tensions and uncertainty weighed on **European equities** with the U.K. edging closer to a hard Brexit in 2019 and a new Italian government, whose views on fiscal policy stand at odds with the European Union's guidelines. The MSCI **Emerging Markets** (EM) Index entered 'bear market' territory in September as it struggled in the face of a stronger U.S. dollar, tightening global liquidity, a slowing Chinese economy, trade uncertainty and a variety of issues (mainly political) in Turkey, Russia and Latin America.

Trade tensions dominated headlines in 2018. The U.S. and China's tit-for-tat tariff battle weighed heavily as investors feared its impact on an economic cycle that was already "long in the tooth". President Trump and his trade team were rarely outside the news headlines, setting the tone for capital markets. The U.S., Mexico and Canada finally came to a tentative agreement on a revised NAFTA (now called the USMCA), but the drama weighed heavily on Canadian equities.

Monetary policy divergence remained a prescient theme. The U.S. Federal Reserve continued its quarterly rate hike path with four rate increases, bringing the total to nine since late 2015, while continuing to shrink its balance sheet from its QE-induced largess. Europe and Japan maintained their ultra-easy policy stances. The Bank of Canada hiked rates three times, hesitant to move as aggressively as the U.S. due to ongoing NAFTA negotiations, weak domestic oil prices and highly indebted consumers. A weak loonie provided solace for Canadian investors with foreign investment exposure.

Canadian Equities

Pipe dreams!

Sentiment toward Canadian equities remained weak. Losses for the S&P/TSX Composite (TSX) were greatest during the two periods of global equity instability in late January and in Q4. NAFTA negotiations were a headwind and provided little relief, even when a tentative agreement was reached in October. Another factor

weighing on the TSX was its outsized exposure to underperforming sectors, most notably energy. While the S&P/TSX Composite underperformed the S&P 500, it outperformed European, Japanese and emerging market equities in local currency terms.

U.S. WTI (West Texas Intermediate) oil prices collapsed during the fourth quarter, falling over 40% from their October peak of \$76USD. This only tells half the story for the Canadian energy sector however. Pipelines were the theme for 2018. Or, more accurately, a lack of pipelines. A lack of takeaway capacity wreaked havoc for the sector, with widening differentials (Western Canadian Select versus U.S. WTI) slamming already weak sentiment toward Canadian oil producers. Issues came to a head in July when the Federal government stepped in to buy the TransMountain Expansion project from Kinder Morgan Canada, followed later in the year by unprecedented steps from the Alberta government to start buying railcars and locomotives to bolster crude-by-rail capacity, along with instituting industry-wide production curtailments. Canadian oil prices did improve toward the end of the year, but sentiment toward the sector remained depressed.

The heavyweight financials sector also lagged. Concerns over indebted consumers and a slowing domestic housing market outweighed solid financial results for the banks, with the Big Six banks generating a record total of \$45.3-billion in earnings for the 2018 fiscal year. The materials sector likewise weighed on index performance: copper prices were weak on the back of slowing global growth concerns and gold companies underperformed relative to bullion prices.

A lack of enthusiasm for Canadian equities was even more evident in the small cap space, with the S&P/TSX Small Cap Index entering 'bear market' territory late in the year.

U.S. Equities

The bull creeps on...

U.S. equities continued to outperform their global peers, but it was far from smooth sailing in 2018. The S&P recovered nicely following an early year sell off, notably marking the longest bull market on record in August

(3,453 days at that point), before a fourth quarter correction that narrowly missed entering 'bear market' territory erased all the YTD gains. Strong earnings growth from corporate America, boosted higher by tax cuts, were a key reason for U.S. outperformance. Rising interest rates and the ongoing trade dispute between the U.S. and China more than offset this resulting in valuation multiple compression that pushed returns into the red. A weakening loonie helped to positively boost U.S. equity returns slightly for Canadian investors.

Technology stocks (some now reclassified as 'communication services') finally paused after a relentless run in recent years. The tech-heavy NASDAQ Index managed to outperform the S&P 500 for the year, but entered 'bear market' territory in December. The five FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) experienced drawdowns on average of 36%. Some company-specific issues weighed on the group; most notably, a Facebook personal user data scandal. Fears of a global growth slowdown weighed on cyclically-oriented sectors such as industrials, energy and materials. Signs of slowing growth, a flattening yield curve and political uncertainty hit returns for U.S. financials. Defensive sectors such as health care and utilities were the only gainers – the latter benefitting from the fourth quarter collapse in bond yields.

International Equities

Modest markets and volatile politics

The situation in Europe remained cloudy as 2018 drew to a close. Europe's three traditional powerhouses, Germany, France and Britain, all faced political challenges that weighed on European equity markets. Germany's Angela Merkel lost key political support while French president Emmanuel Macron was confronted with protests as he struggled to follow through on his reform program. No one had a harder job than British Prime Minister Theresa May, whose Brexit plans remain in flux with the March 2019 deadline fast approaching. Against this backdrop, along with some softening economic growth in the region, European equities finished down double digits for the year. The Euro and the British pound also saw sizable declines. Meanwhile, Japanese equities couldn't escape the global equity selloff. A sharp fourth quarter drop resulted in a 'bear

market' that left the Nikkei 225 Stock Index in the red for the year.

After a stellar 34% return in 2017, emerging markets (EM) struggled in 2018, entering 'bear market' territory in September. EM was weighed down by tighter global liquidity (stemming from higher U.S. interest rates and U.S. dollar appreciation) and signs of moderation in global economic growth. The threat of a U.S. and China trade war weighed on sentiment across EM, most notably in Asia, with concerns the current standoff could escalate further and destabilize the global trading order. U.S. dollar strength has adversely affected countries with large U.S. dollar denominated debt, such as Turkey and Argentina, who both faced currency crises in 2018.

Fixed Income

A bumpy ride

The FTSE Canada Universe Bond Index produced a positive total return in 2018; however, bond investors endured a high degree of market volatility. A shifting 'risk on' versus 'risk off' narrative resulted in significant intra-period moves; the Universe Index was down over 1% on a YTD basis on three separate occasions before subsequently recovering into positive territory each time. U.S. 10-year bond yields rose sharply early in the year and broke above the 3.0% level on a few occasions, a level last seen in 2013 (and only briefly then), before a fourth quarter drop saw it finish the year at 2.68%. The Government of Canada 10-year bond yield rose above 2.5% for the first time since 2014, before a similar fourth-quarter collapse saw them end the year roughly where they started. The U.S. Federal Reserve hiked rates each quarter while the Bank of Canada hiked three times. Inflation in both the U.S. and Canada remained stable, with wage growth remaining contained despite extremely low unemployment rates in both countries.

When all was said and done, short-term bonds shone brighter than longer-term bonds, and government bonds bested their corporate peers. Investment-grade corporate and high-yield bonds both ended the year with wider credit spreads, but posted positive returns due to their higher running yield.

2019 Capital Market Outlook

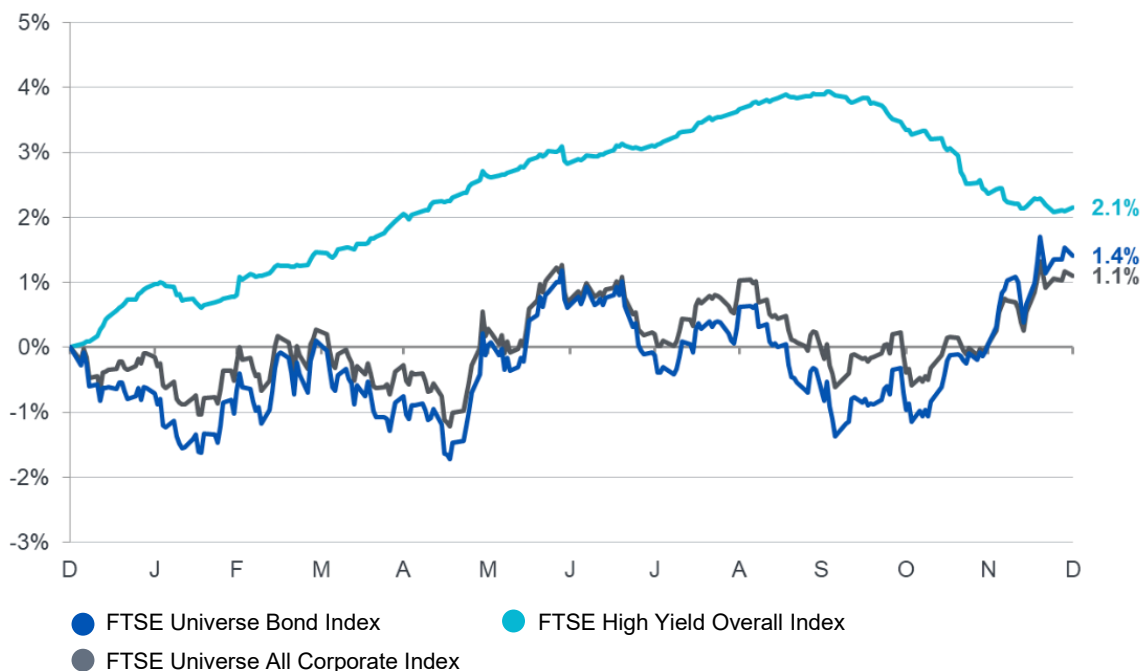
Striking a delicate balance

Heading into 2019, 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. Shifts in corporate earnings, bond yields and equity valuations are changing the opportunity costs of all asset classes. We recommend a neutral stance (risk-tolerance aligned) that is neither overweight in bonds or equities. For more on what capital markets may hold for 2019, please see [GLC's 2019 Capital Market Outlook: Striking a delicate balance.](#)

Canadian Interest Rates

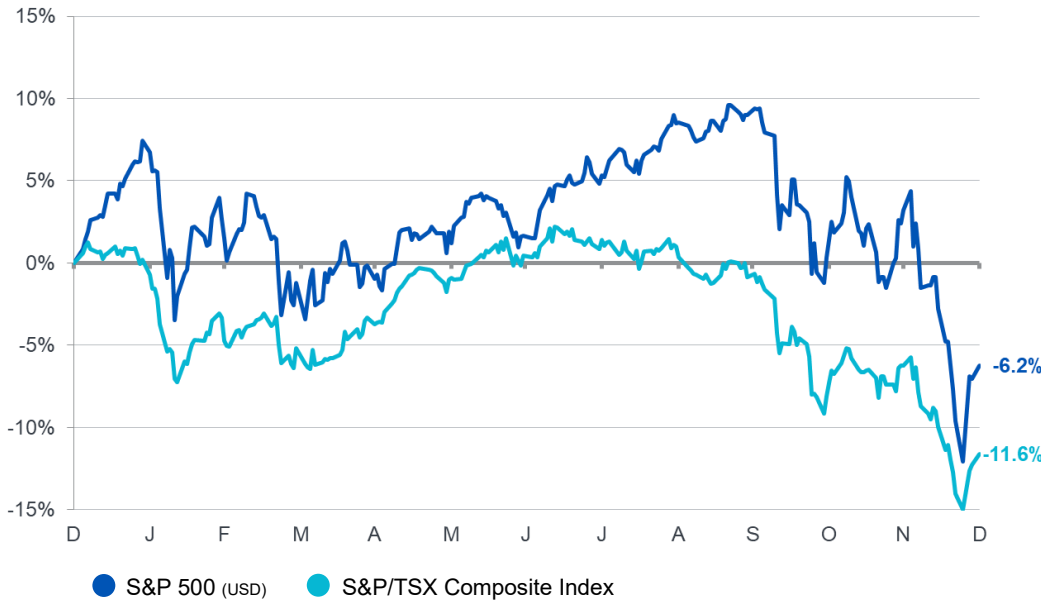
| Treasury Bills | | 1-Yr Change ¹ | |
|----------------------------|-------|--------------------------|--------|
| 3-month | 1.64% | ▲ | 58 bps |
| Government of Canada Bonds | | | |
| 2-year | 1.86% | ▲ | 18 bps |
| 10-year | 1.97% | ▼ | -8 bps |
| 30-year | 2.18% | ▼ | -8 bps |

2018 Canadian Bond Market Performance



Source: Bloomberg | 31 Dec. 2018 | Total return 1. Change in basis points from 31 Dec. 17 to 31 Dec. 18

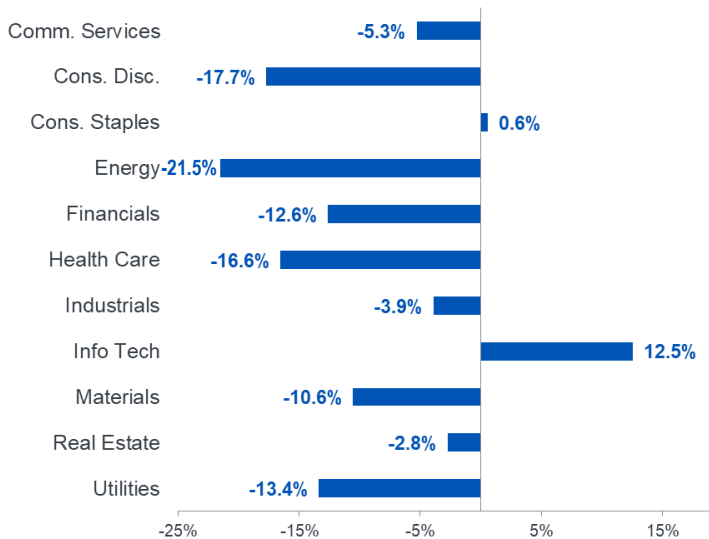
2018 Canadian and U.S. Equity Performance



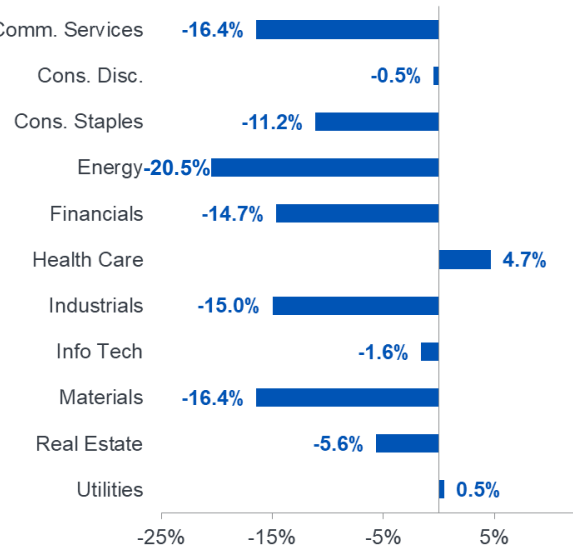
Source: Bloomberg | Price only return | 31 Dec. 18

2018 Sector Returns

S&P/TSX Composite (CAD)



S&P 500 (USD)



Source: Bloomberg | Price only return | 31 Dec. 18

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