

2017 First Quarter Review

“The Beat Goes On” - Sonny Bono

The secular **bull market in stocks remained intact** through the first quarter of 2017, with fresh fuel being provided by a widespread rebound in the global economy, as well as the much-touted commitment by the new US government to lower taxes, reduce regulation and embark on infrastructure spending.

In Canada, stock prices benefitted from positive GDP data - the most recent (January) showing growth at its fastest pace in over five years, notably from manufacturing and mining exports. The hope was that the recent EU trade agreement (CETA) would bolster Canada's prospects and the anticipated NAFTA renegotiation would do no harm. Employment data has been strong for seven consecutive months, partly reflecting the ongoing recovery in the resources sector. The federal government's March budget was generally benign for investors and included significant plans for infrastructure spending. Additionally, the Bank of Canada, in hopes of fostering more growth, left interest rates unchanged.

Now eight years into a bull market, **US equities continued their advance** last quarter. The S&P500 broad market index gained over 5%, while the NASDAQ, which has more of a technology focus,

moved ahead about 10% (both in CA\$ terms). In anticipation of growing strength in the US economy, the Federal Reserve Bank (the Fed) raised its benchmark rate, as expected, by an incremental quarter point.

At the same time, the US dollar, which was at a 14-year high in January, softened against major currencies after the Fed moderated its views on future interest rate increases. The greenback's relative retreat bodes well for all international borrowers of US dollars, especially emerging-markets countries (excluding China). And, like Canada, other central banks maintained accommodative monetary policy. This so-called “**easy money**”, **coupled with ambitious plans for infrastructure spending in Europe and beyond, boosted international equity markets**, which posted very impressive gains.

Turning to fixed income, a global basket of **short-term bonds were up modestly**, even as the Fed increased US interest rates in March. By their nature, bonds cannot perform strongly in a rising interest rate environment. Importantly, however, short-term bonds are very stable and provide valuable “insurance” to offset inevitable stock price volatility.

Following are the returns for major indices for the period ended March 31st, 2017:

	1 st quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.1	0.5	0.6	0.8	1.1
Canadian Bonds (FTSE Short Term Bond)	0.7	1.3	2.1	2.2	3.5
Canadian Stocks (S&P/TSX Comp.)	2.4	18.6	5.8	7.8	4.7
U.S. Stocks (S&P 500)	5.2	20.3	17.5	20.0	9.1
Non-North American Dev. Stocks (EAFE)	6.4	14.7	7.0	12.1	2.5
Emerging Markets Stocks (FTSE / MSCI Emerging)*	10.6	20.4	7.7	6.8	4.2

*Last quarter, 1 year, and 3 year returns are FTSE Emerging. Other periods are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard

Outlook

“Should I Stay, Or Should I Go?” - The Clash

If one looked to the media for investment direction these days, it might seem rash to buy (or even hold) stocks. Certainly, there is no shortage of daunting news: concern about the leadership in Washington, worry about trade wars, agony over Brexit, uneasiness over European populism, superpower tension over military hotspots - to name a few. And, of course, whither interest rates? It is curious, therefore, that in spite of potential calamity, **the overall global economy is gaining strength and stocks continue to rally.**

To sort out these seemingly mixed signals, let's consider the main investment concerns, assess the strength of the global economy in the face of them and gauge the result against current prices in the marketplace:

Taking center stage almost daily is the much-watched drama in Washington, DC, where the first 100 days of the new Trump administration may be remembered more for missteps than achievements. Perhaps the most relevant for investors was the surprising failure of a bill to “repeal and replace” Obamacare, in spite of the Republican majority in Congress. Many (including President Trump) expected it would be an easy lob ball, but a small group of right-wing Republicans, known as the House Freedom Caucus (HFC), refused to sign on. As the White House now regroups to consider future tactics with the HFC, investors wonder whether other campaign promises, importantly tax reform and infrastructure spending, may face similar resistance. And Democrats, feeling much abused by Mr. Trump, may have little reason to cooperate.

Canada is impacted by Washington's new leadership as well. For example, the initial US suggestion that NAFTA needed to be “tweaked” is now sounding as if a more substantial rewrite will be pursued. That possibility, along with the impact of other changing US legislation, leaves enough uncertainty in Canada that, during his recent March budget, Finance Minister Morneau took a mostly “wait-and-see” approach, watching what unfolds in the US before embarking upon meaningful policy shifts.

Abroad, Britain's exit from the EU is now “on the clock” for March, 2019. For investors, there is little to cheer on either side, but Britain has the weaker position. Meanwhile, the EU has a strong incentive to play hardball to discourage other members from considering the same. Yet in spite of a pressing deadline, little progress will be made until after Germany's September election. Also, France and Italy, where populist parties rail against the EU, hold critical elections this spring. **We should expect an element of political uncertainty to be a factor in Europe** for the foreseeable future.

Adding to these issues are deteriorating relations between the US and some major counterparties. These include Russia, with whom events have taken an abrupt turn for the worse following US missile strikes in Syria, and China, who is an essential partner in managing North Korea's escalating provocations. Although **political risks are real and have the potential to intensify into major market events - at least in the short term - experience has shown that when cooler heads prevail, markets recover.** It may not be “Breaking News”, but it is in everyone's self-interest to keep the peace. And they know it.

On the other side of the equation is **an abundance of evidence pointing to a strong and growing economic recovery**, not only in the US, but also in Canada, Europe and in many emerging-markets countries. The US is leading the developed world with positive employment data and an unemployment rate below 5%. This is translating into wage growth, better consumer confidence and renewed demand for housing. Business confidence is also improving thanks to a more robust corporate profit picture, leading to a long overdue uptick in investment. As business invests, employment improves further, boosting consumer confidence and spending, resulting in higher profits. A virtuous circle.

Perhaps most unexpected is the strength in Europe, in spite of tricky politics and lingering debt problems. Even so, GDP is nudging 2%, job growth is at 10-year highs and business confidence is improving. Time will tell if this is enough to temper populist sentiment, but signs are hopeful. In Canada, GDP has also strengthened, as mentioned. But **strongest of all are many emerging-markets economies**. Having battled the headwinds of a strong US dollar for years (most must borrow in USD), they still are managing to far exceed the growth of developed countries.

So therein lies the conundrum for investors. From a security-pricing standpoint, both stocks and bonds are taking an optimistic view. At this point, **US stock valuations are extremely high and are vulnerable** to a correction. Canadian stock prices are somewhat more reasonable, but they too are pricey on a price-to-earnings and price-to-book-value basis. Clearly, the hopes arising from the US election prompted prices to surge ahead of the fundamentals, which will need time to catch up. **Abroad, both Europe and emerging markets are much cheaper** than North American equities, in part due to their particular political situations. All considered, there are sound economic arguments for sustained growth globally, which should be balanced against perceived political risks.

Lastly, although **bonds rates have crept up from their lows of last summer**, they too are priced for a favourable environment that is neither too hot nor too cold. Should US growth shift into a higher gear, leaving the Fed behind the curve, longer-term bonds would be vulnerable. As it looks now, two more quarter-point interest-rate increases are expected in the US this year, as the Fed moves towards a more neutral position.

Portfolio Strategy

Given the strong performance of equities over the past year, many portfolios are reaching rebalancing thresholds, prompting us to make adjustments. Milestone typically allows a 5% “drift” around the policy weighting to take advantage of market momentum and to minimize costs and taxes. We focus on registered accounts first where there is no tax impact but, where this is not feasible, changes are completed in taxable accounts. In most cases, the recent trades involve reducing US or Canadian equities, either to lower overall equity exposure or to add to underweighted international equities, where indicated.

We know there is one thing harder than selling when prices are rising: buying when prices are falling. With that in mind, we want to remind our readers that risk and return are related and it is important to maintain each portfolio’s policy allocation because it best corresponds to specific circumstances and risk-tolerance levels. Even though stocks are an appreciating asset class over time, they can suffer painful declines in shorter time periods, as we have witnessed twice in the past 15 years. Therefore, **Milestone’s discipline of trimming asset classes when they become overweighted will always be an essential feature of our investment management style.**