2017 Third Quarter Review

Markets Advance Amidst Scepticism

Global equity markets kept pace last quarter in the face of uncertainty related to changing trade and monetary policies in several countries as well as escalating geopolitical tensions with North Korea. Canadian stocks bounced back with the recovery of the energy and natural resource sectors. US, international and emerging markets also showed impressive gains, trimmed back somewhat by a rising Canadian dollar.

Surprising many, **Canadian second-quarter GDP growth of 4.5% was reported: the best rate of growth since 2011.** The Bank of Canada (BoC) responded with two quarter-point rate hikes over the summer, pegging its key interest rate at 1%. This prompted the Canadian dollar to climb as high as $0.82US. Because growth forecasts for the second half of 2017 are much lower, the BoC signalled a "wait-and-see" approach to further policy changes in the months ahead.

In the US, the **S&P500, NASDAQ and Dow indices all finished September at or near all-time highs, thanks to a thriving economy**. US second-quarter GDP growth of 3.1% bettered the sluggish first-quarter rate of 1.2%. The Federal Reserve (Fed) announced their plan to begin shrinking the $4.5US trillion portfolio of debt they have amassed since the so-called Great Recession of 2008. This inevitable tightening of monetary policy has been expected and, as the quarter ended, investors seemed to take it in stride.

On the international front, economic conditions in Europe continued to improve. GDP growth for France, Germany and Italy almost met their target of 2%. However, the euro weakened in late September after voters delivered a minority government to Germany's chancellor, Angela Merkel, giving some caution to investors. Meanwhile, worries continued to weigh on Britain's economy, as Prime Minister May struggled to negotiate Brexit with little help, even from some in her own party. Valuations for Japanese stocks were deemed attractive, as "Abenomics" delivered its sixth consecutive quarter of economic growth. And emerging markets stocks, in spite of a recent dip, have returned an impressive 14.6% CAD year-to-date.

In the fixed income market, **yields for US and Canadian bonds rose in response to interest rate hikes**. Most major central banks have affirmed a hawkish tone, predictably resulting in global bond-price weakness. As credit spreads began to shrink, some investors were prompted to seek higher-yielding (riskier) corporate issues.

Following are the returns for major indices for the period ended September 30th, 2017:

	3rd quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.2	0.5	0.6	0.7	1.0
Canadian Bonds (FTSE Short Term Bond)	-0.5	-0.7	1.4	1.7	3.3
Canadian Stocks (S&P/TSX Comp.)	3.7	9.2	4.5	8.1	4.1
U.S. Stocks (S&P 500)	0.7	13.1	15.0	19.9	9.9
Non-North American Dev. Stocks (EAFE)	1.3	13.6	9.0	13.7	3.7
Emerging Markets Stocks (FTSE / MSCI Emerging)*	3.6	13.4	7.9	9.1	4.0

*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

Optimism Is Delayed

As this bull market in stocks approaches 100 months - history's longest except for the 1990-2000 bull market, which ended in the infamous "tech wreck" - some investors wonder if it's time to move to the sidelines. After all, **global stocks have more than tripled since 2009, almost without interruption**. And we have no shortage of worries: tightening monetary policy through higher interest rates and the retraction of quantitative easing, increased protectionism in Britain and the US (two of the world's largest economies) and stretched equity valuations with prices having grown significantly more than corporate profits. And, of course, there is the uneasy situation in North Korea - and possibly Iran. Is this the market's normal "wall of worry" - or something more? Let's discuss.

First, **the early stage of a recovery is just that - recovery**. Stock prices fell 50% during the financial crisis of 2008-2009: it takes a recovery of 100% to bring them back. That takes time. In fact, it wasn't until 2012 that global stock prices bettered their 2007 levels.

Second, **bull markets do not die of old age**. Typically, they end because central banks aggressively ratchet up interest rates to counterbalance too-rapid growth and unhealthy inflation. At this point, most central banks have barely started to ease back on the monetary accelerator and are not yet applying the brakes. Although stock valuations may seem stretched, it is difficult to envision central banks hampering economic growth for a long time yet. Rather, their approach is one of data-dependent caution, whereby future tightening is conditional on stronger economic data. Otherwise, they will stand pat.

Third, **there is no good reason for the corporate profit recovery to end**. *The Economist* recently noted that all 45 countries tracked by the OECD are growing this year, and 33 of them are expected to pick up speed. Over the last 50 years, this has been an extremely rare occurrence. Stronger economies produce more employment, better wages, as well as more robust consumer spending, corporate revenues and profits. Since many corporations have global operations, there is wide participation in a synchronous recovery. Healthier global growth rates may even dampen populist sentiment; some believe recent elections in Germany and France may have benefited in this regard.

A final point is that **late-cycle bull markets typically reveal tendencies of excess and elation** by investors, consumers and businesses alike - famously referred to by Alan Greenspan as "irrational exuberance". Clearly, nothing like that is evident today (notwithstanding the Canadian consumer), as credit conditions in private and commercial loan markets remain subdued in the US, Europe and Japan. John Templeton, a venerable investor, reminds us, "Bull markets are born on pessimism, grow on scepticism, mature on optimism, and die on euphoria". Currently, investors remain cautious, or perhaps cautiously optimistic, in their outlook for stocks.

Despite this benign landscape, we cannot ignore some obvious market risks. Escalating tensions in North Korea are fanning geopolitical tensions. It is not hard to imagine a scenario whereby a decision, a mistake or even an unintended consequence causes tragic loss of life and disrupts financial markets.

Washington's apparent inability to advance important domestic policy also concerns investors. If the much-touted Republican tax reform bill were to flounder as did several "Repeal-and-Replace" health care bills, markets would probably be disappointed. On top of that, the future of NAFTA renegotiations remains a very big question mark.

Canada's affairs are always closely tied to the US, given our shared border and close trading relationship. Additional risks here include the proposed higher taxes on individuals and small businesses, projected minimum-wage hikes in Ontario and Alberta, the recent strength in our dollar which weighs on exports, and higher interest rates for debt-plagued consumers. For example, it is estimated that this year's changes in five-year Canadian mortgage rates has resulted in a 6% increase to mortgage costs for new borrowers.

All things considered, **overseas markets, where monetary policy lags the US and Canada, may offer fewer risks and higher returns**. The European Central Bank (ECB) is holding back on raising interest rates or retracting quantitative-easing until recovery is deemed reliable. Similarly, Britain is challenged by Brexit even as signs of stronger growth emerge. The Bank of Japan's monetary policy lags even further as they add more stimulus to foster a higher inflation rate of 2%. Considering Japan's stock market recovery has taken almost ten years and valuations on equities are not excessive, investors see value there. Emerging markets, having done well in the past year, are still attractive. Recent earnings growth is strong (between 15% and 20%) and dividends are at all-time highs, yet stock prices remain at a 25% discount to their developed-market counterparts, based upon price-to-book or price-to-earnings multiples.

Stocks continue to significantly outperform bonds, as indicated on the first page. In the past year, most equity markets have advanced by double digits compared to flat/negative fixed income returns. Although interest rates in Canada and the US have started to rise recently, they remain low by historical standards and are set to rise further. By definition, the result of that would be a continuation of relatively weak bond returns going forward. Historically, the long-term return premium of stocks over bonds is 3% to 5% per year.

For the last ten years, this relationship has been much narrower due to extremely low interest rates and hampered stock returns. But, we believe a return to the long-term trend, which exists for valid reasons, is likely and would imply stocks continue to outperform bonds.

In portfolios, we have been purchasing GICs, where appropriate, in anticipation of an eventual rising interest-rate environment. The returns available on GICs are higher than those of comparable government or high-quality corporate bonds. And GICs, unlike bonds, maintain their principal value during periods of rising interest rates. We monitor the spreads between GICs and comparable bonds and would move away from GICs if the return premium were to narrow. Preferred shares also remain attractive.

In the equity component, we have been adding to international and emerging-markets positions as part of our disciplined rebalancing process. We do not rebalance portfolios based on any outlook over short periods of time, but rather as part of a consistent process to trim components of the portfolio that have become overweighted and add to asset classes that have become underweighted, relative to individual policy targets. In some portfolios, recent strong equity returns may involve trimming stocks and adding to fixed income positions. As we have discussed many times in the past, we remain certain that a **diversified portfolio and disciplined rebalancing are the keys to long-term investment success.**