2017 Year End Review

A Bellwether Year

Despite ongoing concern about an overdue correction, **global financial markets thrived in 2017 with many indices setting new highs**. Major equity markets recorded double-digit growth with few interruptions. Rising stock prices added more than $9 trillion in market value to global equity markets - the largest one-year gain since the financial crisis.

Canadian equities were positive but greatly underperformed US and international stocks. The S&P/TSX Composite Index returned 9.1% (compared to 21.1% in 2016), hampered mostly by the energy sector. The Bank of Canada (BoC) made two quarter-point increases to its overnight lending rate, now at 1%, in July and September. The Canadian dollar (CAD) strengthened in response.

The US equity market performed exceptionally well in 2017. The S&P 500 Index was up 21.8% (13.6% CAD), delivering positive returns every month of the year, partly in anticipation of significant tax reform. With the tax bill becoming law in December, importantly, it slashes US corporate tax rates from 35% to 21%: welcome news for corporate America.

In the face of very low unemployment rates and incipient inflation, the US Federal Reserve (the Fed) hiked interest rates three times last year, currently targeting 1.5%. Perhaps surprisingly, the **US dollar (USD) remained relatively weak throughout the year** as these moves had been largely anticipated by market participants.

Internationally, developed- and emerging-markets stocks were also strong. In local currency terms, Japan's Nikkei 225 Index returned close to 19.1% and has now achieved its best run in 16 years. As a group, the MSCI EAFE Index, which represents developed countries across the world (excluding Canada and the US), returned 16.6% CAD. However, the best-performing equity category last year was emerging markets, with the FTSE Emerging Markets Index up 22.5% CAD.

As expected on the fixed-income side, **bond prices slipped in the face of higher short-term interest rates**. Nevertheless, fixed-income securities provide an essential balancing force against the typical volatility of stock markets. Similar to other forms of insurance and, especially when interest rates are low, the stability they provide may not be appreciated until it is needed.

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

	4rd quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.2	0.6	0.6	0.7	0.9
Canadian Bonds (FTSE Short Term Bond)	0.3	0.1	1.2	1.7	3.2
Canadian Stocks (S&P/TSX Comp.)	4.5	9.1	6.6	8.6	4.7
U.S. Stocks (S&P 500)	6.7	13.6	14.3	21.2	11.1
Non-North American Dev. Stocks (EAFE)	4.3	16.6	10.6	13.0	4.4
Emerging Markets Stocks (FTSE / MSCI Emerging)*	6.9	22.5	10.3	9.3	4.1

* 4th 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

Forward, Ho!

In 2017, “headline news” and stock markets seemed largely disconnected from each other, with no shortage of unnerving events for investors to digest: geopolitical tensions, natural disasters, political divisiveness and occasional high drama in Washington. Nevertheless, **market performance was robust as investors focused on overall global economic growth**. Looking forward, aggregate global growth remains in a positive trend, but key economies are at different stages of the cycle, suggesting regions have different prospects for future returns.

Let’s start with Canada. After stellar growth in the first half of 2017, our economy has moderated on the heels of two interest rate hikes. Consumers and businesses alike face some stress. Higher rates as well as record household debt levels and tighter mortgage-lending rules may reduce consumers’ discretionary income in 2018. Meanwhile, many corporations are now coping with higher minimum wages and some also worry about the potential breakdown of NAFTA negotiations. In Canada’s oil patch, capital expenditures are a long way from their 2014 peak, with recent pipeline issues being another impediment to the sector’s recovery. This leaves government spending on infrastructure as the major near-term support for GDP growth. Following a strong December jobs report, economists are now expecting a quarter-percent hike from the BoC this month. That noted, we believe any additional hikes this year will be approached with caution so as not to disrupt economic activity in what is still a sensitive environment.

South of the border, it’s a different story. **The US economy is on solid footings and business confidence is high**. At 4.1%, the unemployment rate is at its lowest point in over a decade, and real wage growth is starting to take shape. As 2018 begins, US equity markets are hitting new highs, capping the Trump administration’s first year. While there is some debate as to how much credit President Trump may deserve, there is no doubt that his pro-business stance positively influences investor sentiment, even as he struggles with other controversies. By far his biggest triumph came in December when he signed the first major tax reform legislation in 30 years.

Taking stock of the data, it looks as if the US is in the later stages of its business cycle, and **there are questions about how much further the tax initiative can stimulate an already mature economy**. So far, investors seem to believe it will. Trump’s administration believes that tax reform, coupled with capital-market deregulation, will enhance real GDP growth to 3% from 2%. However, with the economy already operating close to full employment, this could only be achieved through huge (and unlikely) productivity gains. Further, it remains to be seen if the corporations and high-net-worth individuals who benefit most from tax cuts will circulate their windfall back into the economy as a form of stimulus. Lastly, the massive deficit resulting from lower tax revenues could ultimately prove to be a detriment, limiting any fiscal response in the event the US economy falters for some reason.

President Trump may be successful in further stoking growth, but an overheated economy could be subject to both inflationary pressures and the Fed’s efforts to moderate them. **A faster pace of interest-rate hikes could easily be the impetus for an economic slowdown with an attendant market correction**. And finally, while the events in the White House have been largely ignored by markets so far, the ongoing Mueller (special counsel) investigation could be different, depending on the eventual consequences (if any) for the Trump administration.

Outside of North America, the picture for many countries is brightening. Economic recovery in the eurozone lagged behind the US and UK, but now the region's broad-based expansion is playing catch-up as it shifts into second gear. The third quarter of 2017 marked its 18th consecutive quarter of growth. Reassuringly, the "drivers" are domestic in nature: an increase in private consumption due to improved employment, more bank lending and local investment. It bodes well that monetary policy is expected to remain accommodative. Investors will be watching developments around Brexit negotiations where a "no deal" scenario would be damaging to both parties. In Japan, after years of deflation, economic activity has picked up and the central bank is expected to maintain stimulus to encourage higher inflation. While Europe is in second gear, emerging-markets countries remain in somewhat of a hodgepodge: improvements in India and Brazil are expected to offset a slowdown in China.

A final point: we wouldn't be surprised to hear that your neighbours know what a Bitcoin Wallet is, so we feel the need to touch on the subject of cryptocurrencies and their relationship to valuations in other asset classes. To us, this feels a little like 1999 - just before the infamous "tech wreck". **In our view, the bitcoin mania stems from price inflation across most other asset classes, as investors search for outperformance**. Fixed-income investments seem unattractive so demand remains strong for equities - and alternatives. It is true that valuation multiples for US stocks are historically high and yields on riskier and less liquid assets continue to compress. That said, while equity markets may be somewhat expensive, particularly in the US, the diverging trends we have highlighted are likely to present investment opportunities - unlike the bitcoin marketplace, which at this point we view as one of rampant speculation.

We remain in one of the longest bull markets in history, coinciding with a period of extremely low volatility. Unfortunately, this environment will not last forever and **investors should prepare for stock market weakness** which lies ahead at some point. Economic fundamentals look quite solid, but there are clearly some frothy prices. Whether it is the surge in cryptocurrencies or the very strong performance of technology and marijuana stocks, certain market segments appear expensive and vulnerable.

We strongly believe in broad portfolio diversification to weather the variability of equity returns over time. We also tilt our portfolios toward "value" stocks through holdings in DFA, which have historically provided a return premium over "growth" stocks. Importantly, "value" stocks should provide some downside protection in the event of a stock market correction. In portfolios, we continue to rebalance to policy targets, typically trimming equity positions due to their strong relative performance.

In fixed-income portfolios we continue to hold a balance of high-quality bonds, GICs and preferred shares, where appropriate. We are also gradually introducing a new holding, primarily through maturities, to enhance fixed-income diversification. The fund is called *RP Fixed Income Plus* and, by pursuing opportunities in the short-term corporate bond market, its current objective is to generate returns in excess of 3% (after expenses), with little incremental risk.

Overall, **while the global economic outlook is favourable, unexpected shocks can occur**. The best way to ride out inevitable short-term ups and downs in stock markets is to maintain high-quality, fixed-income positions alongside a diversified global equity portfolio, with the asset mix being mandated by each person's individual tolerance for risk.