2018 First Quarter Review

"Fasten your seat belts. It's going to be a bumpy night." - Bette Davis in "All About Eve"

Major markets experienced more volatility in the first quarter of 2018 than in all of 2017. For example, the S&P 500 and Dow Jones Industrial Average (DJIA) indices saw twice the number of days with at least a 1% price change (up or down) compared to all of last year. Early on, investors worried that strong US economic data might lead to rising inflation and aggressively higher interest rates in 2018. Then, President Trump's decision to impose new tariffs, risking a global trade war, caused further market chaos. Most recently, investors were rattled by evidence of some dubious practices among those in the massive tech sector, led by Facebook, Amazon, Apple, Netflix and Google (FAANG), giving rise to loud calls for more government oversight and regulation.

Canada, as always, was affected by the US economy and US interest-rate policy, but last quarter it was our trading relationship that was front and centre. Ongoing NAFTA negotiations kept many investors on edge: the S&P/TSX Composite ended down 4.5%. Another concern for Canada is the troubling level of consumer debt: individuals owe about $1.70 for every $1.00 of their disposable income (mainly housing costs), ranking us among the worst of 35 developed and developing countries. Compared to the US with its recent tax cuts, deregulation and upbeat consumer sentiment, Canada's economy seems less buoyant on several fronts, and untenable consumer-debt levels add to economic headwinds not easily remedied.

The Canadian dollar (CAD) was relatively weak last quarter, boosting returns for US equities in CAD: the S&P 500 gained 2.3% (CAD) in spite of its ups and downs. The DJIA index, which tracks only 30 bellwether US stocks, fell over 10% from its peak in January, officially signaling a market "correction". **Most analysts agree this correction is long overdue - even healthy - given how far stock valuations have stretched in recent years.**

Internationally, the MSCI EAFE index of developed countries returned 1.5% (CAD). In general, **all markets were constrained by rising trade-dispute tensions between China and the US, realizing their economies may also face tougher US policy down the road**. Emerging markets delivered the best performance last quarter, up 4.2% (CAD).

In fixed income markets, a basket of short-term Canadian bonds gained marginally, up 0.2%. **Coupon rates on shorter-term Canadian bonds and GICs have risen subsequent to the Bank of Canada's interest rate hikes**. Abroad, Europe and Japan maintained accommodative monetary policies, resulting in more attractive performance for foreign bondholders.

Following are the returns for major indices for the period ended March 31st, 2018:

	1st quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.3	0.8	0.6	0.7	0.8
Canadian Bonds (FTSE Short Term Bond)	0.2	-0.4	0.7	1.6	2.9
Canadian Stocks (S&P/TSX Comp.)	-4.5	1.7	4.1	6.9	4.5
U.S. Stocks (S&P 500)	2.3	10.4	11.4	18.9	12.0
Non-North American Dev. Stocks (EAFE)	1.5	11.2	6.2	11.7	5.1
Emerging Markets Stocks (FTSE / MSCI Emerging)*	4.2	16.6	7.9	9.5	5.4

* 1st quarter, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

Outlook

“Why can’t we all just…get along?” - Jack Nicholson in “Mars Attacks!”

The return of volatile markets has been unsettling, especially since it was easy to be lulled by many months of uninterrupted gains. It helps to put last quarter’s rough ride into perspective: **at the end of March, the S&P 500 was back to levels we haven’t seen since as far back as…November 2017!** Its drop of 8% from January’s high is actually quite typical when compared to similar past occurrences, and there have been many: US markets have declined by 10% over 150 times since 1926. Granted, it feels unwelcome, but a healthy pull-back was long overdue as we have argued for some time.

Keep in mind that stock-price volatility should be expected: one important reason equities provide a higher long-term return than more conservative investments, such as fixed income, is *because* of volatility. We would prefer to see a series of short, even sharp, corrections rather than the alternative of a more severe, extended bear market. Those tend to occur when prices keep climbing faster than earnings for far too long without a meaningful correction. Suffice to say: investors with long time horizons should not fret - **the return of volatility is a return to normal**.

As mentioned, **Canadian investors are focused on how a “new” NAFTA will impact our economy**. The US has set May 1st as its deadline for an agreement and, until then, reprieve has been granted for proposed US tariffs (taxes) on steel and aluminum, which would almost certainly be detrimental to Canadian metal producers and related industries. Unfortunately, NAFTA isn’t the only challenge the Canadian economy faces.

Other concerns surround the housing market where recently implemented regulations and the trickle-down effect of three rate hikes are having some impact. **Borrowing costs have gone up alongside other prices related to various minimum-wage hikes across the country, both resulting in rising inflationary pressure at a time when Canadian economic growth shows signs of slowing.** The recent federal budget failed to address our deteriorating competitive position vis-à-vis the US even as US tax reform and higher US interest rates are encouraging investment capital to move south. Instead the government committed itself to increasing deficits; a move not considered prudent by investors.

If the US markets started the year in apparent high spirits, the tone has since changed dramatically. President Trump seems to be boldly risking a global trade war even though experts of all kinds, including those in his own administration, agree that nobody wins and everybody loses a trade war. Specifically, his US trade representative, Robert Lighthizer, who’s also negotiating NAFTA, is on record as not in favour; Trump’s former economic advisor, Gary Cohn, resigned in protest.

Perhaps the president’s stance is a form of political posturing related to US mid-term elections this fall (similar to his attacks on Amazon), but investors worldwide can only hope that cooler heads prevail and take a more measured approach to resolving legitimate trade issues.

In Europe, economic growth continues and sentiment remains positive in spite of Italy’s unstable political situation. Investors are encouraged that the region is making significant progress on Brexit, with the UK and EU having recently reached a workable draft agreement for withdrawal. Also, like Canada and Mexico, European exporters have been temporarily exempted from US tariffs, hopefully leaving time for negotiation. Monetary policy is still accommodative or “easy” in the euro zone, although the central bank says it is on a tightening path towards normalization if economic activity continues to pick up.

The outlook for emerging markets is not as bright, mostly because of escalating trade tensions between the US and China. China is a hub for product assembly and many emerging-markets countries ship input parts to China for goods ultimately destined for the US. As a result, fear of protectionist trade policies has negatively impacted most emerging-markets stocks and currencies alike.

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