2019 First Quarter Review

"Happy Days Are Here Again." - Jack Yellen

After the upsetting market turmoil in late 2018, the first quarter of 2019 delivered an astonishing turnaround for global equities. US stocks have not had a better January in over 30 years, as the S&P 500 gained 7.9% USD (4.0% CAD). And **despite ongoing concerns over trade negotiations, interest rates and even a possible recession, corporate earnings remained healthy and growth continued to trend along positively**.

Events in Washington continued to garner attention. After a rough 35 days, the US federal government shutdown finally ended late January when President Trump signed a short-term spending bill. It may have hampered growth somewhat, but recent data show economic expansion continued, albeit at a slower pace than the previous quarter. The labour market was strong with low unemployment, but **indicators do suggest challenges may lie ahead for consumers and businesses**. The Federal Reserve (the Fed) held rates steady last month and the expectation is that rates will remain in their current range of 2.25%-2.5%, probably until 2020. This news left US markets relieved: the S&P 500 returned 11.3% (CAD) for the quarter.

Also recovering, Canada's S&P/TSX Composite Index gained 13.3% CAD last quarter. Investors were pleased the Bank of Canada (BoC) kept rates steady at 1.75% in consideration of our less-than-robust economy. But troubling political headlines involving the federal government and SNC-Lavalin raised questions about the Liberal's re-election prospects in this year's fall election. On top of that, **relations with China became increasingly difficult, threatening our important trading relationship**. Nevertheless, economic data released for January was unexpectedly positive: GDP expanded at 0.3%, with output increasing in 18 of 20 industries.

Internationally, **the UK's Brexit impasse continued with no parliamentary consensus reached** by their original March 29th deadline. Debate continued, but the nature of the ultimate agreement between the UK and the EU remained anyone's guess. Even know-it-all pundits are confounded at this point. Elsewhere however, **markets found renewed hope that progress in the US/China trade negotiations might allow for a deal soon**. Overall, the first-quarter returns for developed international markets and emerging markets were up 7.7% and 8.8% (CAD), respectively.

Bond yields slipped (prices rose) last quarter as central banks shifted to a dovish stance. But for the first time since 2007, the yield curve inverted when the interest rate for US 10-year Treasuries fell below that of 3-month treasury bills. Historically, an inverted yield curve has often been an early warning sign of an upcoming recession. That, along with emerging signs of slower growth, left investors feeling some caution about the future. For the quarter, short-term Canadian government bonds returned 1.7% (CAD).

Following are the returns for major indices for the period ended March 31st, 2019:

	1st quarter actual	YTD actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.4	0.4	1.4	0.9	0.8	0.8
Canadian Bonds (FTSE Short Term Bond)	1.7	1.7	3.5	1.4	1.9	2.5
Canadian Stocks (S&P/TSX Comp.)	13.3	13.3	8.1	9.3	5.4	9.5
U.S. Stocks (S&P 500)	11.3	11.3	13.4	14.6	15.2	16.6
Non-North American Dev. Stocks (EAFE)	7.7	7.7	-0.3	8.3	6.3	9.6
Emerging Markets Stocks (FTSE / MSCI Emerging)*	8.8	8.8	-3.0	10.8	7.6	9.6

* 1st quarter, YTD, 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

"Don't Rain On My Parade!" - Bob Merrill

Looking back, it is now clear that the **primary factor contributing to market volatility last quarter was the prospect of higher interest rates**. In light of more recent evidence that the US economy may not be growing as fast as anticipated, the Fed has since backed off its hawkish stance in a complete about-face on interest-rate policy. The consensus view in the fall of 2018 was for three US rate hikes in 2019 and another in 2020. Now, a few months later, the expectation is for none this year and possibly only one increase in 2020. As a result, stock markets have rallied strongly. The second quarter begins with the S&P 500 only three percentage points or so off its all-time high of last September. That said, March did not end without investors considering some worrying issues that could impact the future trajectory of prices.

At the forefront are **concerns about how much longer the US economy can keep expanding**. This is being reflected in March's drastic drop in mid- to long-term bond yields, as investors reacted to February's poor industrial data and jobs numbers. To explain, lower yields on bonds tend to indicate growth may be slowing. Thankfully, some more recent signals have been positive, including the resumption of US/China trade talks, the Mueller investigation ending with no serious consequences and a very strong jobs report in March. Nevertheless, **we think that over the next several months, conflicting economic data will continue to leave investors trying to gauge whether the US economy still has legs or not, and further price volatility is likely**.

Canada has its own set of conflicting indicators for investors to consider. The political outlook has become less clear as the federal government navigates the messy SNC-Lavalin scandal, making the upcoming October election more of a contest than might have been expected. Meanwhile, the oil patch continues to struggle, consumer spending has decelerated as a result of a downturn in housing and business purchases have also declined. Our relations with China continue to deteriorate, with the federal government having butted heads over the extradition process of Huawei's CFO. Unfortunately, this political spat has led to an unwelcome assortment of trade-related issues, including China now refusing to accept Canada's canola exports.

These ongoing tensions with China, coupled with the risk of lower demand from US consumers if their economy were to stall, will be important for the Canadian market in the months ahead. So far, so good. In the first quarter, Canada's employment data was quite robust and, after contracting in November and December, January's GDP growth turned positive. The BoC is now clearly watching for weaker signals and, like their US counterparts, Canadian monetary policy now reflects their view that "stimulative rates" are needed. This suggests that a Canadian interest rate hike is off the table this year. Some economists are even anticipating a rate cut by December if Canada's economic conditions were to become more tepid.

In Europe, subdued economic conditions persist as the region deals with auto tariffs, a drop in global demand and frustrating uncertainty surrounding the Brexit saga. Yet there are some signs of stabilization, including rising retail sales and unemployment data holding at a multi-year low. The European Central Bank seems to have a handle on inflation, which is encouraging as it should allow monetary policy to remain accommodative if necessary.

Emerging-markets followers will be paying very close attention to China/US trade talks as progress or lack thereof will have far-reaching implications. Thought to have been on a downtrend, **China's economy is showing some positive signals** as Q2 gets underway, with factory orders and employment data picking up again. This is a reassuring development for the world's second largest economy. Other emerging-markets companies, particularly those that do business in countries that borrow in US dollars, have experienced a partial recovery from a difficult 2018 and will continue to benefit from lower US interest rates.

Portfolio Strategy

As we've discussed above, the shift to easier monetary policy in the first quarter had a dramatic positive impact on markets. On the other hand, the unusual occurrence of an inverted yield curve in late March shook some nerves for a few days near quarter end.

By way of background, in a gradually improving economy longer-term interest rates are higher than short-term rates. During normal times of economic expansion, central banks start to raise rates as the cycle matures in order to moderate too-fast growth and/or inflation. Eventually as rates rise, growth slows, resulting in a change in expectations and a subsequent decline in longer-term interest rates.

With the yield curve inverting temporarily in late March, many pundits wondered if it might be a harbinger of an upcoming recession. While this could yet materialize, historically the yield curve needs to remain inverted for an extended period before the real economy or stock markets are negatively affected. This recent inversion was temporary and the yield curve has already normalized. We might hope that perhaps central banks are now more effective than they used to be at managing interest-rate policy. Certainly, their cautious approach of slow measured changes over the past ten years has contributed to the continuation of the current favourable investment environment.

In portfolios, we expect to selectively trim equity positions, where appropriate, given their recent strong rebound, and add the proceeds to fixed income. With the decline in interest rates in the last few months of almost a full percentage point on five-year maturities, we expect to direct new purchases to shorter-term issues. Although the yield curve is not inverted currently, it is relatively flat (i.e., similar rate offered for various terms) with not much of a premium being available on three- to five-year issues.

Unfortunately, no one knows if a recession is on the horizon or not, but we do know that central banks will do what they can to support a stable global economy. Uncertainty about interest rates (and other factors) may add to short-term market volatility in the months ahead but, as we have witnessed (again) over the past six months, **investors who ignore short-term market noise and stick to a longer-term plan hold the key to their investment success over time**.