2018 Second Quarter Review

"I'm mad as hell, and I'm not going to take this anymore." - Peter Finch in "Network" (1976)

There are years when investors monitor the ups and downs of world markets against a backdrop of seemingly normal, if changing, economic and political events. 2018 is not one of those years. After months of growing anxiety over Washington's contentious rhetoric regarding US trade policy, which alarmed friend and foe alike, **June ended with NAFTA negotiations stalled** (possibly until after November's US mid-term elections) and **Chinese officials accusing the US of having launched "the biggest trade war in economic history"**. Investors had good reason to worry for, as expected, the response to punitive new US tariffs was quick: Canada, Mexico, China, the EU and others countered with tariffs on US imports. Tit for tat.

So, even though the Canadian TSX Index gained 6.8% last quarter, **our economic situation was best described as "at a crossroads"**. On the one hand, the economy seemed to be thriving with low unemployment, growing exports and production near full capacity. On the other hand, the prospect of protracted trade negotiations with the US - the destination for 76% of our exports - pointed to difficult days ahead. With that in mind, the Bank of Canada (BoC) held its meeting on July 11th and decided to increase the key interest rate to 1.5% (a quarter-point increase), after numbers from Statistics Canada suggested a growing and healthy economy. The BoC noted that it would continue to keep an eye on trade tensions with the US.

The US enjoyed an even stronger rebound in their economy. Business confidence was upbeat as President Trump's tax cuts and other deregulation started to deliver results. Away from blaring political headlines, consumer sentiment also remained generally positive, with good employment and healthy consumer spending being reported. US stocks, as measured by the S&P 500, were up 5.4% CAD for the quarter. As expected, the Federal Reserve (the Fed) raised its key interest rate in March to the range of 1.75%-2%, its seventh increase since 2015. Further hikes are anticipated this year.

Overseas, escalating trade tensions took their toll on developed and emerging-markets countries alike. In particular, Germany and China, who suffered the brunt of US tariffs, saw growth start to slow. The Japanese economy inched up marginally, but as an export-dependent nation, it too worried about punitive trade barriers. After the expansion of its service sector, the UK economy bounced back last quarter, but complex aspects of the Brexit negotiation remained unresolved. For the quarter, the MSCI EAFE Index finished up 0.6% CAD, while the FTSE Emerging Markets Index was down 6.5% CAD.

Canadian and US bond yields rose significantly more than their global peers. Investors required higher premiums on longer-dated bonds, in part due to rising inflation. As trade tensions escalated, however, bond yields slipped (prices rose) as more investors sought the security of fixed income. A basket of short-term Canadian bonds finished up 0.3%.

Following are the returns for major indices for the period ended June 30th, 2018:

	2nd quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.3	0.9	0.6	0.7	0.8
Canadian Bonds (FTSE Short Term Bond)	0.3	0.4	0.7	1.7	2.9
Canadian Stocks (S&P/TSX Comp.)	6.8	10.4	7.0	9.2	4.2
U.S. Stocks (S&P 500)	5.4	15.8	13.9	18.6	13.0
Non-North American Dev. Stocks (EAFE)	0.6	7.9	6.8	11.3	5.5
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-6.5	7.9	5.3	9.0	4.9

* 2nd 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

"What we got here is a failure to communicate." - Paul Newman in "Cool Hand Luke" (1967)

As we enter the second half of 2018, **the Trump administration is stoking trade-war fires with escalating tariff threats**. And as mentioned, in response to recent US taxes on steel, aluminum and other imports, Canada, the EU, China, Mexico and other nations are retaliating. Despite this, President Trump appears to be "doubling down" on his demand for concessions, going so far as to suggest levies on auto imports to the US: 25% and 20% from Canada and the EU, respectively. This news is being met with widespread criticism, as experts warn such a move would not only harm international producers but also negatively impact US-based auto companies and US consumers, as well.

It goes without saying that, after weathering a turbulent first six months, investors are likely to be paying close attention to trade-related developments for the balance of 2018. Also on their radar: US interest rates. **Continued economic expansion south of the border could prompt the Fed to accelerate the pace of future interest rate hikes**, taking the wind out of the sails of the US stock market. Some analysts already consider it to be overextended based on current valuations and they believe many US companies have entered the later stage of their earnings cycle, leaving little room for additional growth.

In Canada, not only have earlier hopes for an imminent NAFTA deal dimmed, but worse, **trade tension with the US is rising**: new tariffs are now in place on both sides of the border, and the very wellbeing of Canada's auto industry may be hanging in the balance. On that score, analysts have projected that a 25% auto tariff on exports to the US could mean as many as 900,000 of the two million cars Canada produces each year could be at risk. Some scenarios project as many as 160,000 Canadian jobs could be lost, causing GDP to shrink as much as 1%. And, with Mexico not fully transitioning to its new government until December, it may be many months before a NAFTA deal is done. Clearly, this delay complicates the outlook for Canada's economy.

Perhaps the recent rise in oil prices will help offset some of this concern. Caused by a shortage of supply worldwide, higher prices are leading to gains for Canadian energy stocks. In its effort to improve Canada's energy supply lines and to diversify away from the US, the federal government made a bold and controversial decision in late May to purchase the Trans Mountain pipeline. Only time will tell if the project is ultimately profitable, but the $4.5 billion commitment is set to significantly increase deficits in the meantime.

From the standpoint of those in Canada's business community concerned about the outflow of investment dollars to the US following their recent tax changes, **the election of a business-friendly majority PC government in Ontario is viewed as a step in the right direction.** That said, both the cooling real estate market and elevated household debt levels continue to be risks to the Canadian economy, and the July 11 decision by the Bank of Canada to raise rates will further impact housing affordability and borrowing costs.

Elsewhere, after a solid start to the year, **economic growth in Europe is showing signs of moderating**. The region is also facing new political challenges as both Italy and Spain recently elected unstable minority governments. Again however, it is the US posing an immediate economic threat because it is the largest market for EU car exports. As such, any US auto tax would certainly create a significant economic headwind for the euro zone. That risk notwithstanding, rising prices and the improving economy prompted the European Central Bank (ECB) to announce in mid-June that it plans to end its asset purchase program by year end. In addition, the ECB provided guidance

that it expects to maintain interest rates at accommodative low levels until the summer of 2019, at least. This bodes well for Europe's continued economic recovery.

The emergent trade war is causing turmoil in emerging-markets economies too. The most obvious examples are the large export-heavy countries like China and South Korea, but smaller ones in their supply chain also suffer. It is only the commodity producers, such as Brazil and Russia, which are expected to fare better.

As noted, the combination of rising interest rates and a tariff war has increased market volatility this year. Although stock market volatility is normal - even healthy over the longer term - it perhaps feels worse because investors have been lulled by such an atypical extended period of market calm. It is important to remember there are always uncertainties in the global economy - for any number of reasons. Stock markets climb a "wall of worry" - that's a fact. Investment success is achieved by staying on course through these periods of uncomfortable turbulence.

It might help to remember that one of the primary reasons we are experiencing this elongated business cycle with its robust equity markets (ten years and counting) is because of the coordinated global efforts of central banks to keep interest rates very low. While the introduction of new tariffs is not a positive development, it is likely that, **as central banks keep a watchful eye, they are ready to provide monetary support should the trade war escalate**.

In fixed income portfolios, we are taking advantage of the rising interest-rate environment to lock in rates above 3%. While interest rates still remain quite low on high-quality fixed income investments, importantly, they provide valuable insurance against the increased volatility being experienced in equity markets.

(A final note for portfolios holding individual real estate investment trusts (REITs): Canadian Real Estate Investment Trust merged with Choice Properties last quarter with the surviving entity retaining the "Choice" name. The combined company is now the largest REIT in Canada with a portfolio of almost 700 properties.)