Late-Year Selloff Snowballs on Uncertainty

Quarterly Market Commentary

Fourth Quarter 2018

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- The final quarter of 2018 hosted precipitous declines in stock markets around the globe, which settled into full-year losses.
- Domestic fixed-income markets finished the year on a generally positive note, while U.S. high-yield bonds slipped as investors preferred higher-quality bonds with less risk.
- As painful as 2018 was for risk assets, their gyrations were not outside the norm. We see another important risk-on opportunity developing in equities and elsewhere.

SEI's Domestic View

Canadians breathed a sigh of relief when the U.S. came to terms over a re-vamped North American Free Trade Agreement (NAFTA) deal, now known by the ungainly acronym USMCA (United States-Mexico-Canada Agreement). The deal gives the U.S. access to 5% of the Canadian dairy market, a similar share granted to European and Pacific-Rim nations as part of the EU-Canada Comprehensive Economic and Trade Agreement (CETA) and the Trans-Pacific Partnership (TPP) trade agreement. In return, the U.S. agreed to keep intact a NAFTA dispute-resolution mechanism known as Chapter 19. Canadian autos also would not be subject to import tariffs if the U.S. eventually decides to impose them on other countries. USMCA still needs to be approved by a fractious U.S. Congress, but we're assuming it will be supported once the politicians have their say in front of the cameras and, perhaps, after making some additional modest tweaks to mollify the newly empowered Democratic majority in the House of Representatives. In the meantime, U.S. President Donald Trump has generally left Canada alone, reserving his anti-NAFTA tweets for Mexico and the southern border.

And so, economic life between Canada and the U.S. should go on as before. But there are other challenges facing Canada beyond NAFTA. Inflation-adjusted economic growth—that is, real gross domestic product (GDP)—has been running at about a 2% pace for the 12 months ending September 30. That's slightly better than the growth achieved in Europe, but it certainly looks disappointing versus the U.S. acceleration to 3% in the same one-year period. There has been a material downshift in Canadian household consumption, for example, as rising interest rates and high debt levels weigh heavily on disposable income. Fixed investment, meanwhile, has fallen in recent quarters. Businesses may have been discouraged from investing in plants and equipment owing to the uncertain outlook for NAFTA. Perhaps we will see some recovery in 2019.

Investment in the oil patch is a different story, however. Canadian oil and gas producers recorded a reduction in total rig activity in 2018, even as global oil prices were rising. Pipeline and rail constraints that kept Canadian oil locked up in western Canada led to a sharp expansion in the discount at which Canadian oil traded versus West Texas Intermediate (WTI), a grade of crude oil that originates in the U.S. and is used as a benchmark in oil pricing. That differential has narrowed considerably since October, but mostly because the WTI price has collapsed. In addition to the negative effect on investment, the woes of Canadian oil should also bite into the revenues of the provincial governments of Alberta and Saskatchewan.

Trade in goods has been mixed. Total exports (measured as a 12-month moving sum to smooth out the fluctuations) have risen 6% in the year through October. Energy exports are up 17% (although the slide in oil prices should dampen this amount considerably in coming months), while other merchandise exports have advanced by a more sedate 3.6%. Non-oil exports have shown only modest growth since 2016 despite the relatively robust growth seen in the U.S. and the advantage of having a weak currency.

There's an obvious reason why non-oil exports are growing more slowly than they should—Canada's competitiveness, as measured by the trend in unit labour costs, leaves much to be desired. Canada's cumulative increase in unit labour costs over the past 18 years is worse than that of Italy. This poor performance even takes into account the decline in relative unit labour costs achieved between 2012 and 2015. That reduction was caused primarily by the sharp depreciation of the loonie against the U.S. dollar and the euro. More recently, it's surprising to see that wage rates and other measures of labour compensation have eased. This has happened despite a relatively tight labour market. The unemployment rate fell to 5.6% in November, an all-time low.

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Like the U.S. Federal Reserve (Fed), the Bank of Canada (BoC) is expected to slow the pace of interest-rate increases in 2019. However, Canada's policy rate of 1.75% remains a substantial 75 basis points below the U.S. federal-funds rate—a differential that is probably more than warranted by the economic fundamentals. Until that gap is reduced, we may see the Canadian dollar depreciate further.

Canadian equities (as measured by the MSCI Canada Index, total returns) underperformed the U.S. stock market (as measured by the MSCI ACWI USA Index, total returns) in local- and common-currency terms in 2018. This continues a multi-year trend of poor relative performance that extends back to 2011. A weak loonie exaggerates this in common-currency terms. However, even in local-currency terms, the MSCI Canada Index languished at an 18-year low versus its MSCI USA Index counterpart.

SEI's equity managers made minor modifications to their sector exposures, overweighting stocks with value characteristics and underweighting momentum. Sector-wise, our large-cap Canadian equity managers maintained overweights to consumer staples, consumer discretionary, information technology and telecommunications. Underweighted sectors included energy, financials, materials, utilities and real estate. Our fixed-income managers remained cautious on the rate outlook, favouring shorter-duration positions.

SEI's Global View

As painful as 2018 was for risk assets, their gyrations were not outside the norm. Rather, given our views that the global economy will continue to grow and that market participants are overreacting to the concerns of the day, we see another important risk-on opportunity developing in equities and other risk assets. We believe a rebalancing of assets back toward undervalued equity classes is an appropriate and timely response.

We still view the U.S. economic position as fairly solid. Points of strength include the improving economic position of U.S. households as labour markets tighten and real wage growth accelerates, while increased government spending has also helped. With Democrats controlling the House of Representatives and Republicans holding power in Senate, any fiscal-policy agreement made during a period of political gridlock will likely mean slightly more federal-government spending—not less.

The decline in energy prices is especially good news for the broader economy since it reduces concerns about inflation accelerating beyond the Federal Reserve's (Fed) comfort zone anytime soon. It also lowers costs for consumers and businesses on a broad range of petroleum-based products.

Some Fed officials, including Chairman Jerome Powell himself, explicitly acknowledge that the federal-funds rate now is near a level that can be considered neither stimulative nor deflationary. We are penciling in just one rate increase in 2019, and perhaps one in 2020—but these are just guesses. The important thing to remember is that the central bank is adopting a wait-and-see approach to monetary policy and has ended the nearly automatic quarterly rate increases of 2017 and 2018.

We think the odds favour a strong rebound in U.S. equity prices for the following reasons:

- The U.S. economy should continue to grow and corporate earnings per share are expected to post a mid-to-high single-digit gain in 2019.
- Valuations for the S&P 500 Index have declined from almost 19 times one-year forward earnings per share to an attractive level of almost 14 times following the decline in share prices.
- U.S. bond yields remain rather low and have moved down again in late 2018, bolstering the case for riskier assets.
- Investor risk aversion has increased, and we think much of the bad news of recent months is reflected in current stock prices—creating space for potential upside surprises on trade wars, the Fed's policy path, Brexit, corporate profits and elsewhere.
- Fiscal policy will not be the strong catalyst for growth in the U.S. that it was in 2018, but the impact of political gridlock should still be mildly expansionary.

As for Brexit, we believe it's unlikely that the U.K. will fall out of the EU without some sort of deal in place. A no-deal divorce would deliver a mighty blow to the economy. In our view, the real choice now is between Prime Minister May's Brexit deal or no Brexit at all. A no-Brexit-at-all scenario could take one of two forms. The U.K. government could unilaterally revoke Article 50, basically calling off the divorce from the EU. The second alternative is to go back to voters and hold a second referendum. Although the legality would be disputed, we think this is the far more likely scenario. The financial markets probably would respond quite positively to this decision, yet the next few months can still be volatile as the late-March Brexit date nears.

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Although the European banking system is in better shape than it was in the immediate aftermath of the global financial crisis, it is still vulnerable at a time when the ECB is in a holding pattern, policy-wise, and possesses only a few options in the event of a financial emergency. A lack of enthusiasm for Europe's economic prospects is reflected in its equity-market valuations: the MSCI European Economic and Monetary Union (EMU) Index price-to-earnings ratio has sunk to less than 12 times from nearly 15 times at the start of the year. Note that European equities outperformed U.S. equities in fourth quarter 2018.

We are leaning on the optimistic side for emerging markets in 2019. The valuation piece is already in place, in our opinion, with the price-to-forward-earnings ratio collapsing from 13 times at the end of January to 10.5 by year-end. But what could be the catalyst for a turnaround? Big debt expansions in China typically lead to big gains in emerging-market equities. The question is whether the Chinese government has the will to go back to the debt well one more time.

It surely would be a big positive for the country if the threat of tariffs was negotiated away, but we're not holding our breath. On the contrary, the U.S.-China economic relationship will likely continue to deteriorate as the Trump administration seeks to level the playing field—even if it means a less efficient global trading system. When push comes to shove, the Chinese government will probably get even more aggressive in easing lending constraints if the situation warrants.

Commodity prices and the earnings of emerging-market companies are closely correlated in inverse fashion with the movements of the U.S. dollar. For most of 2018, the dollar gained against other currencies, putting downward pressure on commodity prices and the earnings of energy and materials companies that are a large part of the MSCI Emerging Markets Index. In 2017, the opposite conditions held.

We are looking for another change in the dollar's trend in 2019. In our view, U.S. economic and corporate-earnings performance will move toward that of other developed countries. If there are positive developments in some of the pressure-point issues that have roiled markets, investment capital could flow away from the U.S. and back into the world—thereby removing an important source of support for the U.S. currency and a big headwind from the rest of the world. This potential for a reversal in investment flows could accelerate if Fed policy becomes more dovish than currently projected by the central bank.

The awful performance of risk assets in the fourth quarter can certainly prey on investors' emotions. But the global economy is not exactly in dire straits. Yes, there are an unusually large number of uncertainties and concerns, some of which could have a material impact on growth if the worst comes to pass. However, even in an extraordinarily unfavourable economic scenario in which the tariff wars with China and other countries deepen and the Fed raises interest rates too far and too fast, we doubt that the U.S. economy would experience anything worse than a garden-variety recession by 2021. The economic and credit excesses that usually precede a deeper recession simply aren't to be found.

During periods of market volatility like the one we've been going through, we make sure to remind investors about the importance of sticking with a strategic and disciplined approach to investing that is consistent with personal goals and risk tolerances. Diversification is the key to that approach, and the construction of portfolios is consistent with our long-term capital market assumptions.

Ultimately, the value of our assumptions is not in their accuracy as point estimates, but in their ability to capture relevant relationships—as well as changes in those relationships as a function of economic and market influences.

Economic Backdrop

The final quarter of 2018 hosted precipitous declines in stock markets around the globe, exceeding the corrections of the first quarter and erasing the recoveries that followed during the second and third quarters in some parts of the world, to settle into full-year losses. The three-month period began with swift and sharp selloffs, followed by a comparatively flat November overall in most regions; the final month of the quarter saw many markets hit with losses that were more severe than those experienced in October.

Government bonds led fixed-income performance, while riskier segments like high-yield bonds had the sharpest losses, consistent with a flight-to-safety environment. Sovereign yields fell in the U.K. and Europe during the fourth quarter, while the U.S. Treasury yield curve continued to flatten as short-term rates increased and longer-term rates fell; intermediate-term segments of the U.S. yield curve inverted at the beginning of December and broadened through the end of the year. Commodity prices generally tumbled during the fourth quarter, with West-Texas Intermediate crude-oil prices falling by 38%.

U.S. elections in early November produced a partial shift in power away from Republicans and toward Democrats in Congress and statehouses across the country. The new balance of authority in Congress should substantially limit the ability of President Donald Trump and Republicans to pass meaningful legislation; it also enhances the investigatory powers available to Democrats, thereby adding to political risk for the Trump administration. The U.S.-China trade relationship began the fourth quarter on a downbeat, with President Trump threatening to expand tariffs to essentially all of China's imports. The situation improved after the countries' leaders conducted a trade-focused meeting on the sidelines of the early-December G20 summit, agreeing to delay punitive actions and producing a three-month roadmap toward more substantive progress.

EU leaders agreed to terms of the U.K.'s divorce in November, establishing a set of domestic challenges for Prime Minister Theresa May given the absence of parliamentary majority support. December was an especially eventful month, with the European Court of Justice ruling the U.K. could unilaterally halt Brexit by revoking Article 50; Prime Minister May's survival of a no-confidence vote brought about by a subset of her Conservative colleagues (in part by promising to stand down before the next election scheduled for 2022); and a growing chorus of politicians calling for a second referendum. Details of no-deal Brexit contingency plans also began to trickle out on both sides of the English Channel near year-end, addressing subjects ranging from travel to trade, financial services and more.

Elsewhere, German Chancellor Angela Merkel did not seek re-election as leader of the Christian Democratic Union (CDU) party in December after poor turnout in regional elections, leaving Annegret Kramp-Karrenbauer (who was installed as the party's general secretary by Merkel in early 2018) to win the leadership in a vote for continuity. This outcome means that Chancellor Merkel may be able to serve the remainder of her term as head of government through 2021. France was stricken by anti-establishment riots during most of the fourth quarter that were seemingly triggered by the perceived injustice of President Emmanuel Macron's tax policy; the French president attempted to appease protesters in December with concessions that included cutting taxes for pensioners, increasing wages for underprivileged workers and reversing planned fuel-tax hikes. The Italian coalition government passed a budget at the end of December that retained some promised working-class relief after initial drafts were rejected by the EU for unacceptably large deficits.

The BoC held the policy interest rate firm at 1.75% at its final meeting of 2018. Despite the pause, the BoC maintained its position as one of the world's more conservative banks in terms of policy rates. That said, the BoC recently reaffirmed its data-dependent position on the path of future interest-rate policy. The Federal Open Market Committee increased the federal-funds rate in mid-December—the fourth time in 2018—while softening its projections for future rate increases. The European Central Bank (ECB) unsurprisingly announced and issued the final net purchase of bonds as part of its quantitative-easing program in mid-December. Guidance reassured that benchmark rates will remain unchanged as long as needed to achieve the ECB's inflation goal, and that its expanded balance sheet will not begin to shrink until after it begins raising rates. The Bank of England and Bank of Japan's respective monetary policy groups each convened twice during the quarter, and neither introduced new policy actions.

According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) slipped 0.2% in November and slowed to 1.7% for the past 12 months. Healthcare costs declined notably in November, while sharply lower crude-oil prices have resulted in significantly slower increases in transportation costs. Falling oil prices reduced producer costs as well in November as the Industrial Product Price Index (IPPI) and the Raw Materials Price Index (RMPI) respectively fell 0.8% and 11.7%. On a year-over-year basis the IPPI was up 2.8% and the RMPI fell 9.9%, representing a notable deceleration in costs. Unemployment held steady at a historically-low 5.6% in December. 163,000 jobs were added in 2018; this was a slower rate of job creation than the prior two years, but hours worked rose 0.9% as all the gains were in full-time work.

U.S. manufacturing growth eased considerably, yet still ended 2018 at solid levels. Services sector growth was unchanged, remaining in expansion territory at the end of the year. U.K. services growth re-accelerated slightly in December after coming perilously close to contractionary conditions in November; manufacturing activity followed a similar pattern, but at relatively healthier levels. Eurozone business activity softened into year-end, with the services sector slowing toward no-growth territory in December and slow-growth manufacturing conditions holding firm.

Market Impact (Referenced Index Returns are in CAD)

Domestic fixed-income markets finished the year in generally strong fashion. Government bonds performed notably better than other sectors during the quarter. Short-term bonds have also done well as they have been able to quickly absorb the BoC's rate hikes and are now offering higher yields than earlier in the year. Real-return bonds exhibited fairly volatile performance in route to a down quarter—their longer duration profile hurt as the BoC raised rates, which also helped keep a lid on inflation expectations. U.S. high-yield bonds performed poorly on a currency-hedged basis, but benefitted from a weak loonie on an unhedged basis. Investor preference for higher-quality assets amid the broad market selloff and significant exposure to oil prices hurt these risker bonds.

Like the rest of the global equity market, Canadian equities ended the year with a thud. The S&P/TSX Composite Index was off over 10% in the quarter, erasing the meager year-to-date gains it had previously achieved. Smaller companies did even worse. Healthcare was the worst performing sector, while all cyclical sectors except materials declined during the quarter. Defensive sectors, led by consumer staples and communication services, performed better. Foreign equities were down across the board with declines in major markets such as the U.S., U.K., Europe and Japan. Emerging markets were somewhat mixed, but down overall, as China slumped under tariff pressure and a slowing economy. Countries such as India and Brazil, which are not facing significant U.S. tariffs, did better.

Index Data (Q4 2018)

- The S&P/TSX Composite Index fell 10.11%.
- The FTSE TMX Canada Universe Overall Bond Index returned 1.76%.
- The S&P 500 Index, which measures U.S. equities, dropped 8.62%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, returned -7.81%.
- The ICE BofAML U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned -4.97% (currency hedged) and 0.73% (unhedged).
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the "fear index," began the quarter at 12.12, but spiked as high as 36.07 before settling at 25.42.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, plummeted from US$73.25 to US$45.21 as global supplies continued to rise while investors began to question demand.
- The Canadian dollar was generally weaker, falling to C$1.33 per U.S. dollar. The U.S. dollar was stronger versus other major currencies, ending December at US$1.28 versus sterling, US$1.13 against the euro and at 113.55 yen.

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