Markets Ring in the Decade on a High Note
Quarterly Market Commentary
Fourth Quarter 2019

SEI New ways. New answers.®

- Equity and fixed-income markets around the globe wrapped up 2019 with above-average annual performance, giving investors the gift of optimism as they rang in the New Year.
- China and the U.S. settled on a limited "phase-one" trade agreement in mid-December. The deal is expected to provide China with tariff relief and the U.S. with agricultural purchases, assurances that China will address forced technology transfer practices, and greater access to the Chinese financial services industry.
- Figuring out how investors might react to shifting conditions is almost always a challenging exercise. With that in mind, as always, we retain our emphasis on long-term, strategic investing over tactical reactions to short-term events.

SEI's Domestic View

Like most other economies, Canada has been grinding along in a lower gear for the past few years. Economic growth continues to lag the gains in the U.S., but the gap is narrowing as the U.S. slows. In fact, with inflation-adjusted gross domestic product (GDP) growth at a rate of 1.7% year over year through the third quarter, Canada is one of the better performers among advanced economies in 2019.

It could have been a lot worse. The year began with U.S.-Canada trade relations near a low ebb—and then it took until November for negotiators to finally settle on a new version of the USMCA trade deal to replace NAFTA. The U.S. House of Representatives approved the deal in December; the U.S. Senate will take up the legislation in 2020.

It also should be noted that U.S. President Donald Trump removed tariffs from Canadian aluminum and steel back in March. It's taken a while, but trade relations finally appear to be normalizing.

While the easing of tensions is certainly good news, Canadian companies have struggled to gain traction. Shipments of manufactured goods slipped into negative territory in June and have been recording year-over-year declines ever since. Monthly data tracking the GDP of goods-producing industries indicate that the output peaked in July 2018 and has fallen a cumulative 2.1% through October. Some rebound is likely, as the auto strike at General Motors probably exacerbated the decline in October, but the longer-term trend has been less than stellar.

It shouldn't be surprising that merchandise exports have also been lackluster over the past year. Manufacturers' overall new orders are closely correlated to exports. What is surprising, however, is the inability of Canadian exporters to take advantage of a generally weak currency. The certainty provided by a new trade agreement may help them in 2020, but this positive could be offset if the Canadian dollar were to strengthen in a meaningful way.

The Bank of Canada (BoC) could face a difficult challenge in 2020. Consumer-price inflation (CPI), measured in a variety of ways, has been edging higher in recent years. The total CPI and the three measures of core inflation (excluding food and energy) that the BoC prefers to use for policy purposes are all rising close to or beyond the 2% mark. The median core CPI has been leading the way for much of the year, posting a 2.4% year-over-year gain.

Unlike other central banks, the BoC employs a wide target range for inflation, between 1% and 3%. Technically, the central bank is still within its mandate. Nonetheless, inflation in Canada is showing a consistent tendency to rise into the upper half of the target range. If the central bank decides it must lean against this tendency for inflation to accelerate, it may cause the Canadian dollar to strengthen against its U.S. counterpart.

This may explain why the BoC left its policy rate unchanged at 1.75% since October 2018. Prior to the U.S. Federal Reserve's (Fed) pivot to a more dovish policy stance, the BoC was shadowing the Fed's movements, raising rates almost in tandem. The BoC chose not to follow the Fed's last tightening move in December last year, but it hasn't changed its policy rate at all since—even though the U.S. central bank cut its federal-funds rate on three occasions in 2019. As a result, nominal policy rates in both countries are just about the same for the first time in three years.

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We note that historically when the Canadian rate on overnight funds is increasing relative to the federal-funds rate, the Canadian dollar tends to appreciate against the U.S. dollar. This did not happen in 2019. Although the differential narrowed considerably, the loonie held steady against its U.S. counterpart. We believe the loonie will appreciate more dramatically in 2020 now that the interest-rate differential is less of a headwind to its rise.

A stronger global economy would also provide the backdrop for a stronger currency, since Canada is rich in natural resources. We have observed a close correlation that exists between the Canadian dollar and movements in the price of oil. When oil prices are depressed, the Canadian dollar loses ground to the U.S. dollar. In times of oil-price strength, the loonie tends to be strong as well. Although crude oil rose sharply in price from the extreme lows recorded at the end of 2018, it remains quite low versus levels reached prior to the collapse in 2014 to 2015. With rig counts falling in the U.S. and reports of lower-than-expected production out of aging shale fields, U.S. oil output could ease from its breakneck pace of recent years. A continued display of production discipline by the Organization of the Petroleum Exporting Countries and Russia, along with a modest improvement in global demand, also could help tighten the supply/demand balance—helping to drive oil prices and the Canadian dollar higher in the year ahead.

SEI's Canadian equity managers have been adding more cyclical exposure to their portfolios. Industrial stocks are favoured over financials; the over-leveraged financial position of Canadian households and the high price of real estate in the Toronto and Vancouver markets leaves us cautious on the banks. Fixed-income managers also remain pro-cyclically biased, although they also are overweight the securities of banks and other financials. SEI's portfolio managers have a mixed outlook, but the consensus opinion is for a weak economy that avoids recession.

SEI's Global View

A year ago, many investors were licking their wounds following a sharp global stock-market correction. Today, we are confronted with a notably different market backdrop, as share prices generally ended 2019 near their highs of the year. With regard to the U.S. economy, our expectations turned out to be mildly optimistic. But we think it's worth pointing out that quarter-to-quarter fluctuations in the country's gross domestic product (GDP) growth have remained on a relatively narrow path compared to their far more volatile historical range. One reason for the lower volatility is steady growth in U.S. household spending. By contrast, the contribution to U.S. GDP growth from investment, both residential and non-residential, has been in a slowing trend; the pace of business spending in the country has eased dramatically since early 2018. On the positive side, the absence of an investment boom means there should be little to no hangover; even if a recession were to develop in the next year or so, it almost certainly will not be especially painful.

Across the pond, Prime Minister Johnson's decision to hold a snap election paid off. He now enjoys the largest Tory majority in Parliament since 1987, when Margaret Thatcher was re-elected Prime Minister for a third term. The victory eliminated the possibility of a dramatic remaking of the British economy as envisioned by the Labour party—or the chance of a hung Parliament, which could have prolonged the uncertainty surrounding Brexit.

Of course, uncertainty still remains. The U.K. now must negotiate its future trading relationship with the EU by the end of 2020. A no-deal Brexit would provide a substantial negative shock to merchandise trade because dealings with the EU would revert to the most-favoured-nation rules of the World Trade Organization. Trade in financial services, a category critical to the UK's economic well-being, would be saddled with increased regulations, paperwork and costs.

It continues to be our working assumption that a no-deal Brexit will be avoided, although it may take an extension of the transition period to effect a deal that minimizes the disruption. Although Boris Johnson has already announced his intention to exit the transition period at the December 31 deadline.

For Europe, we accurately anticipated a further slowdown in economic growth over 2019. While we were right on the economy, we were perhaps too bearish on European risk assets. The Europe ex-U.K. benchmark enjoyed an exceptional return in 2019 despite a still-significant disparity in economic growth between the U.S. and the Continent.

We think it may make sense to look past the current gloom when it comes to Europe. The lessening of trade tensions and improvement in China's economic growth should provide export-dependent Europe with a moderate boost in 2020.

Government policy also is geared toward encouraging growth. There are signs that ECB policy is having some positive impact. The banking system is slowly recuperating. Lending to households and businesses has been in a modestly accelerating trend over the past few years. There also is more serious discussion nowadays about easing fiscal policy. Even Jens Weidman, President of the Deutsche Bundesbank, member of the Governing Council of the ECB, and a long-time hawk, has recently felt comfortable backing calls for government spending. Perhaps there's hope that fiscal policy will turn into a tailwind for eurozone growth instead of a steady headwind.

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Our expectation that emerging-market economies and equity markets would enjoy a decent 2019 didn't pan out. First, we thought an economic turnaround in China was just around the corner. The country had been pushing through various monetary, fiscal and structural reform measures aimed at jumpstarting economic growth, and we assumed that the Chinese government would go back to the debt well if needed. This happened only to a limited extent.

Of course, one big problem impeding the recovery in Chinese economic growth is the running trade battle with the U.S. We have frequently made the argument that an all-encompassing trade war between China and the U.S. would be in neither countries' interest. The economic and political reverberations would simply be too painful. And so, the agreement on a "phase-one" deal at least helps lower the temperature and halts the tit-for-tat tariff escalations. We expect the truce will hold through the 2020 U.S. presidential election. If we're right, China's economy should be able to build upon the tentative pick-up in growth that has begun to show up in the economic data.

Looking at the big picture for the year ahead, we expect the U.S. and global economies to continue growing, but at a sluggish pace. This should keep inflation under control and encourage central banks to remain accommodative. Quantitative easing also should help keep fixed-income yields relatively steady even as government deficit spending picks up. Altogether, this scenario should be positive for risk assets.

We've summarized the major themes and outstanding questions that could cause markets to behave in ways that run counter to our positioning in 2020:

- The U.S. is converging with the rest of the world as U.S. economic and profits growth decline. Given the disparity in stock-market valuations, international markets can be expected to outperform U.S. equities.
- China's economy should stabilize and improve. The partial US/China trade-war truce and a steady progression of fiscal and monetary stimulus measures over the past two years should pay off in 2020. Early signs of improvement are already apparent, which should boost the economic prospects of trade-dependent economies.
- The U.S. dollar should reverse convincingly to the downside. The Fed's pivot toward an aggressive approach to supporting the overnight lending market has the potential to significantly increase the global supply of dollars. Since we believe the dollar is overvalued on a fundamental basis, its depreciation is a high-conviction call. This would be a tailwind for non-U.S. economies and financial markets.
- The value style should prevail. Modest improvement in global economic growth, a tendency for inflation and interest rates to move higher and the record disparity in valuation between the most- and least-expensive stocks should lead to a better result for value-oriented active managers.
- We foresee less Brexit uncertainty, assuming a trade deal can be reached between the EU and U.K. We expect rationality to prevail, but a no-deal Brexit remains a residual risk. As the year-end 2020 transition deadline nears, U.K. and European markets could experience renewed volatility if the negotiations appear to be foundering on irreconcilable differences.
- Presidential politics could roil equity markets in the U.S. and elsewhere. A sense of which Democratic nominee will face Donald Trump in the coming U.S. presidential election should get clearer in March, when 25 states and Puerto Rico go to the polls; California and Texas, plus 12 other states, will hold their primary elections on Super Tuesday, March 3.
- The impact of Fed policy is a potential wildcard. While we don't see it as a likely outcome, the central bank's dovish stance at a time of full employment could cause a "melt-up" in stock prices.

Even at low interest rates, we would consider a forward-earnings multiple on the S&P 500 Index of more than 20 times as a danger sign. In our view, another stellar year for U.S. equities in 2020 would be a source of concern rather than celebration. Equities and other risky assets are not well-correlated with the fundamentals in the short run. Investor expectations can change much more quickly and far more dramatically than the fundamentals. Indeed, as seen in the past two years, changes in investor expectations can sometimes completely negate the change in the fundamentals.

With that in mind, we will retain our emphasis on strategic investing over tactical moves. We will also continue to take stock of the economic and financial developments around the globe and provide our thoughts on where global growth and interest rates are headed. That's actually the easy part, as the experience of the last few years illustrates. Figuring out how investors might react to the shifts in macroeconomic conditions is almost always the much harder exercise.

Economic Backdrop

The final quarter of 2019 could be taken as a microcosm of the full year and, for that matter, the entire decade. Each period began in the wake of volatile, confidence-testing equity-market selloffs, yet proceeded to soar dramatically—overshooting far beyond the point of recovery.

Equity and fixed-income markets around the globe wrapped up the decade with above-average annual performance, giving investors the gift of optimism as they rang in the New Year. Developed-market equities generally performed quite well for the 12-month period relative to historical averages; U.S. shares shined the brightest, maintaining their dominance of the past decade. Although emerging-market equities lagged for the year and the decade, they outpaced their developed-market counterparts for the final quarter of 2019.

The riskiest segments of the fixed-income universe (high-yield bonds and emerging-market debt) along with U.S. investment-grade corporates outperformed in 2019. Local-currency emerging-market debt was the star of the fourth quarter; however, over the last decade it lagged its hard-currency counterpart, as well as high yield and U.S. investment-grade corporates.

Government bond rates declined over the full year across all maturities in the U.S., U.K. and eurozone. However, government bond rates climbed across the yield curve in the U.K. and eurozone during the fourth quarter. In the U.S., long-term Treasury rates rose but short-term rates fell during the three-month period, resulting in a steeper yield curve that all-but vanquished an inversion that began in late 2018.

The U.S. and China settled on a limited “phase-one” trade agreement in mid-December, which the countries’ leaders agreed to formally sign by mid-January. The deal includes the following provisions:

- A commitment from China to purchase about $50 billion in U.S. agricultural goods over a two-year period; assurances that China will address its long-standing practice of forcing the transfer of intellectual property and technology to Chinese counterparts in exchange for access to the Chinese market; and a promise to continue opening its financial-services industry to foreign investors.
- A reduction of existing U.S. tariffs on Chinese goods (from 15% to 7.5% on $110 billion of goods, with another $240 billion of goods still subject to 25% tariffs); a delay in the imposition of additional tariffs that were previously scheduled for December 15.

Also in December, President Donald Trump’s administration finally secured bipartisan support in the House of Representatives (the House) for the US-Mexico-Canada Agreement (USMCA) to replace the North American Free Trade Agreement—one year after the three countries’ respective leaders signed the deal. This win for the administration came just one day after the House approved articles of impeachment against Trump—making him the third U.S. president in history to be impeached (the political equivalent of a criminal indictment). As the culmination of a three-month investigation, President Trump was formally charged with abuse of power (using the power of the presidency for his own benefit) and obstruction of Congress (blocking Congress’s investigation into his alleged wrongdoing). An impeachment of a U.S. president does not equal removal from office; this is determined in the Senate (the upper chamber of Congress), where a trial must be held once the House passes on the articles. The process was suspended at year end as House leaders said they plan to hold the documents until the Senate agrees to certain trial rules.

The UK’s Conservative Party consolidated its power in a mid-December election—winning a majority of seats in the House of Commons and gaining approval for Prime Minister Boris Johnson’s EU departure deal. The country is set to officially leave the EU at the end of January 2020, giving way to an 11-month transition period during which the U.K. and EU will negotiate the terms of their future relationship. Ursula von der Leyen, president of the European Commission, expressed concern in late December that the transition period may not be long enough and that an extension could be necessary; Johnson previously said he will not tolerate a longer transition period.

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Central Banks

- It has now been more than a year since the BoC raised its policy interest rate to 1.75%. The BoC's Governing Council has reiterated its belief that the target rate is appropriate when balancing the adverse impacts of trade conflicts against a resilient Canadian economy. The next meeting is scheduled for January 22.

- The Federal Open Market Committee (FOMC) cut the federal-funds rate by 0.25% in October, its third cut in as many meetings. In mid-October, the U.S. central bank also made its first monthly purchase of $60 billion in Treasury bills as part of a programme to increase liquidity in the financial system. The FOMC left the federal-funds rate unchanged at its December meeting and noted that "the vast majority of the committee expects to leave rates unchanged next year before very gradually raising rates toward neutral over the next three years." This quote encapsulates the expectations contained in the Federal Reserve's (Fed) final Summary of Economic Projections for 2019, which depicted slowing growth and firming inflation over the next two years.

- The Bank of England (BOE) announced its next Governor in late December following the Conservative election victory. Andrew Bailey, current head of the Financial Conduct Authority, whose working history with the BOE began in 1985, will lead the central bank starting in March 2020. The Monetary Policy Committee held firm through its November and December meetings—keeping its key interest rate unchanged at 0.75%. However, two out of nine committee members voted for a 0.25% rate reduction at both meetings, representing the first glimmers of a preference for a rate cut since the immediate aftermath of the Brexit vote in 2016.

- The European Central Bank (ECB) took no new actions in its final two monetary policy meetings of the decade, held in October (the last with Mario Draghi as President) and December (the first with Christine Lagarde at the helm). However, there was a shift in focus from one leader to another: As Draghi's tenure came to a close, he offered a defence of the ECB's policy move toward further accommodation; Lagarde began her watch by announcing a broad policy review that raises fundamental questions about the central bank's mandate as well as whether it can influence other areas (including disruptive technologies, cryptocurrencies, and climate change).

- The Bank of Japan made no changes to its accommodative monetary policy stance at its October and December meetings, despite expectations that it would introduce additional easing measures to offset the economic pressure created by an October increase in the country's consumption tax.

- The People's Bank of China (PBOC) announced in late December that the Loan Prime Rate (LPR) will serve as the benchmark for existing floating-rate loans beginning in 2020 and that banks will no longer be allowed to sign loan contracts based on previous benchmark rates. This change was taken as an easing measure, as the PBOC trimmed the one-year LPR to 4.15% in mid-November for the third cut in recent months. As the ball dropped in Times Square to signify the end of the decade, the PBOC announced its latest cut (of 0.5%) to bank reserve-requirement ratios, freeing about $115 billion (U.S. dollars) for bank lending.

Economic Data

- According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) was up 0.1% in November and rose 2.2% for the prior 12 months. Excluding gasoline, the annual rate of change was slightly higher at 2.3%. Producer prices were up in November but mixed for the one-year period. The Industrial Product Price Index (IPPI) gained a modest 0.1% and the Raw Materials Price Index (RMPI) climbed 1.5% in November. On a year-over-year basis, the IPPI fell 0.4% while the RMPI was up 9.3%; the different accounting for volatile energy costs in each index caused the mixed results.

- U.S. manufacturing continued to slide further into contraction territory throughout the fourth quarter, ending 2019 at the lowest level of activity in a decade, according to one purchasing manager survey. The services sector increased its growth pace to finish the year at moderately healthy levels. The U.S. unemployment rate fell to 3.5% in November, the lowest rate in 50 years. Overall U.S. economic growth was measured at an annualized 2.1% rate in the third quarter, an uptick from preliminary readings of 2%.

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- The slowdown in U.K. manufacturing worsened in December, contracting for the eighth consecutive month. U.K. services sector activity also slowed further into contraction territory, although not to the same degree as manufacturing. The U.K. claimant-count unemployment rate continued an upward trend that persisted through most of the year, reaching 3.5% in November; meanwhile, the three-month average U.K. unemployment rate remained relatively steady throughout most of 2019, holding firm at 3.8% in the August-to-October period. Average year-over-year U.K. earnings growth for the August-to-October period continued to decline to 3.5% after peaking at 3.9% over the summer. Overall third-quarter U.K. economic growth measured 0.4% (and 1.1% year over year), up from earlier estimates of 0.3% for the quarter (and 1.0% year over year), and rebounding from the 0.2% contraction in the second quarter.

- The eurozone manufacturing landscape eroded further into contraction territory during December, having spent every month of 2019 besides January in contraction. On the positive side, services sector activity accelerated in the final month of the year to healthier growth levels. The eurozone unemployment rate finished October at 7.5%, in line with its pace for much of 2019 after edging lower early in the year. Overall eurozone economic growth held firm at 0.2% during the third quarter and 1.2% year over year.

Market Impact (Referenced Index Returns are in CAD)

Global equity markets finished with strong gains for both the quarter and the full year. U.S. equities were among the top performers for both the quarter and the year, with large companies outperforming smaller companies. Domestic equities were also among the leaders for the year even though their finish was less impressive—technology was far and away the best performing sector. Emerging markets struggled for much of the year, but roared to life with a strong fourth quarter.

Fixed-income markets were mixed during the quarter but notched solid gains for the year. Riskier bonds generally performed better with U.S. high yield setting the pace. Corporate bonds were essentially flat for the quarter but were the top performing domestic sector for the year. Real-return bonds nearly matched the gains of corporate debt for the year, but were notably weak during the quarter. Government bonds also struggled during the quarter. Residential mortgages had a bumpy ride during the quarter, but ended as the best performing domestic sector. Short-term bonds had modest gains for the quarter and year.

Index Data (Q4 2019)

- The S&P/TSX Composite Index rose 3.17%.
- The FTSE Canada Universe Bond Index returned -0.85%.
- The S&P 500 Index, which measures U.S. equities, gained 6.83%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, returned 6.71%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 2.47% (currency hedged) and 0.50% (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,” decreased from 16.24 to 13.78 by the end of the quarter.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market increased from US$54.07 to US$61.06 during the quarter.
- The Canadian dollar strengthened moderately to C$1.30 per U.S. dollar. The U.S. dollar was generally weaker versus other major currencies, ending December at US$1.32 versus sterling, US$1.23 against the euro and at 108.68 yen.

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