January 7, 2019

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Investor Strategy

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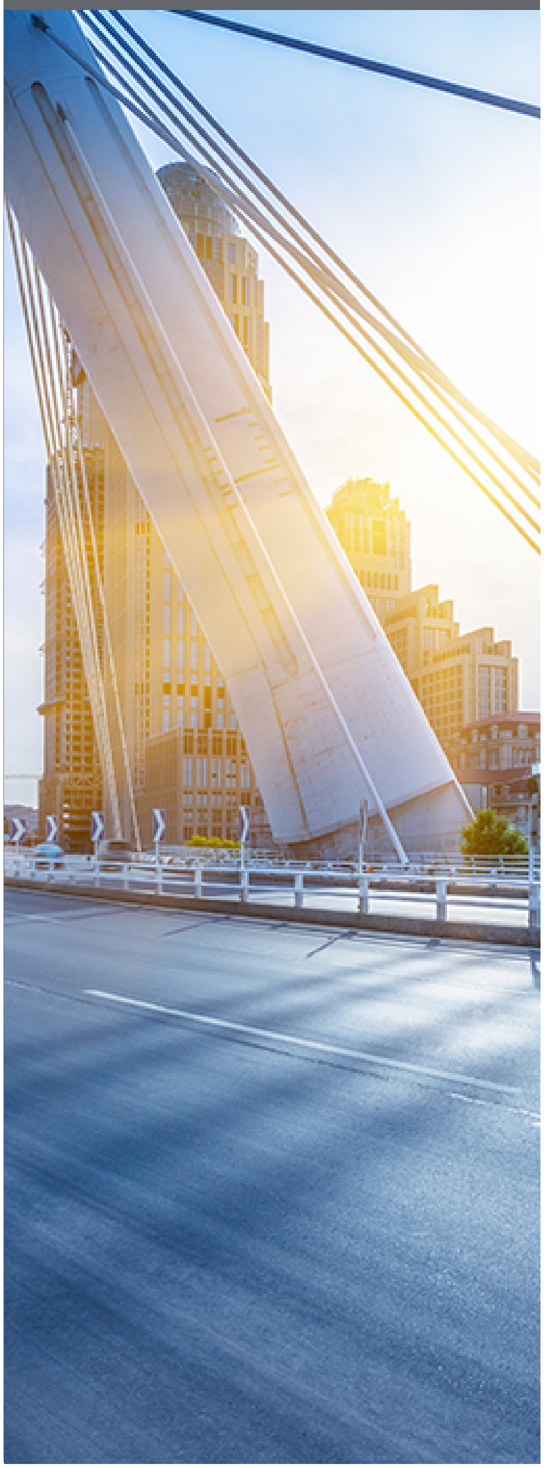
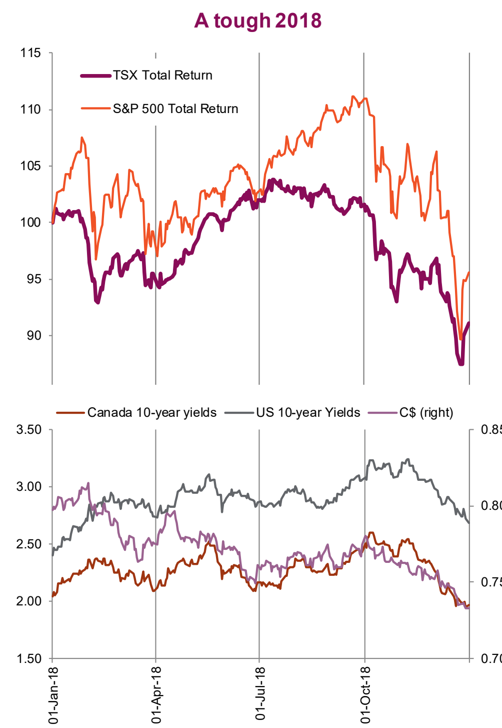


Punch Bowl Hangover

Craig Basinger, Chris Kerlow, Derek Benedet, Alexander W. Tjiang

Summary

I. Market recap 2018: that ended poorly



2018 proved to be a rollercoaster of a year with multiple corrections and multiple new highs. Sadly, the year finished far from the highs. Both corrections initially started in response to rising bond yields, but the correction that gripped global markets for all of Q4 saw the future path of global economic growth called into question.

As we finish the year, just about every major market is down. Many are in the 10-20% range. This has caused valuations in numerous markets to be the most attractive they've been in years. Global economic growth has slowed somewhat, bond yields have retreated and commodity prices fell. Worth noting was the drop in oil prices to below $50 after spending much of the year in the $60-70/bbl range.

This has raised the most important question: is the recent bout of weakness simply that or the start of the bear market. Given the duration of the current bull cycle (nearing a decade old) there is no doubt the bear is getting closer. In the following pages we will share our views on this important question, highlight where we are most focused and our thoughts for 2019.

II. Market Outlook 2019 and Beyond

There are really two major scenarios for 2019, either the stock market performance of 2018 is right or it's wrong. Given double digit declines across most major equity indices, a drop in bond yields and widening credit spreads, the markets are signalling a rising probability of a recession in the coming quarters. Or … the markets are wrong and this has created one more great buying opportunity for this aging bull cycle. Instead of just opining on what we think is going to happen, this outlook will take a different approach.

The work our team has done in the field of behavioural finance over the past few years has taught us many things that have helped our investment process. In particular, **confirmation bias** and **herd mentality** are two dangerous biases when it comes to investing. Confirmation bias causes people to look for evidence that supports their pre-existing views and often discredit contrary evidence. Herd mentality describes how decisions can be influences by the masses, satisfying the desire to be a part of a larger group. Both supress rational decision making and critical thinking. To counter these biases, we are going to provide both a bull and bear case for 2019. From there, you can decide, thus absolving us of all responsibility. Just kidding. We will include our base scenario for next year further on in the report. The desire is to foster more objective thinking and, hopefully, come to better, more accurate expectations.

The Bear Case

Recession is much closer than people think

The global equity markets sent a message in the last quarter of 2018: a clear warning that this aging bull may not be as healthy as previously thought. The global economic recovery started in 2009 and will be a decade old in the coming months. That makes it one of the longest running global economic expansions in the modern economic era. While economic growth continues, there are rising cracks in the economic foundation that are being exacerbated by geopolitical issues. If these cracks continue, they could spell the end of the cycle.

The Economy – Growing but slowing fast

The global economy was firing on all cylinders when 2018 started. The same cannot be said today. Global trade tensions and the Fed raising overnight rates has taken a bite out of global growth. Initially, this was most evident in the more economic growth sensitive emerging markets but has since been spreading to developed economies in Asia and Europe, and now to a lesser extent in North America.

You don't need to look very hard to see growth rates are on the decline. Current consensus economic growth forecasts for most major economies are showing signs of slowing.

Bull Case
Bear Case

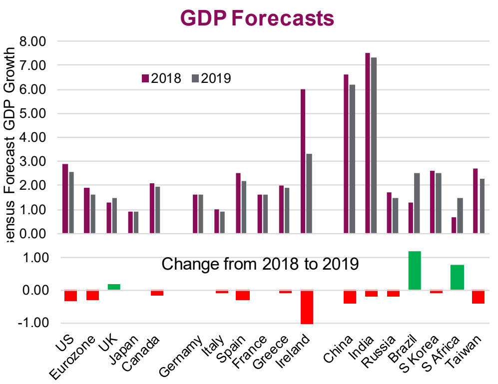
The Bull Case

Valuation reset has created a buying opportunity

The rapid decline in equity prices during the 4th quarter appears overdone, given a still robust global economy. The market has experienced a temporary loss of confidence given headline news on trade disputes, some economic growth rate slowing and rising interest rates. This has re-rated equities and appears to be an overreaction, creating a great opportunity as we head into 2019. There appear to be many similarities with the global market correction of 1998, after which markets enjoyed two very profitable years before the bear finally overcame the bull.

The Economy – Temporary soft patch

Global economic growth slowed as 2018 progressed, in part due to the impact of tariffs and China's slowing economy, notably impacting economies more sensitive to global trade. While this has trimmed expectations for 2019 slightly, the overall momentum in the global economy remains robust and widespread. Starting in 2016, all 34 OECD economies have been expanding simultaneously. This, by definition, is synchronized global growth. While the growth pace is slowing, unless there is an exogeneous shock, the economic momentum isn't going to end abruptly. In other words: it won't end in 2019.



There are three big headwinds for the global economy as we head into 2019: trade protectionism, the Fed and China.

The steadily simmering 'trade war' is unlikely to end anytime soon and will continue to temper growth expectations as the year progresses. The U.S. appears committed to 2016 campaign promises of re-writing global trade on "better" terms. This will continue to inject uncertainty into the global economy and reduce overall growth.

The Fed really started raising rates aggressively in 2017. Given it takes 1-2 years for rate hikes to start impacting the economy, it's not surprising we are increasingly seeing the impact today. Even if the Fed slows its rate hiking pace in 2019, this headwind will continue to increase in strength given the delayed impact. Add to this the gradual unwinding of the Fed balance sheet (quantitative tightening), monetary policy may already be more restrictive than many market participants believe.

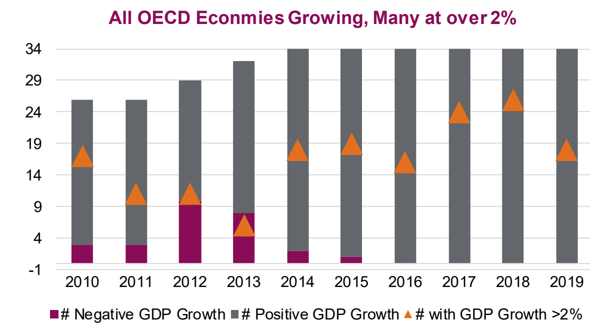
China has long been a big growth driver for the global economy and that pace is slowing. To date, the policy response to slowing growth has been tepid. Instead they are more focused on domestic consumption and services. This is in contrast to how China has responded to soft economic gro wth in the past, when increasing credit and infrastructure spending was the 'go to' solution. While the current strategy may help the Chinese economy, the global economy would much prefer the former that often resulted in increased commodity consumption and corporate spending. This change of strategy is evident in the declines in global commodity prices.

The global economy is not falling off a cliff, but the trend is slowing and this could accelerate, especially if we see policy mistakes by central banks or on trade. Evidence of this is encapsulated in the rapidly flattening yield curve, which is only a couple rate hikes away from inverting. Yield curve inversion has predicated or coincided with all the major U.S. recessions over the past half century.

Bull Case

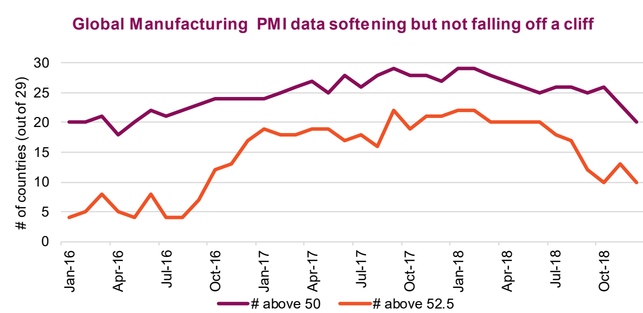
Bear Case

We are not in denial that the global economy is slowing. This was most evident earlier in 2018 among developing economies. Tariffs, China, higher global interest rates and a strengthening U.S. dollar weighed heavily. The slowing has since spread to developed economies, mainly those that are more reliant on global trade. The million dollar question is: does this slowing accelerate and spread? Or is it simply the oscillation of global growth that remains in an uptrend, aka a speed bump?



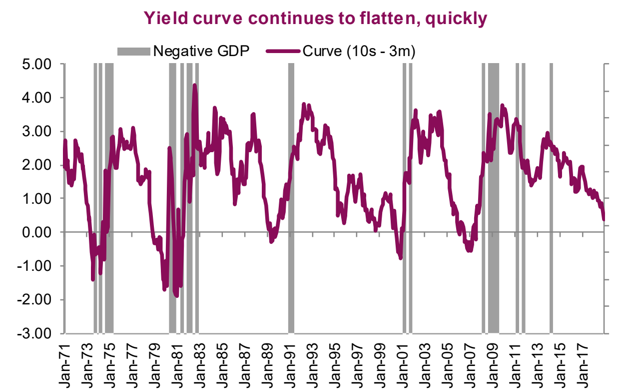
This feels more like a speed bump. The market appears to be fretting about global growth being trimmed by a fraction of a percent in 2019. Keep in mind, a year ago the market was fretting about too much growth resulting in inflationary pressures. Perhaps the take-away here is the market frets, overreacts and that is where investment opportunities are found.

There is evidence this slow patch may be almost played out. Global PMI data (Purchasing Managers) has been trending lower for a year now but we have started to see some stabilization in emerging economies over the past couple months. Plus, it is worth noting that 20 of the 29 countries still have readings above 50. Too early to tell with confidence if these whispers of improving economic activity will build and spread, but it certainly helps dispel the notion the global economy is on the verge of a recession.



This soft patch does have many similarities to 1998, with less severity. In '98 the Russian debt crisis was followed by the Asian currency crisis, which caused a dramatic slowdown in economic activity among emerging economies. This spread to developed economies, with more pain felt in Asia and Europe. The U.S. economy was impacted, but to a lesser extent given its trade mix and great momentum heading into the crisis. Today the U.S. economy is doing well with the consumer in great shape. Slowing economic activity in emerging economies

Bear Case



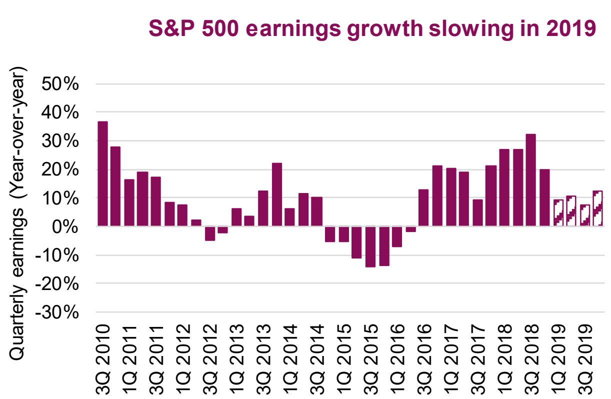
Geopolitics

There are a number of geopolitical issues that appear set to fester as we head into 2019, continuing to weigh on investor confidence. Uncertainty around Brexit remains the top issue in Europe with the clock still ticking and the path remaining unclear. This has proven to be very unsettling for corporate decision making and has weighed not just on markets but the economy and currency as well. The U.S.-China trade war is also likely to remain an issue.

Closer to home, the Mueller investigation of the 2016 election will likely come closer to conclusion in 2019. With that may come additional headaches for the Trump administration, elevated somewhat by the House in the hands of the Democrats.

Fundamentals – Cheaper for a good reason

Even the bears would have a hard time arguing valuations are a headwind as the price-to-earnings ratio for the S&P 500 has dropped from 18.5x at the start of 2019 to 14.0x. That is the biggest drop in the market multiple since the tech bust almost 20 years ago.



However, earnings growth is slowing. Operating earnings for the S&P 500 expanded by 26% in 2018 and this is forecast to slow to 10% in 2019. A lower pace of earnings growth begets a lower multiple that the market should pay for earnings.

Bull Case

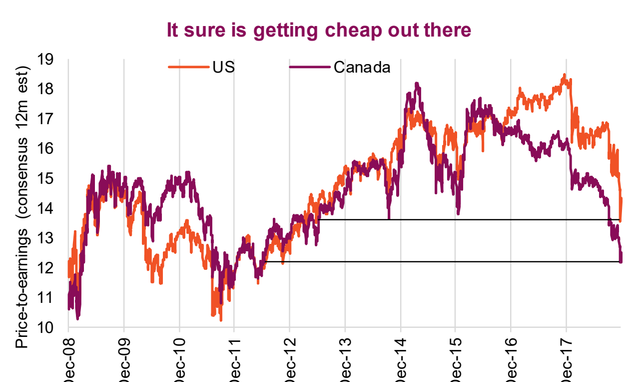
is spreading to developed, but it just does not appear at this time to be strong enough to end the global expansion.

Geopolitics

We're unsure whether there is much of a difference between the bull and bear cases when it comes to geopolitics. The risks are the same. Perhaps there are the 'unknown unknowns', but we have no idea how to write about those or incorporate them into an investment strategy. The concern at hand is how the markets will react. The markets absorb and adjust much faster than most believe. Evidence of this can be seen in how the market reacted to the latest Brexit kerfuffle, or news of the investigation. The market reacts to surprises, and these two geopolitical issues may be running out of surprises.

Fundamentals – Good entry point

What the market is willing to pay for a dollar of earnings sometimes rises and sometimes falls. In 2018, it fell the most since 2002 when the S&P 500 was going through its tech bust. The price-to-earnings ratio for the S&P is its lowest since the end of 2012 and for Canada the lowest since mid 2012. Approximately a quarter of the S&P and TSX constituents are now trading below 10x earnings. This is your Boxing Day sale.



Earnings estimates are coming down a bit but the key for us is sales growth and steady margins. Earnings growth on the back of tax cuts is nice, but the market will pay much more for earnings growth on the back of sales growth. And sales

Bear Case

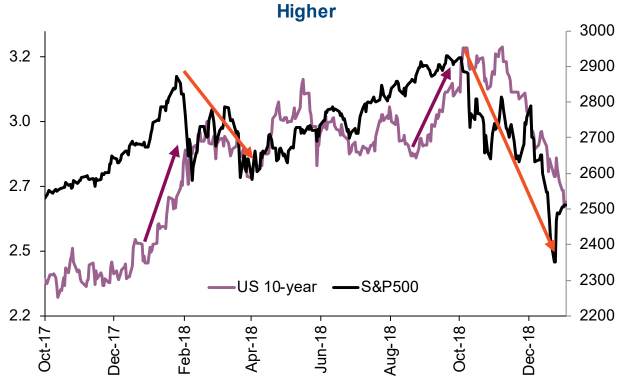
Adding to the woes, those estimates for 2019 are falling fast. The latest earnings revision ratio (which measures how many companies are seeing estimates revised higher compared to estimates revised lower) is down to 0.4. In other words: for every S&P 500 constituent that has seen its 2019 estimates revised higher over the past month, there were 2 ½ companies that saw their estimates reduced.

The market may no longer be expensive but that is simply because things are slowing and risks are rising.

The Great Yield Debate (Bond yields lower)

We believe the two episodes of rapidly rising bond yields, one at the start of 2018 and the other in the early days of Fall, were the catalyst for the equity market sell-offs. Coming into 2018, we were already at the Fed's inflation target. The market was worried that heightened inflation expectations would cause Jarome Powell and his mates at the Fed to expedite their rate hike regime to make sure inflation didn't get out of control. So as bond yields rose from a low of 2.3% to 3.0% in February, it seemed to hit a pain point for investors. It triggered the first correction in roughly two years. The sell off was violent but recovered quickly. A similar event took place this fall with yields hitting a new high (just below 3.3%), sparking the latest selloff.

Markets Wont Deal Well With The Next Swift Move Higher



Bond yields have retreated substantially during this rout in equity prices. If the soft economic data persists, the path for yields will continue to be lower. This softness has caused inflationary fears to fall far down on the list of things the market frets about. We could easily see central banks back off from their rate hiking ways.

Bull Case

continue to rise. Which then brings the biggest question: margins.

Sales growth is rising thanks to the economy but costs are rising too. If sales growth slows or costs rise too fast, we will see margin deterioration. We believe this will be an early sign the economic expansion is nearing its apex. At this point, with over 50% of S&P 1500 constituents experiencing rising margins, the warning bells remain silent.

The Great Yield Debate (Bond yields higher)

If this soft patch in the economic data does prove to be temporary, and the momentum in growth turns positive again in 2019, you better believe those inflationary concerns will return. The good news is this soft patch has eased the pressure and could create a window for a nice recovery. A rapid increase in bond yields, when the market is nervous about inflation, can certainly spook equity markets as we saw in 2018. But from current depressed yield levels, the market would probably embrace rising yields in the near term.

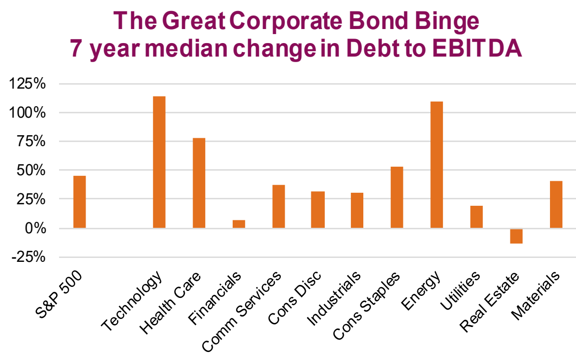
Don't forget, below the surface of some soft economic data in the past few months, the seeds of inflation are starting to sprout. The labour market is very tight and continues to tighten. Wage pressures are starting to become more prevalent and other costs (including transportation/logistics) are now rather elevated. We think with the magnitude of the recent move lower in bond yields, there is room for recovery. However, should the accent happen too quickly or break out to new highs, that could start yet another correction. Or even worse: a recession.

Another key factor that could put upward pressure on bond yields is the supply / demand dynamic. The Fed has ended their bond purchase program and is now shrinking their balance sheet by $50bb a month. The ECB announced in December that this will be their last month of bond buying and it is expected that the BoJ tapers their purchases in 2019. In aggregate, central banks have been the biggest buyer of bonds for years and that has changed. Less demand may mean yields will rise to entice private sector to pick up the slack.

Bear Case | Bull Case

Credit – Too much punch

Access to cheap credit has been too easy for far too long. Quantitative easing contributed to lower yields and alternative lenders filled the void left by the big banks. This created an environment that almost begged companies to issue more debt to fuel acquisitions, share



buybacks or dividend increases. This has led to much higher corporate indebtedness over the past decade. Many may have gone too far. The chart above denotes how widespread issuance has been and how much debt many companies have added. We would note that this is debt to EBITDA, and if we see the global economy slow substantially, that EBITDA will begin shrinking. This could easily exacerbate problems for companies that have stretched their balance sheet.

Credit – A manageable risk

No doubt imprudent or gluttonous use of debt can lead to longer-term ramifications. And we believe that during the next global recession, companies that have piled on too much debt will likely suffer more than those that were more conservative. But that is not the case today. Even with higher credit spreads during the past few months, there have not been any credit flare ups. As an example, United Health raised $3bb in debt late in December. The book was 5.5x oversubscribed and the yield fell by 20bps from initial pricing thoughts. This indicates that, despite volatile market condition, the appetite to lend still exists.

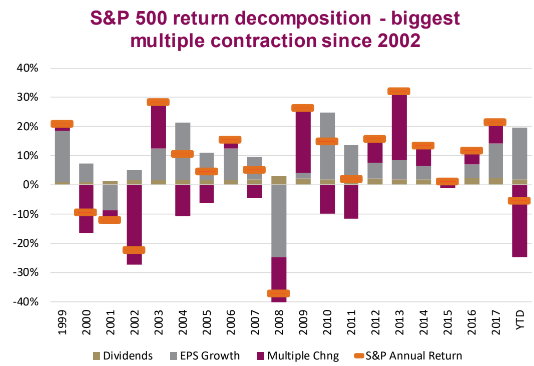
Plus, this isn't 2008. In the last recession, the vast majority of credit was owned to a much larger degree by levered investors (aka banks, financial institutions that deploy leverage). When prices dropped, they were forced to sell, causing prices to drop more and then sell even more. Compared to a decade ago, much more debt is owned by unlevered investors. These include private credit investment vehicles, pensions, ETFs, etc. If credit does become an issue, it shouldn't have nearly as big an impact on the overall financial system as in 2008. For all the faults of the financial markets, one thing is for sure: it does learn from its mistakes.

We hope you enjoyed our bull vs bear approach and come to your own independent conclusion based on a rational review of all the evidence. For ourselves and how we are positioning client assets, we currently see the bull case carrying a higher probability.

Punch bowl hangover

The market correction (or whatever you want to call it) during Q4 of 2018 has been exhausting. Perhaps we'd become accustomed to corrections that started and finished over a quick 4-6 week period. That had recently been the norm. Maybe we became accustomed to corrections that followed the script of dropping 7-10% max, then start recovering. Those were the best and we miss them. Maybe we all became accustomed to investing in a quantitative easing market (QE) and we are now in a quantitative tightening environment (QT).

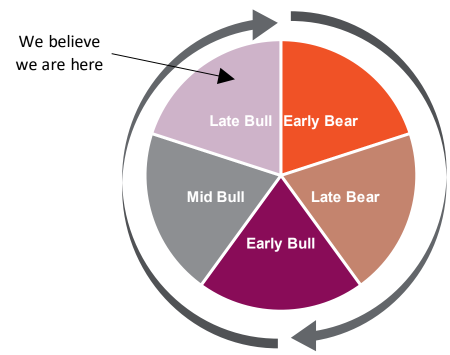
The impact of QE is very difficult to truly measure. Over much of the past decade, the Fed, the Bank of England, the Bank of Japan and the European Central Bank injected trillions into the financial system by primarily buying up bonds. This steady injection of liquidity may have helped the global economic growth (that remains debateable), but it certainly helped asset prices. QE helped asset price inflation contribute to higher prices on global real estate, bonds and stocks. This steady inflow of liquidity also supressed volatility and made many of those past bouts of market weakness so much more tolerable and almost enjoyable.



The problem now is we have moved from global QE to QT. A few central banks are still active in QE but they are slowly backing off. Meanwhile in aggregate we have recently moved to QT. In QT, central banks are doing more bond selling than buying. If you agree QE lifted asset prices across many asset classes and supressed volatility, then it is not too far a leap of logic that QT will contribute to the opposite. This contributed to the biggest drop in the market valuation multiple since 2002 during the current correction.

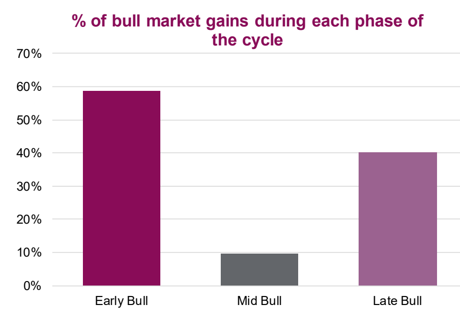
QE, and super low interest rates, was the punch bowl this cycle. And now with QT we are feeling the hangover, the painful payback for those good times.

Stage set for a good 2019

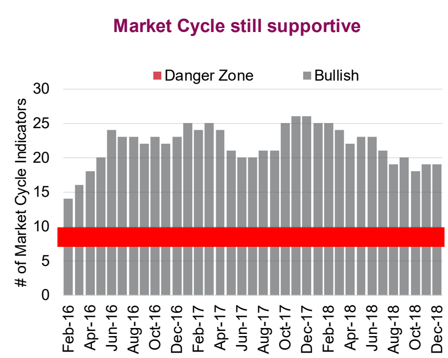


It was not that long ago (about six months) that fear of inflation was top of mind as yields moved higher, central banks tightened and wage pressures grew. Today, inflation fears are gone and have been replaced by economic growth concerns. This is late bull market investing. In six months' time, we would not be surprised to see recession fears fade and inflation or yield concerns back to being top of mind.

In this late phase of the bull market, volatility tends to be very elevated, both up and down. We do believe investors should be gradually preparing for the bear market by tilting their asset allocation, improving investment quality and reducing credit. However, this phase of the market sees some of the best gains of the cycle and it tends to require a tactical mindset. The oscillations of the market during the final years of a bull market tend to see big swings. Adding equity exposure on weakness and trimming on strength has the potential to add more value during this part of the cycle than any other. The key is to not be adding when the bear begins.



To measure the health of the market, we have developed our market cycle framework. Based on the view that no one signal or model will work in every cycle, we created a basket of about 30 models that have historically had some success in predicting the overall market direction. These models are across disciplines including economic, technical, sentiment, yields and fundamentals. Typically, when less than 10 models are bullish, it is time button down the hatches. Currently 19 of the signals remain positive, which is still in the safe zone by a decent margin.

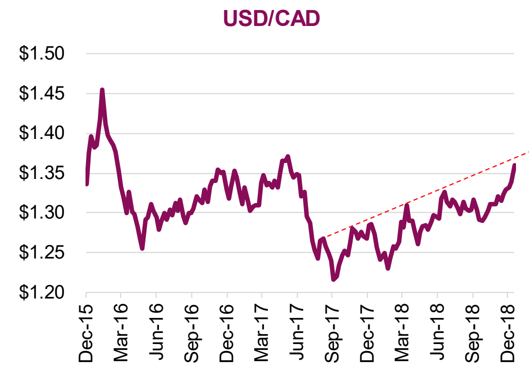


With the Market Cycle framework remaining positive, we have confidence during this period of extended market weakness to be opportunistic buyers. This correction has also set the stage for potentially a very profitable 2019 for investors.

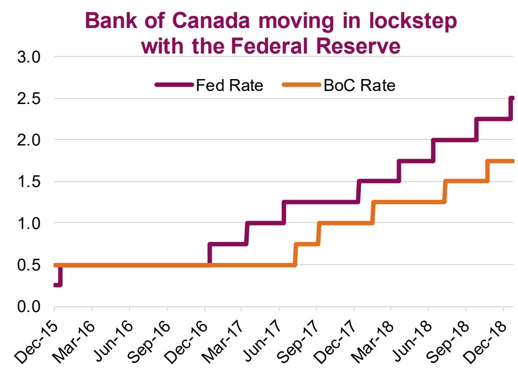
Positioning for 2019

- We believe this punch bowl hangover will pass as many asset prices, including equities, have been largely re-rated with lower valuations. As growth fears fade, this should result in a decent recovery in equity prices.
- The one caveat being that if the data does take a sudden turn to the downside, we do reserve the right to change our minds.
- We do believe the U.S. equity market will remain the leader in this late stage of the bull cycle and be the most popular destinations for global capital flows. New highs are not out of the question for 2019.
- Exposure to the U.S. dollar should continue to be embraced longer term. If economic growth fears fade, the Canadian dollar will enjoy a relief rally but the Fed will be the continued leader in tightening relative to other central banks. This should continue to be positive for the USD longer term and we would want exposure for the next bear.
- Shorter term, by embracing the tactical mindset mentioned earlier there is an opportunity to add alpha by embracing the CAD in 2019. Timing is everything but given the recent weakness in the loonie and the oversold conditions, we’re looking to further hedge our USD exposure.
- We expect yields to recover back above the 3% level and should the accent be controlled, the markets will likely take it in stride. However, the next time inflationary fears grip the market and increase the pace of rising yields, equities will be exposed to another correction, or worse…
- Exposure to emerging or developing economies should be minimized. Higher USD and higher yields are negative for this asset class. Additionally, these economies will likely materially suffer more once the bear does arrive.
- We continue to believe investors should be reducing credit exposure and take the recent rally in bonds as an opportunity to further reduce duration.
- The Canadian equity market should enjoy a recovery, mitigated by our markets higher exposure to global growth and reliance on housing, but lifted by some very attractive valuations and apparent oversold levels.

III. Canadian Dollar



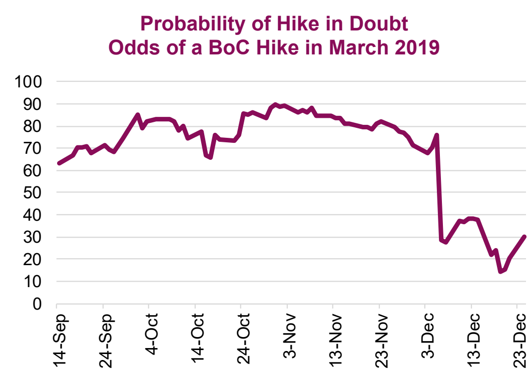
The Canadian dollar has closed out the year at its lowest level against the U.S. dollar in 18 months (Top chart). The recent news flow concocts mixed messages for the Canadian dollar. On one hand, we have a reduction of trade hostilities between Canada and the U.S., which is good. The USMCA is now in the hands of Congress. Crude's move to new lows argues for further weakness. Bond markets are also clearly pointing to a less positive economic outlook. Meanwhile, the BoC is focused on raising rates to what they consider a neutral state. Conditions are anything but straightforward now, and it's precisely this uncertainty which is weighing on the currency at present. Not to be lost is the fact that the Canadian dollar has actually been rather steady against other majors (including the Euro). However, the backdrop of a bullish USD trend makes it tough for the loonie to keep up.



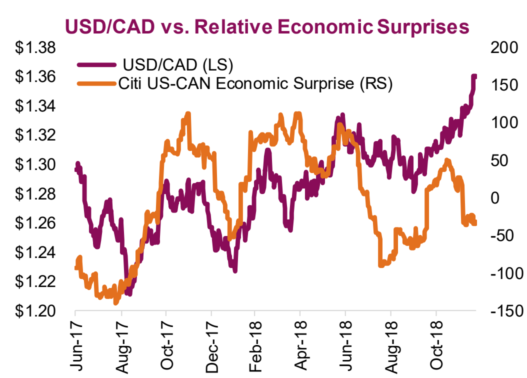
We expect the main driver for USD/CAD in 2019 will be the relative monetary policy between the U.S. and Canada. While it's certainly possible for it to trade in a narrow range over the year if policy stays in step with the U.S., there is the outside possibility of a currency shock if crude collapse worsens or the Canadian economy slows materially.

Monetary policy

The BoC is trying to move in step with the Fed (chart 2) while balancing the precariously debt-laden situation many Canadian's find themselves in. The bank has hiked five times in the past 15 months and the general mood is that Canadian's are becoming fatigued with borrowing costs. The neutral rate has garnered plenty of attention: it's a moving target with a rather wide range between 2.5 and 3.5%. Like landing a jet on a carrier, conditions are in flux and remaining on a steady flight path is a dangerous plan. It's wise to remain data dependent. There are a lot of unknowns and much of it is out of Canada's control. Keeping an eye on how well the economy adapts to higher interest rates is paramount for the central bank. Every meeting is potentially in play, though you can see that the expectations for further BoC tightening expectations in the spring have faded. (chart 3)



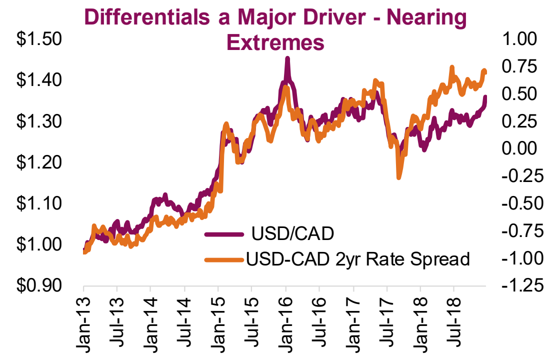
Economy



The Canadian economy slowed in Q3 and fell by 0.1% in September – the first monthly decline in eight months. Business investment is falling (mainly due to weak energy markets) and consumer spending growth has been cut in half. Confidence is falling, with the economic mood index down to the lowest level since early 2016. The growing regional disparity also can not be ignored. The economic mood is strongest in Quebec, with current confidence readings above their 5-year averages. Meanwhile in the Prairies confidence has plummeted back to lowest levels since 2008. Relative to the U.S., the data has actually been somewhat better in Canada versus expectations (chart 4). Historically, this typically leads to Canadian dollar strength. Though with markets in flux, the safe haven U.S. dollar remains in demand. Though the central bank may be looking at the economy through rose coloured glasses, the bond market appears to be discounting a more sour outlook, with 10 year bond yields trading below 2%.

CAD/USD bond yield differentials

This is something that cannot be overlooked, spreads have historically ruled the pair's performance. Correlations between the exchange rate and the respective Canadian/U.S. spreads are historically very high (chart 5). Despite the BoC's quest to move to a neutral rate, the U.S./Canadian yield spread now stands around the highest level seen over the past five years. It should be noted that this extreme typically marked a turning point in years past and we would expect a narrowing in **yield differentials** with the U.S. when the risk-off temperament permeating markets plays out in due course.



Implications

The U.S. dollar is a safe haven currency and the loonie is more levered to global growth. As such, we'd expect it to continue to weaken if markets continue to sell-off and concerns over global growth prevail.

The largest homegrown risk for the loonie is the infrastructural impasses for the oil patch. There have been some improvements on the oil front and if concerns over global economic growth fade, we could very easily see some improvement in the CAD in 2019. With yield differentials at historical extremes and the currency reaching technically overbought levels, the stars have potentially aligned for an eventual CAD reversal. Beyond the next few quarters, we are likely U.S. dollar bulls once again as a strategy to position for the inevitable bear.

Charts are sourced to Bloomberg unless otherwise noted.