Q3 2018 Review

Cross-currents remain in place as the U.S. continues to outperform

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Market Review

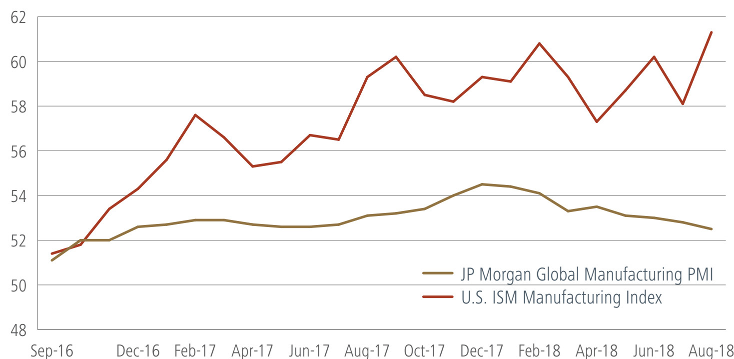
'The U.S. vs. the World' was one of the key themes that emerged in Q3. Equities continued to outperform bonds over the quarter, with the MSCI ACWI returning 4.7% in local currencies and 2.5% in CAD terms. This compares favorably to -0.2% on the Bloomberg Barclays Global Aggregate Bond Index hedged to CAD and -1.1% on the equivalent Canadian bond index. U.S. equity returns continued to be the primary driver of equity returns, with the S&P 500 returning 7.7% over the quarter. As U.S. growth continues to show resilience, pressures have begun to appear in regions vulnerable to increases in U.S. interest rates and a strengthening U.S. dollar. We continue to view several cross-currents and counterweights across markets and maintain our neutral stance between equities and bonds heading into Q4.

Outlook & Strategy

Q3 2018 – Risks Appear Around the World, but U.S. Economy Remains Resilient

Trade tensions and EM difficulties were present this quarter, but the U.S. economy remained broadly unaffected, as indicators of manufacturing sector activity continued to outperform the rest of the world (chart 1). The U.S. administration's imposition of tariffs on certain Chinese products and initial uncertainty over the future of NAFTA raised questions on the immediate outlook for global trade. Yet by and large, U.S. manufacturing activity came out unscathed, accelerating through the quarter. NAFTA uncertainties also dissipated toward the end of the quarter.

Chart 1: U.S. manufacturing activity strengthens despite global risks
Manufacturing PMI Indices



Source: Mackenzie Investments (Markit and ISM data via Bloomberg)

Other economies, while continuing to grow, did so at a slower pace. The slowdown that took place in Europe in the first half of this year did not fully stabilize in Q3. Europe also had to grapple with concerns over the Italian budget, which put Italian government bonds under pressure again. Meanwhile, in China, the slide in the value of the renminbi was halted, but economic data continued to point toward a slowdown. This became evident in slower growth in fixed asset investment and industrial output. This took place as global trade concerns continued to weigh on China.

Global equities still managed to gain over the quarter, with U.S. equities continuing to power ahead on strong growth and supportive corporate earnings. Japan also did well, with a gain of about 10% for the Nikkei 225 Index, albeit occurring mostly at the very end of the quarter. Emerging market equities, meanwhile, remained under pressure as trade tensions and the Chinese slowdown weighed on developing economies and currencies. Continued Federal Reserve tightening is proving to be challenging for those EMs with weaker fundamentals and high external financing requirements, as we saw in Turkey over the quarter.

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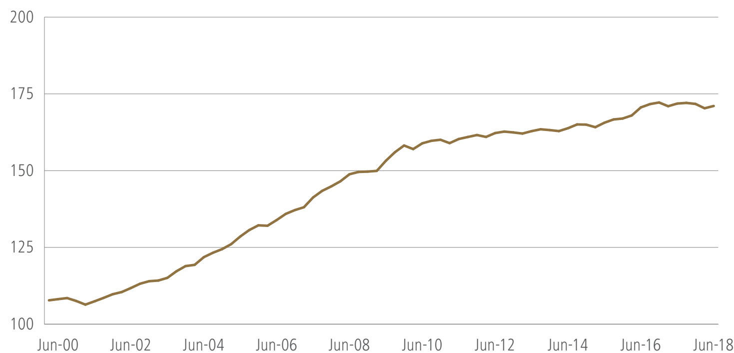
Canadian economic data was mixed in Q3, as job growth continued to moderate relative to last year's above-trend progression. Wage growth also slowed down from the high levels reached in the first half of the year. However, this is more a reflection of the economy reaching potential, or near-potential, than of a nascent, more meaningful slowdown. Consumer spending remained robust despite the household deleveraging process that has begun, as evidenced by a peak in debt-to-income ratios. In this context, the Bank of Canada continued its gradual interest rate normalization process, hiking rates by 25 basis points in July and signaling more to come in the next several months. The Canadian dollar moved slightly higher against its U.S. counterpart over the quarter (+2%) and the S&P/TSX was slightly down (-0.6%) over the quarter, with Energy stocks (-5.7%) acting as a drag.

Chart 2: Canadian households start to reduce pace of debt accumulation
Household debt-to-disposable-income ratio, %



Source: Mackenzie Investments (StatsCan data via Bloomberg)

Q3 Outlook – Markets and Economies Continue to Experience Cross-Currents, Making Risks Balanced

Risks remain present across the macro landscape. Developments with respect to the nascent trade wars continue to pose risks to global growth and to markets. The U.S.'s recent imposition of 10% tariffs on certain Chinese goods – with the threat to increase tariffs to 25% should no progress occur in trade talks – could hinder the flow of global trade and disturb several supply chains. China's ongoing economic rebalancing – which includes crackdowns on shadow banking and attempts to reduce leverage – is reducing the pace of growth, posing risks to economies highly exposed to China. Finally, the political calendar remains heavy with the Brazilian Presidential election in October and the U.S. midterm elections in November.

Nevertheless, there are also many positive factors. For example, some bellwether data points offering good cues on the state of global growth began to rebound in recent months. This includes data such as German business confidence, or new European passenger car registrations. The resolution of NAFTA uncertainty is also a positive factor for North American growth. This suggests that the lull in growth experienced in the first half may be coming to an end.

U.S. growth is also supportive despite the Fed's continued tightening toward the neutral rate. Wage growth is accelerating, supporting consumer spending. Corporate investment is returning, contributing to aggregate demand. Overall, it seems too early to worry about the onset of a meaningful contraction in U.S. growth.

This helps Canada, which remains highly tied to U.S. growth dynamics. This exposure to strong external demand is especially important given Canada's high levels of household indebtedness, which pose a risk to domestic demand. The dissipation of NAFTA risks will also remove a cloud over the country's growth picture and enable the Bank of Canada to continue its gradual normalization of monetary policy. Removal of NAFTA uncertainties also will enable Canada to benefit from the full extent of the strength in U.S. demand. Meanwhile, Canada's housing market seems to be recovering from some of the recent tax measures that were imposed on foreign buyers.

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Investment Views for Q4 2018

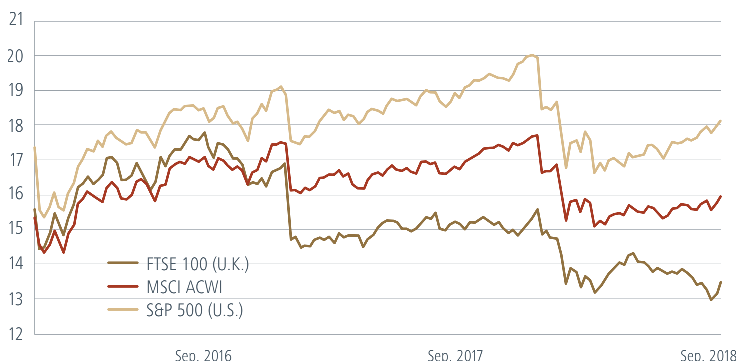
Our key tactical asset allocation views include the following:

- Neutral position between global stocks and government bonds.
- Slight overweight in U.K. equities relative to the rest of global equities.

We believe that the macroeconomic cross-currents described above support our neutral positioning between stocks and bonds. Bond yields and equity valuations have moved higher since the beginning of the year. In relative terms, this has reduced the appeal of equities relative to fixed income assets. For example, the U.S. two-year bond yield is now higher than the S&P 500's dividend yield. However, this is balanced by the fact that U.S. economic growth is likely to remain solid in the near term and by several positive factors in terms of corporate earnings growth. For these reasons, we do not believe that being underweight equities would be warranted at this juncture of the cycle.

Within equities, we view the overall dispersion of opportunities at the regional equity level as remaining low, as we see the relative attractiveness of various equity markets (U.S., Canada, Europe and EM) as being similar. However, we do think that U.K. equities appear cheap relative to other global markets. U.K. dividend yields look particularly high relative to other equity markets – as well as relative to the U.K.'s own bond market. Valuations are low in relative and absolute terms, as Brexit risks are embedded in stock prices. The U.K.'s weak currency is also a boon to the earnings of the multinational corporations included in U.K. indices.

Chart 3: UK Valuations Down Significantly Since Brexit
12-month forward P/E ratios



Source: Mackenzie Investments (data via Bloomberg)

**Global Investment Committee:
Asset Allocation Views, 2018 Q4**

	Underweight				Overweight		
	Strong	Moderate	Slight	Neutral	Slight	Moderate	Strong
Asset Allocation							
Equities vs Fixed Income				•			
Relative Equity*							
U.S.				•			
Canada				•			
Europe				•			
U.K.					•		
Japan				•			
Emerging				•			
Currencies (vs CAD)							
USD				•			
EUR			•				
GBP				•			
JPY				•			

*Refers to local currency index; Emerging Markets is in USD.

Q3 2018 Review

Outlook Q4 2018

Steve Locke,
Mackenzie Fixed Income Team Lead

This year, U.S. stock markets seem to have given investors somewhat distinctive price action in each individual quarter. In Q1, there were large swings in volatility and prices that contrasted strongly with the low volatility environment investors experienced in 2017. The second quarter saw prices moving mostly sideways on stock indices, leaving investors to factor the unknown implications of budding global trade wars alongside a strong U.S. economy. The third quarter brought around a steady and significant rise in U.S. stock indices as markets seemed to embrace the strong domestic growth story, while shrugging off increased geopolitical tensions and a slightly more hawkish monetary policy leaning from the Fed.

It was a different story during Q3 for many non-U.S. markets, both developed and emerging. For these regions, total returns were largely flat, or in some cases, quite negative, reflecting rising risks around increasing trade tensions with the U.S. and the cumulative effects of Fed policy tightening since 2015. Including the 0.25% hike at the end of September, there have now been eight hikes, with four announced in past 10 months alone. Continuing tight labor market conditions and measures of core inflation hovering above the 2% target, have the Fed projecting a tightening path through 2019 and into 2020.

Emerging markets have perhaps begun to feel the pinch of the stronger U.S. Dollar and higher U.S. Dollar funding costs. Two key drivers have been larger current account deficits in emerging markets and a pessimistic market view of political and economic governance within these markets. For some of these countries – especially those that are significant commodity importers – the weakening of their currencies in USD terms has created economic and sometimes political headwinds at home. In general, EM debt indices, both in USD and local currencies, have underperformed other forms of credit.

The good economic growth picture in North America, particularly in the U.S., provided a good backdrop for corporate credit spreads to narrow during the third quarter. Corporate profitability remains strong and cash flow is quite adequately covering interest payments, leading to little near-term debt servicing risks. Leverage across the corporate sector has started to rise, but has not reached levels considered dangerous.

Unless market volatility and economic risks for the domestic U.S. markets rise notably during the fourth quarter, the Fed and the Trump administration will remain focused on its America-first economic agenda. This means that the Fed will probably follow through on another rate hike by December, as Chairman Powell pushes the rate toward the yet-to-be determined neutral level for Q4 and beyond. The yield curve is likely to continue to flatten as this occurs. With the NAFTA renegotiations complete and on the road to ratification, the Bank of Canada will mirror the Fed's higher policy rates. However, continuing concern over higher Canadian household debt will most likely indicate that implementation will lag Fed announcements.

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