Mackenzie Asset Allocation Team

Q2-2018 COMMENTARY

Market Review

The theme of higher volatility, which began in the first quarter, continued through the second. Equities outperformed bonds over the quarter, but it was not smooth sailing as markets reacted, sometimes forcefully, to signs of a slowdown in global growth or to political events. The gradual return of inflation and the resulting central bank exits from ultra-accommodative monetary policies remained a theme that weighed on global bond markets. The MSCI ACWI equity index returned 2.9% in local currencies over the quarter, and about 2.8% in Canadian dollars. The Bloomberg Barclays Global Aggregate Bond Index hedged to CAD returned -0.02%, while Canadian bonds performed slightly better (+0.5%).

Outlook & Strategy

Q2 2018 – Policy Concerns and Signs of a Slowdown in Growth

- Following the heightened volatility experienced in Q1, markets had to grapple with slightly weaker growth in Q2, as indicators of manufacturing growth decelerated around the world. In addition to slowing growth, increasing trade tensions began to surface around the world, with reciprocal tariffs being imposed. A heavy political calendar, with elections in several countries, also added to uncertainty.
- However, amid this globally-coordinated slowdown, the U.S economy continued to outperform other developed economies. Despite the Fed's continued tightening, the U.S. economy continued to progress at a healthy pace, with solid readings for retail sales and signs of a comeback in corporate capital expenditures. The continued effects of fiscal stimulus, via tax cuts, also supported U.S. growth relative to other countries.
- This reinforced the recovery in the value of the U.S. dollar versus most currencies, weighing on emerging markets. While global equity markets managed to gain ground in Q2, this was not the case for emerging market equities. Emerging market governments and companies borrow in dollars and are dependent on dollar liquidity remaining easily accessible and affordable. As such, EM assets, from bonds to equities and currencies, underperformed in Q2 as the U.S. dollar rose.
- Canada was no exception to the growth slowdown, as job growth, consumer spending and credit growth all moderated from the strong levels reached in recent years. Despite rising wage growth and inflation, the Bank of Canada refrained from raising interest rates, instead choosing to signal that rate hikes are coming in the next few months. As a result, the Canadian dollar fell against its U.S. counterpart, as interest differentials favored the United States. Meanwhile, the S&P/TSX enjoyed a positive quarter (+6.8%) as energy stocks rallied along with crude oil prices.

Q3 Outlook — Risks Become Increasingly Apparent, but Growth Continues

- Several risks have become apparent in the last few months. Political developments in countries as diverse as Italy, Mexico, Brazil, Turkey and the United States have proven to generate ripple effects on global markets. The rising threat of trade wars is becoming more and more real, with the United States imposing tariffs on many of its largest trading partners, including China, the European Union and Canada, all of whom have reciprocated. NAFTA negotiations also continue generating uncertainty for the Canadian economy. The increased tariff threats take place at a time of slowing global growth, compounding the risks to global trade.
- Yet several positive factors continue to balance out the aforementioned risks. Chinese policymakers remain proactive in addressing risks and continue to ease monetary policy, with a view to supporting growth, which appears to be stabilizing, following a slowdown that began to develop late last year. As China remains a significant exposure for much of the emerging world, stabilization in Chinese growth in the face of growing trade risks is a support to global growth.
- U.S. growth also looks set to continue, despite tighter monetary policy and the risks mentioned above. The Fed is tightening at a measured pace and wage growth continues to recover slowly, supporting consumer spending. The housing sector also remains strong, supporting household balance sheets. Overall, it seems too early to worry about the onset of a meaningful contraction in U.S. growth.

MACKENZIE Investments

- Canadian growth is more mixed. Canada is facing increasing risks related to the housing and credit markets, which have undergone significant slowdowns in growth this year. Given the high levels of household indebtedness, this could hamper growth going forward. Also, our indicators of shorter term growth pressures are picking up. However, the labor market remains solid, with high rates of wage growth recorded and the Bank of Canada, cognizant of the risks, is raising rates at only a slow pace.

Investment Views for Q3 2018

Our key tactical views include the following:

- Asset mix: neutral position on stocks, underweight bonds, overweight cash.
- Relative equity: overweight emerging market equities, underweight Japanese equities

We are underweight bonds relative to cash. This view is now shared by 89% of our bond timing models. For example, all our valuation metrics suggest bonds are expensive, our inflation pressure readings are negative for bonds, our models of investor sentiment are bearish, and the shape of the yield curve has flattened considerably in the U.S. and Canada, all this decreasing the relative appeal of longer term government bonds relative to cash.

Within equities, we view the overall dispersion of opportunities at the regional equity level as remaining low. However, we maintain an overweight in emerging market (EM) equities, albeit downgraded from the previous quarter. EM corporate earnings are still significantly below their long-term trend, as EM economies are still early in their recoveries and are not yet overheating. The gradual rise in commodity prices is also proving to be a tailwind for many emerging economies. Also, several EM currencies appear cheap on a real effective exchange rate basis, which is beneficial for export companies. From a valuation perspective, EM equities continue to trade at a discount relative to developed market stocks. However, the recent increase in global trade risks have warranted a more cautious approach to our EM positioning. At the other end of the regional equity spectrum, we hold a slight underweight position in Japanese equities. As an export-driven equity market, Japan is particularly affected by the current trade war jitters and the slowdown in global trade.

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