Mackenzie Multi-Asset Strategies Team

Q3-2018 COMMENTARY

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 heading into Q4.

Outlook & Strategy

At the time of writing this article (October 11, 2018), the S&P 500 has fallen 6.4% (5.5% in Canadian dollar terms) since the beginning of the month with other equity markets following suit. Recent equity volatility appears to stem from the bond market. Real yields have risen sharply while inflation expectations remained flat. This if very significant because it captures two things: 1) the better-than-expected growth of the U.S. economy, and 2) a re-appraisal of prospects for Fed tightening, with more likely to take place. A number of asset prices around the world, including equities, were priced off lower for longer rates. This assumption is now being challenged, which has been a shock for markets. In addition, trade tensions are not helping in terms of market sentiment: markets appear to be spooked by any negative news about the prospects for U.S./China tensions.

However, it is our view that the economy is not rolling over just yet. Some slowdown is likely in 2019 Q1-Q2 from this year's fiscal stimulus, but things remain robust overall. Recession signs are minimal (if at all present) right now. We have been neutral on equities since March. The recent market turmoil has moved our position to slightly underweight equities and we are keeping a closer eye on how the markets develop. Should markets continue to collapse, we will be adjusting our positions accordingly.

Q3 2018 – Risks Appear Around the World, but the 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. 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.

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 towards 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 emerging market economies with weaker fundamentals and high external financing requirements, as we saw in Turkey over the quarter.

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.

Q4 Outlook — Markets and Economies Continue to Experience Cross-Currents, Making Risks Balanced

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 and 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.

Investment Views for Q4 2018

Our key tactical views include the following:
• Asset mix: neutral position on stocks, underweight bonds, overweight cash.
• Relative equity: overweight UK, overweight Japan
• Currencies: overweight U.S. dollar, underweight euro

We are underweight bonds relative to cash. This view is generated by our poor assessment of value across the fixed income markets and our macro views, which suggest growing inflationary pressures, a negative factor for bonds. Our models of investor sentiment are also negative for the asset class. The gradual flattening of the yield curve in the U.S. and Canada is decreasing the relative appeal of longer term government bonds versus cash.

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. We are also overweight Japan, which has seen an improvement in macro conditions. Moreover, our models of investor sentiment point to a positive shift in Japan. The country's easy monetary policy contrasts with other developed central banks, which are removing accommodation.

Within currencies, we are currently overweight the U.S. dollar relative to the basket of currencies. The strong comparative performance of the U.S. economy relative to Europe and emerging markets suggests to us that a hawkish Fed will continue to provide support to the U.S. dollar. At the other end of the spectrum, we are underweight the euro relative to the basket. We think that several issues will prevent the European Central Bank from normalizing interest rates in the near term. The recent budget issues in Italy underscore economic difficulties in the Eurozone periphery, which continue to weigh on the prospect for monetary policy normalization. Our sentiment readings on the euro are also negative.

PORTFOLIO MANAGEMENT TEAM:

Alain Bergeron, MSc, CFA, CMT, Senior Vice President, Investment Management, Mackenzie Investments

Andrea Hallett, CFA, Vice President, Investment Management, Mackenzie Investments

Nelson Arruda, MFin, MSc, CFA, Vice President, Investment Management, Mackenzie Investments

Michael Kapler, MMF, CFA, Associate Portfolio Manager, Investment Management, Mackenzie Investments

Steven Armstrong, MBA, CFA, Associate Portfolio Manager, Investment Management, Mackenzie Investments

Gleb Sivitsky, MFE, CFA, CAIA, Senior Investment Analyst, Investment Management, Mackenzie Investments

Christopher Hau, MFE, Investment Analyst, Investment Management, Mackenzie Investments

Jeffrey Grabell, BMath, Assistant Vice President, Senior Systems Analyst, Investment Management, Mackenzie Investments

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