

Market Review

It was a strong quarter for equities. The MSCI World index returned 5.4% in local currency terms and has gained for 14 consecutive months dating back to November 2016, which is the longest string of positive monthly returns since its inception in December 1969. In local currency terms, we saw very strong performance from the Pacific region led by Japanese equities, which returned 8.6%. The U.S. equity market was also a strong performer, returning 6.5%. The worst performing region was the Eurozone, which posted a slight negative return of -0.6%. Canadian equities, though returning 4.5%, lagged many of the major regional markets.

In bonds, we experienced a flattening of the yield curve in Canada, where shorter term yields rose as longer term yields fell. This resulted in Canadian bonds, as represented by the FTSE TMX Canada Universe Bond Index, rising 2.0%, with long term bonds leading the way. Globally, inflation linked bonds performed well with the Bloomberg Barclays Global Inflation-linked Bond Index Hedged to CAD returning 2.5%, while high yield bonds and government sovereign bonds lagged with slightly positive returns in local currency terms.

Outlook & Strategy

Despite a stormy political year, most major economies shared in the broad cyclical upturn in world GDP in 2017 with low inflation. Investors were rewarded for taking risk as the 'goldilocks' backdrop supported high returns in equities and credit markets with low volatility.

Many economic factors combined to set the stage for a surprisingly synchronized cyclical expansion that rewarded globally diversified investors. Global manufacturing activity strengthened as capital spending improved, supporting firmer commodity prices and a rebound in world trade. Global monetary conditions also remained supportive overall as direct asset purchases and negative policy rates of the ECB and Bank of Japan (BoJ) offset rate hikes by other major central banks and the announced unwinding of Quantitative Easing (QE) by the US Federal Reserve. Inflation remained low in most major economies, keeping a lid on interest rates and supporting equity markets.

In Canada, the surprisingly robust economic recovery in 2017 after the oil price shock failed to translate into an equally impressive year for the TSX compared to other major markets. In the first half of 2017, the annualized pace of real GDP growth exceeded 4%, well above Canada's sustainable growth rate at full capacity. With declining economic slack and growing concerns of inflationary pressure, the Bank of Canada hiked interest rates twice, catching markets by surprise and leading to a rapid surge in the loonie by over 10% from May to the September peak. With the economy rapidly absorbing spare capacity, real GDP growth slowed considerably in the second half of 2017, leading markets to scale back expectations of further rate hikes. The TSX underperformed other major stock markets, partly due to the stronger loonie. The TSX had stronger momentum beginning in September as the Canadian dollar reversed some of its earlier gains and oil prices rallied by about a third.

Globally, most major economies shared in the broad cyclical expansion. In the US, the economy approached full employment in 2017 as growth in real GDP exceeded 2.25%, well above its full capacity rate. The economies in Europe and Japan also grew above their sustainable long-term trends, although considerable remaining slack in those economies provides room for a sustained period of rapid growth. EM economies shared in the global upswing, rebounding from a multi-year slowdown given stabilizing commodity prices, stronger trade growth and loose global financial conditions.

2018 – Another Strong Year Ahead

Many of the economic factors that supported pro-cyclical assets in 2017 are expected to persist in 2018. Economic growth rates in the US and China – the two main engines of the global economy – are expected to remain strong. Tax cuts in the US will support short-term growth, which may lead to inflationary pressure. The Fed is expected to respond by lifting interest rates about three times in 2018 while it steadily reduces its balance sheet. However, we expect the ECB and BoJ to continue expanding their balance sheets in 2018 with direct asset purchases, maintaining supportive global monetary and financial conditions.

Economic momentum is expected to continue globally. In Europe and Japan, spare capacity provides a runway to continue growing above their sustainable long-term trends. We also expect China to engineer a gradual transition to a lower sustainable growth rate as it focuses on structural reforms to reduce excess industrial capacity, restrain housing excesses and reduce debt. EM economies are expected to continue rebounding as commodity prices remain stable, trade growth remains strong and global financial conditions remain accommodative. The UK is an outlier as it deals with higher inflation and slower economic growth, and investors remain uncertain about the UK's post-Brexit prospects.

In Canada, we expect the economy will continue growing above its sustainable long-term trend with the Bank of Canada hiking rates broadly in tandem with the Fed. Canadian real GDP is expected to grow by about 2.2% in 2018 compared to about 3% in 2017. Household spending may slow as house price gains continue cooling and debt-service costs increase with gradually rising interest rates. However, solid commodity prices, strengthening business investment, scaled up infrastructure spending and stronger exports should cushion the impact of slower personal spending.

Tactical Positioning for 2018 Q1

Our key tactical views include the following:

- Overweight in global stocks relative to government bonds;
- Overweight in EM equities and underweight in Canadian stocks; and
- Slightly underweight in the US dollar relative to the Canadian dollar.

Our overweight in global stocks reflects three key factors. First, stocks appear expensive compared to their own history, but are still relatively attractive compared to government bonds given today's still low yields. Second, we expect a continuing economic upswing in the global business cycle with little indication of a global slowdown in the next year. Upward cyclical pressure on long-term interest rates should be gradual and limited by structural downward factors, such as a glut of global savings, population aging and the slowdown in productivity. Third, our behavioural sentiment models indicate that investors remain enthusiastic about equities relative to bonds as the "fear of missing out" in the powerful equity rally attracts outflows from bonds and into stocks.

Within the equity sleeve of our portfolios, we expect EM stocks to outperform and Canadian stocks to underperform (in local currency terms). Following a strong year in 2017, Canadian economic activity is expected to slow in 2018, providing a headwind to the Canadian stock market. At the same time, the spread in the economic growth rates of EM and developed markets in 2018 is expected to reach its widest point since 2013, supporting local EM stock markets. Domestic economic fundamentals have also improved in many EM economies with firming commodity prices and loose financial conditions providing an attractive backdrop for investors. EM equity market valuations relative to long-term fundamentals are also relatively attractive after a multi-year bear market.

We are slightly underweight the US dollar relative to the loonie. While the US dollar weakened in 2017, it remains over-valued based on our models following a multi-year rally. The still strong US dollar reflects the more advanced stage of the US business cycle and the Fed's divergent monetary policy in recent years compared to the ultra-loose policy stance of other major central banks. In the longer term, we anticipate fair value of the Canadian dollar at about US\$0.84.

Key risks in our bullish scenario for pro-cyclical assets include a higher-than-expected increase in inflation and interest rates, which would affect the valuation of asset classes that embed low discount rates, or 'policy accident' by a major central bank or government that slows the pace of economic expansion. For Canada, more aggressive US trade policies could negatively impact confidence in Canadian exporters. Geopolitical shocks also remain a risk. However, our baseline view of continued strong and synchronized global growth is expected to support many pro-cyclical asset classes.

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