TRIASIMA

Economic and Financial Markets Commentary

Third Quarter 2018

The United States ... and the others

The economic backdrop so far this year contrasts sharply with that of the second half of last year. While 2017 witnessed a period of synchronous global growth, 2018 has been marked by the divergence between the economic performance of the United States and of the rest of the world. The former has been strong and steady, while momentum has faded in most other countries and regions. Consequently, corporate earnings have been rising in the United States while stagnating elsewhere. Meanwhile, political noise is as present as ever.

The **United States** remains the driving force behind the world economy. The Goldilocks environment persists, with full employment, strong internal demand, and recent corporate tax cuts; an ideal combination for continued earnings growth. Rising labour income stimulates consumption, the main driver of economic growth. This, in turn, is supporting government and corporate investment.

In **Europe**, growth has slowed after an acceleration in 2017 and also relative to lofty expectations. This is due to the weakness in Germany and France, both countries with Purchasing Manager Indices (PMI) at their lowest level in several months. The PMI for the Eurozone had been at unsustainable high levels early in 2018 and had to decline. This region is also hurt by the past strength in the euro and the emerging markets' weakness.

European politics were once again at the forefront as two Italian anti-establishment parties (Northern League and Five Star movement) formed a coalition last spring. Resentment towards the European Union and poor economic performance since adopting the Euro fomented their rise. Their program contains a number of deficit raising measures such as tax cuts and a guaranteed minimum wage. Since these measures could cost €100 billion overall, or approximately 6% of the GDP, European financial markets were spooked. Meanwhile, economic growth remains lackluster in Italy.

Emerging countries have been under a cloud of uncertainty. The appreciation of the U.S. dollar, rising interest rates and oil prices are wreaking havoc on many countries. Higher dollar and interest rates make it harder to service dollar-denominated debt.

Not all emerging markets are in the same situation. For example, Chile, Turkey, and Argentina have a larger proportion of U.S. dollar-denominated debt than India, Korea, and China.

The US-**China** trade war intensified over the last six months. Tit-for-tat tariffs were announced between the two countries. In the end, it is the consumers, in both countries, who pays more for their goods and services as the law of comparative advantage is pushed aside. Financial markets adjust to such antics, primarily through foreign exchange rates in the short term, as the renminbi has been weakening relative to the U.S. dollar.

China is more susceptible to suffer from the trade war due to its higher dependence on exports. Further, its pace of growth will moderate nonetheless going forward as the country focuses more on the quality of growth rather than the quantity, and on supply-side reforms, such as reducing overcapacity in the steel and coal producing sectors.

These were important themes that emanated from the 19th National Congress of the Communist Party of China, held in the fall of 2017. This was a strong departure from the past. China has indeed begun its transition to a middle-class led and household consumption-based economy.

Growth accelerated in **Canada.** The GDP rose at an annualized rate of 1.3% in the first quarter and 2.9% in the second. The trade balance recently provided a nice tailwind due to surging exports. Government and business investments also offset the weakness in residential construction.

The United States has reached an agreement with Mexico and Canada in the renegotiation of NAFTA, which will be renamed the US-Mexico-Canada

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Agreement (USMCA). The USMCA preserves the main features of NAFTA, but with some changes, notably a greater local content in North American automobiles and increased access for American producers to Canada markets for poultry, egg, and dairy products.

The Canadian labour market remains tight with very low unemployment in many regions, including Québec. Increases in minimum wages in some provinces have contributed to wage inflation and so has the higher proportion of full-time workers compared to part-time workers.

The United States also has a full-employment situation. Because of this, investors are on the lookout for wage inflation, which has begun to emerge alongside rising interest rates. However, wage inflation is good for consumer confidence, which is positive for the economy.

Late in the cycle, interest rates climb

Interest rates in North America moved up substantially all along the yield curve over the quarter. This is due to rising inflationary expectations.

Cost pressures are surfacing in many industries and wages are rising. In Canada, trailing twelve-month inflation reached 2.8% in August, the highest level since 2011. Inflation, not just expectations, is also slowly rising in the United States. The Fed has been tolerant of higher inflation since it spent the better part of the past 6 years below its 2% target. The Fed thus delayed raising rates in earnest, which it is now doing, prodded along by the solid economic expansion.

The Bank of Canada recently increased the discount rate to 1.5%, the highest level since January 2009 when it was rapidly dropping it in a panic mode. The BoC justified its action by stating that the economy is now operating close to full capacity and is expected to exceed its long-term potential.

North American yield curves are thus lifting, and they are also flattening as short-term rates are rising fast. A situation indicative of the lateness of the current economic cycle.

The yield-to-maturity of the FTSE TMX Canada Universe Bond Index jumped 24 basis points to 2.91% over the quarter. This is the highest rate since June 2011, two years after the end of the Great Recession when prevailing rates were falling from much higher levels.

Yields are rising, so bonds perform poorly. The Index was down 1% over the past three months (the long bond index fell 2.4% !) and is essentially flat for the nine-month period at -0.4%.

The economic cycle is less advanced in Europe and upward pressures on rates and inflation are less pronounced. The European Central Bank announced the end of aggressive quantitative easing late in 2017, but has done little firming up of its monetary policy since.

Equities: a tale of two markets

The MSCI All Country World Equity Index advanced 2.5% in the third quarter, a commendable outcome. The progress was not however equally shared as the economic divergence among world regions was reflected in equity markets. The American S&P 500 Index outperformed, rising 5.9%, while both the Canadian S&P/TSX Composite Index and the International MSCI EAFE pulled back a little, 0.6% and 0.4% respectively.

The American market has outperformed because the United States economy is growing faster and corporate profits are climbing sharply.

The Canadian market has lagged because of the resource-heavy make-up of its index where the Energy and Materials sectors account for 29%. These mature and cyclical sectors have difficulties sustaining profitability and commodities-based companies were shunned.

Profit growth is lackluster in Europe and the MSCI EMU Index pulled back 2%. Worries over the Italian fiscal

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situation and the exposure of European banks to emerging markets were overhangs for the region.

China is battling a slowdown and the effects of the trade dispute with the United States. As a group, emerging markets pulled back 3%, also hurt by the strength of the US dollar.

One standout was Japan, with the Nikkei Index rising 3.5%. The yen has been weak, helping Japanese exporters.

At the sector level, laggards were the Materials and Utility sectors. Commodities-based companies and those impacted by trade uncertainties did poorly. As for Utilities stocks, they are of defensive in nature with high dividend yields, and they suffer from the firmness of interest rates. Conversely, the Industrial and Technology sectors did well, pulled along by the entrepreneurship and strength of the American economy.

We have to emphasize again the outstanding performance of technology companies. They have been growing earnings above that of the index for a protracted period now, and the sector has climbed each of the last nine quarters for a total gain of 81% over that 27-month period. We live in a world of rapid technological advancement.

Year-to-date, the MSCI ACWI is up 9%, led by the United States where the S&P 500 Index has jumped 14%. Elsewhere in the world, most equity markets have lost their momentum and corporate profits have stalled. Meanwhile, discount rates used to value future cash flows, themselves a function of interest rates and inflation, are rising, putting downward pressure on equity valuations.

The standout sector was Healthcare, up 9%. In Canada, cannabis stocks fared well as the date for legalization approached. In the United States, the subsector life science tools has been very strong. We live in a very pioneering period where the movement towards precision medicine is driving innovation.

Insights from our Three-Pillar Approach™

Growth and momentum stocks have been outperforming value stocks for the better part of the past two years.

However, an important regime change possibly occurred in October when these two factors, growth and momentum, fell out of favour and substantially underperformed the broad indices, which, themselves, pulled back. The MSCI ACWI falling 7%, the S&P 500 Index, 5%, and the S&P/TSX Composite Index, 6%. (*We delayed issuing this third quarter Commentary to give us a little more time to see how the correction would pan out*.)

A first shot across the bow had taken place last February when all three markets dropped in the vicinity of 8% over a two-week period. The primary concern then, like now, had been rising interest rates.

October is the second warning, and a more serious one: we are further into the economic cycle and interest rates are higher. The 10-year US Treasury yield-to-maturity is 3.2%; it was 2.8% the first time around. The difference is significant. (We currently rate the 10-year US Treasury rate +2: trending up.)

Apart from rising interest rates, other reasons invoked for the damaging October pullback are slowing world and American economic growth, less accommodative monetary policy, peak earnings, and crowded use of the growth and momentum factors amongst investors.

Equity markets are no longer in uptrends following the October pullback. The Canadian market was rated +1 at the end of September and -0.5 at the end of October. Over the same month, the American market went from +2 to 0 and the International market, from -1 to -2.

These are crucial downward revisions to trend ratings for markets that had previously been rated +1 or +2 for most of the past nine years.

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At the end of the quarter, Triasima's equity portfolios had a growth orientation. As they still have a momentum bias, October's result were not good, lowering the relative performance for the year.

Conclusion

The highlight of the third quarter was the dichotomy between the economic and the stock market performance of the United States versus that of Europe and the emerging countries.

The United States did well despite the Federal Reserve having a restrictive monetary policy: raising the short-term discount rate and no longer buying bonds. This policy shift, combined with a full-employment situation, is lifting the yield curve up.

Profits in the United States grew enough in the third quarter to push stock prices up. Not so in Canada, Europe, and the emerging countries where equity markets pulled back.

October saw markets fall further, with the American following suit. Valuation multiples adjusted to higher interest rates, a process that impacts growth stocks more than value stocks.

The October pullback suggests we are nearing an economic slowdown and are facing an uninteresting equity market, caused by classic end-of-cycle factors.

As for the bond market, it remains unappealing in the context of rising interest rates.

We appear to be far enough into the current expansion phase for corporate profit margins to peak, which is never good for the stock market. Rising interest rates, rising costs of goods and services, and rising unit labour costs in a full-employment environment are all reasons for this. Household income is increasing but consumers are also facing higher costs.

It is probably an opportune time to emphasize safety and stability in portfolios.

Unless otherwise specified, financial information presented is in Canadian dollars.

Triasima assigns ratings to securities studied. The three analytical methods are fundamental, quantitative, and trend based. For each analytical method, ratings range from +2 (good) to -2 (bad).

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