Economic and Financial Markets Commentary

Third quarter 2019

A global slowdown...

Growth in Canada and the United States began to sputter late in 2018. In 2019, economic indicators have been underwhelming and the slowdown has become widespread in recent months.

One cause is the protracted trade war between the United States and China. This is creating trade disruptions which, combined with the lagged effect of the move away from easy monetary policies in 2018, has led to a major manufacturing slump in Europe, the United States, and China.

To wit, Global Purchasing Managers Indices have been falling, hitting a ten-year low of 49.7 in September. Another widely followed indicator, the ISM Manufacturing Index, recently broke into recessionary territory at 47.8 in the United States, the first time since June 2009 this index fell below 50. This number reflects the fact companies are holding back capital spending, and by ricochet, also impacts sentiment.

Germany's manufacturing sector fares badly too. The Purchasing Managers Index for that country fell to a six-year low of 50.4 in August.

The consequences from this developing manufacturing recession continue to mount. In the **United States**, third quarter GDP growth cooled to an annualized rate of 1.9%, versus a 3.1% read for the first quarter. Germany, **Europe**'s largest economy, risks slipping into a recession with the economy contracting 0.1% during the second quarter, with further weakness visible in the third quarter.

In **China**, economic statistics such as retail sales, industrial production and foreign investment have all been weakening. To revive its export-oriented economy, the country has initiated various stimulus measures. At the political level, China is also facing political turmoil in Hong Kong.

Fortunately, the manufacturing malaise has so far been largely offset by a strong services sector. The Canadian and American consumers, especially, remain economic powerhouses. Households are resilient because unemployment is low or declining and labour markets are robust nearly everywhere after many years of economic expansion.

It should be noted that there are some winners from the American-Chinese trade war. Emerging Asian countries such as Vietnam, Bangladesh and the Philippines are seizing market share away from China. Exports from such countries to the United States rose 10% in the first half of 2019 while they were down 12% from China.

... Leads to easy money and...

This turn for the worse for economies is now global, having first begun in Europe nearly two years ago. It has forced the hand of central bankers away from nascent restrictive policies and monetary tightening. They have instead reverted to monetary easing to try and combat the slowdown.

This is especially true for the Federal Reserve which had increased by 0.25% its fund rate on nine separate occasions since December 2015, from 0.25% to 2.5%. Reversing the trend by the end of the third quarter, the Fed actually lowered its benchmark rate twice, to 2.0%. Chairman Jay Powell called these moves a "mid-cycle adjustment", the intention being to provide insurance against ongoing risk. A further cut to 1.75% was implemented in late October.

Given the poor economic backdrop, the European Central Bank was also forced to act. The current governor Mario Draghi, nearing the end of his eight-year term, is going out with a bang by reviving its 2.6 trillion euro quantitative easing program at the pace of 20 billion euros per month and by cutting the central bank deposit rate from -0.4% to -0.5%. These moves should keep interest rates low on the continent for the foreseeable future. To insulate

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banks from the harmful effects of negative rates, the ECB introduced a tiering system whereby banks will only be charged negative rates on a portion of their deposits at the ECB.

This easy monetary policy is expected to stay in place until inflation comes close to the elusive ECB 2% target.

The Bank of Canada has been steadier, leaving its overnight rate unchanged at 1.75%. The Bank mentioned that current policy remains appropriate despite escalating trade uncertainties since inflation has perked up a little and the labour market is robust and in a full-employment situation.

… Falling interest rates

A key consequence of the global slowdown has been lower interest rates. Prospects for prospective economic growth have been revised down while serious inflationary pressures remain absent.

Rates have thus been falling steadily for nearly a year in both Canada and the United States.

As the table shows, the 10-year sovereign bond yield for Canada went from 2.45% in September 2018 to 1.16% at the end of last August. The drop has been even more dramatic in the United States, from 3.06% to 1.50%.

Government Bonds Yields

	Canada	U.S.
30-Sep-18	2.45%	3.06%
31-Aug-19	1.16%	1.50%
30-Sep-19	1.36%	1.67%

Government Yield Curves, Sept. 30, 2019

	3 mths	5 years	30 years
Canada	1.65%	1.40%	1.53%
U.S.	1.82%	1.54%	2.12%
Europe	-0.67%	-0.69%	-0.42%

The ultimate low took place on September 4 when the 10-year US Treasury bond reached 1.43%. A violent rebound ensued and the 10-year yield jumped right back to 1.90% by September 13.

During this period of a few days, a number of political and economic risks abated such as diminished prospects of a hard Brexit, China withdrawing its extradition law in Hong Kong and global PMIs improving for the first time in 16 months, providing the fuel for the bounce in rates.

Falling rates in 2019 first caused yield curves to drop and then to invert in Canada and the United States. The table show rates higher at short-term maturities, at a trough around the five-year maturity and climbing at longer maturities.

These spoon shape yield curves are unusual, forecasting very little inflation for the next several years.

The picture is worse in Europe where the entire government yield curve is, astonishingly, below 0%.

In Canada, the yield-to-maturity of the FTSE Canada Universe Bond Index has been unchanged at 2.12% and the FTSE Canadian Bond Index rose 1.2% during the third quarter. The Index is up a surprising 7.8% after nine months in 2019.

A lower discount factor for equities

Global bourses continued their run over the past quarter. The MSCI All Country World Equity Index advanced 1.3%, and has now climbed a solid 12.6% year-to-date. Declining interest rates are supporting the equity markets advance; not corporate profits which are stagnating. Price-earnings ratio has been expanding as a consequence.

Quality and growth had been outperforming factors in 2019, but these two prevailing themes were rocked in September when investors anticipated a reacceleration of economic growth. A sudden factor shift from growth into depressed value stocks led to resources and cyclical sectors outperformance. This sentiment change was accompanied by a sharp rise in interest rates over the course of only a couple of weeks.

The cyclically oriented S&P/TSX Index rose 2.5% in the third quarter, the S&P 500 came in at 2.9%, while the MSCI EAFE was nearly unchanged at 0.1%. Year-to-date, the three indices are up 19%, 17%, and 10% respectively.

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One standout was Japan, with the Nikkei Index rising 5%. After decades of poor performance, the country is apparently undergoing some sort of revival. It is not altogether clear to Triasima as to why.

Conversely, Emerging markets, dominated by China, have been performing poorly, down 3%. China is very impacted by decreasing worldwide growth. Latin America, itself part of the emerging markets group of countries, has lagged too, down 4%. Argentina, Brazil and Chile all have to contend with political turmoil.

Notwithstanding the September factor shift, the defensive Consumer staples, Utilities, and Real estate sectors outperformed over the third quarter while the Energy, Materials, and Health care sectors lagged.

Health care is not a cyclical sector but is currently exposed to policy risk in the United States, most notably over the increased noise by Democrats around Medicare-For-All. In Canada, this sector was dragged down by the debacle of cannabis producing companies battling drastically reduced growth and profitability expectations.

The Utilities and Real estate sectors, which also offer above-average dividend yields, have performed remarkably well so far in 2019, being up 15% and 16% respectively. The Technology sector remains ahead of the pack, however, up 25%. Technology services companies are growing fast: software, and not physical assets, are the infrastructure backbone for most industries. We indeed live in a world of rapid technological advancement.

We believe Utilities are also helped by a change in their business. Essentially, power production is increasingly decentralized, privatized, and of a renewable nature in North America and in Europe. This represents a long-term secular shift for the industry that improves its growth prospects and the general appeal of utility companies.

Musings and conclusion

Worldwide, economies have been slowing down so far in 2019, primarily due to the ongoing manufacturing recession. We do not fear this will develop into a full-fledged recession because government spending and the service sectors now dominate the economies of advanced countries, and are inherently more stable than manufacturing.

Our expectations are for an economic trough to take place in the last months of 2019 or early in 2020.

This year's big story remains the huge move downwards in global market interest rates. We believe bond prices are not in a bubble and like to point to two key reasons for the phenomenon of falling rates. Looked at over the (very) long term, this trend actually began in 1982 and has largely gone on unabated since.

One reason is that the world has gradually become richer over time, generating an excess of global savings over investment and capital spending needs. Needs are lower because long-term economic growth expectations are also lower and because the capacity to spend is constrained by higher levels of indebtedness, particularly for federal governments. Needs are also lower because a service oriented economy requires lower levels of capital spending per unit of GDP. They are no signs this overall situation will change.

The second reason is low inflation, a key driver for interest rates. In a nutshell, inflation remains low because the supply of labour is relatively plentiful, which keeps unit labour costs down, and because of productivity gains.

Labour mobility has probably gone down in recent decades, but the ability of companies to move production around the globe to where labour is cheap is higher than ever. This does wonder for productivity and help keep costs of production low, which benefits consumers everywhere.

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Incidentally, it seems to us the extent of productivity enhancements is not well understood and that productivity growth is underestimated.

As for the trade war between the United States and China, it may go on for years. These two countries have radically different social beliefs and economic systems; it is difficult to imagine how confrontations could die down over time.

Equity markets have moved up nicely so far in 2019. This was made possible by falling interest rates since profits have been stagnant. If rates experience a cyclical rebound, which may have begun last September, equity markets will likely pause in the short term until corporate profits resume growing later in 2020 alongside a reacceleration of economic growth.

Triasima's fixed income portfolios have maintained relatively long durations this year in view of our belief in down trending interest rates.

In equity portfolios, a growth orientation has been emphasized in 2019, while the value factor was shunned because of falling growth. This structure began evolving late in the third quarter towards a diminished growth overweight, a smaller value factor underweight, and a fair representation of defensive and high-dividend paying industries.

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

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