The Stan Clark Financial Team's

PERSPECTIVES

Mid-Year REVIEW

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Welcome to our 2019 mid-year review issue

Michael Chu and I have collaborated on a mid-year review of how Canadian, U.S. and international markets performed in the first half of 2019 – and what the major influences were over the last six months.

We hope you find this review both informative and useful in understanding the current economic context – and how we're keeping your portfolio firmly on course.

Enjoy your summer!

Stan

CIBC Wood Gundy

Mid-Year Review: Good start for 2019

By Stan Clark - Senior Investment Advisor and Michael Chu - Investment Advisor

We trust you are enjoying the summer! Being the midpoint of the year, it's also a good time to review what has happened so far in 2019 – and what we might expect in the future.

For the first half of 2019, all major markets were up. The World Equity Index, a gauge of stock markets around the world, was up 12.3% (in C$). At home, the Canadian TSX was up 16.2%.

The chart below shows the returns of major markets around the world. Note these returns are in Canadian dollars, so the effects of currency changes are included.

Resurrection

It's easy to forget, but the market has come a long way since the end of last year. During Christmas in 2018, the U.S. market was down 19.8%, just shy of the 20% threshold textbook definition of a bear market. Many pundits spoke of the bull market in the past tense, e.g., "It was a remarkably good run." Since that point, the U.S. market has enjoyed its best first half since 1997. Remarkable, indeed. It just goes to show, again, that markets are unpredictable in the short term and that financial decisions should be made using long-term data.

What caused this resurrection? Little has changed. No big news from the G20 conference. Trade tariffs remain in place, and you can add Iran tensions to the mix. Most of the credit probably belongs to the U.S. Federal Reserve and the prospects of interest rate cuts. Investors are currently assuming a rate cut at the end of July. You'll recall that in December that the market was worried about the nine straight rate increases that started in 2015. Basically, investors love rate cuts as they provide the fuel for a higher stock market. With interest rates so low, earnings and dividend yields look increasingly attractive. Even if earnings growth isn't the best, these factors can push the stock market higher.

U-turn on interest rates

Just as regular rate increases started becoming the norm, central banks around the world once again began tilting toward lower interest rate policies to help global growth. The U.S. Fed noted that the economic outlook had become cloudier in the last few months, with rising uncertainties over trade and global growth. Perhaps the Fed was also surprised at how sensitive the market and economy have become to rising interest rates. Maybe because there is so much debt, that smaller change in rates is having a bigger effect than in

	Q1 2019	Q2 2019	H1 2019
Canada (S&P/TSX)	13.3%	2.6%	16.2%
U.S. (S&P 500)	11.2%	2.3%	13.8%
Europe	8.5%	3.1%	11.9%
Japan	3.5%	1.3%	4.8%
EAFE (Europe, Australia, Far East)	7.7%	1.7%	9.5%
Emerging Markets	7.6%	-1.3%	6.2%
World	10.1%	2.0%	12.3%

Source: Bloomberg

the past. This may have caused the central bank to reassess its next move on interest rates. The Fed is now expected to cut interest rates by 0.25% at its next meeting in late July.

The economy has been growing for over 10 years straight and unemployment recently hit a generational low. Many would have predicted we'd be seeing substantial increases in wages and prices by now. While wage growth has also been subdued, it has only just begun to increase in the last few months. And price inflation has remained surprisingly low.

Where's all the inflation? This question has been confusing economists, too. But part of it can be explained by the disruptions and increased efficiencies caused by technological innovation. For example, online shopping, unconventional oil extraction and globalization of the workforce and automation. All these have had an impact in keeping prices down.

So, it seems like central banks are no longer in the mood for raising rates. They will likely keep rates the same or slightly lower. Perhaps the central banks have discovered that low interest rates are the new normal.

At home, the Bank of Canada seems in no rush to change rates, even as the U.S. Fed is signalling an upcoming rate cut. Part of this is due to Bank of Canada Governor Stephen Poloz raising rates more cautiously than his U.S. counterpart. This now looks to have been a wise course of action by Poloz. Also, unlike the White House, Canada's political leaders are not pressing for a rate cut. Canadian mid- to long-term interest rates are falling. They are about 0.5% less from the beginning of the year. Canada's Central Bank has held its policy interest steady so far this year – but that may change if the economy weakens or the Canadian dollar goes up too much.

Negative interest rates?

Around the world, interest rates are going down. In fact, 25% of global government debt has negative yields. Negative yields mean investors lend money knowing they will receive less in return. No investor should willingly do that. But some have requirements (like pension funds); others still see it as a guaranteed "return" if things get worse, or if we get deflation. Most of the negative yields are from European governments (14, in fact). Governments don't mind lower rates as it reduces their costs of borrowing. In theory, negative rates incentivize banks to aggressively lend money, in an effort to boost economic growth.

Yield curve

We've been talking about the *yield curve* for some time. To recall, the yield curve is a graphical representation of interest rates across various maturities (one month, three months, five years, 10 years, etc.). The yield curve is usually upward-sloping, meaning longer-term rates are higher than short-term rates. Lately, the curve has been flat and has actually inverted in some cases, causing some concern about an upcoming recession.

While every recent recession was preceded by an inversion, not all inversions have led to a recession – there are often false alarms. As you may recall from our last economic review in April, we discussed how we shouldn't overreact to slight or temporary inversions.

The three-month to 10-year curve is currently barely inverted by 0.1%. It has been this way for part of May and all of June. The two-year to 10-year curve is flat, but not inverted.

We have also discussed how the yield curve is just one indicator of recessions – it's important to look at other factors, too, when evaluating the economy. Also, the Fed can "fix" the curve overnight by just lowering interest rates. While the trend has been rate hikes for the past few years, the current forecast, as noted earlier, is a rate cut at the end of July. This should help to "un-invert" the curve.

Longest run

The end of June marks the longest economic recovery in the 240-year history of the U.S. We already have the longest bull market in the 227-year history of Wall Street, currently running at 10.3 years, eclipsing the 9.5 year previous record of the 1990s.

Sure, records are meant to be broken, but could things be getting a bit ridiculous? These days, we often hear the economy is "long in the tooth" or "in the late innings," basically implying that things will end soon. The problem with timing markets or economies is that using a clock is the wrong measuring tool. It's the speed we should be concerned about. Previous bull markets ended sooner than 10 years because they grew faster and blew a tire from overheating. Same with economic expansions.

The current bull market has enjoyed a 327% appreciation in 10.3 years. But the second longest (9.4 years) bull market of the 1990s gained 417% before ending. It only ended because of the tech bubble, but we have seen nothing similar to that kind of excess this time around.

It's the same with the economy. Rapid 5% growth rates of the mid-1980s to the late '90s have not been repeated in the last decade. So, we can now enjoy a longer but slower recovery – dubbed *Goldilocks*, neither too hot nor too cold.

Bull markets usually end because of economic recessions. And recessions result from excessively fast economic growth. Here's another way to look at it: 5% economic growth for eight years is the same as 3% growth for 13 years, or 2% growth for 20 years. Which would you prefer? "Go-go" growth for eight years followed by a deep recession, or 13 to 20 years of slower more manageable growth that ends with a soft landing?

While the market has been good overall, the last 10 years have been anything but smooth. It's so easy to forget those rough periods we have recently experienced. According to economist Ed Yardeni, this record-setting bull market has endured 63 panic attacks. Of the 63 sell-offs, there have been six outright corrections, with the S&P 500 down by 10% or more but not 20% (which would mark a bear market). Two of these corrections were near being bear markets – in 2011 and 2018. Some of the fears during the corrections included: Eurozone debt crisis, recession worries, flash crashes, trade wars and interest rates hikes.

The key is to remember that each of these panic attacks was followed by a market recovery. Many of the recoveries led to new record highs in the stock market.

Recessions

Recessions are a necessary evil in a financial system like ours. Recessions wring out the excesses in an economy. They can be devastating, especially if you're not prepared with a resilient financial plan and the right mindset. The current economic expansion will end at some point; we just don't know when. But, to give some perspective, let's look at the characteristics of previous recessions.

The Great Depression was brutal. The economy contracted 27% in 1929 and then 18% in 1937. The stock market was down 76% and 27%, respectively. Scary stuff. Since then, there have been 12 recessions, with the economic impact being much more moderate. The average contraction since the Great Depression has been about 3%. The average stock market performance during these contractions has actually been up 4%. Why? Stock markets and recessions don't exactly coincide. Stock returns during the first part of the recessions are worse, but they improve towards the end of a recession because the stock market is forward-looking. But before the stock market improved – in other words, at the worst point for stocks during a recession after the 1930s, stocks were down 22% on average.

That still sounds bad. But let's look at what happens *after* a recession. According to Ben Carlson of Ritholtz Wealth Management, in the year following a recession, the stock market is up 17% on average. Two years after, it is up 46%. Five years after a recession, stocks are up 90% on average. This shows that investing during times of unrest usually pays off for investors.

In general, stocks tend to underperform in the year before and during a recession. They then perform *above* average in the following years. Of course, this is based on a small sample, but it gives us some perspective on what we expect. Every cycle is unique and no one knows for sure what will happen. But historically, expansions far outweigh the contractions in terms of magnitude and length, so it makes it sense to invest despite the negatives.

Growth vs. value

Overall, growth stocks are continuing to beat value stocks. So far this year, according to MSCI, growth stocks returned 22% while value stocks returned 13%. Traditionally, value stocks do better because they beat the low expectations while growth stocks often miss their lofty expectations. So far in 2019, growth stocks, along with their higher valuations, have actually met or exceeded their expectations.

We have made some adjustments to our stock strategies for a more balanced approach. But overall, our strategies have a value bias. While this works well in the long term, it will affect our results in "abnormal" periods like this.

Sentiment survey

At the end of June, the bearish sentiment survey was 32%. This is based on the American Association of Individual Investors' (AAII) sentiment survey. If you recall, the survey is widely thought to be a contrarian indicator, since investors tend to be negative at market bottoms and much more positive at market tops. Over the long term, the reading averages 30% and usually ranges between 20 and 40%. So, the reading is currently in neutral territory despite the rise in the market.

Earnings

July marks the start of earnings season for the second quarter. Earnings seasons lasts about six weeks and happens every three months while the majority of large companies report their quarterly numbers.

China and tariffs will probably be mentioned often in financial reports. The escalation of trade disputes between the U.S. and its trading partners will have a negative impact on analyst expectations. Earnings growth expectations are low, but due to other factors like stock buy-backs, and that positive surprises are common, we might see earnings growth of a few per cent compared to a year ago. This is good, given we have already enjoyed a big earnings jump from corporate tax cuts in the last two years.

Valuations

The table below shows earnings and dividends of various regions compared to Canadian and U.S. 10-year bonds.

As you can see, dividends from stocks in Canada are much higher than 10-year bonds. In the U.S., they are close, which makes stocks look good from this valuation perspective. And dividends from international markets look even better when compared to the U.S.

	Trailing P/E	Trailing Earnings Yield	Dividend Yield	10-Year Bonds
Canada (S&P/TSX)	16.8	6.0%	3.2%	1.5%
U.S. (S&P 500)	20.9	4.8%	1.9%	2.0%
Europe	15.7	6.4%	3.7%	
Japan	12.8	7.8%	2.5%	
EAFE (Europe, Australia, Far East)	15.0	6.7%	3.4%	
Emerging Markets	13.4	7.5%	3.0%	
World	18.3	5.5%	2.5%	

Source: Bloomberg

The earnings yields as shown are based on (reported) earnings over the last 12 months. It's also useful to use estimates of future (or forward) earnings. Earnings in the U.S. have grown significantly in the last two years, largely because of big corporate tax cuts. Profit margins this year will likely be under pressure, but could be maintained from increases in productivity and cost-cutting.

U.S. S&P 500 companies are expected to grow 3% in 2019 and 5% in 2020. This implies a forward (operating) earnings yield of 5.7% and 6%, respectively. Given that current valuations are similar to the five- and 10-year average, this bodes well for stocks. Of course, these estimates can change.

Presidential cycle

The presidential cycle is an indicator that says markets tend to do poorly in the first two years of a U.S. president's term and then better in years three and four. The theory behind why this happens is that politicians will promise everything imaginable to get re-elected; meanwhile, investors feel better and look forward to positive changes in government. According to this indicator, 2019 (year three) and 2020 (year four) should be kind to the U.S. stock market. Remember, it's just one indicator and it will not be perfect.

Widely recognized economist Ed Yardeni believes U.S. stocks could rise 15% by the end of 2020. This bullish call isn't just based on fundamentals; it's more about President Trump's evolving trade war with China. In Yardeni's opinion, this is forcing the Fed to lower rates.

The Fed is supposed to be independent in setting policy by basing decisions on economic conditions. This hands-off approach has been in place since the 1990s. But before that, presidents did complain about the Fed. Today, it seems like we are back to that tactic, with the White House often being critical of the Fed.

According to Yardeni, "Trump has figured out the perfect way to force the Fed to lower rates. All he has to do is keep creating uncertainty about U.S. trade policy." Trump could keep negotiations open and continue to alternate his message about how the talks are going, Yardeni says. "It's all about winning the second term and playing [Fed Chair Jerome] Powell to do so."

No one can predict what will happen to the stock market. But political pressure to lower interest rates should help stocks in the meantime – as portrayed by years three and four of the presidential cycle.

Canada vs. the U.S.

Diversifying our stocks around the world is one of our investment principles. This is because certain geographies will do better or worse at different times. Diversifying allows us to reduce risk because we don't put all our eggs in one basket.

But sometimes diversifying seems like it can backfire. For example, if one country does better than others, year after year, why would you want to diversify? The U.S. stock market has outperformed Canada's for seven of the last eight years, and also so far this year. For the last 10 years (to 2018), the U.S. stock market has returned about 13% compared to Canada's 8% (per year). Why don't we just put everything in the U.S.?

It's true, you would have been better off. But that's only part of the picture. Canada outperformed the U.S. from 1999 to 2010. That's 12 years of outperformance for Canada. If we were back in 2010, we would be discussing the opposite – putting everything into Canada!

In the years before 1999, long strings of outperformance were not as common. When we look at a longer time frame, it shows that things change. The winners of the past are not necessarily the winners of the future. And it's hard to know when things are going change. That's why it's best to diversify.

	S&P 500	TSX	Winner
1999	21%	32%	CAN
2000	-9%	7%	CAN
2001	-12%	-13%	US
2002	-22%	-12%	CAN
2003	29%	27%	US
2004	11%	14%	CAN
2005	5%	24%	CAN
2006	16%	17%	CAN
2007	5%	10%	CAN
2008	-37%	-33%	CAN
2009	26%	35%	CAN
2010	15%	18%	CAN
2011	2%	-9%	US
2012	16%	7%	US
2013	32%	13%	US
2014	14%	11%	US
2015	1%	-8%	US
2016	12%	21%	CAN
2017	22%	9%	US
2018	-4%	-9%	US

Source: Bloomberg

China dispute

Probably the most negative economic news recently is that protectionism has been gaining. At the moment, it seems like the "temporary" tariffs will remain in place. As a result, there will probably be slightly less growth in the world economy – but likely not by an overwhelming amount unless the dispute gets worse.

Overall, uncertainty has been increasing. This creates the risk that companies put off capital allocations, delay expansion plans, disrupt supply chains – creating additional frictions that companies will need to waste time and resources on.

Canada

Oil prices are higher compared to the beginning of the year. That helps Canada's oil sector, though not as much as about five years ago, when oil was in the triple-digit range. Of course, Canada is more than just oil. Housing is also important but it is not moving as fast as it was. Furthermore, tax cuts in the U.S. have made it a more attractive place to do business than Canada. All this has resulted in more muted, though still positive, growth in Canada.

Canadians across the country will be visiting the polls for the federal election in October. It's early, but so far looks to be a close race between the Liberals and Conservatives.

Brexit

Yes, we're *still* talking about Brexit. No one has left yet. It's been three years since the United Kingdom voted via referendum to leave the European Union. And things seem nowhere closer to a resolution. There will be a new prime minister, leading to more elections, possibly even more referendums, amongst other changes. Meanwhile, this will damage the British economy, and to a lesser extent the European economy.

Looking forward

Though expected to slow, corporate earnings growth should remain still good enough to support current stock prices. As usual, anything can happen in the short term, especially given interest rates, politics and global trade. These events are difficult to predict, as are their consequences. That's why it's important to establish a custom asset mix for you through resilient financial planning, and owning a diversified portfolio of companies with strong characteristics of doing well. ■

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