October 5, 2018

Despite the passing of a decade, the 2008 financial crisis is still top of mind for many investors. This is understandable given that the Great Recession was the worst global financial downturn since the Great Depression of the 1930s. In order to arrest the downturn, central banks around the world, led by the U.S. Federal Reserve (Fed), pursued unconventional policies including quantitative easing (QE) programs. While most market participants thought that these emergency measures would only be necessary for a short period of time, many major central banks, such as the Bank of Japan and the European Central Bank, are still actively participating in large-scale asset purchase programs today.

A decade after the Great Recession, many are trying to predict what will trigger the next crisis. As the saying goes, "history doesn't repeat but often rhymes". We do not think that the next financial crisis will be caused by a housing market crisis or simply as a result of the duration of the current bull market. Rather, we think surging overall global debt levels will likely be a contributing factor to the next crisis. Also, harsh U.S. policies including an aggressive trade war with China and unilateral sanctions on countries could potentially send shockwaves through global markets and lead to an equity market downturn. Like the changing of the seasons, the economic cycle is immutable – from recovery, to expansion, to peak and ultimately to recession. Despite some material risks on the horizon, we do not expect a recession in the near term and continue to have a preference for equities relative to fixed income and cash.

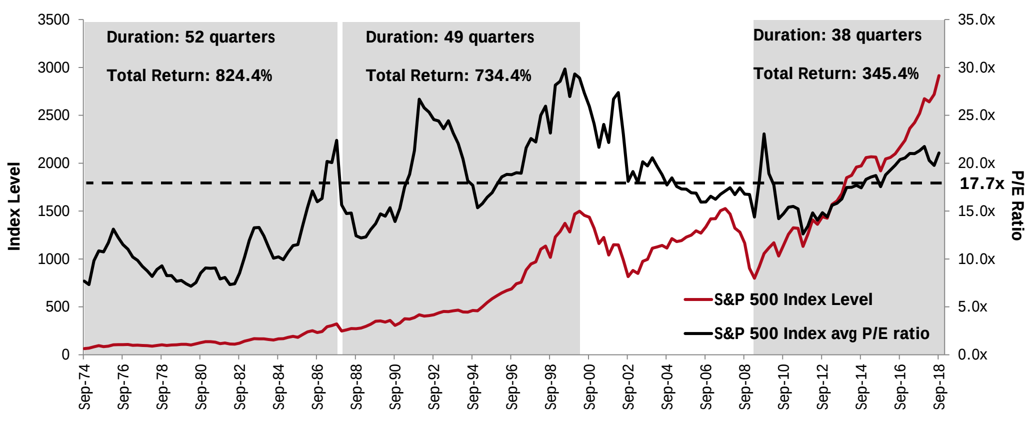
In this first of a four-part series, we take a closer look at the economic cycle, duration of the current bull market, valuations, expectations of growth rates, potential risk factors, and the importance of portfolio diversification and rebalancing in order to reduce risk.

BULL MARKETS DON'T EXPIRE FROM OLD AGE

A percolating concern in recent quarters has been the notion that the current bull market in equities is long in the tooth and is therefore near end-of-life. We would suggest that bull markets do not expire simply as a result of duration. However, given that we are in the later stages of the current expansion phase, we take a closer look at the current bull market in equities in comparison to historical periods of rising equity prices.

Despite the longevity of the current bull market, it is not the longest in history nor has it produced the most significant returns. The bull market in U.S. equities that began in the 1970s lasted 52 quarters and generated a total return of 824.4%; the bull market that began in the late 1980s and ended with the bursting of the "technology bubble" lasted 49 quarters and produced a total return of 734.4%. The current market rally that started on March 9, 2009, is 38 quarters old and the S&P 500 Index has generated a total return of 345.4%. The S&P/TSX Composite Index (TSX) has also been in rally mode for the past 38 quarters and has generated a return of 143.0%. As our examples demonstrate, historical rallies have lasted longer and have generated bigger returns. But what about valuations?

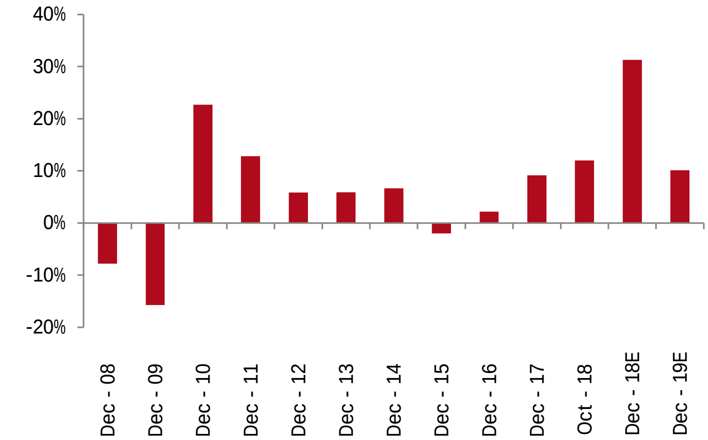
U.S. Bull Markets



Source: Bloomberg

U.S. equity market valuations are elevated. Since the mid-1970s, the price-to-earnings (P/E) ratio has averaged 17.7x for the S&P 500 Index. Today, it stands at 21.1x. Certainly, elevated valuations are in part due to robust global growth, which has fuelled earnings per share (EPS) growth. In 2018, for instance, the S&P 500 Index EPS growth is expected to be roughly 31% year-over-year, based on Bloomberg estimates. However, this rate is expected to decelerate to 10% in 2019. In turn, slower earnings growth might cause equity valuations to compress and market volatility to rise.

S&P 500 Index EPS (YoY change)

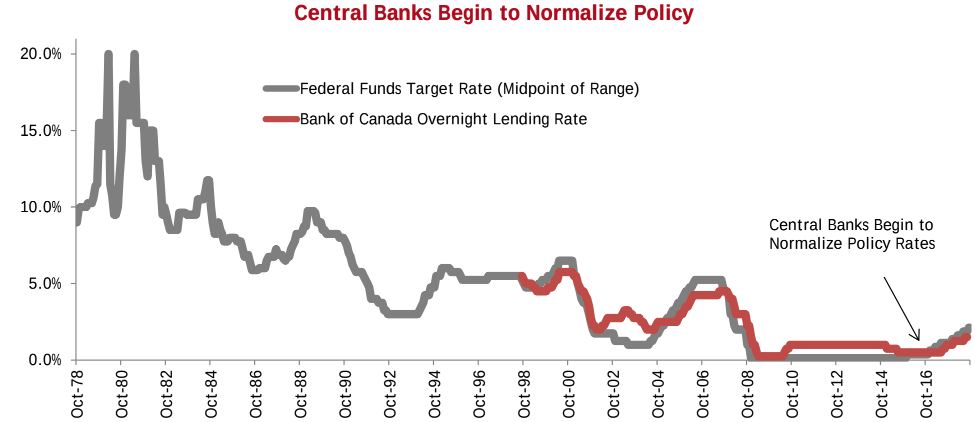


Source: Bloomberg

RISING DEBT LEVELS AND TRADE WARS/SANCTIONS ARE MATERIAL RISK FACTORS

While we don't think that the longevity of the current bull market is a major risk factor, we do think that the rising global debt level, the potential for the U.S. and China to enter into an aggressive trade war, and upcoming sanctions on Iran are material risk factors.

Central Banks Begin to Normalize Policy



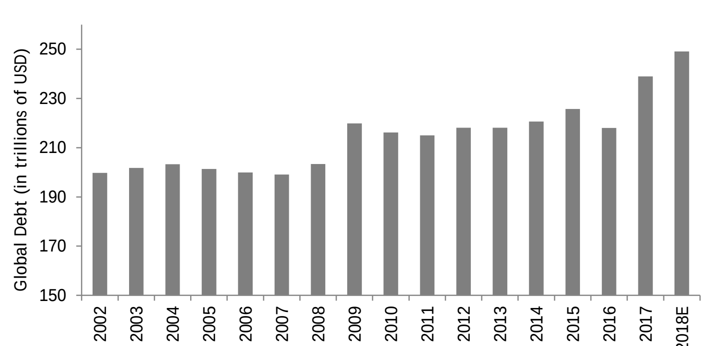
Source: Bloomberg

As a result of a prolonged period of very low central bank policy rates and QE programs after the 2008 financial crisis, government bond yields declined dramatically across all maturities. However, with the global economy generating robust growth, Canadian and U.S. central banks have begun to normalize policy, raising key policy rates. A tight labour market and higher oil prices have also supported higher inflation expectations and have caused longer-term sovereign yields to rise, underpinning the case for the Fed, in particular, to be more hawkish. Meanwhile, global debt levels have continued to rise and stood at a record US$247 trillion at the end of the first quarter of 2018.

Years of nearly free money incentivized consumers and companies to borrow, with many doing so aggressively. As borrowing costs rise further, servicing record amounts of debt will become more difficult for consumers and corporations. This could be all the more true if global growth slows materially (as we discussed above, U.S. corporate EPS are expected to decelerate in 2019 compared to 2018 based on estimates; we have also previously postulated that global growth for the current cycle may peak in 2018).

U.S. policies could lead to a significant deceleration in global growth. A drawn-out and aggressive U.S. trade war with China would almost certainly stymie global growth. China's leadership has orchestrated an incredible three decades of growth by opening its financial and trade markets. The result has been the

Global Debt Levels Continue to Rise



Source: Institute of International Finance opportunity for many Chinese citizens to escape poverty and join the middle class. As disposable incomes increased, so too did consumption and imports. Significant and escalating tariffs being enacted by the U.S. on China threatens this positive growth trend. Additionally, upcoming sanctions by the U.S. on Iran could result in a spike higher in the price of oil. While higher fuel prices are little more than an annoyance for most Canadians, the ramifications for emerging economies is very significant; as households spend a larger portion of their income on fuel, they have less income left over for basic essentials such as housing, food, medicine and education. As such, the growth rate of individuals joining the middle class could falter and in the case of some countries, poverty levels could actually begin to rise.

Overall, these risk factors could cause global growth to decelerate materially and could even potentially contribute to the next recession.

CAN WE HEDGE FOR THESE RISK FACTORS IN OUR PORTFOLIOS?

Although we are cognizant of the discussed risk factors and acknowledge that global growth might peak this year for the current economic cycle, we remain bullish on equities and think that there is still significant positive growth momentum in economies around the world. That said, we should remain mindful of the importance of taking profits and rebalancing investment portfolios on a regular basis and staying diversified.

Take profits. We often focus on the theories of behavioural economics to better understand how investors make decisions in financial markets. As markets rise, investors are reluctant to take profits even as positions become significantly overweight in the portfolio, in part because of tax consequences but also because of the fear of missing out on the rally. On the other hand, as equity prices fall, investors become reluctant to sell at a loss even if the investment thesis has changed materially. Both are examples of behavioural biases. Rebalancing one's portfolio on a quarterly basis is advisable. As sectors, industries, and stocks perform well and become an outsized component of the portfolio, profits should be taken and the portfolio rebalanced. By taking profits we are safeguarding capital and ensuring our portfolio remains well balanced.

Stay diversified. Nobel laureate and one of the founders of modern portfolio theory, Harry Markowitz, once famously quipped that diversification is "the only free lunch in finance". Diversification helps reduce risk and improves risk-adjusted returns. Additionally, by maintaining a diversified portfolio, an investor is better able to navigate market volatility on the path to one's financial goals. By holding a well-diversified portfolio with securities that have low correlations with one another and are diversified across asset classes, sectors and geographies, investors are able to reduce volatility and generate better risk-adjusted returns.

In the later innings of the expansion phase, global growth is still robust and inflation has not yet begun to accelerate rapidly. Looking at data going back to the 1960s, it is true that once the Fed shifts from a dovish policy regime to one of tightening, a recession is inevitable; lags from the central bank's last rate hike in the cycle to the onset of a recession range from one to six quarters. Currently, we are still in the early stages of the Fed's tightening cycle. We also note that stocks tend to perform well through most of the tightening phase as the central bank is removing monetary stimulus in order to prevent an already robust economy from overheating. Overall, we do not expect a recession in the near term and remain bullish on equities. That said, throughout the economic cycle, we must take profits, rebalance portfolios on a regular basis and ensure our portfolios remain diversified. By doing so we can reduce risk and stay better focused on our longer-term goals.

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