CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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Strong Global Economy Faces New Risks in 2018

In this fourth quarter (Q4) edition of our Newsletter, we will take a break from the discussion of individual portfolio holdings and provide some broader perspective on where North American markets may be headed in 2018. Despite geopolitical issues and some uneven patches economically, the last two years have been broadly positive for equities and economic growth. Our portfolios have performed well, without the need for any major repositioning. Despite signs that the global economy is currently enjoying a period of coordinated growth, 2018 is likely to bring new challenges and new risks.

Central banks are withdrawing monetary stimulus, and interest rates have started to head higher. Equity valuations are at levels that make it much more difficult for us to find many undervalued companies to buy. In addition, equity market volatility has been incredibly low in recent years, which could easily change. All things considered, we anticipate a more difficult environment for equities in 2018, which could easily include a meaningful market correction at some point during the year. Despite our concerns, we believe our strategy of buying high-quality companies at attractive valuations is likely to continue to perform well. We have managed portfolios through challenging years before, and we have found that equity market volatility can create excellent investment opportunities.

Coordinated Global Economic Growth

There have been many times in the past 10 years when worries about a particular country or region have dominated the business headlines. At the moment, we are fortunately experiencing a period of coordinated global economic growth. According to the World Bank, global GDP is forecasted to grow by 3.1% in 2018, and this comes after a stronger-than-expected 2017.[1] In Canada, 2017 was stronger than expected, with GDP growing around 3%[2]; looking ahead, Canadian growth in 2018 is projected to be around 2.2%.[3] The U.S. economy is also in good shape at the moment. Most forecasts see U.S. GDP growth coming in around 2.5% for 2018.[4] There have also been positive numbers out of Europe recently. For example, Germany, Europe's largest economy, experienced GDP growth around 2.2% in 2017, a six-year high. Germany is projected to grow its GDP by 2.6% in 2018.[5] China is projected to grow its GDP by 6.4% in 2018.[6]

A Long, Weak Expansion

Despite the length of this period of economic expansion, we are not seeing any signs that a recession is imminent in any of the world's largest economies. In the U.S., the longest period of economic expansion on record is 10 years. A U.S. recession took place in the early 1990s from July 1990 to March 1991, and a decade of economic expansion followed before the economy fell into the early 2000s recession from March 2001 to November 2001.[7] The current U.S. economic expansion will become the longest ever expansion if it continues into June of 2019.[8] Some commentators believe that the depth of the 2008-2009 recession and

the initial slow pace of the recovery have set the U.S. up for an unusually long cycle.[9] The probability that a recession may happen in the next few years is rising; however, we do not see signs that one is imminent.

Interest Rates

Interest rates are likely to rise in both Canada and the U.S. during 2018. The strength in both economies no longer justifies emergency-level low interest rates. On January 17, the Bank of Canada increased its overnight lending rate from 1% to 1.25%. In December 2017, the U.S. Federal Reserve increased its federal funds rate from 1.25% to 1.5%.

These increases in short-term rates will likely flow through to interest rates on savings accounts, mortgages and car loans. We are also starting to see somewhat higher rates on longer-term bonds. For example, U.S. 10 year government bonds are now yielding around 2.54%, a bit higher than the prevailing rates in recent years.[10]

Looking back over the last 10 years, interest rates in Canada and the U.S. have stayed low for longer than we had anticipated. We believe that the moderate increases in rates that we have seen so far are a good sign. Higher rates signal confidence in economic growth; however, if Canadian and U.S. rates rise too fast, that could contribute to a potential correction in North American equity prices.

Transition from Quantitative Easing to Quantitative Tightening

Headlines about short-term interest rate moves by central banks only tell part of the story. Interest rates changes are a very visible component of monetary policy, as most of us are savers, borrowers or both. The less visible, but very significant other shift in monetary policy is the recent transition from “quantitative easing” towards “quantitative tightening”.

The term “quantitative easing” refers to the central banking policy of buying large amounts of government bonds or other financial assets in order to stimulate the economy. For example, starting in 2008, the U.S. Federal Reserve has done several rounds of quantitative easing by purchasing Treasury notes, mortgage-backed securities and bank debt.[11] Central banks outside of the U.S., like the European Central Bank, have also done quantitative easing. To put these policies in perspective, globally, central bank assets have ballooned from around US$6 trillion before the 2008-2009 financial crisis to around US$22 trillion currently.[12] In other words, central banks have added an enormous amount of money to the global economy over the past 10 years through the policy of quantitative easing.

In the U.S., the Federal Reserve is no longer engaged in quantitative easing. Instead, the Federal Reserve is allowing around US$30 billion of the Treasury notes that it owns to mature each month.[13] This is a policy that will tighten the money supply and reduce the assets held by the Federal Reserve. Some commentators are calling this “quantitative tightening”. If quantitative tightening continues, money will be withdrawn from the economy, and new buyers will have to purchase the Treasury notes and other assets that the Federal Reserve is not buying. Globally, Deutsche Bank has projected that the combined expansion of all central bank balance sheets will decline from a 12 month growth rate of US$2 trillion per year to zero by the end of 2018.[14]

We view quantitative tightening as one of the largest risks to global equity market performance in 2018. Many investors may choose to reduce risk if they perceive that central banks are providing less support to asset prices and economic growth.

Market Valuations and Speculative Activity

We mentioned in our introduction that we believe equity market valuations are at levels that make it difficult to find undervalued companies. For example, the price to earnings ratio for the S&P 500 is sitting at 26.83, far higher than its long-term average of 15.69. The price to sales ratio and price to book value ratio for the S&P 500 also appear to be elevated relative to recent years.[15]

We look at market valuations from several perspectives. First, higher valuations have limited near-term predictive power. We cannot simply conclude that the market is highly valued and therefore it must correct in the near term. We do believe that higher valuations increase the probability of a correction, but they do not dictate the timing. Perhaps the best way of viewing higher equity valuations is that they will likely reduce the multi-year return that an investor can reasonably expect from buying stocks. It is not reasonable for investors to expect equity prices to indefinitely grow faster than underlying corporate earnings.

Our second perspective on market valuations is that we are active investors, not indexers, and we can therefore avoid the companies that we view as overvalued. Looking at the holdings in our model portfolios, we do expect some turnover this year, but we do not view any particular company as wildly overvalued. If we thought otherwise, we would sell the holding. Our discretionary model portfolios also allow us to shift client asset allocations towards higher weightings in fixed-income assets and cash, if we believe that would be advantageous.

A third perspective on market valuations is that near the end of long bull markets, some market participants become euphoric, which can lead to large, unsustainable gains, particularly in lower-quality, speculative companies. This behavior can be a warning signal that the bull market is getting closer to its end. We are starting to see evidence of euphoria and irrational behavior, but it is mainly confined to the marijuana and blockchain technology industries.

Regarding marijuana, the total market value of listed Canadian companies in that industry recently totaled $25 billion.[16] There will undoubtedly be significant sales growth for many of these companies assuming that the trend towards legalization continues. That said, we believe that many of these companies will not generate adequate earnings in the next few years to justify their current valuations.

Regarding blockchain technology, we have seen examples of junior companies changing their names to include the word “blockchain” and being rewarded with huge gains in their market capitalizations overnight. Blockchain technology itself may prove to be a massive innovation. A blockchain is a decentralized and distributed digital ledger that is used to record transactions across many computers so that the record cannot be altered retroactively.[17] There appear to be numerous applications for blockchain technology; however, it may take several years for the leading companies in the industry to emerge and become profitable. The common thread linking the emerging marijuana and blockchain industries is the presence of numerous inexperienced but enthusiastic investors who are making high-risk decisions to buy based on price momentum rather than a careful assessment of the fundamentals.

A fourth perspective on high market valuations is that not all industries are following the same cycle. Some industries may contain more undervalued companies than others. This is an advantage for active managers in comparison to passive indexers. For example, as discussed in our Q3 Newsletter, we recently added slightly to our energy sector weightings in our Total Return and High Yield Portfolios because we believe that the energy sector could be emerging from a bear market. In recent years, movements in energy sector companies have not been perfectly correlated to movements in the overall market in Canada or the U.S.

Conclusion

Despite signs of coordinated global economic growth, we are growing somewhat more cautious about the outlook for equity market performance over the next couple of years. It is likely, in our view, that we will experience a meaningful correction in North American equity markets sometime during 2018. In the context of the rally over the past two years, a correction could be healthy and should not be surprising. A correction may not even indicate a recession is imminent, given the current positive global economic environment. We have managed through difficult markets before, and we have often taken advantage of market downturns to purchase high quality companies at undervalued prices. We believe that our strategies will perform well in 2018, and we will do our best to mitigate against the risks that we believe the markets are facing.

Thank you for reading our Q4 Newsletter. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] http://www.worldbank.org/en/news/press-release/2018/01/09/global-economy-to-edge-up-to-3-1-percent-in-2018-but-future-potential-growth-a-concern
[2] https://ca.reuters.com/article/businessNews/idCAKBN1F41PD-OCABS
[3] https://www.bdc.ca/en/blog/pages/2018-economic-outlook-global-growth-brings-good-news-canadian-entrepreneurs.aspx
[4] https://www.cnbc.com/2017/11/28/morgan-stanley-predicts-2018-will-be-tricky-one-for-global-economies.html
[5] https://www.reuters.com/article/us-germany-economy-gdp/in-surplus-and-growing-fast-german-economy-powers-on-idUSKBN1F018G
[6] https://www.reuters.com/article/us-worldbank-china/world-bank-raises-china-2017-growth-forecast-maintains-2018-outlook-idUSKBN1ED035
[7] https://www.quora.com/Whats-the-longest-period-of-time-between-two-recessions-in-the-US-economy-since-1850
[8] https://www.marketwatch.com/story/current-us-economic-recovery-may-end-up-as-longest-ever-2016-07-18
[9] https://www.cnbc.com/2017/05/08/goldman-says-u-s-economy-may-be-slowly-growing-into-the-longest-expansion-in-history.html
[10] https://www.bloomberg.com/quote/USGG10YR:IND
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[14] https://www.zerohedge.com/news/2018-01-14/citi-reveals-reason-behind-markets-meltup
[15] http://www.multpl.com/s-p-500-price-to-sales

[16] https://www.theglobeandmail.com/globe-investor/inside-the-market/marijuana-stocks-blockchain-transform-canadas-investing-landscape/article37595620/
[17] https://en.wikipedia.org/wiki/Blockchain

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