Financial Markets Summary

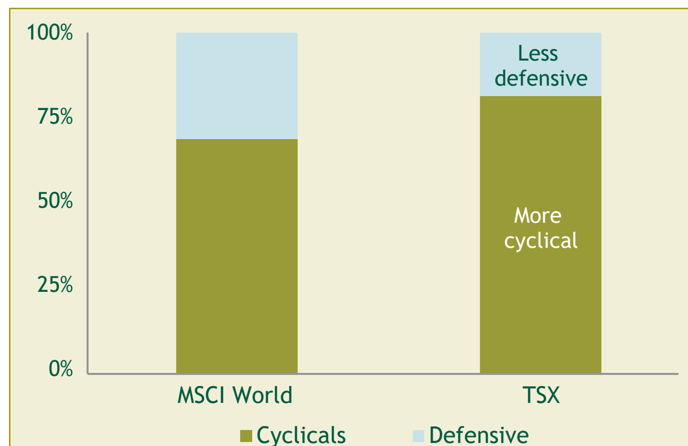
December 31, 2018

PORTFOLIO MARKETS SUMMARY

The fourth quarter began on a positive note with the US, Canada and Mexico agreeing a new trade deal—but investors' focus quickly shifted to the risks associated with higher interest rates and more challenging access to money for companies and individuals. Global and Canadian equities subsequently declined by 8.3% and 10.1% respectively over the period, resulting in all but the most conservative portfolios experiencing negative returns on the quarter and the year. Canadian equities underperformed their global counterparts due to their higher weighting to industries more affected by the strength of the economy (cyclicals), such as financials, industrials and energy. As the quarter progressed, investors' worries turned to slowing global economic growth. Consistent with a slowing growth environment, commodity prices fell, equities less dependent on the state of the economy (defensives) outperformed and safe-haven currencies appreciated.

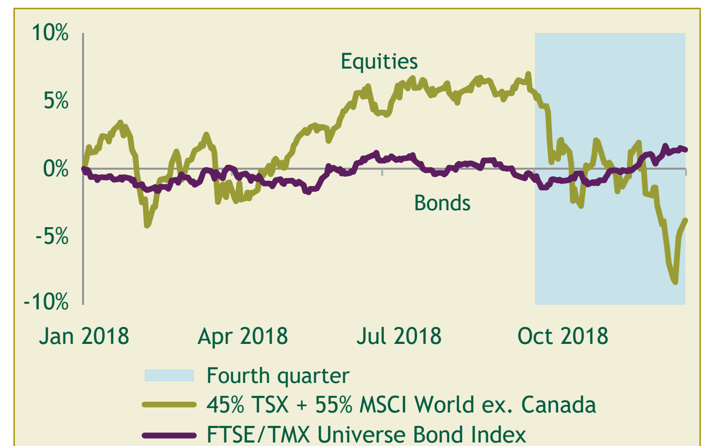
Fixed income securities fared better during the quarter with bonds rising 1.8%. While this asset class hasn't provided significant total return over the past several years, it continues to be an important source of diversification during times of higher volatility. Riskier, high-yielding corporate bonds also underperformed as investors anticipated a higher probability of corporations not meeting their obligations. One of the unintended consequences of lower interest rates was the large increase in corporate debt. The result of higher corporate leverage is that a small increase in the cost of debt can have an outsized negative impact on companies' earnings.

Canadian equities typically more affected by the economy



Source: MSCI, S&P, CC&L Private Capital

Equity and bond performance in 2018



Source: MSCI, FTSE/TSX

PORTFOLIO STRATEGY

Our investment process flagged slowing global growth for most of 2018. Respecting our process, we used periods of equity market strength in the first three quarters of the year to pare back our risk exposure—especially to Canadian equities—as we believe the sector composition of the S&P/TSX Composite Index heightens its riskiness in a period of slowing growth. Our overweight allocation to global equities compared to Canadian equities was meaningful and added value over the course of the year, as well as in the fourth-quarter sell off. We believe 2019 will follow a similar pattern with the continuation of slowing global growth and harder access to money. With this in mind, we will hold our overweight allocation to global equities.

Within fixed income, we favour shorter duration investment-grade and sovereign bonds. Central banks around the world look set to continue hiking interest rates, and in a rising rate environment bonds with a shorter duration tend to fare better. Furthermore, as the yields of short-term and long-term bonds are very similar (a flat yield curve), buying longer maturity bonds provides very little additional yield and income.

We continue to believe that over the long term, alternative asset classes such as hedge strategies, real estate, infrastructure and private loan investments can provide investors with a strong source of diversification and risk-adjusted returns.

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