Financial Markets Summary

June 30, 2018

PORTFOLIO MARKETS SUMMARY

In the second quarter, balanced portfolios made further gains as stocks and bonds contributed to positive returns. Equities performed well in Canadian dollar terms, increasing 5.5% in the US, 6.8% in Canada and 1.1% in the Europe, UK and Asia region. Canadian equities' performance was driven by the energy sector, which welcomed a 12% rise in the price of oil. Globally, the technology and consumer discretionary sectors spurred the world equity index higher. Global small caps significantly outperformed their large cap counterparts this quarter, primarily due to events related to global trade. Typically, small cap firms do much of their business within their domestic markets, meaning they aren't as affected by trade tariffs as large cap companies, which are more often multinationals.

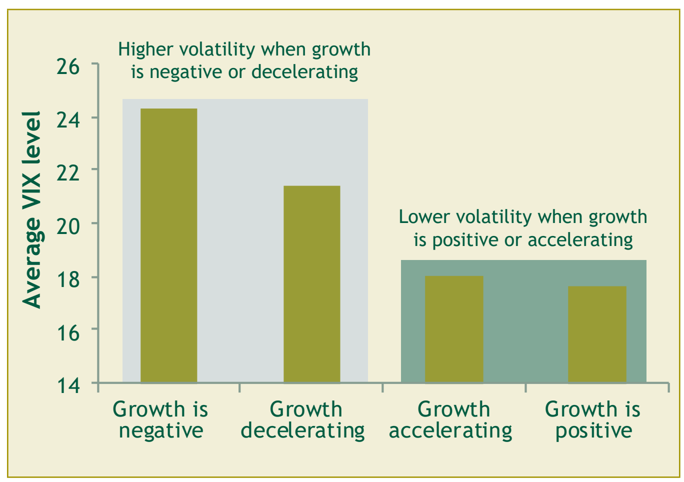
In fixed income, government bonds and higher-quality corporate credit outperformed riskier high yield bonds. The US Federal Reserve raised interest rates again in June, and the European Central Bank announced the year-end wind up of its bond buying program, with a view to increasing rates towards the end of 2019. These moves saw short-term interest rates rise as investors' expectations on the future direction of interest rates became more hawkish. In contrast, longer-maturity bond yields were flat, which implies bond investors don't believe the current path of interest rate hikes is sustainable.

We expect the higher-volatility environment of the first six months to continue through the end of 2018. As global growth slows, investors are likely to become more concerned about risks, such as trade wars, political uncertainty and tightening financial conditions (higher interest rates), which, when economic growth is accelerating, they can find easier to ignore. This is why our tactical investment process always begins with economic growth momentum.

Small cap equities outperform in the second quarter 2018

Source: Thomson Reuters Datastream, CC&L Private Capital

S&P500 Index volatility under varying economic conditions



Source: Thomson Reuters Datastream, CC&L Private Capital

PORTFOLIO STRATEGY

In a reversal of circumstances from 2017, when almost every nation experienced improved economic growth, in 2018 most regions' economic growth is slowing. This is mainly due to the uptick in global interest rates that began in 2016. The US is an exception, where growth is still accelerating despite the US Federal Reserve's recent rate hikes. This is due to the personal and corporate tax cuts the Trump administration made at the start of the year, but while it benefited the US economy, in many instances its effects have been negative for the rest of the world. This is why US equities, the US dollar and domestically focused US stocks have outperformed. We expect our portfolios to benefit with their overweight allocation to global small caps and—as slowing global growth is usually a drag on the S&P/TSX Composite Index—an underweight allocation to Canadian equities.

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We still hold a neutral stance on stock and bond allocations. The current environment of slowing economic growth and rising rates has historically proved not to be an opportune time to add to risk to portfolios. However, we aren't holding an underweight allocation to risk, as our shorter-term indicators are showing a mixed picture, not a negative one. Within fixed income, we favour higher-quality credit as we believe the credit cycle is turning: defaults are on the rise and the difference in yields between government and corporate bonds is widening. We continue to encourage clients to explore our alternative asset class offerings, which have a lower correlation to the capital markets compared to traditional assets.

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