Market Review
Fourth Quarter 2017

The world's stock markets were up over 20% in 2017, under the impetus of the U.S. stock market. Short-term interest rates rose in Canada and the United States as both economies approached full employment, while long-term rates remained stable because inflation appeared quiescent.

In this context, the Canadian stock market was the poor relation, with a return of only 9%. Even so, the Canadian economy performed very well in 2017. Corporate earnings were up, commodity prices firmed on the world markets and the Canadian dollar rose slightly from US$0.74 at the start of the year to almost US$0.80 at year-end. The weak oil price is the main reason for the two countries' different performances. It declined from US$53 at the start of the year to US$42 in June, only to go back up to US$60 in the fourth quarter. Even so, oil stocks did not rise at the end of the year. It appears that investors think the oil market has changed fundamentally.

The global economy will continue to see synchronized growth in 2018, expanding by about 4%. The global economy's maximum long-term growth rate was previously 5% a year, but is now slightly lower because the populations in the developed countries are aging. This rate of growth should sustain commodity prices on the world markets, and inflation should accelerate slightly in the countries that reach full employment.

In the developed countries, the main central banks will pursue less expansionary monetary policies, putting upward pressure on interest rates.

Stock Markets

U.S. stock market

The U.S. stock market is still the main valuation yardstick for the world's stock markets, and most of the parameters indicate that the bull market that began in 2009 has already recorded most of the gains that are accrued during a normal bull market. In March 2018, this bull market will be nine years old. It is the second-longest bull market of the past 125 years. Moreover, if we look at valuations such as the price-earnings ratio or the book-value multiple, they are at 90% of the highest historical valuations.

This context suggests that the time to overweight equities in a portfolio has passed, but it does not necessarily mean that you should sell everything, for the following reasons. First, equities provide solid long-term returns even if bear markets occur. Next, the final periods of bull markets often give rise to very solid performances. Lastly, selling equities forces an investor to make another crucial decision to obtain solid long-term returns, and picking the right time to buy back into the market after a significant decline is very difficult. The best returns are obtained at the start of a market reversal. For these reasons, investors should sell equities only when a recession is expected, which is not the case at the moment.

Canadian stock market

For a Canadian investor, the domestic stock market has significantly underperformed the U.S. market for the past nine years. The Canadian market has returned 135% whereas the U.S. market has returned 269% in Canadian currency. One of the most important factors favouring the U.S. market is its large weighting of technology companies. These companies have recorded strong growth and many of them have come to dominate their market, which is reflected in their share prices. Moreover, abnormally low interest rates have been favourable to high valuations for growth stocks in general.

As for the Canadian stock market, it has a high proportion of value securities and securities that depend on commodity prices. In a context where commodity prices are firming and interest rates are rising, it is quite possible that the Canadian stock market will catch up over the next two years.

Performance in Canadian dollars				
	3 months	1 year	3 years (annualized)	5 years (annualized)
Bonds	2.1%	2.5%	2.5%	2.9%
Canadian equities	4.5%	9.1%	6.6%	8.6%
U.S. equities	7.0%	13.5%	14.3%	21.3%
Europe and Pacific equities	4.6%	16.5%	10.6%	13.0%
Emerging market equities	7.8%	27.9%	11.9%	9.3%
REITs	5.7%	9.9%	7.2%	5.1%
Canadian/U.S. dollar	-0.8%	6.9%	-2.6%	-4.6%

Source : Bloomberg, December 31, 2017

Oil price

Global oil inventories peaked in mid-2016 and have been falling since the spring of 2017. Consumption is not rising in the developed countries, but it continues to increase in the developing countries, especially in China, where as many cars are being sold as in the United States. Meanwhile, OPEC has restricted its output.

The oil price began to firm in the summer of 2017 and is now above US$60, a price that is profitable for U.S. and Canadian producers alike. Even so, the share prices of oil producers have not followed suit, possibly because of a delayed market reaction. If so, such equities should recover fairly strongly, especially as the oil price is expected to continue rising in 2018.

Inflation

If there is one variable that has confounded most economists in recent years, it is the rate of inflation. An increase has been predicted for years, but has still not occurred. Bond investors have done a much better assessment of the situation because they expected interest rates to stay low throughout this period and they have been proven correct.

That being said, the inflation rate will probably start to rise in 2018. We are not forecasting a sharp acceleration, like that of the 1970s, but rather a gradual increase as wages rise, which is normal when the economy is at full employment.

Yield curve

The yield curve of bond maturities is simply the difference between the long-term interest rate and a short-term interest rate. The bigger the difference, the sharper the curve. The yield curve is closely followed by investors because over the past 30 years it has been a powerful indicator of economic turning points: a steep curve indicates a recovery and, above all, an inverted curve indicates a recession over the more or less long term. Sometimes it takes up to two years for the recession to occur, but it always ends up happening.

Two-year bond yields have been rising since mid-2016 and are approaching long-term yields. The two-year yield is 1.8% in the United States, whereas the 10-year yield is holding steady at 2.5%. The difference between these two yields is diminishing, but we will not forecast a recession until the two-year yield exceeds the 10-year yield.

Canadian dollar

We can use a model to show that three variables cause more than 90% of the fluctuations in the Canadian dollar: the difference in interest rates between Canada and the United States; the price of crude oil; and the price of commodities other than oil. The Canadian dollar is trading at exactly the level estimated by these three variables, which indicates that its current level does not take into account the possibility that U.S. President Donald Trump will decree the end of NAFTA, a development that would be catastrophic for Canadian exports. The decision will not be made until the spring, but we will have to be cautious because Mr. Trump has an annoying habit of trying to keep his promises.

U.S. tax reform

The Senate and the House of Representatives have finally agreed on a tax reform that is the most significant since Ronald Reagan's. Essentially, it reduces the tax rate for U.S. corporations from 39% to 21%, a rate comparable to those in effect in the other major industrialized countries. The reform slightly reduces the marginal income tax rate for the wealthiest individuals, but it caps the deduction for state income and property taxes at only US$10,000 in total. The reduction in business taxes was necessary, but we wonder whether it is wise to stimulate an economy that is already at full employment.

Momentum Asset Allocation Portfolio

This portfolio invests only in index funds according to an asset allocation model we developed several years ago. The model selects the seven asset classes with the best performance over the previous nine months from a universe of 16 asset classes. The asset classes cover Canadian and international equities, various types of bond, REITs, commodities and gold.

The portfolio returned about 9.0% in 2017. It is interesting to note that the portfolio is almost fully invested in equities as 2018 gets under way.

Dashboard

December 31, 2017	
Canada	
Canadian dollar vs. U.S. dollar	=
Corporate bonds	=
Long-term government bonds	-
S&P/TSX 60	+
REITs	=
United States	
U.S. dollar vs. euro	=
Long-term Treasury bonds	-
S&P 500	+
NASDAQ	+
Europe	
Euro vs. U.S. dollar	=
MSCI Europe	+
Asia	
Yen vs. U.S. dollar	=
MSCI Japan	+
Emerging Markets	
MSCI Emerging Markets	+

= : neutral + : overweighted – : underweighted