Market Review
Third Quarter 2018

Performance table (Canadian currency)

Source: Bloomberg, September 30, 2018

	3 months	YTD	3 years (Annualized)	5 years (Annualized)
Bonds	-1.0%	-0.4%	1.6%	3.3%
Canadian equities	-0.6%	1.4%	9.7%	7.8%
U.S. equities	6.0%	14.2%	16.0%	19.3%
Euro-Pacific equities	-0.2%	1.8%	8.0%	9.3%
Emerging markets equities	-2.6%	-4.6%	11.1%	8.5%
REITs	3.5%	9.8%	11.0%	9.0%
Canadian/U.S. dollar	1.7%	-2.6%	1.0%	-4.4%

The U.S. stock market performed well in the third quarter, rising 8%, for a year-to-date return of 11%. The other stock markets performed less well; as a result, the MSCI World Index, which includes the United States, is up only 5%. Emerging markets and Canada are at the bottom of the performance list so far in 2018, with returns of -7% and 1%, respectively. This is the eighth year that the Canadian market has underperformed the U.S. market.

Long-term interest rates in Canada and the United States rose gradually during the quarter. The central banks in both countries are raising their key rates slowly but surely, which is putting slight pressure on long-term yields.

The most important event of the quarter for Canada, and possibly the rest of the world, came a half-hour before the quarter ended, when the governments of the United States and Canada announced that they had reached an agreement to renew the NAFTA with slight changes. The Chinese government undoubtedly noted the progress of the talks and will take it into account in its own negotiations with President Trump. The federal government should be congratulated for its outstanding work on the negotiations; it received no support from the provinces and even faced opposition from Québec politicians who wanted to protect the milk-supply management system.

U.S. stock market

With the U.S. stock market trading at a new peak, what is the outlook? If we compare U.S. equity prices with 10-year average earnings, as Shiller does, U.S. equities are expensive. But if we compare them with the record earnings of the past year, they are not. The question is whether corporate earnings will stay as high for a long time. The capital and labour shares of national income follow very-long-term trends because they are influenced by long sociological and technological trends. Several years ago, we forecasted that corporate earnings would remain abnormally high for a long time because of market globalization and the profound technological changes occurring.

Equity prices are also supported by very low real interest rates, even though rates have risen recently. In fact, the increase in interest rates is rather positive for equities because an increase means that the economy is doing well. Historically, the correlation between stocks and bonds is positive when interest rates are below 5%.

Canadian stock market

Canadian equities are trading at an average of 14 times next year's earnings, which is far less expensive than the multiple of 17 for U.S. equities. In recent years, the Canadian stock market has underperformed for three reasons: 1) the weak oil price; 2) the lack of capacity to transport oil and gas out of Alberta; and 3) more recently President Trump's attacks on NAFTA. The oil price is back above the $70 on the international market, the free-trade agreement with the United States has been renegotiated and Royal Dutch Shell recently announced a $40-billion investment to build a West Coast terminal to transport liquefied natural gas to Asia. With these hindrances out of the way, there is a good chance that the Canadian stock market will make up for at least some of its underperformance vis-à-vis the U.S. market.

Inflation

The North American economy is operating at full employment and, as a result of the ultra-expansionary monetary policies of recent years, inflation should accelerate. In fact, if we were in a context like that of the 1970s, inflation would currently be above 5%. But we are not in the same context at all. Today, workers do not have the same negotiating power because employers can move their production capacity elsewhere or replace workers with robots. Moreover, the rapid adaptation of production processes to new technology is slowing price increases.

The inflation rate in North America has reached the 2% target set by the central banks. Monetary policy is already less expansionary and short-term interest rates are gradually going up.

Long-term interest rates

The yield on the 10-year U.S. Treasury bond recently reached 3%, which should be its equilibrium level at this point in the economic cycle. The cyclical bottom for U.S. yields was reached in 2016 at 1.5%, and the peak, which will occur in a few years, should not exceed 4% for the following reason: in an economy in which core inflation is 2%, a real rate of 1% is perfectly adequate because no substantial demand for credit is expected from households, governments or businesses. In fact, businesses will remain in surplus for several more years.

The situation is different in Canada, where a slight increase is forecast. For several years, the Bank of Canada has been keeping Canadian rates below those of the United States. As a result, the 10-year yield on Government of Canada bonds is 2.4% versus 3% for the United States. Given that the economic conditions are fairly similar in both countries, there is no reason to maintain the differential, and the Canadian rate should rise toward the U.S. rate over the next year.

REITs

Canadian REITs have performed well since the start of the year, returning 9.8%, even though interest rates have gone up. U.S. REITs have also done well. It is important to remember that these securities are neither stocks nor bonds and in this sense they help diversify a portfolio. Despite the recent increase, the REIT yield is still far higher than that of Government of Canada bonds.

Global Momentum Asset Allocation Portfolio

Our global portfolio invests in the asset classes that have performed best over the past 12 months. We monitor a total of 15 asset classes, including Canadian, U.S. and emerging market equities as well as gold, commodities and bonds.

The portfolio has returned 9% so far this year, a return comparable to the 9% increase for the MSCI World Index in Canadian currency. Currently, the portfolio holds mainly U.S. and Japanese equities. It also holds Canadian REITs and commodities, but no bonds.

Dashboard

September 30, 2018	
Canada	
Canadian dollar versus U.S. dollar	+
Corporate bonds	=
Long-term government bonds	-
S&P/TSX 60	+ +
REITs	=
United States	
Long-term Treasury bonds	=
S&P 500	+
NASDAQ	+ +
Europe	
Euro versus U.S. dollar	+
MSCI Europe	+
Asia	
Yen versus U.S. dollar	=
MSCI Japan	=
Emerging markets	
MSCI Emerging markets	=

= : neutral + : overweighted – : underweighted