Investment Notes

December 31, 2018

GLOBEINVEST
CAPITAL MANAGEMENT INC.

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Overview

A tumultuous fourth quarter characterized by heightened volatility, extreme intraday price swings and negative returns. Most major stock indices around the world posted double-digit declines in the last quarter of 2018, resulting in overall negative returns for the year (see Statistical Summary at the end of the Note).

The spectre of rising U.S. interest rates, both short and long term, was what initially caused equity markets to pullback in October. This was followed by uncertainty surrounding the U.S/China trade war, softening economic data from the Eurozone as well as China and a flattening U.S Treasury Yield Curve, raising fears of an economic recession. The abrupt collapse in crude oil prices (WTI) from a high of US$76/bbl in October to the US$45/bbl level at year-end also weighed in on investor sentiment.

Another factor that has and will continue to exacerbate stock markets moves, on both the downside and upside, is high frequency trading systems driven by computer algorithms (HFT algos), which have grown substantially over the past ten years. The Congressional Research Service (the public policy research arm of the U.S. Congress) estimated in 2016 that HFT algos accounted for about 55% of trading volume in U.S. equity markets and about 40% in European equity markets. Algo trading essentially takes the human emotion or analysis out of trading, in order to generate profits based on a defined set of rules, e.g. technical indicators, arbitrage opportunities, at a speed and frequency that is impossible for a human trader.

Negative sentiment, political and economic uncertainty combined with dramatic market swings raised retail investors' angst and subdued their risk appetite. These developments lead to net redemptions of $75.5 billion from U.S. mutual fund and exchange-traded funds that track stocks in December, the biggest exodus from stock funds in a single month (Lipper data going back to 1992), putting further downward pressure on stock prices.

Our view remains that stock markets are experiencing corrections or panic attacks and adjusting to a slower pace of growth in 2019, but growth nonetheless. The key issues that may potentially derail growth prospects include the U.S./China trade tensions, U.S. Federal Reserve Policy and geopolitics.

Commentary

We track numerous indicators and data points to assess market conditions and formulate long-term investment strategy for our clients.

One we have discussed in the past is the U.S. Treasury Yield Curve. While the inversion of the front end of the curve is somewhat worrisome, inversion at the longer end of the curve is a more relevant leading indicator of a pending recession and for now the spread between the 10 Year and 2 Year Treasury Bonds remains positive at about 15 basis points. The yield curve has inverted prior to each U.S. recession over the past 50 years, with the lead time between inversion and the onset of the subsequent economic contraction ranging from 14-34 months. Importantly, equities rose on average 12% in the 12 months following the inversion with a range of -0.4% to +26% (in only one of the last five recessions was the market down in the 12 months after the inversion).

The cycle indicators we track point to expanding economic activity, albeit at a slower pace. The employment situation in the U.S. remains healthy with preliminary reports suggesting holiday retail sales were the strongest in six years. The GDP growth rates of 4.2% (Q2/18) and 3.4% (Q3/18) are clearly not sustainable, with Q4/18 expected to be 2.6% and slow further in 2019, but remain positive.

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The tenet to our constructive view has always been and remains, higher corporate profits into 2019. While the rate of earnings growth likely peaked in 2018, e.g. earnings per share (EPS) for the S&P500 companies is expected to be up 23% versus 2017, EPS growth in 2019 is projected to still be positive, up 7%. The largest source of risk to higher earnings is the impact of tariffs through potentially higher input costs and profit margin compression as well as slower global economic growth. With growth in the U.S. economy decelerating and the Chinese industrial economy contracting, we think there is an incentive for both sides to reach a mutually beneficial agreement. China has also been ramping up stimulus measures to support its economy.

The U.S. Federal Reserve has raised interest rates nine times since the recession ended in June 2009. Chairman Powell has recently adopted a more dovish message and has said that the Fed's policy is not on a fixed course and that it reacts to changes in the economy. Recall that in 2016, despite projecting four rate increases in December 2015, due to worries of a growth slowdown in China and a collapse in crude oil prices (eerily similar?), the Fed went on pause for a year and raised its benchmark rate just once in December 2016. Should economic conditions slow materially, we suspect the Fed will react similarly.

Valuations for the broad indices have significantly improved since the beginning of the year and are now below historical long-term averages. For example, the S&P500 Index is trading at a forward price to earnings ratio of 14.1x compared to 18.6x a year ago. Similarly the TSX/S&P Index is trading at 12.2x compared to 16.5x a year ago.

Summary

For our constructive view to hold, corporate profits have to continue to grow this year, which will provide fundamental support for stocks. In the coming weeks, as companies report Q4/18 financial results and provide guidance for 2019, we will be better positioned to gauge the profit outlook.

We remain vigilant of matters that may hinder that growth. We are mindful that our goal is to preserve and grow your capital over the long-term.

As we begin 2019, we wish you and your family a Happy, Healthy and Prosperous New Year!

Peter Brieger, HBA, CFA
Christine Poole, MBA, CFA
Wendy Sanita, CFP®, CIM®
Chris Blumas, MBA, CFA

2019 BNN Dates

Christine: Thursday, January 10 @ 6:00pm
Christine: Wednesday, January 30 @ 7:00am
Christine: Wednesday, February 13 @ 12:00pm
Christopher: Friday, February 22 @ 7:00am
Christine: Tuesday, March 12 @ 6:00pm
Christine: Wednesday, April 10 @ 6:00pm
Christine: Tuesday, May 14 @ 12:00pm
Christine: Tuesday, June 11 @ 12:00pm
Christine: Wednesday, July 10 @ 6:00pm
Christine: Tuesday, August 13 @ 12:00pm
Christine: Thursday, September 12 @6:00pm
Christine: Wednesday, October 9 @ 6:00pm
Christine: Tuesday, November 12 @ 12:00pm
Christine: Tuesday, December 10 @ 12:00pm

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December 31, 2018 Statistical Summary

STOCK MARKETS	QTD	1 Year
S&P TSX Composite Total Return (CAD)	-10.1%	-8.9%
S&P 500 Total Return (CAD)	-8.6%	3.7%
S&P 500 Total Return (USD)	-13.5%	-4.4%
DJIA Total Return (USD)	-11.3%	-3.5%
NASDAQ Composite Price Return (USD)	-17.5%	-3.9%
MSCI World Index Price Return (USD)	-13.7%	-10.4%
COMMODITIES		
GOLD	8.3%	-1.2%
SILVER	5.6%	-8.8%
COPPER	-5.0%	-17.5%
NATURAL GAS	-2.3%	-0.4%
WTI	-38.0%	-24.8%
BRENT	-34.8%	-18.8%
CANADIAN UNIVERSE BOND INDEX	1.8%	1.4%

TREASURY BONDS	12/31/18	12/29/17
2 Year Maturity (CAD)	1.87%	1.69%
(US)	2.59%	1.89%
5 Year Maturity (CAD)	1.89%	1.86%
(US)	2.59%	2.20%
10 Year Maturity (CAD)	1.96%	2.03%
(US)	2.73%	2.40%
30 Year Maturity (CAD)	2.16%	2.24%
(US)	3.05%	2.74%
Inflation		
CPI Nov/18 (CAD)	1.7%	1.9%
(US)	2.2%	2.1%

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