Market Review

February 7, 2018

Despite the volatility over the past few days, we remain constructive on equity markets. We do not see the pullback this week as a start of a bear market.

With the S&P 500 Index having gone over a year without a correction of 5%, the likelihood of a pullback occurring was relatively high. The duration and depth of a correction will be somewhat dependent on the cause. The catalyst for Friday's stock market decline appears to have been interest rate driven (potential wage inflationary pressures arising from strong economic growth and driving interest rates up) with the 10 year U.S. treasury yield at 2.80% today up from 2.47% a month ago.

So far, inflationary pressures remain moderate so we do not think there is a need for rapid interest rate increases by the central banks. Investors have been accustomed to abnormally low interest rates. We think a normalized rate for 10 year Treasuries are in the 3.5% to 4.0% range.

The decline on Monday was also exacerbated by technical factors and disconnected from underlying fundamentals. Stock valuations are now looking more reasonable. Prior to the pullback, the S&P500 Index in USD was up over 7% year-to-date, and as of February 7th close, up 0.70% this year. So over a very short period, the Index gave back its gains this year.

The TSX is a bit of a different story - the Index is down 5.4% year to date, reflecting the heavy mix of energy, metals and gold which represent 30.5% of the TSX. As you know, we are relatively light in all these sectors. The take away capacity for Canadian crude remains an issue, of which there is no short term solution. The negative price performance from these groups more than offset positive attribution from the other sectors.

Despite F/X risks, we continue to advocate non-Canadian investments in our client portfolios for both sector and geographic diversification.

Our continued longer term constructive view on equities is based on a strengthening global economy and along with that, rising corporate profits. Corporate earnings in the U.S. for 2018 are being revised upwards due to tax reform. So far, Q4/17 earnings for the S&P500 companies are coming ahead of the consensus expectations of 12% year-over-year growth; it looks like it will be closer to 15%. A record 75% of companies that have reported have raised 2018 earnings per share guidance. The weaker USD is also a tailwind for multinationals.

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All the economic data, indicators, manufacturing & services survey data, and sentiment measures suggest growth is sustainable, with no signs of a recession on the horizon. Presently, earnings for 2018 are expected to be up 16% for the S&P500 and 11% for the TSX.

We will remain vigilant for signs of a weakening economy as recessions are the cause of bear markets.

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