THE COERENTE VIEW

4TH QUARTER 2018

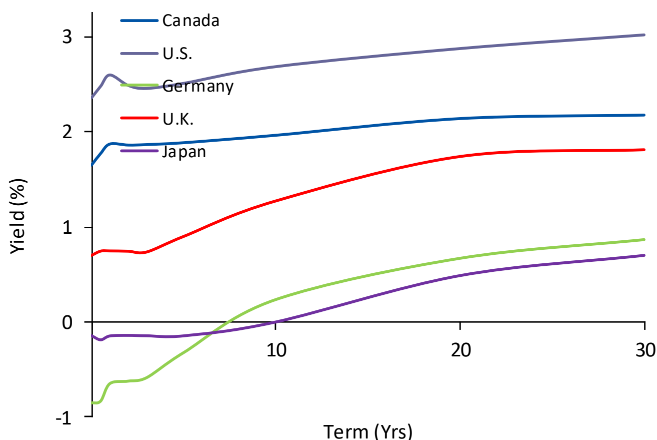
Market Statistics

	Dec/18	Sep/18	Jun/18	Dec/17
Yields (%)				
90 Day T-Bill	1.64	1.59	1.26	1.06
10 Yr. Canada Bond	1.96	2.43	2.17	2.04
30 Yr. Canada Bond	2.19	2.42	2.21	2.26
Rates (%)				
C.P.I. (annual)	1.68	2.22	2.45	1.87
US$/C$	0.73	0.77	0.76	0.80
Euro/C$	0.64	0.67	0.65	0.66
Prices (US$)				
Crude Oil (bbl.)	45	73	74	60
Natural Gas (mm)	2.94	3.01	2.92	2.95
Gold (oz.)	1,278	1,192	1,251	1,306

Market Returns

	Periods Ending Dec. 31/18			
			Annualized	
	3 Mo.	1 Yr.	5 Yrs.	10 Yrs.
S&P/TSX	-10.1	-8.9	4.1	7.9
S&P 500 (C$)	-8.9	4.0	14.0	14.4
S&P 500 (US$)	-13.5	-4.4	8.5	13.1
MSCI EAFE Net (C$)	-7.8	-6.3	5.7	7.5
MSCI EAFE Net (US$)	-12.5	-13.8	0.5	6.3
MSCI World Net (C$)	-8.8	-0.7	9.9	10.9
MSCI World Net (US$)	-13.4	-8.7	4.6	9.7
FTSE Universe Bond	1.8	1.4	3.5	4.2
FTSE 91 Day T-Bill	0.5	0.8	0.8	0.8

Yield Curves



The Economy

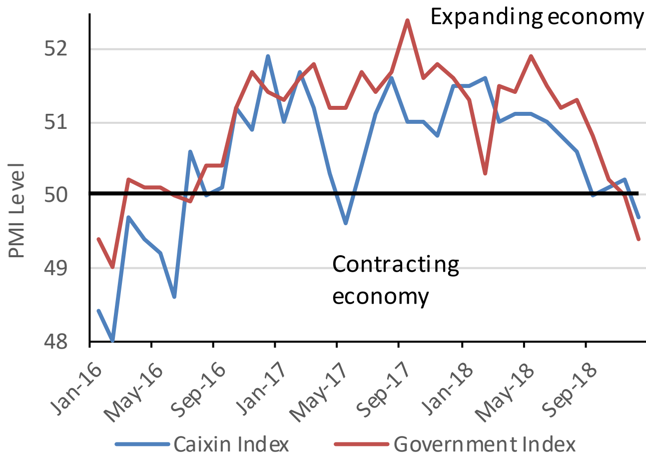
There were no new reported statistics in the recent quarter which altered our global slow growth economic outlook. The U.S. continues to lead with Canada, Europe, and Japan lagging. However, a significant stock market correction during the fourth quarter would now suggest that something has indeed changed. During the quarter, in local currency terms, all of the major equity markets reported negative returns. The S&P 500 at -13.5%, the offshore EAFE based index -12.5% and the Canadian based S&P/TSX index -10.1%.

Two fundamental events partially explain the share price declines. The price of oil fell quickly from $73 dollars per barrel in September to the $45-dollar level at year end as supply from U.S. based shale producers continued to expand. There was also the correction in technology related share prices which had reached overly optimistic levels.

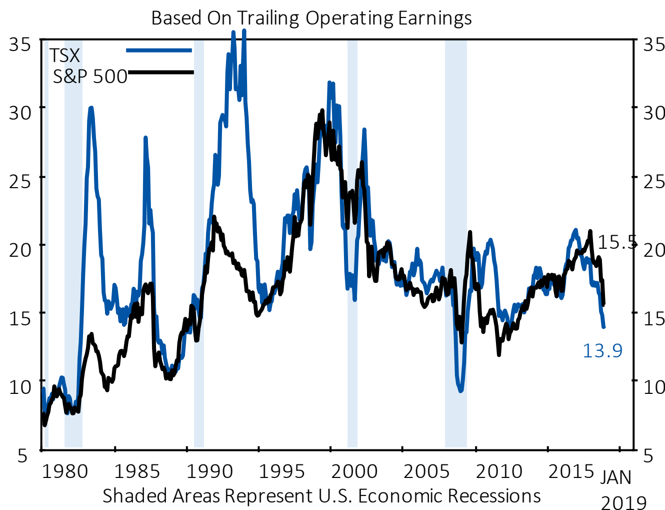
The negative sentiment that prevailed in the stock markets during the fourth quarter appears to have been the result of President Trump and his aggressive approach to trade with China. Initial tariffs on trading partners such as Canada, Mexico and others were viewed as short term irritants that were not hindering U.S. economic growth. The stakes with China are greater as their economy is almost as large as the U.S. and integrated with other countries in terms of supply chains for the manufacturing of a wide range of goods. The dispute is also more encompassing as it includes copyright theft and varied hurdles foreign corporations experience operating in China versus local competitors.

Any reduction in Chinese economic growth would certainly be felt globally as their economy currently contributes just over one quarter of the world's economic growth. Evidence of a slowdown is now appearing as purchasing managers indices (PMI), normally a good predictor of growth, have fallen below the 50 mark as shown on the top chart of page two of this report. The PMI has in the past fallen below 50 only to recover quickly. The economy in China is known to be responsive to government policy with little lag as the communist regime is able to implement change at a quick pace. Our conclusion is that there is most definitely a slowdown occurring in China but we do not yet know if it will be prolonged. Local exporters (countries) in Asia will be most affected by any economic slowdown in China. The U.S., as a major importer ($375 billion trade deficit – largely electronic goods), could initially experience some added inflationary pressures while it shifts to alternative suppliers.

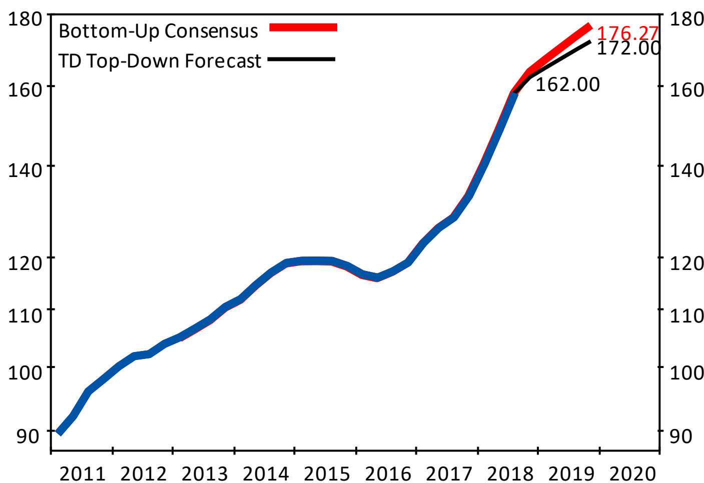
China Purchasing Manager Indices



Price-Earnings Multiples



S&P 500 Operating Earnings



The Markets

A difficult fourth quarter for stock markets globally ended with sizable price declines during the month of December. In fact, there has not been a monthly correction this severe since the great recession in 2008

Dec/18 Stock Market Performance	
(local currency %)	
US - S&P 500	-9.0
Canada - S&P TSX	-5.4
UK - FTSE 100	-3.5
Germany - DAX 30	-6.2
Japan - Nikkei 225	-10.3
China-Shanghai Comp	-3.6

As discussed, there appear few fundamental reasons for the correction but sentiment most certainly turned negative at year end and algorithm-based portfolio management resulted in significant day to day and intraday price swings. Stock market valuations are inexpensive now at levels not seen since 2010. The chart opposite indicates that price earnings ratios are in the 14-15 times range. Only if there were to be a significant earnings decline, i.e. severe recession in the coming months, would we temper our views and consider current valuations as “just fair”. The bottom chart shows earnings growth slowing for the broadly-based S&P 500 but not declining. Most of the slowdown is in fact due to lower oil prices but at quarter end OPEC indicated they would once again cut supply to restore balance. We expect that any indication of a recession would quickly be met with an easing of tariffs by a President seeking re-election and lower interest rates.

The current correction has provided opportunities in the equity markets but we will be prudent in our selections preferring stocks least exposed to trade with China. As well, we will continue to avoid the shares of risky technology related companies where share price earnings valuations are extraordinarily high.

Fixed income securities currently provide very low levels of income with little added reward for purchasing longer term maturities. The yield chart on page one highlights the flat Canadian yield curve with interest rates at essentially the 2% level, only matching the current rate of inflation and therefore will at best help preserve capital in client accounts. Dividend yields are currently higher than bond yields with our portfolios exceeding 3.0%, thereby providing a reasonable alternative source for income.

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Sources: TD Securities Inc., Scotia McLeod, Bloomberg, Thomson Reuters