# THE COERENTE VIEW

2ND QUARTER 2019

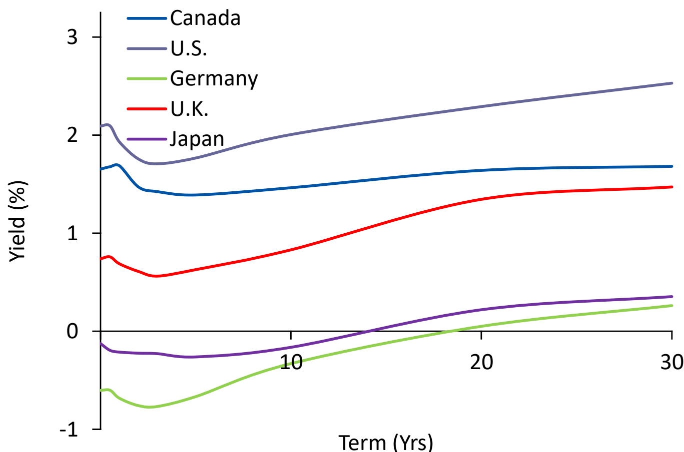
## Market Statistics

| | Jun/19 | Mar/19 | Dec/18 | Jun/18 |
|---|---|---|---|---|
| **Yields (%)** | | | | |
| 90 Day T-Bill | 1.66 | 1.67 | 1.64 | 1.26 |
| 10 Yr. Canada Bond | 1.47 | 1.62 | 1.96 | 2.17 |
| 30 Yr. Canada Bond | 1.69 | 1.89 | 2.19 | 2.21 |
| **Rates (%)** | | | | |
| C.P.I. (annual) | 2.40 | 1.88 | 1.99 | 2.45 |
| US$/C$ | 0.76 | 0.75 | 0.73 | 0.76 |
| Euro/C$ | 0.67 | 0.67 | 0.64 | 0.65 |
| **Prices (US$)** | | | | |
| Crude Oil (bbl.) | 58 | 60 | 45 | 74 |
| Natural Gas (mm) | 2.31 | 2.66 | 2.94 | 2.92 |
| Gold (oz.) | 1,410 | 1,293 | 1,278 | 1,251 |

## Market Returns

| | Periods Ending Jun. 30/19 | | | |
|---|---|---|---|---|
| | | | Annualized | |
| | 3 Mo. | 1 Yr. | 5 Yrs. | 10 Yrs. |
| S&P/TSX | 2.6 | 3.9 | 4.7 | 7.8 |
| S&P 500 (C$) | 2.1 | 9.7 | 15.3 | 16.1 |
| S&P 500 (US$) | 4.3 | 10.4 | 10.7 | 14.7 |
| MSCI EAFE Net (C$) | 1.5 | 0.5 | 6.5 | 8.2 |
| MSCI EAFE Net (US$) | 3.7 | 1.1 | 2.2 | 6.9 |
| MSCI World Net (C$) | 1.9 | 5.7 | 11.0 | 12.0 |
| MSCI World Net (US$) | 4.0 | 6.3 | 6.6 | 10.7 |
| Bond Universe | 2.5 | 7.4 | 3.9 | 4.5 |
| 91 Day T-Bills | 0.4 | 1.6 | 0.9 | 0.9 |

## Yield Curves




## *The Economy*

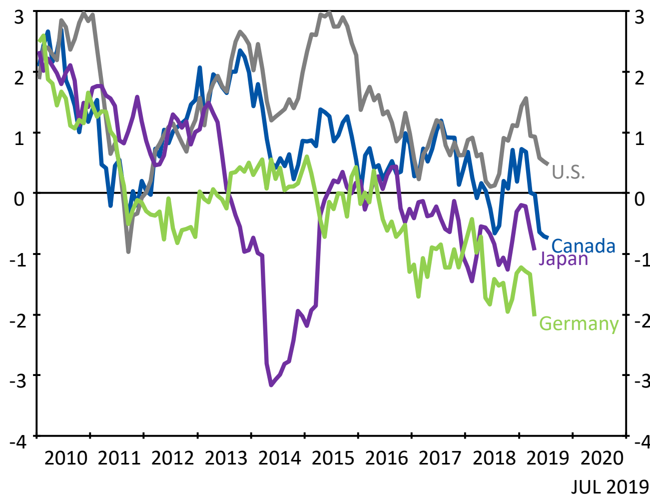
Global economic growth has been consistently slow and inflation low since the great recession of 2008. The U.S. has led the developed economies in terms of growth throughout this period. As a result, the U.S. Federal Reserve has been leaning toward "normalizing" interest rates – i.e. raising them from historical low levels. Other regions, with weaker growth rates, have kept interest rates steady. However, recent indications of weaker economic growth combined with declining inflation rates have caused central banks to consider reversing course and potentially lowering interest rates. This view is being reinforced by the current state of the export oriented Chinese economy where trade wars are taking their toll. Below are the International Monetary Fund forecasts for gross domestic product (GDP) and inflation.

| | GDP Growth (%) | | Inflation Forecast (%) | |
|---|---|---|---|---|
| | 2018A | 2019E | 2018A | 2019E |
| Canada | 1.8 | 1.5 | 2.2 | 1.7 |
| U.S. | 2.9 | 2.3 | 2.4 | 2.0 |
| Euro Area | 2.2 | 1.6 | 2.2 | 2.2 |
| Japan | 0.8 | 1.0 | 1.0 | 1.1 |
| U.K. | 1.4 | 1.2 | 2.5 | 1.8 |
| China | 6.6 | 6.3 | 2.1 | 2.3 |

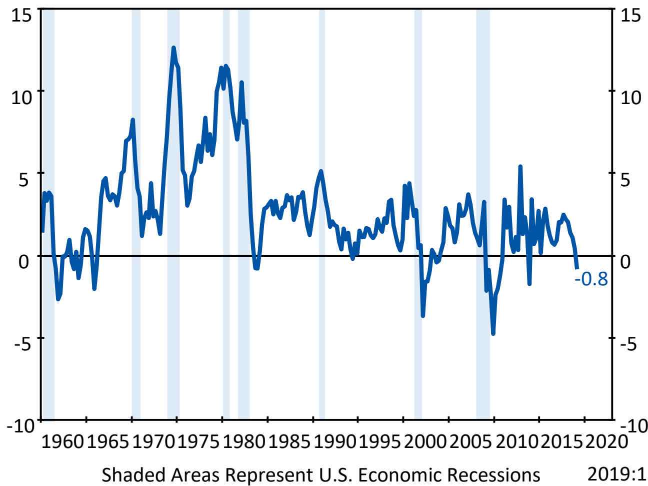
While periods of weaker growth have not been unusual over the last decade, it is the slowdown in inflation that alarms central banks. The issue is of particular concern for the North American economies. The bond markets have reacted as expected with yields following inflation downward. Canada 10-year bonds now yield 1.5% verus 2.2% one year ago. European and Japanese bonds carry negative yields for terms exceeding 15 years (see yield chart at bottom of page).

It is surprising to find inflation rates falling in North America and more specifically in the U.S. The unemployment rate is below 4% and yet wages have not increased at a significant pace. As well, the implementation of tariffs by the U.S. has not raised the prices of imported goods for Americans as they appear to have been largely absorbed by the exporters themselves. To date, tariffs are estimated to have cost the U.S. economy only 0.15% in terms of GDP growth. Further, President Trump is explicitly lobbying for lower interest rates as he does not relish the prospect of slower growth during his re-election campaign. All of this has resulted in the futures market indicating the next interest rate move on the part of the U.S. Federal Reserve will be a cut. Canada will eventually follow or find its currency rising which would only dampen Canadian economic growth.

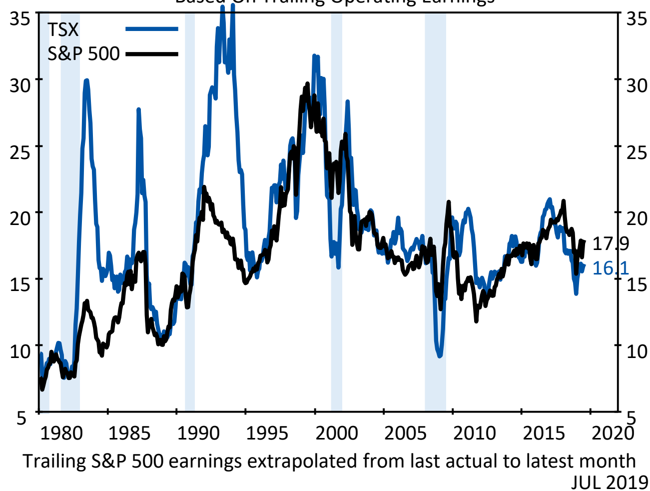
## Real Long Term Government Bond Yields (%)




## U.S. Unit Labour Costs (Non-Farm Business)




## Price-Earnings Multiples




## *The Markets*

The strong first quarter equity results in 2019 were mostly a recovery from the rapid decline experienced in December of 2018, when the U.S. announced tariffs targeting China. As mentioned, the tariffs have not materially affected U.S. growth and as a result the equity markets have continued their upward move into the second quarter. The gains have been widespread globally as investors became less focussed on China and more focussed on the potential for easy monetary policy further elongating this economic cycle. Declining inflation rates also drove long-term interest rates lower and propelled bond prices higher.

We view the current low level of bond yields as precarious. For many countries long-term bond yields no longer provide a positive rate of return and they certainly do not reflect balance sheet risk. For example, a ten-year Italian bond currently yields 1.6% while six years ago, when investors were highlighting debt concerns for the country, the yield was just over 7%. Over this time Italy's balance sheet has only deteriorated further. Commercial banks cannot profitably carry low or negatively yielding sovereign bonds. Nor can they help fuel economic growth at existing yields.

It has been suggested that North American bond yields may follow Europe and Japan into negative territory as long as inflation remains low and growth slows. We see this as unlikely given the North American economies have the potential to far exceed 2% real GDP growth rates while Europe and Japan do not as there is a lack of productive labour growth (reluctance to accept immigrants is not helpful) and limited natural resources to self fuel their economies. We believe a more likely scenario is for North American real economic growth moving back to the 2% level and inflation closer to the level of wage gains. The middle chart on this page illustrates that unit labour costs, which also incorporate productivity gains, rarely remain below zero in a growing economy.

At the current low level of interest rates, owning long-term bonds is not conducive to building wealth. Short-term bonds, however, provide liquidity and insurance in case of an equity market decline or losses resulting from bond yields rising. We continue to favour equities as lower interest rates will help maintain current undemanding valuations despite any potential slowdown in economic growth. Strong cash flow companies with dividend yields exceeding bond yields are easily found in today's equity market.

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*Sources: TD Securities Inc., Scotia McLeod, Bloomberg, International Monetary Fund (IMF)*