Spring 2018

While 2017 was noted for its historically low volatility, 2018 has flipped last year's script. The year started out smoothly for most equity markets before turning meaningfully lower in early February. This marked the first time since the second-half of 2015 that the S&P/TSX Composite Index (S&P/TSX) or the S&P 500 Index (S&P 500) experienced a correction of 10%. For context, corrections of that degree while not frequent do occur with regularity, usually every couple of years. What made this one a little different is that it occurred following an extended period of very low volatility and only took a matter of days. Since its initial February decline the S&P 500 has bounced back and forth between -4% and +3% on a year-to-date basis, while the S&P/TSX has fared a little worse, between -7.5% and -3.5%, as the Canadian benchmark equity index did not have any January gains to act as a buffer: S&P/TSX -4.52%, S&P 500 1.99%, U.K. London FTSE 2.15%, German DAX -1.92%, MSCI Japan 3.78%, China Shanghai Comp 4.48%, MSCI EAFE 1.32%, MSCI Emerging Markets 4.28%, and MSCI World Index ex-USA 1.66%. Contributing to the relative underperformance of Canadian equities was a Canadian dollar that weakened in the first quarter. On a by sector basis, it was Health Care, Energy, and Telecom fared the worst in Canada, with Real Estate and Technology being the only sectors to stay above water. It was more evenly split within the S&P 500, with 4 of 11 sectors holding year-to-date gains. As it was an increase in interest rates that prompted the roll over, it's unsurprising that it was the more interest rate sensitive sectors, Utilities, Real Estate, and Telecom, that felt the brunt of the U.S. weakness.

As telegraphed, the U.S. Federal Reserve's Federal Open Market Committee (FOMC) maintained the path indicated in their late 2017 and early 2018 meetings by raising their target federal funds rate by 0.25% in March to a range of 1.50% to 1.75%, for an effective target rate of 1.625%. Their post-meeting commentary and economist consensus indicate that they are likely headed for two more hikes over the balance of 2018, with the next hike to occur following their June or August meeting. Given the political back drop, we are not in the camp that is expecting a fourth hike this year.

The Bank of Canada (BoC) continues to lag behind their U.S. counterparts and is expected by TD Economics to increase their overnight rate target twice in 2018. One of those hikes occurred in January to 1.25%, with the second expected to come in July. Recent commentary from Governor Poloz has been leaning towards the cautious side of the equation with heightened household debt levels and recent Canadian economic data coming in softer than expected (Q1 GDP of 1.3% v. a 1.6% estimate). Add the uncertainty surrounding the NAFTA negotiation and the resulting reluctance for corporations to commit long-term capital, a slower pace than that of the FOMC seems prudent.

Discounting future rate hikes, short-term interest rates have continued their recent trend and moved higher through the first quarter. While long-term rates are higher than they were at the beginning of the year, their move has been less significant than short-term rates with the U.S. treasury 2-10 and 10-30 years spreads narrowing to 0.50% and 0.17%, respectively. While not inverted, this narrowing is one of the economic warning signs we monitor. While the pattern is similar in Canada, it has occurred to a lesser degree which is consistent with slower economic growth on this side of the border. The makeup of the bond market and the trend in interest rates has continued to result in coupon payments just offsetting price

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declines for the FTSE TMX Canadian Bond Index. While the trend has been higher, with the 10-year U.S. Treasury yielding breaching 3% for this first time in four years, we expect that the move higher should abate for the time being. This level was the point where bonds started attracting capital back in 2014 and North American interest rates remain attractive when compared to other developed market government debt, such as the 10-year German Treasury bond that's currently yielding 0.64%. We continue to advocate using tactical global fixed income mutual funds that can efficiently access markets with differing characteristics and preferred shares that carry a positive correlation to interest rates.

With a surge in market volatility, money flowed out of the Canadian dollar in favour of the U.S. dollar. Add in that the Bank of Canada is on a lower rate-hike trajectory that that of U.S. Federal Reserve's Federal Open Market Committee and not even a surge in in energy prices was enough keep the Loonie in positive territory for the year. For the year, the decline was -2.6% relative to the U.S. dollar. As a portion of the U.S. dollar's gains were the result of the traditional risk-off trade, the decline relative to most other currencies was less significant. While we don't expect a significant move lower, the trend since last summer, which we expect to continue, is for a Canadian dollar that lags.

While U.S. Treasury has long held a "strong dollar" policy, comments by the current U.S. Presidential Administration are more aligned with a weak dollar policy. The price trend of the U.S. Dollar Index, a basket of foreign publically-traded currencies, since President Trump's election reflects that, with a decline of 9.5% since Election Day. The U.S. dollar has been a frequent topic of President Trump’s tweets and we expect that will continue as he uses the social media platform as a negotiating tactic. Despite being in positive territory on a year-to-date basis, we view this as a counter trend rally and expect that the U.S. dollar will head lower later this year.

One of the impacts of higher interest rates is their impact as a discounting mechanism on company valuations. With the same principal as a bird in the hand being worth two in the bush, corporate profits earned today are worth more than future profits. An increase in interest rates impacts that relationship by pressuring the valuations of high growth companies whose value is based on earnings that are farther out in the future. In that environment, we expect volatility will continue to be higher than what was experienced in 2017. Our view is to maintain benchmark equity exposure, but shift the internal positioning of the equity allocations to a slightly more defensive stance.

Sources:
Bloomberg Finance L.P. as at March 31, 2018. Total Index returns. Index returns calculated in C$.
bankofcanada.ca/rates/exchange/currency-converter/

Interest Rates as of Apr 26, 2018

Fixed Income Securities	1 year	2 years	3 years	5 years	10 years	20 Years	30 Years
GICs**	1.70%	2.15%	2.40%	2.70%			
Canadian Treasury Bonds*	1.28%	1.44%	1.46%	1.59%	2.03%	2.32%	2.31%
U.S. Treasury Bonds*	1.41%	1.60%	1.69%	2.02%	2.41%	2.62%	2.92%

* Rates provided by TD Securities
** Rates provided by TD Wealth

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