Quadrant
ASSET MANAGEMENT

2017 – The Song Remains the Same

QAM Perspectives – January 2018

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"The idea that you can actually predict what's going to happen contradicts my way of looking at the market."

George Soros, legendary hedge fund manager, business magnate, philanthropist, political activist and author.

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At the beginning of each new year, we like to look back at the year that just ended and try to make sense of it all, as well as look forward to what the upcoming year may bring. From unexpected interest rate increases to surging global equity markets, 2017 was full of highs and lows as various topics and tweets took their turn in the sun.

When 2017 began, the consensus expectation for the Canadian economy was for mediocre growth. The Bank of Canada was expected to stand pat on interest rates for the entire year. This expectation turned out to be entirely incorrect. It all changed in mid-June as yields in Canada began to rise following comments made by senior Bank of Canada officials, in response to stronger than expected economic growth, that signalled the prospect of a rate hike in the near future. The Bank of Canada followed through and raised its benchmark short term interest rate (also known as the overnight rate) by 0.25% twice, once in July and again in September, bringing the overnight rate to 1.00%. As QAM pointed out in its bond primer newsletter earlier this year, "Bond Basics", interest rates and bond prices move in opposite directions. The increase in interest rates, which is positive for savers (who will now earn a bit more on their deposits), was negative for bond investors as bond prices declined. From early June to the end of September, the Canadian fixed income benchmark (the FTSE TMX Canada Universe Bond Index) declined by almost 3.5%, eliminating most of its year to date return.

As expectations for a third interest rate increase in 2017 declined due to weaker than expected inflation figures, interest rates across the term spectrum began to decline in the fourth quarter. This caused bond prices to appreciate, helping Canadian fixed income investors regain some of the losses experienced earlier. For the year as a whole the Canadian fixed income index posted a positive return of 2.02%.

Canadian corporate bonds were less negatively impacted by overall interest rate increases throughout the year due to compressing corporate spreads, which are currently at historical lows. The FTSE TMX Corporate Bond Index outperformed the general fixed income market with a return of approximately 3.3% for 2017. Rate reset preferred shares also performed better than more traditional fixed income investments during 2017 due to their rate reset characteristics, which adjust dividends upwards as interest rates rise.

Rising interest rates also impacted the Canadian dollar, as higher interest rates made deposits in Canada more attractive relative to investing in other countries, spurring an appreciation in the value of the Canadian dollar relative to other currencies. At its peak in September the Canadian dollar appreciated over 10% relative to the U.S. dollar. However, as expectations for a third interest rate increase in 2017 declined during the fourth quarter, the Canadian dollar gave back some of its gains. For 2017 as a whole, the Canadian dollar appreciated approximately 6.9% relative to the U.S. dollar.

In Canada, the equity bull market continued in 2017, although returns in Canada were not as impressive as other markets. Among developed equity markets for the year, Canadian equities (as measured by the S&P/TSX Composite Index) performed among the weakest with a "not too shabby" annual return slightly over 9%. This was a reversal from 2016 when Canadian equities were at the top of the global equity league tables when it came to performance. Canada underperformed other markets in part because the two weakest performing sectors in Canada, Energy and Materials, are also two of the largest sectors, having a combined weighting in the index of 30%. Energy and materials firms underperformed broader equities despite the prices of oil and gold each advancing over 10% during 2017.

In the U.S., the continued price expansion in equities was noteworthy for 2017. As you may recall, in 2016 we discussed how the current U.S. bull market is now the second longest in history ("Bear in Mind the Aging Bull"). It has been 18 months since that article and in the time since, the bull market has continued charging forward. The S&P 500 (U.S. broad market index) returned over 20% (in local currency), while volatility was at record lows. It seemed like hardly a month went by when the index did not reach a new record high. The appreciation of the Canadian dollar versus the U.S. dollar dampened some of this return for domestic Canadian investors, making returns in Canadian dollars somewhat less remarkable (although still almost 14%) as explored in more depth earlier this year when we asked "Where's my 14% Return?".

Multiples Matter

The earnings multiple or price to earnings ratio (P/E ratio) measures how much investors are willing to pay for $1 of earnings. As an example, for a stock with a P/E ratio of 20, this means that the stock is trading at a multiple of 20 times its earnings. This multiple fluctuates over time based on the price the stock is trading at and earnings reported by the business. In looking at P/E ratios, one should be mindful of what is driving a changing P/E ratio. An increase in the P/E ratio indicates that equities are becoming "expensive" while a decreasing value indicates that equities are becoming "cheaper". Changes to this measure are caused by:

- An increasing/decreasing share price (which in turn can be influenced by general market sentiment to economic conditions or specific industry dynamics);
- Decreasing/increasing company earnings; or
- A combination of the two items above.

A primary driver of the bull markets in equities over the previous few years has been expanding multiples (paying more for each dollar of earnings) meaning that share prices have increased more than earnings have grown. Current equity market valuation levels (as measured by the P/E ratio) are above their 10-year averages for Canadian, U.S. and International Equity markets (as measured

by the S&P/TSX, S&P 500, and MSCI EAFE, respectively), implying that equities are "expensive" relative to their earnings.

For 2017 Canadian equity markets witnessed a contraction in earnings multiples as earnings growth outpaced price increases. Canadian earnings grew nearly 30% which helped Canadian equities "grow into their valuations". In the U.S. we did see earnings grow, although multiple expansion still occurred. For 2017, earnings growth provided greater than half of the return for the S&P 500 index in contrast to 2016 when multiple expansion provided nearly the entire return. Seeing the "valuation gap" narrow due to earnings growth is a positive indicator for equity markets. However, as mentioned, valuation levels are still fairly elevated relative to historical averages.

Equity Market Total Returns (in CAD dollars)	Q4 – 2017	2017
Canada (S&P/TSX Composite)	4.44%	9.08%
BMO Canadian Small Cap Weighted Index	5.29%	6.40%
S&P/TSX Capped REIT Index	5.81%	9.85%
U.S. Large Caps (S&P 500)	7.00%	13.46%
U.S. Small Caps (Russell 2000)	3.69%	6.76%
MSCI EAFE	4.65%	17.07%
MSCI Emerging Markets	7.71%	28.07%

Fixed Income Total Returns (in CAD dollars)	Q4 – 2017	2017
Canada Universe Bond Index	2.02%	2.52%
Canada Real Return Bond Index	3.89%	0.09%
US Investment Grade Index	0.77%	-3.55%
US High Yield Bond Index	0.50%	-0.82%
US Treasury Inflation Protected Index	1.60%	-3.96%

Looking ahead

Looking forward to 2018, and for the first time in several years, expectations for interest rates in Canada and the U.S. are the same. In Canada, where the unemployment rate has fallen to the lowest rate in over 40 years, the expectation is for the Bank of Canada to make a further two or three 0.25% rate increases (first one occurring on January 17, 2018). In the U.S., the Federal Reserve is expected to continue the process of slowly yet steadily raising interest rates. At their last meeting of the year in December 2017, the Fed released projections showing that they expect to raise interest rates three times (0.75%) in 2018[1]. Inflation in North America continues to remain within accepted central bank targets of 2% - 3%. However, event risk continues to exist as stimulus in the form of changes in the tax code (U.S.) or a tightening labour market (Canada) could be the triggers to lead to surprise bursts of inflation. This in turn could lead to more rapid normalization of interest rates than investors or central banks currently expect.

Canadian equities have had a muted but positive start for the first couple of weeks of 2018. The renegotiation of the North American Free Trade Agreement (NAFTA) continues between Canada, Mexico and the United States. The outcome of the negotiations is currently uncertain and in the

first weeks of 2018 Canada has signaled that it believes the United States may pull out. The renegotiation process may lead to periods of volatility for Canadian equities, despite expectations of continuing economic expansion and earnings growth. U.S. equity markets have begun the first few weeks of 2018 exactly as they ended 2017, broadly advancing. The equity rally in the U.S. has carried forward into 2018 and received a boost from the recently approved bill reducing the corporate income tax rate from 35% to 21%. Maybe with lower corporate taxes, U.S. firms will increase earnings and "grow into their valuations" like Canadian firms did in 2017.

Warren Buffett's maxim of "be fearful when others are greedy" should continue to guide investors. Returns are good now but they may not be in the future. Volatility is inherent in the capital markets (even if 2017 didn't get the message) and all portfolios should be designed to ensure that they strike the proper balance of risk and reward for the long term while being able to ride out the inevitable short term volatility (see "The 4Ds of Portfolio Management"). The song remains the same. In the long term what matters is remaining disciplined and sticking to a properly diversified portfolio.

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.

Notes:

1. https://www.bloomberg.com/graphics/fomc-dot-plot/

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