Quadrant
ASSET MANAGEMENT

A Tariff on Tweets?

QAM Perspectives – April 2018

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

"We don't have to be smarter than the rest, we have to be more disciplined than the rest."

Warren Buffet.

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The tone of the financial markets ended the first quarter markedly different from where it began.

At the beginning of 2018, equity markets continued to move higher, buoyed by strong economic fundamentals, with U.S. equities receiving an added boost from the recently announced reductions to the corporate tax rate. Economic indicators in both Canada and the U.S. showed strengthening economies, improving employment productivity and contained-to-moderately-increasing inflation.

In response, the Bank of Canada and the U.S. Federal Reserve each raised interest rates by 0.25% during the quarter (January and March, respectively). As these interest rate increases were widely anticipated, both bond markets showed little reaction. In general, interest rates finished the quarter relatively unchanged as equity markets took the spotlight.

The continuing bull market then evolved into a roller coaster ride as the quarter went on. From that point forward the central theme for equity markets was the return to volatility which was sparked by:

- Strong economic data increasing the expectations for further interest rate increases;
- NAFTA renegotiations between the U.S., Canada and Mexico; and
- Protectionist trade policies from the U.S. fueling concerns of trade wars.

Returns (local currency) as of March 31, 2018	3-Month Returns
Canadian equities (S&P/TSX Index)	-4.52%
U.S. equities (S&P 500 Index) USD$	-0.76%
International equities (MSCI EAFE Index) USD$	-1.41%
Canadian fixed income (FTSE TMX Canada Bond Universe Index)	0.10%

Canadian equity markets finished the quarter 4.5% lower, as measured by the S&P/TSX Index. Nine of the eleven sectors of the Canadian equity index finished the quarter in negative territory, with the largest negative contributions coming from the Energy and Financials sectors. In the U.S., equity markets finished the quarter 0.8% lower in U.S. dollar terms (also with nine out of eleven sectors posting negative returns). As the Canadian dollar depreciated by approximately 2.5% during the first quarter, this translated to a 2.2% gain in Canadian dollar terms.

NAFTA – Accelerating Anxiety

Canadian equities underperformed other equity markets largely due to concerns regarding the NAFTA renegotiation process. The past quarter was plagued by changing expectations (and tweets) regarding the status of negotiations and rumours that the U.S. may withdraw from NAFTA altogether.

The U.S., Canada and Mexico are currently in continuous negotiations. Chrystia Freeland, Canada's minister for foreign affairs commented on April 23rd that "we have had some very energetic and productive conversations. We are certainly in a more intense period of negotiations, and we are making good progress." The heightened frequency of discussions is being fueled by the Trump administration's desire to conclude negotiations by early May to meet their legislative deadlines in order to get U.S. Congress approval of the new NAFTA deal before the next mid-term elections. Otherwise, the U.S. risks having to wait until after the mid-term elections which is not ideal given current expectations that the Trump friendly Republicans may lose control of the House.

Until the NAFTA renegotiation process is concluded, market volatility will continue. At this point we don't know which industries may (or may not) be affected on a long term economic basis although we do know some of the points of contention such as automobiles, dairy, and the dispute resolution process. While it's important to not get caught up in the noise, if a new NAFTA agreement is reached we need to remain cognizant that there may be long term economic impacts to Canada, both positive and negative.

Tit for Tat

Definition: A blow or some other retaliation in return for an injury from another.

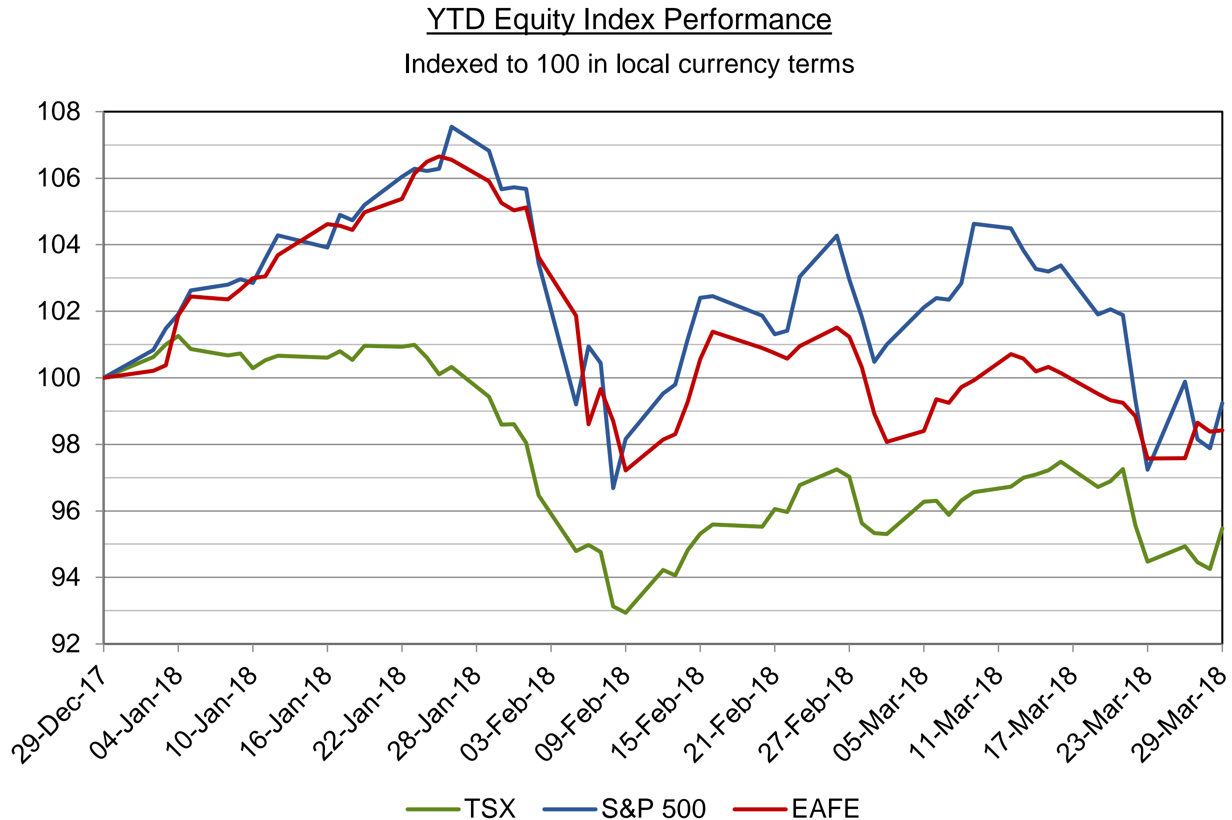
Also dominating the headlines this past quarter were concerns of a global trade war sparked by U.S. tariff announcements. In early March, President Trump announced via Twitter (really!), hefty tariffs on steel and aluminum imports aimed at China, but which could also affect key allies such as Canada and the European Union. Shortly after the announcement, President Trump also tweeted that Canada and Mexico would be exempt from these tariffs until May 1st. Interesting coincidence given that the U.S. is trying to reach a new NAFTA agreement by early May.

China, in a calculated response to the U.S. using more conventional communication methods, countered with tariffs aimed at key U.S. imports including soybeans, planes, cars, whisky and chemicals, worth approximately $50 billion U.S. A total of 106 items were included, with many being agricultural products in states from Iowa to Texas (key states that voted for Donald Trump in the 2016 election). Not one to be outdone, President Trump tweeted another tariff announcement targeted at approximately $50 billion U.S. worth of Chinese imports. While $50 billion U.S. may seem like a large number, it amounts to 12% of China's exports to the U.S. or 2% of China's global exports.

It is unclear at this time how far this situation could escalate and whether we may be facing a global trade war. Similar to the NAFTA renegotiations, it is important to not be swayed by short-term volatility while being mindful of potential long-term impacts, should there be any.

Tying it all Together

The chart below illustrates the impact these events had on equity markets during the first quarter.



"Stop trying to predict the direction of the stock market, the economy or the elections."

"We don't have to be smarter than the rest, we have to be more disciplined than the rest."

- **Warren Buffet**

During these times, it's important to not lose sight of market fundamentals. In prior publications we have discussed the importance of equity market valuations as a multiple of expected earnings. The earnings multiple or price to earnings ratio (P/E ratio) measures how much investors are willing to pay for $1 of earnings. In times of increasing equity markets, stock prices can be driven higher by increased earnings or an increase in the multiple being applied to those earnings. During the past few years, the bull market in equities was primarily driven by increasing multiples, meaning that share prices have increased more than earnings have grown.

During the first quarter, share prices declined while earnings continued to grow, meaning that multiples have contracted. In plain words, expensive equity markets are becoming more reasonably priced, especially in the Canadian and international equity markets. U.S. equity multiples have declined slightly but are still fairly high compared to historical averages. Earnings supporting these companies have not declined; rather it is the market "noise" that has produced these declines. Earnings have been increasing, consistent with the solid economic growth we have seen.

Maintaining focus on long-term investing is key and investment advice should stand the test of time. As we noted in our 2016 newsletter "Depoliticize your Portfolio", when it comes to long term investing it is best to focus on things you have control over. Quadrant maintains a long-term view and focuses its efforts on asset allocation policy, manager selection, systematic rebalancing and understanding our clients' individual financial circumstances. Presidents will come and go, business cycles will continue to roll on and the capital markets will remain a fundamental building block in creating and preserving wealth.

If only we could implement a tariff on tweets…

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