The O’Neill Wealth Management Group

Wealth Management
Dominion Securities

Q1 Executive Summary

The O’Neill Wealth Management Group

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In contrast to the last quarter of 2018, the good news is the first quarter of 2019 was defined by a strong rebound in equity markets, helping to calm investor fears which peaked around the holidays. We are pleased our portfolios have participated in this rally. Our emphasis on quality positions in both equity and fixed income allowed us to manage through the volatility, in both directions, reasonably well.

Our view is constantly evolving. A lot remains the same, though there are some notable updates. While the decisions of foreign leaders, central bankers, and the subsequent reaction by financial markets are largely beyond our control, what never changes are the things within our control. Namely our ability to plan ahead based on personal circumstances, priorities and goals. Or our decision-making process, involving a clear investment discipline with well-defined rules, guidelines, boundaries and parameters, which allow us to adjust as the macro environment advances, and constantly evaluate our individual investment choices for their contribution to the long-term success of individual plans. Finally our commitment to ongoing communication and service remains constant.

One of the primary changes to our outlook is we no longer expect interest rates to rise over the next year. Both the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC) materially changed their policy on future hikes over the last quarter in response to slowing growth, contained inflation and extraordinary financial market volatility. RBC Global Asset Management (RBC GAM) does not expect any rate hikes among developed world central banks in 2019. While this change in policy has helped fuel the equity rebound year-to-date, and may reduce the risk of recession over the next few quarters, RBC GAM remains cautious that the pivot in strategy may increase risk later on as faster growth may lead to higher inflation and a tighter economy – classic signs of the end of the cycle.

At the same time global growth continues to slow, although that does not mean it is expected to be negative. The U.S. economy benefited from major tax cuts in 2018 which contributed to impressive economic growth domestically and resistance to declining growth numbers elsewhere. However, since then a number of factors indicate the U.S. economy should begin to slow, including effects from the recent government shutdown (the longest in history), tighter financial conditions, evaporating fiscal stimulus, and protectionism. Acknowledging the potential drags, RBC GAM is forecasting 2.25% growth for the U.S. economy in 2019.

Focusing on Canada specifically, RBC GAM identifies four key challenges. These include our link to slowing U.S. growth, a weakening housing market, poor competitiveness vs the U.S. and a tough environment for the production and transport of crude oil. The energy environment is not as grim as it was last fall, as oil prices have rebounded, and should improve further in a year or two if transportation capacity is secured, but for now it remains a precarious environment and a source of economic softness. All told RBC GAM expects the Canadian economy to decelerate to 1.5% growth in each of 2019 and 2020. This is slower than the U.S., but faster than the U.K., Eurozone and Japan.

The key macro risks we have highlighted for some time include protectionism, Chinese growth, and the advanced U.S. business cycle. There are plausible resolutions to these risks which could lead to improved scenarios. However we must evaluate and accept the uncertainty associated with the downside consequences.
Protectionism is no longer actively deteriorating, but the effects of previous decisions is starting to show up. Global trade growth has slowed meaningfully, and import prices have risen amid Brexit, U.S. tariffs and other non-tariff barriers. Consensus is growing that the U.S. and China will be able to finalize a trade deal, though RBC GAM suspects further friction between the two countries extending beyond the negotiation window. In addition U.S. blanket tariffs, including those on steel and aluminum, remain in place affecting several countries including Canada. The Brexit story continues. The EU granted an extension to the original divorce deadline of March 29th to April 12th. Theresa May announced she is prepared to resign if her Brexit deal passes.

China continues to merit careful attention. Policymakers introduced a multi-layered stimulus package via a mix of monetary and fiscal policy to try and counteract the significant economic slowdown underway. However concerns remain longer-term that the stimulus may contribute to the country's already worrisome debt.

RBC GAM uses a "scorecard" approach to determine the stage of the U.S. business cycle, and at this point it signals a "late stage" that is advancing. This does not mean that risk-taking should be eliminated, but rather should be approached with more caution as the risk-reward equation isn't as favourable as it was earlier in the cycle. In the credit space auto-loan and credit card delinquencies are rising, though mortgage default rates are still low.

The Yield Curve is one, of several, long-standing metrics which provides insight into the stage of the business cycle. The yield curve has recently been given much attention. In late March, for the first time in nearly 12 years, short-term (3 month) rates were above 10 year rates in both the U.S. and Canada. An inverted yield curve is an early warning sign that a recession could be ahead – on average a year later according to RBC GAM. We cannot ignore rising recession risks. Lead Strategist at RBC Capital Markets (RBC CM) Craig Bishop states "We do not fall in the 'this time is different' camp. While others may dismiss yield curves because of the Fed's balance sheet, low rates, or any number of reasons – we believe the yield curve is still one of the best market-based metrics for gauging how tight monetary policy is and rising recession risks". The New York Fed estimates the chance of recession within 12 months at roughly 30%, while RBC GAM's estimate, based on the scorecard model, is similar at 35% in 2019 and slightly higher in 2020. By no means is a recession a foregone conclusion, but it is realistic to say the risks are elevated.

Chief U.S. Equity Strategist for RBC CM Lori Calvasina believes there is still some room for upside from here, but acknowledges stocks will face a big test in the coming months. "In order for stocks to hold onto their recent gains, or to climb higher, investors will need to see evidence that the economy is back on track relatively soon". She also believes politics will remain a significant headwind for the US Equity market, and will likely contribute to volatility. Even if a deal is reached with China, other issues include trade relations with Europe, and the 2020 elections.

We are prepared for more volatility ahead. We have tilted fixed income positions to be heavier in higher-quality government backed securities, and lowered exposure to corporate debt. We have higher levels of liquidity and cash-equivalents, in both Canadian and U.S. dollars, for income requirements where they are needed, and for buying opportunities within equity markets that periods of volatility inevitably produce. Our equity models remain defensively positioned. We recognize the profit outlook for 2019 may not be as attractive as previous years, but the balance of risks and opportunities still suggests economic growth is sufficient to deliver moderate gains in equities, and therefore are worthwhile compared to fixed income alternatives.

The choices we can control during the planning process, and strategic investment decisions, allow us to focus on what's really important to each of us long-term. Our motivation is to make each decision with your priorities, goals, and long-term success in mind.

Thank you for the trust and confidence you place in us. Enjoy the warmer temperatures and the renewal of spring!

Best regards,

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