The O'Neill Wealth Management Group

Wealth Management
Dominion Securities

Q4 Executive Summary

The O'Neill Wealth Management Group

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What a difference a year makes! It is amazing how different the end of 2018 looks compared to 2017. In fairness 2017 was remarkable in the magnitude and steadiness of the stock market's advance. There is nothing quite like a swift change in volatility and the direction of equity markets to shake our confidence.

As we know, confidence is built when we plan ahead, run scenarios, and prepare. We set guidelines to follow, rules for investment decisions, and targets for cash flow, liquidity and growth that all relate back to our individual priorities and goals. When we are clear on what we are trying to achieve; whether it is securing cash flow for retirement, a legacy for our beneficiaries, building enough savings for the future, or any other purpose; we can build a plan and investment strategy around it, knowing that there will be challenges along the way. Our discipline allowed us to protect capital reasonably well in 2018, despite a much more difficult environment.

This quarter, investors in global equity markets suffered through a miserable three months as virtually all indices' experienced losses. Even the U.S. market, measured by the S&P 500 index, which had been resilient throughout the year, and hit a record high in September, was not exempt from the most recent sell off, as higher interest rates and rising protectionist concerns regarding the U.S. – China relationship in particular, and slowing global growth numbers weighed heavily. In the end 2018 has proven much less profitable and much more volatile than 2017.

A consistent theme in these commentaries throughout the year has been our acknowledgement that the economy is approaching, or genuinely in, the "late-stages" of the cycle, and as a consequence we outlined our plan to dial-back risk within our portfolios. As such, heading into Q4 we had already taken profits consistently on individual stocks, rebalanced portfolios to their Asset Allocation targets several times, and proactively added defensive positions not only in equities, but also within fixed income, by taking advantage of higher interest rates on better credit quality issuers, including government bonds and GICs. All of this preparation helped to provide downside risk protection during the most recent sell-off, position portfolios to be resilient, and participate directly in a subsequent recovery.

The present environment can be described as fragile for equity investments given the combination of slowing global growth estimates, inflation which is trending higher and central banks that are actively increasing interest rates, though there is now more debate as to the timing of future rate hikes. RBC Global Asset Management (RBC GAM) is forecasting further deceleration of global growth into 2019, nevertheless is expecting positive growth in the coming year, albeit at a slower pace. There are more risks surrounding this base-case view than usual. Protectionism, China's economic slowdown and the business cycle are the three most prominent.

Protectionism is among the very largest macroeconomic risks in the world today – mainly in the context of the U.S. - China relationship. The breadth of tariffs levied in both directions has increased substantially in recent quarters and now covers several hundred billion dollars of bilateral trade. It will take a sizeable further deterioration in the trade environment before the resulting economic damage would plausibly become outright recessionary. As a result RBC GAM is budgeting for diminished economic growth over the next year, while not forecasting outright recession.

China's slowing economic growth has been abrupt. RBC GAM is forecasting 6% for 2019. This has implications for other countries, including Japan, other emerging markets in Asia and commodity exporters including Canada.

Signs that the business cycle is advancing further into the "late-stage" were more evident during the fall quarter. Labour markets in the U.S. are now extremely tight. An inverted yield curve, an often quoted signal of pending recessions, occurs when interest rates on longer dated bonds fall below those on shorter-dated bonds. The U.S. yield curve has been flattening for several years, and is conceivably on track to invert in 2019. This does not necessarily promise an imminent recession, as the yield curve tends to invert well in advance of a recession, but it is further confirmation that the risk of recession is rising over the next year, though not enough to represent a base-case forecast, let alone a certainty.

U.S. corporate profits surged in 2018, but several factors suggest the pace of earnings growth will likely slow next year. While earnings have been growing upwards of 25% on a year over year basis in 2018, the fact that earnings and margins are now above their trend lines, and won't have the tailwind of further tax cuts next year, suggests that the pace of profit growth will slow to the high single digits in 2019, and analysts are now reflecting that in their estimates. Even though analysts expect a more moderate pace of earnings growth next year, we think estimates are still at risk of being revised lower. The bulk of increase in profit margins over the past 2 decades was driven by factors that are unlikely to be repeated; falling interest rates, declining tax rates, the relocation of factories to low-cost countries and the use of tax havens accounted for 85% of the improvement in profit margins. It's unlikely that these gains can persist and many of these factors such as interest rates are now becoming headwinds.

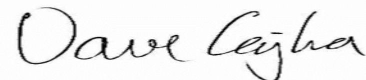
While earnings can still continue to grow as the economy expands at a moderate pace, investors should be prepared for a meaningfully slower pace of profit growth than has been the case for the past several quarters. This scenario shows that equities can still deliver attractive and above-average returns from current levels if earnings materialize as analysts expect. However should the outlook for earnings deteriorate equity-market performance would likely be less impressive. The onset of a recession for example could result in an earnings decline of as much as 25%, likely pushing stocks into a bear market. As long as the economy avoids recession the average decline in stocks suggests much of the damage that occurs during a typical cyclical decline may already be behind us.

The outlook for Canadian growth is also expected to slow. The combination of slower expected U.S. growth, higher interest rates (and thus borrowing costs) globally, and the Canadian specific issues of lower oil prices, poor competitiveness and a cooler housing market combine for an underwhelming GDP growth forecast of 1.75% in 2019 according to RBC GAM.

For the most part we have opted not to add to equities during the recent correction, instead we want to ensure we have adequate liquidity and flexibility to be able to take advantage of buying opportunities once there is more clarity about the direction for the economy. We believe the defensive characteristics of our portfolios served us very well this past year, and will continue to do so in 2019 – including companies with solid dividend yields that are growing and relative strength compared to the broad market. The fixed income allocation will help to provide a solid foundation and counter balance for possibly tougher equity markets ahead.

It is true that the New Year may present more challenges in equity markets. However proper planning and portfolio management mean you can also fully enjoy many rewards in the form of personal milestones, experiences and achievements. We would like to thank you for sharing your vision for the future, and express our gratitude for your partnership in 2018. We look forward to many more meaningful reviews and discussions in 2019.

Sincerely,



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