The PFP Quarterly

Wealth Management
Dominion Securities

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Quarterly update

After experiencing subdued market volatility in the first nine months of the year, the last three months not only showcased a higher level of volatility but went to extremes. The fourth quarter shaped up to be the worst quarter in a long while, with global stock markets dramatically selling off, the yield curve flattening, a disconnected U.S. President and Federal Reserve Chair and heightened trade dispute rhetoric between China and the U.S. This recent bout of volatility has caused investors to feel uneasy and to question their risk tolerance. Amidst all the negative sentiment that has surrounded the markets, we don't believe that this is the end of the cycle, nor the beginning of a recession, but rather a resetting of the markets.

From an economic standpoint, not much has changed from the beginning of 2018 to the end of 2018. It seems like a broken record but: unemployment is extremely low, wage growth has yet to rise, the yield curve has yet to invert, inflation remains low and interest rates are still below their desired neutral range of 2.5-3.5%. These are still very accommodative times and the imminent recession that everyone seems to be speaking about isn't peeking its head around the corner. As seen in Figure 1 on the following page, nothing at the moment is flashing red and we have no reason to believe that our next recession is upon us.

There does, however, appear to be a real disconnect between the markets and the global economy. As mentioned above, everything remains relatively positive from an economic standpoint, and not one of those indicators was the catalyst to the down market. But not everything is binary. The issues that were top of mind at the beginning of the year have been resolved or fizzled away. The markets have seemed to be reacting to the constant tit-for-tat between the United States and China, as well as the growing ill will between the executive branch and the Federal Reserve.

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Figure 1: Wealth Management U.S. economic indicator scorecard

Indicator	Status		
Yield Curve (12-month to 10-year)	–	✓	–
Unemployment Claims	✓	–	–
Unemployment Rate	✓	–	–
Conference Board Leading Index	✓	–	–
ISM New Orders Minus Inventories	✓	–	–
Fed Funds vs. Nominal GDP Growth	✓	–	–

Expansion	Neutral	Recessionary

Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed

New feuds arising

The constant back and forth between the global superpowers has been felt across major markets. At one moment it seems that both sides are on board to come to a resolution and the next moment they are threatening more tariffs. This struggle to prove who is bigger and stronger has increased uncertainty and led to increased volatility – more than the market and investors have been used to for some time. This led to all major indices posting negative returns for 2018. On top of the back and forth trade threats, the market pull back has been furthered by investor uncertainty and bearish sentiment. This was seen no more than in December when the S&P 500 produced the worst December return since 1930. Much of this decline was led by the FAANG stocks, all of whom experienced all-time highs at some point in 2018 only to pull back in the fourth quarter. Recent months have led investors to want to believe that this is something bigger, but we believe it was only a correction in this current cycle. We believe there is still room for this cycle to continue and, unless something dramatic happens, we also believe that China and the United States will come to a resolution that will be beneficial for both sides.

The clear struggle between the Federal Reserve and the Executive branch of the United States has been made public over the last few months. This has trickled down and influenced market sentiment, causing everyone to listen and react to every word said by Jerome Powell. In December, the Federal Reserve raised rates for the fourth time in 2018. This drove the market into a state of confusion, as the market as a whole was experiencing a pull back and economic indicators did not signal the need for another rate hike. The Federal Reserve has since retreated from their hawkish tone towards a more dovish stance. This constant struggle by the Federal Reserve to achieve a “soft landing” may be far-fetched (as shown in Figure 1), but it appears that they are reluctant to implement further rate hikes at this point.

What are we doing?

In times of sharp negative volatility, doubt and uncertainty of the future cause some to question our longer-term strategy. Our outlook has evolved over the last few years from outright bullish to a now more cautious stance. We do believe that the last quarter was a correction; however, over the following quarters we will continue to prepare our portfolios for the next recession. Although our asset allocations did not change much in the last quarter, we did make numerous adjustments to our Canadian and U.S. equity positions as well as remove our Emerging Market equity exposure. We continue to adjust our overall fixed income allocation, adding high quality bonds and short term GICs, while taking advantage of December’s volatility to add more individual preferred share positions in lieu of our ETF position. Although in the short term we expect global economies to grow, albeit at a slower rate, we believe we are moving into the later stages of the economic cycle and, therefore, we will be transitioning our strategy to a more conservative stance.

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