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February 2018 INVESTMENT COMMENTARY

Greetings from a very cold Toronto! And if Punxsutawney Phil the groundhog is right, we've got at least another 6 more weeks of very cold war to go! January was a very strong month for US and International equities (the TSX must not have gotten the invitation) and now starting February we're seeing a very sharp pullback in the markets.

Although the S&P 500 has dropped about 150 points in the last couple of trading days, it is important keep in mind that the S&P is still up about 20% over since the beginning of 2017 (including this recent pullback). It's never pleasant to experience these periods of heightened volatility and steep market losses; but it's important to try and keep a long term perspective in mind that volatility and losses are normal (at least in the short-term).

Pundits will spend a lot of time discussing the causes of the recent pullback and they are many of the same that I've discussed in previous commentaries. The US political situation is still a mess with Congress looking to pass another short term budget deal because there's a lack of consensus. Interest rates are starting to increase as the Federal Reserve looks to hike three (maybe four) times this year with the Bank of Canada following suite and fixed income investors are starting to begin to worry about inflation. The continued stand-off with North Korea always creates the tail risk of going wrong while the Middle East situation continues to get worse.

However not all is bad; the global economy continues to perform well and 2017 was the first time since the financial crisis that every major developed or developing economy expanded and we expect this to continue in 2018. A growing global economy should lead to higher company revenues and profits and would be supportive of another positive year for the equities (but unlikely to be as good as 2017). Rising interest rates will be a drag on returns for both equities and fixed income, but keep in perspective that interest rates are still low (Canadian 10-year bond yield is just over 2.30%) and real rates (interest rates after inflation) are still around zero or negative for much of the world.

The TSX, unlike the US and International markets, has not had a great start to the year. Although US and international oil prices are up to start the year, Canadian oil prices have barely budged. Continued delays in getting the legacy Keystone pipeline back up to full operating capacity (after a leak in December) has resulted in a buildup in Canadian oil that is trapped with no end market. The worsening relationship between the Alberta and BC government's (both NDP ironically) over the Trans mountain pipeline expansion has further hurt investor sentiment and sent the energy companies down a lot to start the year.

To add to the TSX's problems, the marijuana companies (which have been the high fliers for the last year and offsetting losses in the energy space) have now dropped 50% or more in the last week or so. At the same time, early readings show that the housing markets in Toronto and Vancouver continue to slow from both higher interest rates, more regulations and possibly buyer fatigue as home prices have far exceeded incomes over the last decade. Unfortunately a slowing housing market is bad for the TSX (banks are the largest component) and the economy overall (larger than manufacturing and the oil and gas combined).

Needless to say, investment opportunities at the moment look better outside North America and that is the main reason for us to be overweight international equities over Canadian and US equities. Within the Canadian equities, we have currently a small allocation to energy stocks and no exposure to bank or marijuana stocks. The net result is that the Canadian portion of the portfolio has held in pretty well so far this year and the US and International which are more defensively constructed have done ok as well.

Again I would just like to empathize that market corrections are unpleasant but should pass with time and I still expect modestly positive returns from equities for the year. However if you have any concerns with your portfolio please do not hesitate to contact myself or a member of the team at **416-956-8888** or teamkarim@rbc.com and we would be happy to assist.

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