Wealth Management
Dominion Securities

RBC Dominion Securities inc.

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Market update

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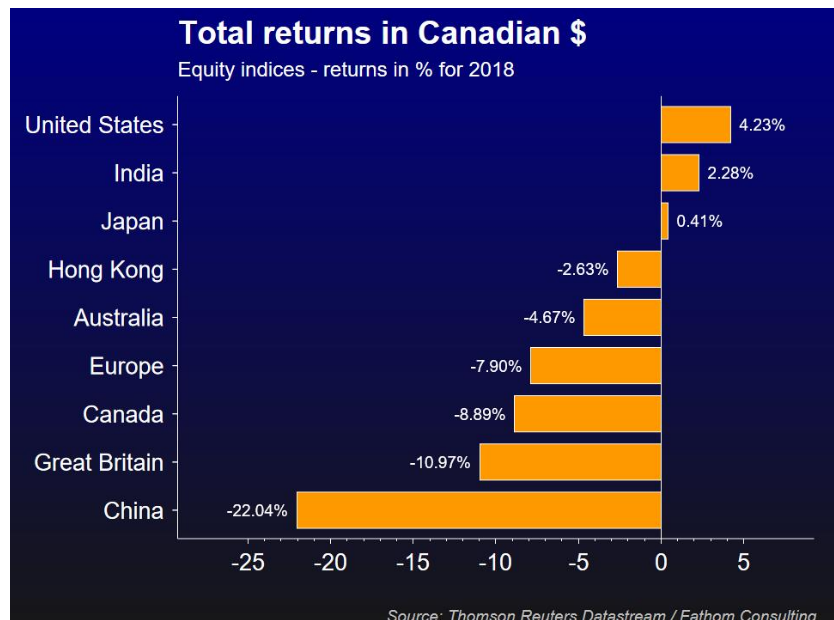
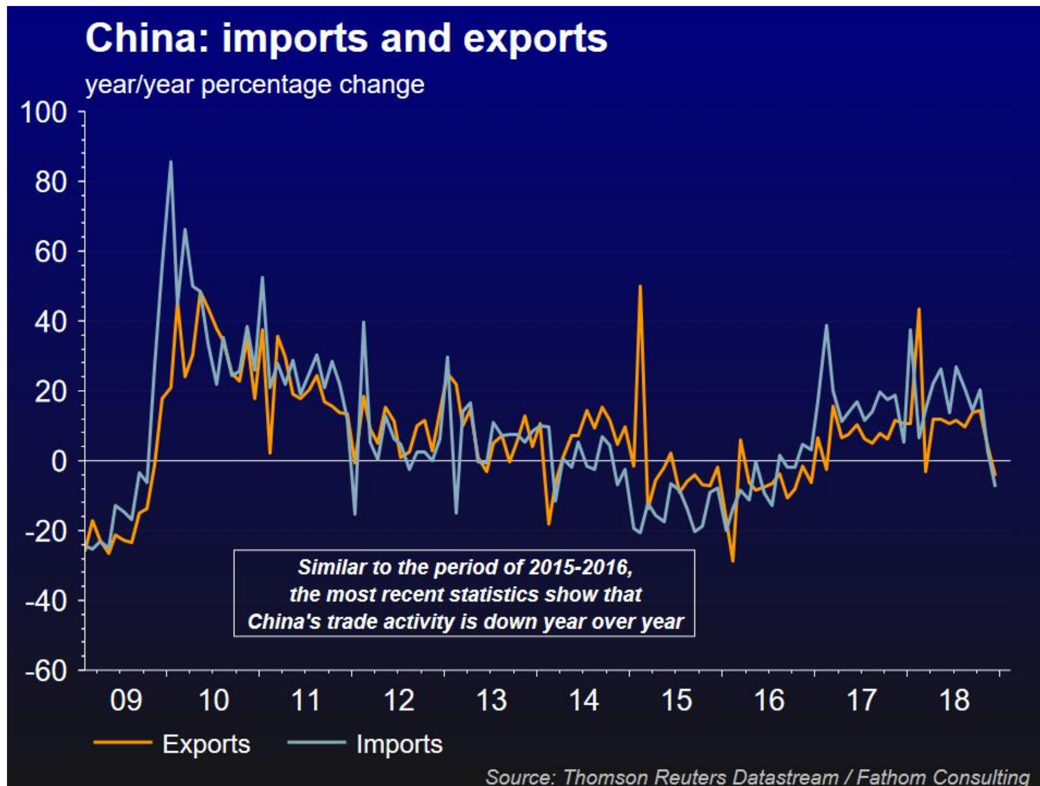
Stock market indexes

Marked by renewed volatility, 2018 was a turbulent year for stock market indexes around the world. After a difficult start to the year, markets subsequently recovered and most indexes were posting attractive year-to-date returns by September. However, in the fourth quarter, stock market indexes fell sharply worldwide, erasing all the gains that had been achieved since the beginning of the year. Even the U.S. equity index, which had delivered the best performance up to the end of September, succumbed to investors' sombre mood. The following table shows how the world's major stock markets performed in Canadian dollars during 2018.



Pinpointing a single factor to blame for the market index correction is quite difficult. In reality, it was a combination of various concerns that ultimately sapped investor confidence and undermined expectations for corporate profit growth.

There is no doubt that the protectionist trade policy implemented by the United States was a source of uncertainty and confusion that ultimately impacted the real economy. For example, the Chinese economy, which ranks second largest globally, slowed considerably in reaction to the relatively harsh U.S. protectionist measures. Our indicators show that a number of economies, including China's, will advance at a slower pace in 2019. The graph below clearly illustrates this slowdown in China's trade flows.



It is also important to highlight the Federal Reserve Chairman's role in fuelling year-end fears when he reaffirmed his intention to continue tightening U.S. monetary policy. Against the backdrop of a trade war and slower global economic growth, that was all it took for investors to immediately start pricing in the possibility of a recession.

There was a range of other factors that also fed market uncertainty, such as household debt (in Canada), stormy Brexit negotiations in Europe, the U.S. dollar's high value for certain indebted emerging nations, and a populist trend in many regions of the world.

In our view, this slowdown does not signal an imminent recession. The Fed has clarified its message since then and we believe that China and the U.S. will come to an agreement. Despite our optimism, we are remaining cautious because the current economic cycle is already very far along.

Bond market and preferred shares

The bond and equity markets moved in opposite directions this past year. In a context of rising rates both in Canada and the U.S., the bond market underperformed the stock market indexes until September. From that point onward, bonds became a safe haven as uncertainty bubbled to the surface. The Canadian fixed income index therefore closed the year with a slightly positive return of 1.41%.

Meanwhile, the year end was rough for preferred shares, which turned in a disappointing performance. Because that market is less liquid, the downward movement was amplified beyond what we considered justified. Consequently, we believe that a number of preferred shares are offering attractive returns at this juncture.

Our equity portfolio

In 2018, our equity portfolio outperformed the benchmark indexes. Our approach focusing on the quality of each company means our portfolio tends to be less volatile during periods of greater uncertainty. Additionally, our heavy exposure to the U.S. and the greenback turned out to be beneficial. It is also worth noting that our decision to keep cash levels higher in recent months has helped limit the decline in our portfolio's value.

At the start of 2018, we were mainly concerned about the Fed's monetary tightening as well as the risks surrounding a possible trade war between the U.S. and the rest of the planet. To protect against those risks, we reviewed our portfolio and made some adjustments.

With a view to making the portfolio less sensitive to higher interest rates, we scaled back our exposure to real estate investment trusts and the telecommunication services sector. Accordingly, we sold part of our holdings in Canadian Apartment REIT and lightened our exposure to BCE. We also expanded our exposure to the Canadian life insurance sector by bumping up our Manulife position and to the U.S. banking sector by initiating new positions in PNC and U.S. Bancorp.

We also examined how our portfolio would be impacted in a scenario where international trade slumped at the global level under pressure from severe protectionist measures. In that context, we decided to limit our investments internationally and focus on North America. Moreover, we went ahead and reduced our exposure to the rail sector by shrinking our CN Rail position while negotiations for a new free trade agreement were underway between the U.S. and Mexico. We opted instead to take new positions in WSP and Toromont, two companies that are not directly dependent on international trade.

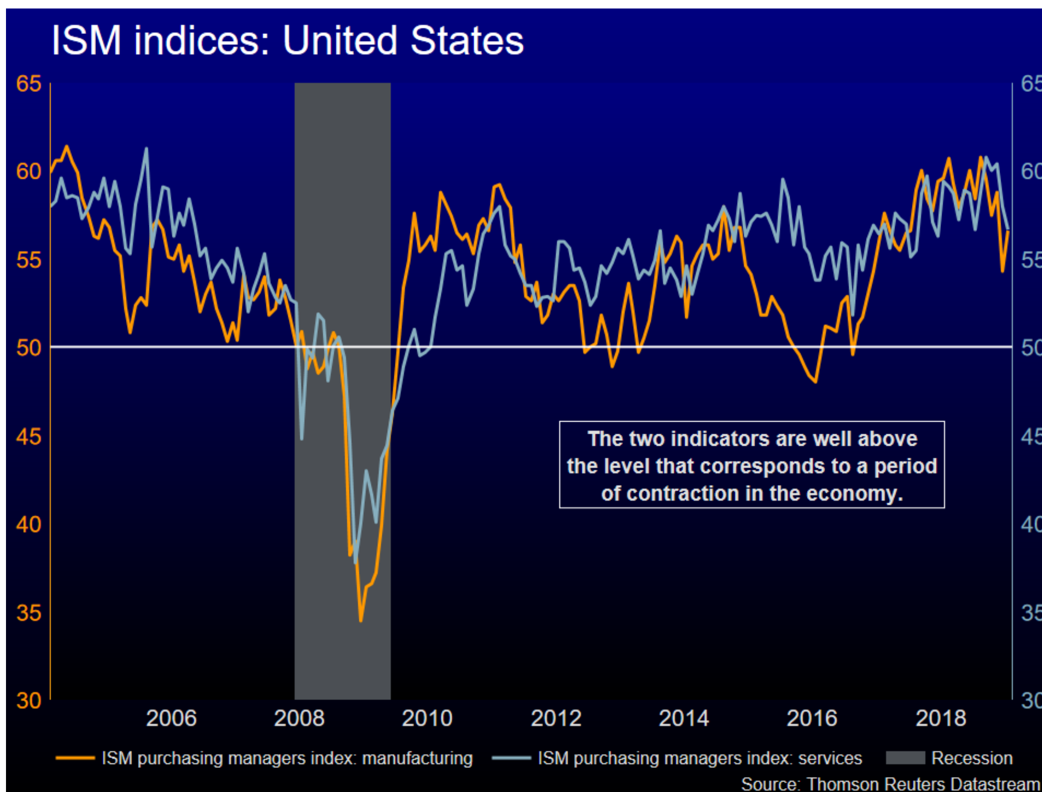
Despite the widespread market downturn in 2018, a few names made positive contributions to the portfolio's performance. On the Canadian side, Canadian Apartment REIT, CGI and Loblaw generated returns of 22.2%, 22.3% and 12.6% respectively, including dividends. Dollarama and Canadian Natural Resources, in contrast, had a very challenging year with returns of -37.8% and -24.1% respectively. Even though we had trimmed our Dollarama position by 25% in late 2017, our exposure to that stock was still high when the company announced disappointing results over the course of 2018. And, like the entire energy sector, Canadian Natural Resources was pulled down as oil prices dropped.

Looking south to the U.S., Amazon, Pfizer, Microsoft and Visa had an outstanding year with returns of 28.6%, 24.8%, 20.8% and 16.5% respectively, including dividends. On the other hand, Vodafone and DowDupont were a drag on the portfolio's performance, producing returns of -29.7% and -23.2% respectively. We liquidated our Vodafone holdings in November 2018 because we were worried the company would eventually have to cut its dividend. With respect to DowDupont, growing fears of a recession as the year ended had a major impact on that company, which is sensitive to the economic cycle.

Outlook for 2019

We believe the stock market indexes will do better in 2019. The sharp contraction in the equity market at the end of 2018 has made valuations more appealing. We also think profits will grow by 5% to 7% in the U.S. and Canada this year. A slight improvement in valuations combined with our forecast for corporate profitability growth creates return potential higher than the historical average. The graph below shows how the Canadian market's price/earnings ratio has lost a lot of ground in terms of valuations in the past few years.

To generate those returns, we are counting on several factors. First, the U.S. Federal Reserve will have to show more discretion in 2019 when it comes to tightening its monetary policy. The latest statistics indicate that inflation is still moderate, which could allow the Fed to take a break for a few quarters. We also hope that the negotiations between the U.S. and China will progress and that the two feuding countries will find common ground on trade. In the meantime, we are encouraged that the Chinese government intends to implement fiscal and monetary measures that could kick start the country's economic growth. For our stock market outlook to become reality, the global economy will of course have to make a soft landing and avoid a recession. The indicators are rather reassuring for the time being. The graph below shows the two primary ISM indicators. Any reading above the 50 level, as is the case now, means the economy is expanding. However, the economic slowdown is clear following the release of the December 2018 figures.



Although we are optimistic about 2019, we think it is important to remain cautious since the economic cycle is already very far along and the situation is still uncertain. At this point, we therefore prefer to enhance the quality of both equity and fixed income holdings in the portfolios. In line with our approach, we will pay special attention to specific factors in selecting our investments: companies' indebtedness, their ability to generate positive cash flows, the return on invested capital and the potential impact on profitability resulting from a significant economic slowdown. In addition, we will continue to favour companies that pay dividends and have highly rated senior management teams. Keeping in mind that setbacks are the norm rather than the exception and that our focus is financially sound companies that can bear the brunt of more challenging conditions, we believe we are in a good position for 2019.

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