# Market outlook 2018

## What, me worry?

**Will 2018 bring more of the same strong markets? Could be.**

One thing is certain: we're now nine years closer to the next market downturn. This alone should raise eye brows, but equity markets, at least, haven't batted an eye.

Predicting the future is a fool's game but we'll do it anyways (while seriously hedging our language along the way). So here it goes. By the end of 2018, North American economies and equity markets will be in worse shape than when they started the year. And Europe may finally step out of the shadows and lead, if only for a brief time.

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# THE U.S.

More stabilization

in 2018

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We recommend investors remain cautious when making trades on anticipated news.

## THE SHINING STAR OF THE GLOBAL ECONOMY MAY BEGIN TO FADE – OR BE MUTED BY OTHER RISING STARS.

- **The U.S Federal Reserve Board ("Fed").**
  The Fed is a little less predictable than in recent memory, especially as incoming Fed chair Jay Powell gains his footing. Nimble investors will probably benefit from this, while nervous investors may end up making rash decisions and lose out.

- **Interest rates rising.**
  Interest rates are going up unless the U.S. employment data is warped and not truly representative of what's really going on.

- **Inflation rising too.**
  Inflation see-sawed in 2017, but we expect to see a bit more stabilization in 2018. The economy appears to be running at, or close to, full employment, and consumer spending is still a key driver of economic growth. Now that inflation is hovering around the Fed's target of 2%, rate hikes should continue.

- **Not the tech companies of yesterday.**
  We're not sure we see an end to the strength of the information technology sector. Things are different than during the dotcom bubble. Back then, companies that weren't worth the paper they filed on garnered outrageous valuations. Now, behemoths just keep gobbling up companies, if not entire industries. What's stopping Amazon from dominating financial services, pharma, automotive and AI? Nothing, unless people lose faith in the company. Despite concerns about hiring practices and the company's negative impact on small businesses, people in consumer mode love Amazon.

- **Consumers exuberant, but caution warranted.**
  When consumers are happy, investors are happy – and policymakers are happy too. But shouldn't someone be cautious? Although not as stretched as their neighbours to the north, U.S. consumers are carrying a significant debt load.

- **Health care sector prognosis uncertain.**
  You can't help but marvel at the volatility in the health care sector. During the 2016 election cycle, health care was a disaster. Strong companies with excellent R&D and robust product pipelines were getting crushed alongside startups making dubious claims. Things have changed. Will it stay this way in the coming year? It seems to all be about pricing and politics, which are both very uncertain in the U.S. right now.

- **Financials sector payday?**
  First buoyed by expectations of reduced regulations and corporate tax cuts, then a helpful hand from increased rates, financials are busy counting their profits. Investors too. There have been a few minor blips on the radar (i.e., trading profits) but all-in-all, financials are in great shape. We expect that to continue throughout 2018, but believe a market pullback is possible.

- **Utilities and real estate sectors overshadowed (for now).**
  Both of these defensive sectors act as proxies for the bond market. With rising interest rates, stock prices in these sectors tend to pull back. If the economy keeps humming along and interest rates rise, stock prices could be negatively affected.

- **Federal policy question marks.**
  Tax reform? In its early innings. Repeal of the Affordable Care Act? Not yet. Decreased regulation? Well, the Fiduciary Rule has been delayed. What's in store out of Washington in 2018 is anybody's guess. We recommend investors remain cautious when making trades on anticipated news.

# EUROPE

U.K. could still get out of its messy divorce with Europe.

There have been small hints of an interest rate increase by the ECB.

WHILE THERE'S PLENTY OF POLITICAL UNCERTAINTY IN EUROPE, THE REGION'S ECONOMY IS IMPROVING.

- **Is France heading in the right direction?**
  This will be a big year for the pro-free market administration of Emmanuel Macron, as it hasn't achieved all that much so far.

- **No consensus in Germany.**
  Coalition building was something the Germans excelled at. That knack, which inspired much of the European Union ideal, came to an end in 2017, as Angela Merkel struggled to bring parties with disparate ideals together. The problem is that more parties are gaining momentum, on both the right and the left. Germany has struggled with too many parties in the past but, hopefully, times have changed. Some European countries excel with many parties. Scandinavia, for example, is home to a plenitude of parties and governments with a demonstrated ability to function.

- **Anarchy in the U.K.?**
  What can you say about the U.K.? In late 2017, the author of Article 50 said the U.K. could still get out of its messy divorce with Europe. Will it? We're sure the financial industry hopes so. Kids brought up living with extreme mobility throughout Europe would probably like to recast their votes as well. Everyone else? You may as well turn to the bookies for insight.

- **Interest rates: Lower for longer.**
  While there have been small hints of an interest rate increase by the European Central Bank ("ECB"), given inflation headwinds and a somewhat muted economy, a rate increase, at least one in early 2018, seems unlikely.

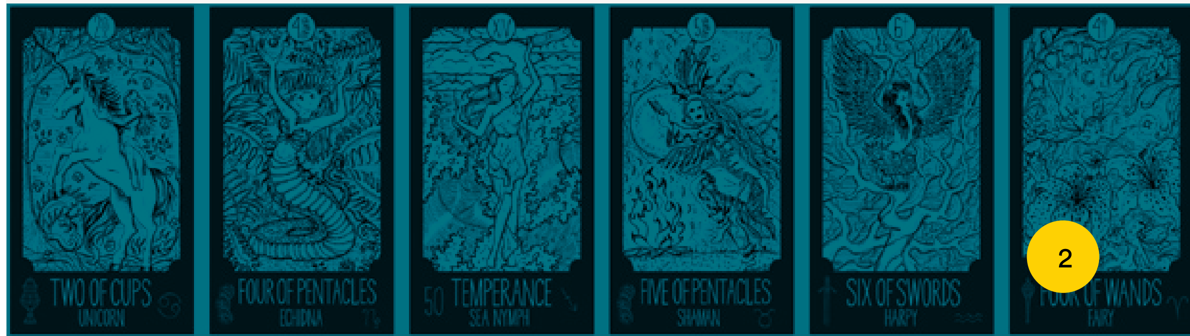
- **European economy propped up by fiscal stimulus.**
  ECB president Mario Draghi said himself that European inflation is almost entirely driven by government stimulus. The nudge could drive European economies in the coming year. However, the flight could be short-lived and result in a harder landing post-2018 if stronger fundamentals fail to materialize.

# CHINA

CHINA WILL CONTINUE ITS MASSIVE ECONOMIC OVERHAUL ... FOR A LONG, LONG TIME.

- **What consumer-driven economy?**
  We're not entirely convinced that the shift to a completely consumer-driven economy will ever happen. Some market commentators spoke as though this transition would take a few years, but it'll likely be closer to a few decades.

- **Strong economy poised to continue.**
  In the mid-6% range, China's economy is growing at a blistering rate. Although that level of growth is sure to decline eventually, successfully calling that decline is near impossible. The government would have to be unable to provide support. We can't imagine anything beyond a colossal economic catastrophe that would make that happen. And with China's increasingly diversified trade relations, even Trump's attempts to "reshore" U.S. manufacturing is leaving the economic behemoth relatively unfazed.



# CANADA

WHILE SPECULATION ABOUT THE CANADIAN HOUSING MARKET IS ON THE TIPS OF TONGUES EVERYWHERE, THE TERM ITSELF DOESN'T MAKE MUCH SENSE. AT 5,514 KILOMETRES FROM CAPE SPEAR, NEWFOUNDLAND TO THE YUKON-ALASKA BOUNDARY, CANADA'S STORIES ARE MANIFOLD. TO THE EXTENT THAT TORONTO AND VANCOUVER ARE BAROMETERS OF REAL ESTATE HEALTH, THE HAND-WRINGING IS WARRANTED. ONE THING IS CERTAIN, IF THE HOUSING MARKET WAVERS, CANADA COULD BE IN TROUBLE.

- **The Bank of Canada ("BoC").**
  We'll tell you one thing: we hope the BoC's leadership knows what they're doing. You take housing out of the gross domestic product equation and you're left with trouble with a capital "T", economically speaking.

- **The North American Free-Trade Agreement ("NAFTA").**
  It's hard not to think that Canada will be a loser in the NAFTA negotiations, if for no other reason than the fact that we're not coming from a position of great bargaining strength. NAFTA wasn't loved by everyone during the Bush (Clinton) -Mulroney(Chrétien)-Gortari years. In the Trump-Trudeau-Peña Nieto era, it seems equally disliked. The problem with bashing this "unloved" free trade deal is that North America is doing very well compared to many other regions because of it.

- **Interest rates rising.**
  Interest rates are going up, but it's hard to say how much and for how long. Given that we're nine years away from the last meaningful recession, they may go back down in the near term.

- **Inflation at bay, but edging up.**
  The BoC has stated that low inflation is temporary – caused largely by food price competition, falling oil and gas prices along with electricity rebates in Ontario. Question is, how long is temporary? With that in mind, we expect inflation to move up in 2018, although headwinds – like high debt levels and an expected rise in interest rates – remain, potentially keeping inflation in check.

- **Housing!**
  Vancouver real estate is clearly out of control, and it's a shame that younger generations can't own a home in their own city. Even the burbs are now richly valued. Toronto is heading in that direction, although at a much slower pace. In practically every other city, housing markets are relatively normal. New rules that may slow the housing market are coming online in early 2018. It'll be interesting to watch.

- **Wherefore art thou, oil sands?**
  We haven't seen much intelligent conversation recently about the viability of the Canadian oil sands. With the Organization of the Petroleum Exporting Countries production cuts on one hand, and the U.S. shale industry production blitz on the other, it's hard to grapple with the concept of strong oil sands demand in the near term. The big players are playing a strategic game, and Canada remains on the sidelines watching. Several multinational oil companies have divested their assets, so we'll see if this is a leading indicator.

- **Material changes in the materials sector.**
  The sector could be in a heap of trouble if NAFTA renegotiations don't go well for Canada (see: precious metals, steel, forest products). Needless to say, a lot is riding on the trade deal.

- **The (too) Big (to fail) 5.**
  The Royal Bank of Canada was recently added to the "To big to fail" list of banks. That's an ugly phrase that makes one shudder at the memory of August 2008. It also points to what leviathans Canada's banks have become. Will others join RBC? Canada's banks avoided big troubles in 2008, almost exclusively because of their strong management teams and the industry's regulatory oversight. We believe that if management remains strong, Canada's banks will ably handle any potential economic downturn.

- **"O Canada, we stand on guard for weed."**
  The looming legalization of marijuana, which provincial governments have decided to sell mostly themselves, is going to have a bigger impact on the Canadian economy than people realize. While it seems improper for a government to put people in jail one day and then profit from them the next, we believe that legal marijuana will create a massive revenue stream as Canadians go the legal route. Why? Novelty, ease and variety. Adam Smith's principles apply here.

# FIXED INCOME

WHILE DIVERGING CENTRAL BANK POLICIES WILL CAPTURE THE HEADLINES, CURRENCIES MAY PROVIDE SOME UNWANTED DRAMA IN 2018.

- **Central bank policy divergence.**
  On a global scale, there already is, and will continue to be, a divergence in central bank policies. This will certainly impact yields in many different countries. We have seen the U.S., Canada and, most recently, the U.K. raise rates. As these rates diverge from other central banks, there will be opportunities to add yield to portfolios by looking globally.

- **Imminent flight to safety?**
  Where do people want to be when the stock market turns bearish? Bonds. The safety and comfort of sitting back and collecting your coupons as the stock market falls is a huge benefit to holding bonds. If equity markets do pull back later in the year, expect the demand for bonds to rise.

- **Currency a wildcard.**
  Interconnected with bonds is currency. No doubt, yields and demand will drive major currencies higher. Should commodity prices rise, the Canadian dollar could experience an uptick in 2018. But beware of debt levels. Government debt around the world has never been higher, and could significantly impact currencies.

We're not professional prognosticators – and we'd warn you against listening to anyone who says they are – but we're confident the current economic environment warrants caution and discipline.

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