Steady Markets, Uncertain Politics

QAM Perspectives – April 2017

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

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Q1 2017 in Review

The first quarter of 2017 was relatively quiet, steady, and positive from a global markets perspective – a stark contrast from the same period last year. Last year began with equity and commodity markets around the world declining rapidly as investors feared that deflation, caused by falling oil prices and a slowdown in China could spark a global recession. This year began with rising equity markets, stable bond yields, and an overall sense of investor optimism amidst a backdrop of stable oil prices, increased inflation expectations, and a more positive outlook for global growth.

The S&P/TSX Composite Index in Canada, representing Canadian equities, returned 2.4% over the quarter. The Consumer Discretionary, Utilities, and Information Technology sectors reported strong returns while the two heavy-weight sectors in the index, Financials and Energy, essentially canceled each other out (Financials were modestly positive while Energy was modestly negative).

The S&P 500 Index in the United States, representing US equities, returned 6.1% in local (USD) currency terms over the quarter. This translates into a 4.9% return in Canadian dollar terms (the USD declined relative to the CAD). Similarly to the Canadian market, the Consumer Discretionary and Information Technology sectors led the charge.

The MSCI EAFE Index, representing International Equities (Europe, Australasia, Far East), returned 6.2% in Canadian dollar terms over the quarter. Financials and Industrials contributed the most from a sector perspective while the Asia Pacific region (ex-Japan) posted the strongest returns from a geographic perspective.

Fixed income returns were muted as bond yields and spreads remained fairly range-bound over the quarter. Yields jumped following the US election in November 2016 due to expectations of pro-growth and inflationary policies to be brought forward by Donald Trump. Bond markets now appear to be in a "wait and see" period while the Trump administration attempts to turn its promises into policies. The failure of one of Trump's first major pieces of legislation regarding the repeal and replacement of the Affordable Care Act (Obamacare), despite a Republican majority in both legislative branches of government, showed that implementation of the Trump agenda may not be as easy as initially expected.

The US Federal Reserve raised its benchmark policy interest rate in March for the third time since the global financial crisis in 2008. The central bank is on a diverging path from other developed economies (including Canada) that continue to follow accommodative (i.e. low interest) monetary policy. This will continue to put downward pressure on the Canadian dollar relative to the US dollar.

Equity Market Total Returns (in CAD dollars)	Q1 - 2017	YTD	1 Yr	3 Yr	5 Yr
Canada (S&P/TSX Composite)	2.41%	2.41%	18.53%	5.82%	7.83%
S&P/TSX Capped REIT Index	3.66%	3.66%	10.73%	6.57%	6.04%
U.S. Large Caps (S&P 500)	4.91%	4.91%	19.80%	17.44%	19.98%
U.S. Small Caps (Russell 2000)	1.34%	1.34%	29.72%	14.08%	18.98%
MSCI EAFE	6.22%	6.22%	14.47%	7.54%	12.70%
Germany (DAX)	7.58%	7.58%	18.67%	6.44%	13.63%
MSCI Emerging Markets	10.23%	10.23%	20.94%	8.04%	7.11%

Fixed Income Total Returns (in CAD dollars)	Q1 - 2017	YTD	1 Yr	3 Yr	5 Yr
Canada Universe Bond Index	1.07%	1.07%	1.22%	3.71%	3.17%
Canada Real Return Bond Index	-1.55%	-1.55%	-0.96%	3.45%	1.01%
US Investment Grade Index	-0.30%	-0.30%	2.99%	9.20%	8.27%
US High Yield Bond Index	1.16%	1.16%	17.61%	8.80%	11.17%
US Treasury Inflation Protected Index	0.20%	0.20%	3.91%	8.58%	6.81%

***Stated returns are from ETFs designed to track the associated index and may have minor differences compared to the pure index returns.*

Going Forward

The world continues to watch the Trump administration unfold in the United States. The core principles of its economic platform are focused on lowering taxes, increasing infrastructure investment, and renegotiating trade deals to put “America First”. Lower taxes and infrastructure investment are both good for equity markets but the focus on renegotiating terms of trade has uncertain impacts, especially if the US decides to adopt a more protectionist stance (import tariffs, export subsidies, etc.).

Trump has repeatedly stated his desire to renegotiate the North American Free Trade Agreement (NAFTA), which is a trilateral trading bloc composed of the United States, Canada, and Mexico. The rhetoric from Trump initially focused on making changes between US and Mexican trade relations, and it was expected that Canada would make it through relatively untouched. However, recent events have shown that Canada will indeed be targeted by the administration, at least to a greater extent than was initially expected. As of April 2017, Trump has publicly accused Canada of unfair trade practices specifically in regards to dairy and soft-wood lumber, and has imposed an import tariff on the latter. Following these events, Trump has threatened to totally withdraw from NAFTA, then stated he would renegotiate it instead, and then finally said that he would renegotiate it but totally withdraw if America doesn’t get a good deal – all within the span of a few days. Arguably the brash style and seemingly constant flip-flops on policy are perceived as negotiating tactics by Trump. Regardless, the future of Canada-US trade relations is uncertain at this time.

On the Canadian front, the Liberal federal government released its second annual budget in March. The fiscal plan includes approximately $28.5 billion in planned deficit spending for the 2017/2018 year, followed by a slow tapering decline to $19 billion in the 2021/2022 fiscal year. Themes in the budget include building a strong middle class, investing in innovation, and ensuring tax fairness. Pre-budget rumours of an increase in the capital gains tax inclusion rate (currently at 50%) did not materialize. Ultimately, raising taxes in Canada will be difficult if the US follows through on its plans to reduce taxes. Business and skilled labour, which are key drivers of an economy, are inherently self-interested and typically flock to environments with a more friendly tax regime.

Overseas, the United Kingdom officially invoked Article 50 of the Lisbon Treaty, formally beginning the negotiation process in regards to the UK's withdrawal from the European Union (Brexit). The allowable negotiation window is two-years and it is still highly uncertain as to how it will all play out. Banks and financial institutions are already preparing relocation strategies to move their business from the financial hub of London to other EU member countries if the negotiated terms are unfavourable for the status quo. While the initial Brexit vote and associated furor seems like a distant memory to most, the reality is that the real Brexit is only just beginning. For a more detailed breakdown of the main issues surrounding Brexit, see the QAM newsletter titled BREXIT: The Basics.

Following the invocation of Article 50, UK Prime Minister Theresa May called for a snap election to be held on June 8, 2017. This move came as a surprise and, given the currently strong public support for May's party (conservative), is expected to increase the conservative majority in parliament. This snap election introduces more uncertainty to the region as it begins its Brexit negotiations and during a time when multiple other European countries are in or soon entering election cycles, including France, Germany, and Italy. The result of the recent primary election in France, in which the two main political parties that have governed since World War II failed to move forward to the final round of voting, is a testament to shifting political ideals and an anti-establishment movement in Europe. The final round of voting will be held on May 7, 2017 and the choice is between Marine Le Pen, the leader of a right-wing populist party (National Front) which supports leaving the European Union, and Emmanuel Macron, the leader of a newly formed progressive party (En Marche!) which seeks to be more pragmatic and free from typical "left" or "right" ideologies.

The impact of rising populism and anti-establishment politics in Western nations is uncertain. Even given the recent Brexit referendum, the election of Trump, and the ongoing European elections that are shaking up longstanding norms, not much has yet fundamentally changed from a global economic perspective. Significant policy and legislative reform takes time, involves compromises, and the real effects of any changes can only be seen over a long time horizon.

Restating the quote from the first page:

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When it comes to investing it is best to focus on things that you have control over. QAM maintains a long term view and focuses its efforts on asset allocation policy, manager selection, and systematic rebalancing in light of each client's individual financial circumstances.

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.