glc asset management

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# 2017 Year in Review

Exceeding expectations

## Global equity markets produced strong gains in 2017

Equity markets were buoyed by synchronized global economic growth and modest inflation that propelled robust corporate earnings growth, and returns that exceeded expectations set out at the start of 2017.

The year opened with enthusiasm over the pro-business agenda of the new Trump administration, but uncertainty surrounding trade and immigration policies loomed. Failed attempts at travel bans and healthcare reform, and a war of words with North Korea pre-occupied President Trump and media outfits, as did the frequent White House personnel turnover. Washington politicians eventually pivoted to tax reform in the latter stages of the year and policymakers passed the highly anticipated legislation just before the Christmas holiday.

The Canadian economy delivered surprisingly strong growth, prompting the Bank of Canada to raise interest rates twice; driving 2-year bond yields to more than double their start of year levels, and boosting the loonie by 5 cents.

Outside of North America, strong economic growth and continued easy monetary policy supported European and Japanese stock markets. The European political climate was supportive of markets, highlighted by Emmanuel Macron (with a pro-euro, centrist agenda) winning the French presidential election in May. Japan's central bank has yet to move away from its ultra-accommodative negative interest rate policy.

Emerging markets benefited from both the synchronized global growth environment and the secular growth trade.

## 2017 Market Summary

| 2017 Market Summary | | | Year (%) | |
|---|---|---|---|---|
| **Canadian Fixed Income** | | | | CAD |
| FTSE TMX Canada Universe Bond Index | 1,036.84 | ▲ | | 2.5 |
| FTSE TMX Canada All Corporate Bond Index | 1,175.87 | ▲ | | 3.4 |
| **Canadian Equities** | | | | |
| S&P/TSX Composite | 16,209.13 | ▲ | | 6.0 |
| S&P/TSX Small Cap | 660.51 | ▲ | | 0.3 |
| **Currency** | | | | |
| Canadian Dollar (CADUSD) | $0.80 | ▲ | | 6.9 |
| **Global Equities** | | | Local[1] | CAD |
| S&P 500 | 2,673.61 | ▲ | 19.4 | 11.7 |
| NASDAQ | 6,903.39 | ▲ | 28.2 | 20.0 |
| EURO STOXX 50 | 3,503.96 | ▲ | 6.5 | 13.6 |
| FTSE 100 | 7,687.77 | ▲ | 7.6 | 10.2 |
| Nikkei 225 | 22,764.94 | ▲ | 19.1 | 15.6 |
| Shanghai Composite | 3,307.17 | ▲ | 6.6 | 6.2 |
| MSCI Emerging Markets (USD) | 1,158.45 | ▲ | 34.3 | 25.7 |

Price only equity returns │ 1. Local currency unless otherwise specified │ Source: Bloomberg │ 31 Dec 2017

Stock market volatility was historically low, especially in the US. The S&P 500 avoided a 3% drawdown for the first time since 1995. The VIX Index, which measures expected S&P 500 market volatility, hit an all-time low of 8.54, averaged 11.1 over the year, and never once spiked above its long-term average of 19.4. Outside of the US, equity markets exhibited similarly lower-than-normal levels of volatility.

Under the surface, two dominant (often opposing) themes pushed and pulled on both equity and bond markets.

On one side was the 'reflation trade': market moves based on the view that the world economy is in synchronized economic expansion that will bring firming inflation and normalizing monetary policy. Expectations for the reflation trade were boosted by expansionary fiscal policy in the US. When this theme ruled (most notably in the last four months of the year), bond yields rose and cyclically-oriented equity sectors (financials, energy, materials and industrials) benefited. Markets like Canada and emerging markets were beneficiaries of the reflation trade.

On the other side was a view that economic growth would fade, inflation would remain elusive, and US fiscal stimulus policies wouldn't see the light of day. When this view was in vogue (most notably between March and August), bond yields fell, and investors looked for secular growth stories such as companies with unique growth prospects that are not predicated solely on robust underlying economic growth. These stocks are found predominately in the information technology and health care sectors. In this environment the S&P 500, with its 38% weighting in tech and health care sectors, tops the S&P/TSX with its paltry 4% respective weight.

Emerging markets saw a double shot of adrenaline from both trades. Emerging markets have significant exposure to traditional cyclical sectors, but innovative growth stories also abound. Emerging market sector exposure has broadened out such that information technology is now the single largest sector at 28% of the MSCI Emerging Market index.

## Fixed Income

### A positive return for fixed income markets

In addition to the on-again, off-again reflation trade views, an overriding theme for North American bond markets was a flattening yield curve. The Federal Reserve (Fed) hiked rates three times, while the Bank of Canada (BoC) hiked twice. These central bank moves pushed short term yields higher. Longer term bond yields failed to get the same lift as inflation remained moderate, effectively flattening the yield curve. Global bond yields also continued to be weighed down by easy monetary policy in Europe and Japan.

The year's positive return was slightly above our 2017 forecast as September's highs for Government of Canada 10-year bond yields were unable to hold into year-end, and overall index results received a bigger boost from credit spread tightening. High yield bonds were the standout performers within the fixed income space, benefitting from their higher running yield and narrowing credit spreads.

The FTSE/TMX Universe Bond Total Return Index did see a fair degree of volatility, with a mid-year peak-to trough move of -3.55%, thanks to a flip-flopping of policy views from the BoC. After keeping a rate cut on the table through most of the first half of 2017, the BoC recognized Canada's strong macro-economic momentum and hiked overnight rates by 25bps in both July and September – the second move coming sooner than many anticipated. This caused Canadian government bond yields to move sharply higher, particularly at the short end of the curve where 2-year bond yields more than doubled in the space of three months (July – September). Canadian 10-year yields similarly jumped higher and almost crossed over the US 10-year yield levels in September before trending lower for the rest of the year after the BoC became more vocally dovish, pushing out expectations for further rate hikes. These bond market moves narrowed the 2-year bond yield differential between the US and Canada, and resulted in further Canadian dollar strength.

## Canadian Equities

Canadian equities muddled along for much of 2017

Despite a hot streak for the Canadian economy, Canadian equities were one of the weaker performing markets in 2017. Still, the total return for 2017 is a respectable 9.1%. Canadian investors should remember that equity markets don't hand-out returns in neat calendar year bundles. The S&P/TSX was an exceptional performer in 2016, besting the S&P 500 by 11% on a price basis in Canadian dollar terms, and offering a higher dividend yield to boot. On a total return basis, the S&P/TSX stands a cumulative 32% higher over the past two years versus a 24% total return in Canadian dollars for the S&P 500.

The Canadian economy exceeded expectations and was one of the standout economic performers in 2017. Solid employment gains and house price appreciation continued to fuel consumer spending in Canada. Canadian equities muddled along for much of 2017 before responding to the 'reflation' trade and higher oil prices in the last four months of the year. The S&P/TSX Composite's relative under performance stems largely from its sector weightings. The energy and financial sectors account for more than half of the index (each underperforming their US counterparts), while the year's darling sectors of information technology and health care combined are a scant 4% weight of the S&P/TSX Composite versus 38% weight in the S&P 500.

The September rate hike from the BoC provided a timely boost for financial stocks and helped the sector to a respectable high single digit return. Prior to then, financial companies had seen their share prices stagnate as the yield curve flattened and negative headlines about skyrocketing house prices, over-indebted consumers and an accounting scandal at alternative lender Home Capital each took a toll on investor sentiment. NAFTA uncertainty also weighed on the outlook for Canadian equities as US, Canada and Mexico NAFTA talks (beginning in August) made little progress on contentious issues.

### Oil

*Oil ultimately ended the year up 12.5%, but it wasn't a straight line. Crude entered bear market territory in June, before rallying 42% to the end of the year. Global oil prices were supported by OPEC and allies agreeing to extend production cuts to the end of 2018. Signs of stronger future demand (helped by global synchronized growth) also helped lift crude prices higher. Unfortunately, a series of uniquely Canadian issues (mainly pipeline related) saw Canada's crude oil benchmark (Western Canada Select) slide 21% at the end of the year to finish 8.5% below the opening year price.*

## US Equities

US Equities continued to climb higher in 2017

The 106 month bull market is now the second longest on record and the S&P 500 racked up an impressive 62 new all-time highs in 2017.

The US economy continues to be in good shape. Measures of business and consumer confidence hit record high levels during the year. Megacap technology-related names Amazon, Facebook, Apple, Microsoft and Alphabet were leading contributors on the secular growth trade. The tech trade took a few minor breathers during the year as investors worried whether momentum had shifted, but these blips were short lived. Bank stocks were also strong performers, benefitting from higher interest rates, deregulation and the prospect of tax reform.

## International Equities

International equities were focused on synchronized global growth and secular growth themes

Constructive political developments and surprisingly strong European economic growth lifted European equity markets. Investors let out a sigh of relief in May when pro-euro candidate Emmanuel Macron won the French presidential election only to have their resolve tested again by uncertainty over German and Spanish politics later in the year.

While politics grabbed much of the headlines, the market was more focused on the continued economic recovery in Europe. Growth and inflation picked up in 2017, while unemployment ticked down to cycle lows. Equities were also supported by continuing easy monetary policy in the region. The ECB only made baby steps in gradually removing stimulus measures, while the euro currency benefited from the improving economic environment and was up 14.1% versus the US dollar for the year.

The UK FTSE 100 lagged global peers as Brexit continues to cloud the outlook for businesses, and falling real incomes (a result of rising inflation and stagnant wages) has dented consumer spending and confidence. Brexit negotiations did take a positive step forward in December. Some issues were resolved, but investors are acutely aware that there is still much work to be done.

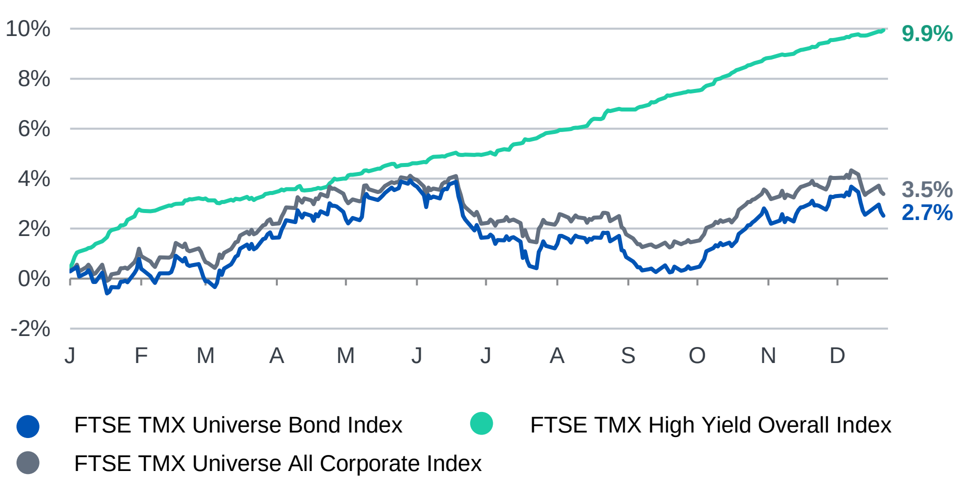
Japanese equities were strong performers with much of the gain coming in the final four months of the year. The move higher coincided with Prime Minister Shinzo Abe's victory in a snap election in October. With inflation still nowhere near the Bank of Japan's 2% target, Abe's victory points towards a continuation of loose monetary policy and economic reforms known as "Abenomics". Despite the lack of inflation, things have been quietly improving for the Japanese economy, with a rebound in business and consumer spending resulting in seven straight quarters of growth and an unemployment rate at 23 year lows.

The shifting landscape of emerging market equities allowed them to 'double dip' on the benefits of both the synchronized global growth and secular growth themes. After struggling to keep up with their developed market peers for most of the past six years, emerging markets were the year's top performer. In particular, the cyclical components of emerging markets are beneficiaries of a rebound in global trade and stability in the US dollar. Similar to the story in the US, technology shares with secular growth drivers were strong performers as Asia's 'BAT' stocks (internet giants Baidu, Alibaba and Tencent; Asia's version of the US' 'FAANG' stocks) surged higher.

## 2018 Capital market outlook strikes a balance

**Heading into 2018, we believe the world economy and financial markets are progressing through the later stages of the business cycle.** We feel that the global economy has enough momentum and that inflation and financial conditions will remain accommodative long enough that we continue to favour equities over fixed income. Within that outlook, we acknowledge the attractiveness of equities over bonds on a risk-adjusted basis has narrowed. The result strikes a balance - a tempered risk-on position with a slight overweight in equities. For more on what capital markets may hold for 2018 and beyond, please see GLC's 2018 Capital Market Outlook.

### 2017 Canadian Bond Market Performance

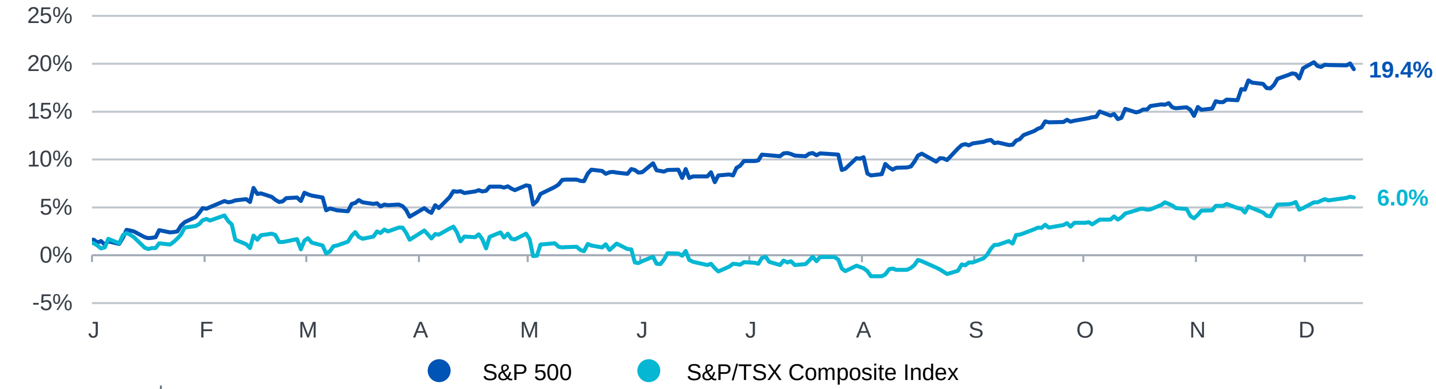



### Canadian Interest Rates

| Treasury Bills | | | 1-Yr Change[1] |
|---|---|---|---|
| 3-month | 1.06% | ▲ | 60 bps |
| **Government of Canada Bonds** | | | |
| 2-year | 1.69% | ▲ | 94 bps |
| 10-year | 2.04% | ▲ | 32 bps |
| 30-year | 2.26% | ▼ | -5 bps |

Source: Bloomberg │ 31 Dec 2017 │ 1. Change in basis points from 1 Jan 17 to 31 Dec 17

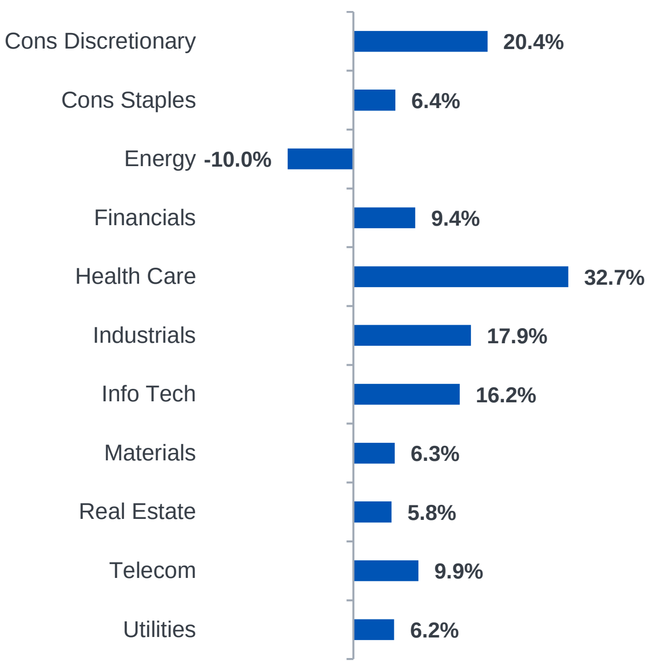
## 2017 Canadian and US Equity Performance



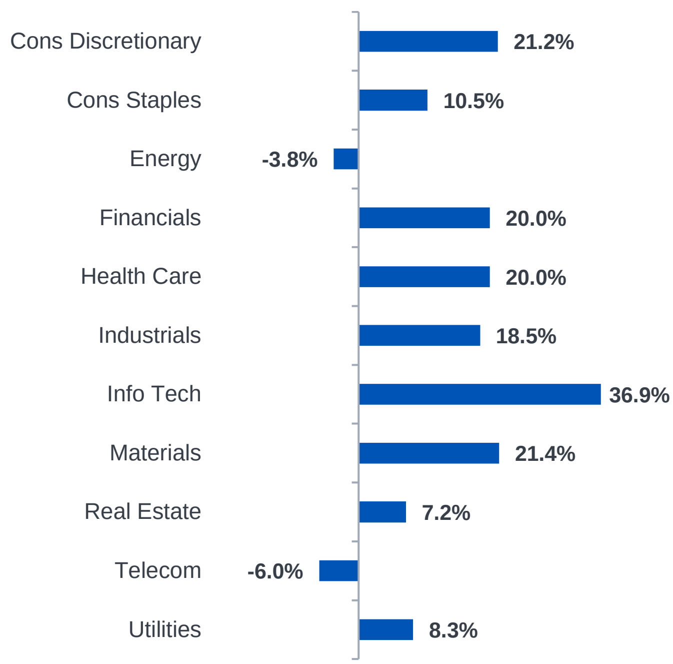

Source: Bloomberg | 31 Dec 17

## 2017 Sector Returns

### S&P/TSX Composite (CAD)




### S&P 500 (USD)




Source: Bloomberg | 31 Dec 17

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