Striking a delicate balance

EXECUTIVE SUMMARY

glc asset management

2019 Capital Market Outlook

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The World at Large: All things in moderation

Step back from the edge. Big corporate earnings and bull market gains have lured some investors to believe it will be different this time and to move toward, and beyond, the edge of their normal investing comfort zone. Others have been more sensitive to the recent market volatility, with 2008 flashbacks tempting them to bail on long-term investment plans. Our advice to both is the same: step back from the edge – away from the emotional extremes of risk aversion, or over-confidence. **A fact-based and reasoned look at current market conditions leads us to our 2019 Capital Market Outlook. Using our analysis, we outline ways to de-risk your portfolio AND remain invested toward your long-term goals.**

"Excessive sorrow laughs. Excessive joy weeps."

– William Blake, English poet, painter and printmaker, 1757-1827.

The general theme underpinning our outlook is moderation.

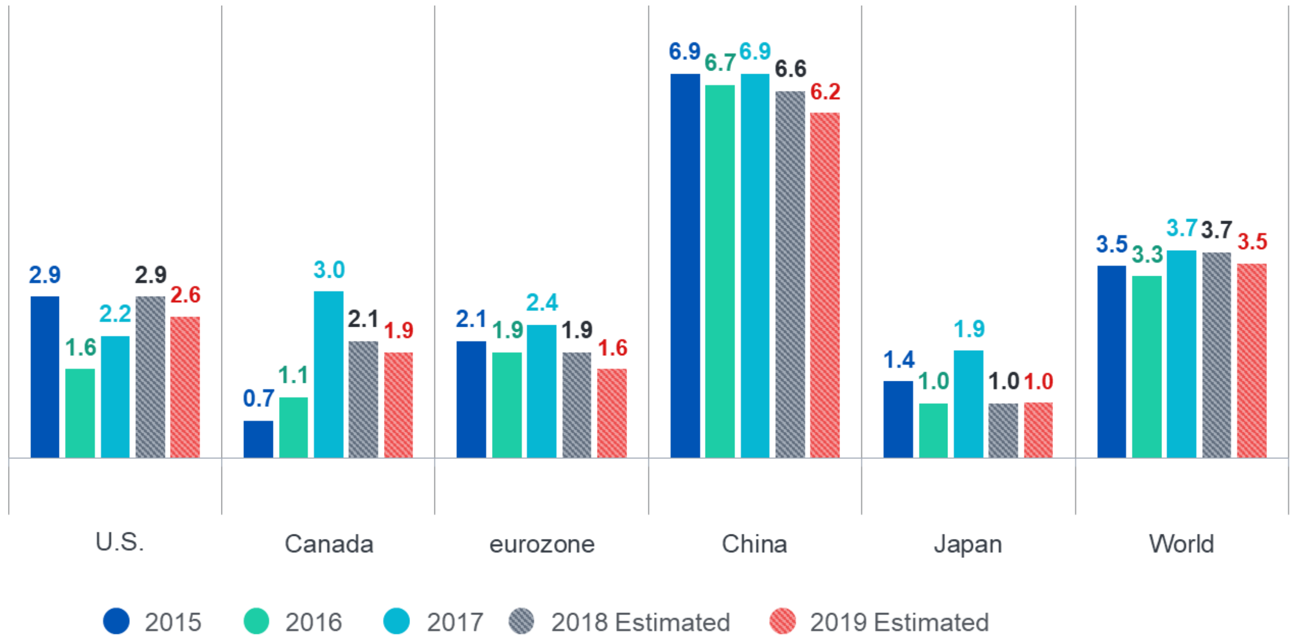
For market cycles, we believe acceleration is followed by moderation, before eventually giving way to decline, with moderation being a normal, albeit less desirable stage. Importantly, this means growth has peaked, but that does not immediately give way to economic or corporate earnings decline, rather just lower growth. ***Today's debate is around how much global economies and corporate earnings will grow and, importantly, not how much will they shrink.***

Shifts in corporate earnings, bond yields and equity valuations are changing the opportunity costs of all asset classes, resulting in narrowed expected outcome differentials between asset classes. On the macro-economic side, all manner of politics, geopolitical risks, trade and inflation are creating unique concerns for various regions and industry sectors around the globe. All these factors combine to increase today's complex task of finding a path forward.

From a top-down asset class level, we recommend a neutral stance (risk-tolerance aligned); this is neither overweight in bonds or equities. Under the current climate of increased volatility, slowing economic growth and rising interest rates (i.e., the tell-tale signs of progress through the later-stage of a market cycle), we believe a balance between risks and opportunities can best be achieved by fine-tuning portfolio positions within asset classes.

1.1 | Real GDP growth, year-over-year percent change

Moderating global GDP growth



Source: Bloomberg | Dec. 7, 2018

Bottom line: We believe a neutral stance (within one's personal risk tolerance) with a defensive bias is most appropriate for today's investors. Our 2019 Capital Market Outlook calls for equity price gains between 9 and 12%; we suggest continued exposure to participate in equity market growth without stretching one's risk tolerance. **Within equities, we recommend broad and diversified geographic and sector allocations – with a slight overweight to Canadian and U.S. equities, and neutral non-North American developed market equities with an underweight in emerging markets. For fixed income investors, we see a 1 to 2% total return in 2019 for the Canadian asset class as a whole, with an overweight in investment grade corporate and government bonds.**

GLC Outlook Summary

[1] From June 2018.

	Change in view[1]	Under	Neutral	Over
Fixed income	=	○○○	○●○	○○○
Government bonds	▲	○○○	○○●	○○○
Investment grade corporate bonds	▼	○○○	○○○	○●○
High-yield corporate bonds	=	●○○	○○○	○○○
Equity	=	○○○	○●○	○○○
Canada	=	○○○	○○●	○○○
U.S.	=	○○○	○○●	○○○
International	=	○○○	○●○	○○○
Emerging markets	=	○○●	○○○	○○○

Fixed income

Fixed income's value as a risk-mitigation tool has increased, and continues to increase, the longer we go in the cycle. Bond yields have moved up such that income flowing is now better than it has been for the past two years. We expect further increases in bond yields, which will erode some of the income component, but the yield increases we forecast will leave a small positive total return. Maintain a neutral weighting in fixed income, with a move toward higher credit quality. Our base case scenario calls for a total bond market return in 2019 between 1 and 2%.

Government bonds

Government bonds are attractive for their superior risk-mitigation qualities. Sovereign bond yields have risen enough that they can provide an income component while delivering the highest level of upside in the event of a risk-off scenario.

Investment grade corporate bonds

We see investment-grade corporate bonds as most attractive given their mix of yield pickup and modest safety. We expect investment-grade corporate bonds to outperform governments. Spreads have limited room for further tightening. Their generally shorter duration and higher running yield is a benefit in a rising rate environment.

High-yield corporate bonds

High yield spreads remain low. Given the very narrow spread levels and their lack of risk-mitigation characteristics, we see the risk/reward trade-off in high yield as unattractive.

Equity

We believe that the global economy and corporate earnings growth are shifting from acceleration to moderation (not decline), keeping our near-term outlook for equities constructive. Our expected return outcomes between equities and bonds, and amongst regional equity allocations, have narrowed. On a risk-adjusted basis, a neutral stance is most appropriate.

Canada

Canada is a favoured market due to its significant expected earnings growth and attractive valuations. These factors have existed for some time, with little appreciation. Canadian equities require a positive shift in sentiment to unlock their value.

U.S.

We hold a constructive view on U.S. equities based on reasonable valuations and earnings growth potential. Past peak, but a shift to a period of normalized earnings growth and improved valuations will help them post a high single-digit return. The return outlook, lower risk profile and diversification benefits lead us to maintain a slight overweight.

International

We hold a neutral view toward EAFE equities as the group offers a combination of reasonable earnings growth and valuations. Risks remain, but we see a moderation in many of the key risks through 2019 that allows EAFE equities to narrow the performance gap that has opened up against U.S. equities.

Emerging markets

We recommend an underweight to emerging markets, although some of the headwinds from a firmer U.S. dollar, global bond yields trending higher and moderating Chinese growth are set to abate (not disappear). The risk profile of this asset class tempers any enthusiasm at this stage of the market cycle.

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