Economic and Financial Environment

As at March 31, 2018

Geopolitics and volatility

By Sébastien Mc Mahon, M.E.Sc., PRM, CFA
Economist
Industrial Alliance Insurance and Financial Services Inc.

The great geopolitical chessboard is undergoing a major transformation.

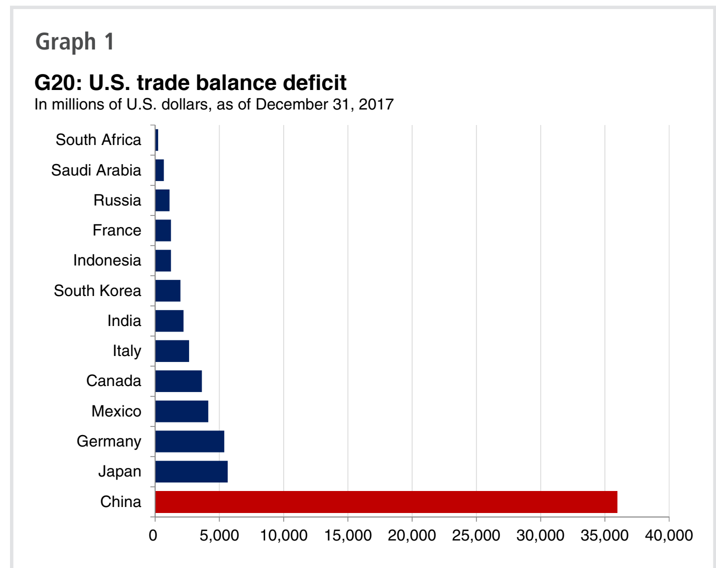
Chinese President Xi Jinping has just been proclaimed president for life, which should give him ample time to complete his plan: to make China the flagship of the global economy for centuries to come.

Over the last few years, Mr. Xi has worked to consolidate his power so as to put himself in a position where he can redefine China's international zone of influence and, insofar as possible, make up his own rules within it. All this at a time when some people are questioning U.S. leadership, thereby creating a void that China is ready to fill.

All world leaders will likely agree that China does not play by the rules when it comes to international trade, especially in terms of respecting intellectual property. This is therefore the context for the current U.S. trade offensive: the American giant is seeking to rein in its rival by trying to impose, at minimum, a playing field where the rules of the game are the same for everyone. Despite their considerable size, the Americans will not be able to do this alone, which explains the strategy of encouraging commercial partners (by means of threats of tariffs on processed metals) to join them in forming a common front.

The real risk here is that of embarking on an escalating spiral leading to a trade war between the planet's two largest economies. While this does not seem likely at the moment, it would still seriously upset the global geopolitical balance.

On the financial markets, volatility was back in force in the first quarter. We could not have expected the environment of a near absence of volatility on the stock markets to continue forever, and pessimists were rewarded in February when the majority of stock markets fell more than 10% in just a few days. Once again, this was a purchasing opportunity, and it will likely be advisable to adopt an active behaviour in 2018 so as to benefit from the return to healthy volatility.



World: A spectre of protectionism hovers over the planet in 2018

The tone for the 2018 economic year was set by the Trump administration: threats of protectionist measures are sprouting everywhere. It all began last year, of course, with the start of North American Free Trade Agreement (NAFTA) renegotiations, but the U.S. strategy became clearer during the first quarter.

First, in early March, the U.S. announced the expansive imposition of customs tariffs on steel and aluminum imports, under the pretext of national security. Fortunately for Canadians, exemptions were quickly announced for our southern neighbour's key allies, including Canada and Mexico, which found itself directly in the line of fire of a strategy that was clearly targeting China, which is responsible for 40% of the U.S. trade deficit (Graph 1). Initially, the means seemed poorly chosen since, while China is certainly one of the world's most important producers of processed metals, it accounts for only a very small share of this market in the U.S. (Graph 2).

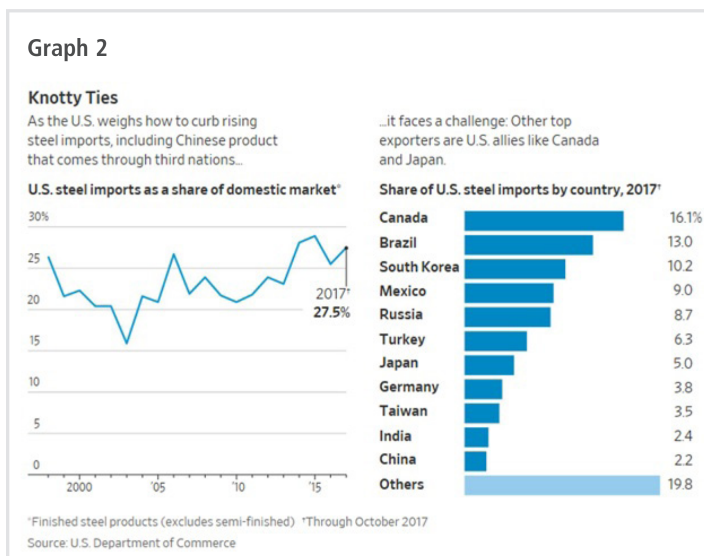
This announcement was met primarily with outcry.

Despite an initial sharp reaction, especially in Europe, where threats of retaliation quickly burst forth (in fact, Europe is already working on imposing a digital tax, targeting U.S. giants such as Google and Facebook), a consensus seems to have slowly taken shape among the world's politicians. They recognize that China is acting unfairly in several areas of trade, especially with regard to intellectual property, and it is high time for the international community to unite and form a common front.

From this angle, the U.S. strategy appears to be hitting true: by putting pressure on its primary trading partners with threats of protectionist measures, it seems to be succeeding in obtaining their cooperation in the response to give to China. It is important to remember that any foreign company wishing to operate on Chinese territory is obligated to enter into partnership with a local company and, incidentally, to give it access to its technology.

Turning to economic data, Japan is attracting increasing attention.

There have now been eight consecutive quarters of positive economic growth in Japan (Graph 3), after two full decades of false starts and sticking in the mud. After emerging victorious from his early-election gamble in the fall, Shinzo Abe has been able to continue pursuing his three-arrow plan (ultra-accommodating



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monetary policy, fiscal stimulus and structural reforms), which now seems to be bearing fruit. Inflation, which had eluded Japan for more than twenty years, is now heading steadily toward the 2% target (Graph 4). This makes the Bank of Japan confident that it, too, will eventually be able to normalize its monetary policy. But caution is still required, and the bank's governor, Haruhiko Kuroda, does not expect to make any changes in direction until at least 2020.

One of the main goals sought by the Abe government was to raise women's participation rate in the labour market; at the moment, the results are highly encouraging. The net effect is that total employment has risen in Japan, despite a decline in the overall population (Graph 5). This is therefore quite an achievement for a country feeling the full brunt of an ageing population.

Europe: Good news continues

The Old Continent has just had its best economic year in over ten years, and all indications are that 2018 will be a good one too.

Economic growth in the eurozone was at its highest since the financial crisis, growing at a pace of 2.7% in 2017. Household confidence was also strong at the start of the year, despite a slight drop as compared to the 17-year high reached last quarter.

All this momentum is reflected in the evolution of the European credit cycle, which continues to accelerate for both households and businesses (Graph 6). And this is precisely the result sought by the European Central Bank (ECB), which for the last two years has maintained one of the most accommodating monetary policies on the globe, with a negative key rate and monthly bond purchases on the secondary market (a measure commonly known as quantitative easing).

There has also been continuous improvement on the job market.

The rate of job creation in the eurozone surpassed 1.5% in 2017, a level not seen since the end of 2007, a clear acceleration since 2014, and even outpacing the U.S. (Graph 7). In fact, one will recall that the eurozone lost jobs in 2012 and 2013!

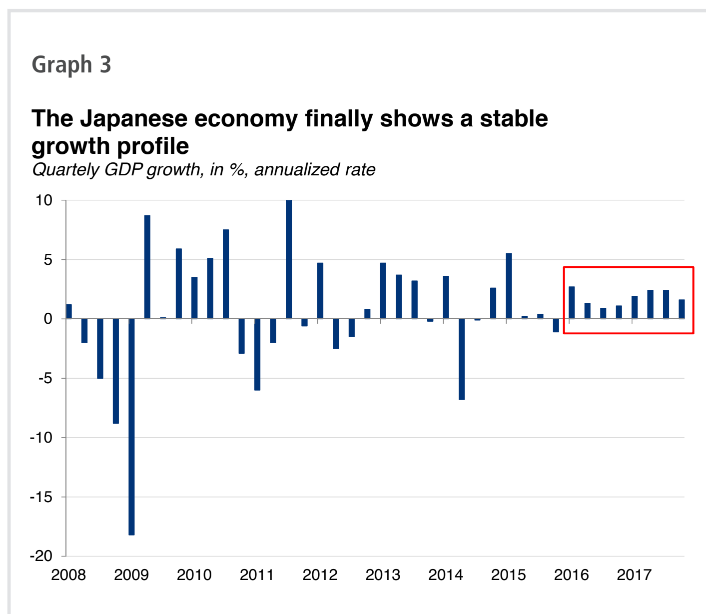

Chart 1
Returns of the Canadian Bond Market as at March 31, 2018

Index	Returns (%) 3 months	Returns (%) 1 year
FTSE TMX Canada Universe Bond Index	0.1	1.4
FTSE TMX Canada Short Term Bond Index	0.2	(0.4)
FTSE TMX Canada Mid Term Bond Index	0.0	(0.5)
FTSE TMX Canada Long Term Bond Index	0.0	5.1
FTSE TMX Canada Federal	0.3	(0.2)
FTSE TMX Canada Provincial	(0.3)	2.6
FTSE TMX Canada Municipal	0.0	2.9
FTSE TMX Canada Corporate	0.3	1.8

This sharp improvement of the situation is such that the unemployment rate within the eurozone reached 8.7% at the end of 2017, a high level by North American standards but which nonetheless represents significant progress compared to levels of over 12% in 2013. Looking more closely at a reduced sample of the 28 largest economies of the region, the unemployment rate dips to 7.3%, a level that is barely a few tenths of a percentage higher than the pre-recession lows observed in early 2008 (Graph 8).

All this progress was sufficient to convince the ECB to prepare the ground for the following stage: normalization of its monetary policy. At this time, the ECB is gradually reducing the size of its monthly bond purchases with a goal to ending them by September 2018.

Meanwhile, investors are looking everywhere for hints of when the first hike of the ECB's key rate might occur.

A first signal was perhaps given in March, when the ECB communicated its most recent decision. Although the Governing Council opted to maintain the status quo, the press release accompanying this statement no longer mentioned the possibility of extending or increasing the size of the monthly purchases, marking a significant change in tone.

Some media then reported comments by members of the council suggesting that a strategy of gradually raising the key rate could be implemented starting in the first half of 2019. We therefore expect changes in European monetary policy to exert upward pressure on global interest rates in the coming year.

United States: Year 2 of the Trump era

We are now entering the second year of Donald Trump's presidency, and it seems that this year could be even more eventful than the first.

While 2017 was clearly focused on the domestic economy (e.g. deregulation of the financial sector, major tax reform), it seems that the Trump administration is looking outside the country in 2018. Beyond the inflammatory declarations, the U.S. trade strategy is starting to take shape.

It all began, as mentioned above, with the 2017 launching of the renegotiation of NAFTA, the most important trade agreement on the planet. No one questioned

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Chart 2
Market Returns as at March 31, 2018

Index	Returns (%)	
	3 months	1 year
FTSE TMX Canada 91 Day T-Bill Index	0.3	0.8
FTSE TMX Canada Universe Bond Index	0.1	1.4
S&P/TSX Composite Index	(4.5)	1.7
S&P 500 (Can. $)	2.1	10.2
MSCI - EAFE (Can. $)	1.3	11.0
MSCI - World (Can. $)	1.6	9.8
Exchange Rate (Can. $ / US $)	2.9	(3.3)

Chart 3
Market Returns as at March 31, 2018

Index	Returns (%)	
	3 months	1 year
S&P/TSX Sector returns		
Energy	(9.4)	(10.9)
Materials	(4.3)	(2.9)
Industrials	(2.6)	10.7
Consumer Discretionary	(2.9)	11.4
Consumer Staples	(5.9)	(1.2)
Health Care	(13.5)	29.0
Financials	(3.5)	5.7
Information Technology	10.2	20.3
Telecommunication Services	(6.7)	2.0
Utilities	(5.9)	(2.8)
Real Estate	0.5	6.8
S&P/TSX Composite Index	(4.5)	1.7

the need to update the terms of this 25-year-old agreement, which no longer accurately reflected the North American reality. At the same time, the exercise provided the President with a test bench to prepare his negotiation strategy for his real target: China.

In addition to its practices of not respecting intellectual property, China is commonly accused of flooding certain markets, such as steel, with products sold at prices considered to be unreasonably low, an obvious advantage for the Chinese who operate under a controlled economy where the government can direct the use of resources as it sees fit. For example, the Chinese government can acquire international market share by directing loans and workers into a particular sector, resulting in lower production costs than its competitors.

This therefore brings us to the slapping of tariffs on aluminum and steel, which at first glance seem to miss the true mark, but which, upon closer inspection, are perhaps merely a bargaining tool for the Americans vis-à-vis their trading partners. Any country wishing to be exempted from these tariffs is encouraged, among other conditions, to side with the U.S. on the issue of China's trading practices.

After this initial phase, the Trump administration proceeded to the second step at the end of March, with the announcement of tariffs targeting approximately US$50 billion in goods imported from China. It also announced its intention to drastically limit access for Chinese companies wishing to make acquisitions on U.S. soil. China's response was restrained, and at the end of the quarter, constructive negotiations appeared to be taking place toward a friendly resolution to the situation. As always, the devil will be in the details, but there seems to be a genuine willingness to avoid a trade war between the world's two biggest economies.

In terms of economic data, the first quarter was once again characterized by a slowing in GDP growth. Even though we expect the first world economy to perform well in 2018, stimulated by the effects of the tax reform, consumption is flagging.

The fact that the household savings rate was near historic lows (Graph 9) already suggested that consumer spending was likely to slow, but the situation should change course during the year once the wealth effect, resulting from income tax cuts, takes hold. We also expect an increase in business investment spending. Like households, businesses will benefit from lower tax rates and have declared their optimism for the long-term outlook (Graph 10).

Finally, the U.S. Federal Reserve (the Fed) raised its key interest rate for the first time in 2018 on March 21. It was the Fed's first decision under the chairmanship of Jerome Powell, who has officially taken over from Janet Yellen.

In short, although the Fed acknowledges the slight slowdown seen at the beginning of the year, it has revised its growth expectations upward for the coming years. However, the Fed does not foresee any imminent increase in inflation, which the markets perceived as a cautious approach. We now anticipate four interest rate hikes in 2018, followed by three or four additional rate hikes in 2019.

Canada: Maintaining cruising speed

The Canadian economy is expected to grow at a slower pace than our southern neighbours in 2018, but there is no cause to worry as all signs point to green.

As in the U.S., the economic indicators in Canada showed a definite slowdown at the start of the year. Whether it was in manufacturing sales, international trade or retail sales, there was a deceleration or a weaker-than-anticipated recovery in activity.

However, this softness in economic data was not sufficient to prevent the Bank of Canada from going ahead with another increase in its benchmark interest rate in January. The Bank even noted the surprising vigour of the economy in 2017 as well as notable improvements in the job market, which is currently sporting its lowest unemployment rate since 1976 (Graph 11).

The Bank is now turning its focus to the NAFTA negotiations, which we believe are taking a positive turn.

Initially, the most recent round of talks, held in early March, seemed to have ended on a sour note, with the U.S. representative repeatedly asserting that that time was becoming too short to reach an agreement (coming elections in Mexico, Ontario and Quebec could likely cloud the issue).

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Chart 4
Asset mix: Diversified Fund (040)

	Min.	Neutral	Max.	Actual Weight	Over Weight (+)/ Under Weight (-)	Change in quarter
Money Market	**0**	**5**	**25**	**6.0%**	**+1%**	**-2.0%**
Gold (ingot)		**0**		**2.5%**	**+2.5%**	**+0.5%**
Canadian Bonds	20	45	70	27.0%	-18.0%	-4.0%
International Bonds	0	0	15	0.0%	0.0%	0.0%
Total – Bonds	**20**	**45**	**70**	**27.0%**	**-18.0%**	**-4.0%**
Canadian Equities	**5**	**25**	**45**	**38.0%**	**+13.0%**	**+7.0%**
U.S. Equities	0	12.5	45	13.0%	+0.5%	-0.5%
International Equities	0	12.5	45	12.5%	0.0%	-2.0%
Emerging Markets	0	0	45	1.0%	+1.0%	+1.0%
Total – Foreign Equities	**5**	**25**	**45**	**26.5%**	**+2.0%**	**-1.5%**
Total – Portfolio		**100**		**100.0%**		

But to everyone's surprise, since then the media have reported that the negotiation climate has shifted, and that all parties are keen to reach an agreement quickly. The Americans have apparently even agreed to abandon some of their more controversial demands regarding the rules of origin in the auto industry (they initially demanded that every car produced in North America contain at least 50% U.S. content), thereby removing at least one major obstacle. It is highly likely that a significant concession will be demanded of Canada and of Mexico in exchange for withdrawing this requirement, but as the next round of negotiations approaches, the tone appears optimistic.

Canada's federal government tabled Budget 2018 in March. To the surprise of many economists, it did not contain any measures for stimulating Canadian business competitiveness. This, despite the fact that several analysts had encouraged the minister of finance, Bill Morneau, to react to the U.S. tax reform with measures seeking, at the very least, to maintain the relative competitiveness of Canadian businesses. Businesses will therefore have to remain patient, since Mr. Morneau has stated that the Canadian tax system is already among the most advantageous in the world.

The main tax measure announced in the 2018 budget was, instead, improving the Canadian parental leave program, which will now be more generous for fathers of new children. The goal is to foster women's participation in the workforce. This type of measure has already proven its worth in Quebec, where the employment rate of women aged 25 to 44 has jumped since its implementation more than 20 years ago (Graph 12).

The Governor of the Bank of Canada, Stephen Poloz, referred to this new measure directly in one of his speeches, noting that its implementation could increase the number of Canadian workers by 500,000, potentially boosting the country's level of economic activity by 1.5%.

Moreover, this budgetary measure seems to be influencing the governor with regard to monetary policy for the next few years; he considers the Canadian economy to be well positioned and that it is the Bank's duty not to stifle its momentum. We are still expecting two to three rate hikes in 2018.

Financial markets: Volatility makes a comeback

As we had anticipated, volatility made a strong comeback in 2018, with stocks posting negative first-quarter returns—a first in nearly three years. It should be remembered that 2017 was one of the least volatile years in the S&P 500's long history and that, in this context, the question that investors should have been asking themselves was not if volatility would return, but when.

The month of January had, however, begun on a highly positive note, with the S&P 500 up more than 5%, one of its best starts to a year. A number of media circulated the idea of a possible "melt-up," that is, a euphoria pushing up stock prices in a way typically seen during the formation of a speculative bubble. Optimists looked to upward revisions of U.S. corporate earnings growth rates, as the tax reform is expected to boost earnings for these companies by roughly 18% in 2018.

February marked a turning point, as the gradual raising of interest rates and, more precisely, the fear of an overly quick tightening of U.S. monetary policy (triggered by a sudden increase in wages in the U.S., which turned out to be just a temporary effect of the minimum wage hike in some states) caused markets to fall. There was nothing benign about this, as it was the fastest correction of more than 10% recorded in S&P 500 history.

Moving forward, the geopolitical backdrop combined with the anticipated tightening of U.S. and European monetary policies should help maintain a climate of healthy volatility on the stock markets for the coming months.

More specifically, there seems to be a growing desire to accelerate the normalization of U.S. monetary policy; over the last few months, the majority of voting members of the Fed's decision-making committee have adopted a more hawkish tone. The recent publication of the committee's forecasts showed that 7 of the 15 members now expect the Fed to go ahead with four rate hikes in 2018, a marked increase since December, when only 4 of 16 members were of such opinion.

Add to this the potential end to quantitative easing in Europe in the fall, and we can expect the bond market to be under pressure throughout the year. It was in fact interesting to note the near-absence of reaction in interest rates during the February correction, suggesting that the bond bull market is well and truly over.

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Chart 5
Estimated Gross Returns for the Next 12 Months Starting on March 31, 2018

Market indicators	Interest or dividend	+	Capital gains	=	Total estimated gross return
FTSE TMX Canada 91 Day T-Bill Index	2.60%	+	2.20%	=	0.40%
FTSE TMX Canada Universe Bond Index	3.35%	+	(6.60)%	=	(3.25)%
Canadian stocks (S&P/TSX Composite Index) including dividends					9% to 11%

In the first quarter, the Canadian bond market, as measured by the FTSE TMX Canada Universe Bond Index, posted a slim gain of 0.1%. The FTSE TMX Canada Short Term Bond Index delivered a return of 0.2%. Finally, the FTSE TMX Canada Long Term Bond Index stayed flat at 0.0%.

The U.S. stock market, measured by the S&P 500 Index, offered a return of -0.8% in the first quarter (+2.1% in Canadian dollars), its first quarterly drop in nearly three years. The Canadian stock market also underperformed, down 4.6% for the first quarter.

Stock markets in Europe and Asia were hit by the sharp return of volatility as well. The European market, represented by the MSCI - Europe Index, lost 4.4% (+1.0% in Canadian dollars), the MSCI - EAFE Index fell 4.3% (+1.3% in Canadian dollars), and the MSCI - World Index dipped 2.2% (+1.6% in Canadian dollars). The emerging markets, measured by the MSCI - Emerging Markets Index, once again managed to pull to the front of the pack with a gain of 0.8% (4.4% in Canadian dollars).

Strategy: The return of volatility demands active management

The financial environment should offer good opportunities for active investors in 2018.

We still recommend staying overweight in equities, since the combination of a robust world economy and a gradual return of inflation provides a good base for riskier asset classes to do well. The impact of tax reform south of our border should not be overlooked, as it is likely to contribute to strong growth in U.S. corporate earnings. In short, although the road may be bumpy, returns should be positive by the end of the year.

Even though we remain optimistic about U.S. equities, we prefer to concentrate this overweight outside the U.S., for two reasons.

First, valuations of the Canadian, European, Japanese and emerging markets are currently at historically low levels relative to the U.S. market (Graph 13).

The Canadian stock market lagged behind considerably at the start of this year, and its underperformance, in Canadian dollars, even reached over 10% at one point in relation to the U.S. market. Foreign interest for Canadian stocks, and more generally for energy stocks, has been rather weak for the last few months, causing us to see growth potential over the coming quarters. In our opinion, it would take just a few positive surprises in the NAFTA negotiations for foreigners to become interested in Canada once again, which would bolster both the S&P/TSX Index and the loonie.

Second, an analysis of the historical behaviour of the U.S. stock market shows that the price-to-expected-earnings ratio for the S&P 500 tends to drop an average of 2.5 points whenever the Fed is in the process of tightening its monetary policy. In other words, under the hypothesis of a strong compression equivalent to the current ratio (estimated at 17.0X at the end of the first quarter) in the next 12 months (thereby dropping to 14.5X), the impact could be a 15% decrease in anticipated profits. Given that anticipated growth for earnings is around 18%, this aggressive scenario points to a rather low potential return for the U.S. stock market in 2018.

The Diversified Fund's exposure to equities increased significantly in the first quarter, as we considered the episode of the 10% drop in equities to be a good buying opportunity. This overweight is not supported by a holding of index put options, given the high level of volatility which makes the options expensive in our view. In fact, we sold our holding of options during the violent upswing of the VIX Index in early February, at a very attractive price.

At the end of the quarter, Canadian equities represented 38% of the Diversified Fund, compared to a total of 29% for foreign equities.

More specifically, the weight of Canadian equities jumped significantly during the quarter, for two reasons. First, we sought to take advantage of the opportunities provided by the return of volatility on the markets, by making purchases during the February correction. Second, the attractive relative valuation currently offered by the Canadian stock market compelled us to gradually build a strategic overweighting of Canadian equities, which accounted for 35% of the fund's size by the end of the quarter. Added to this is a weight of 3% in Canadian preferred shares, which we continue to favour given our expectations of higher interest rates.

We have maintained an underweighting in bonds, in light of the international trend toward monetary policy tightening, as well as the new prospects for increases to the Canadian key interest rate in 2018. We have nonetheless maintained a dynamic management strategy of maturities in relation to our peers over the quarter, taking positions in long-term U.S. bonds in order to protect the portfolios in the case of a stock market decline and to benefit from long-term U.S. rates, which appear well ensconced for the moment.

The weighting of bonds decreased to 27%, a level that remains well below the 45% target, due to the good performance of the asset class. The reduction in bond weight was achieved through the sale of short-term Canadian bonds, which were exposed to underperformance should the Bank of Canada raise its key rate.

Cash is now close to target at 6%, which gives us the possibility of taking advantage of any opportunities that present themselves on the stock markets.

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Chart 6
Economic and financial scenarios

Economic scenario

		2016	2017	2018	2019	2020	Change since December 31, 2017: 2018	Change since December 31, 2017: 2019
United States	Real GDP	1.5%	2.3%	2.8%	2.5%	2.2%	+0.3%	+0.3%
	Inflation rate	1.3%	2.1%	2.5%	2.3%	2.3%	+0.4%	+0.1%
	Unemployment rate	4.9%	4.4%	3.9%	3.7%	3.7%	-0.1%	-0.1%
Canada	Real GDP	1.4%	3.0%	2.2%	1.8%	1.8%	--	--
	Inflation rate	1.4%	1.6%	2.3%	2.2%	2.1%	+0.2%	+0.2%
	Unemployment rate	7.0%	6.3%	5.9%	5.8%	5.8%	-0.1%	-0.2%

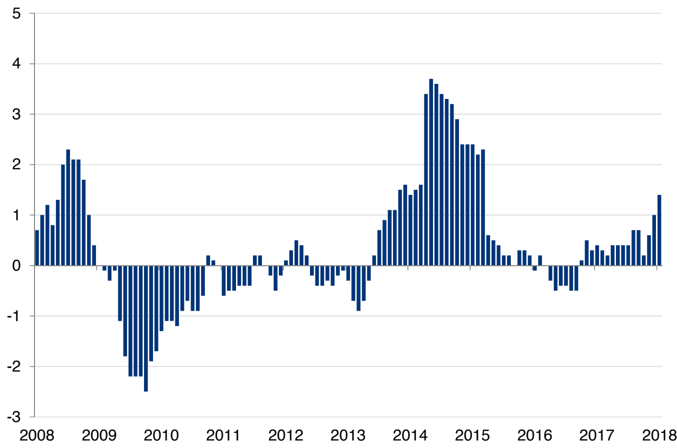
Financial scenario*

		Actual	Targets: June 2018	Targets: Dec. 2018	Targets: June 2019	Change since December 31, 2017: June 2018	Change since December 31, 2017: Dec. 2018
Interest rate							
	U.S. 10-year rates	2.75%	2.90%	3.25%	3.50%	+0.20	+0.30
	Canada 10-year rates	2.10%	2.50%	2.75%	2.95%	+0.15	+0.15
Exchange rates							
	US $/Can. $	0.8	0.8	0.82	0.85	-0.03	-0.02
	US $/Euro	1.18	1.22	1.23	1.25	+0.02	+0.01
	Oil price (WTI), US $	51.67	65	67	68	+6	+7
	S&P 500	2,519	2,100	2,950	3,050	+120	--
	S&P/TSX	15,635	17,175	17,825	19,075	+525	--

* end of period

Graph 4

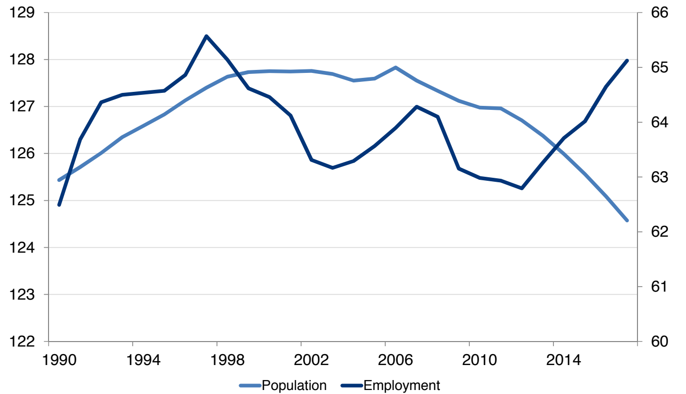
Japan: Inflation on the way to 2%



Graph 5

Japan: employment is growing even with a declining population

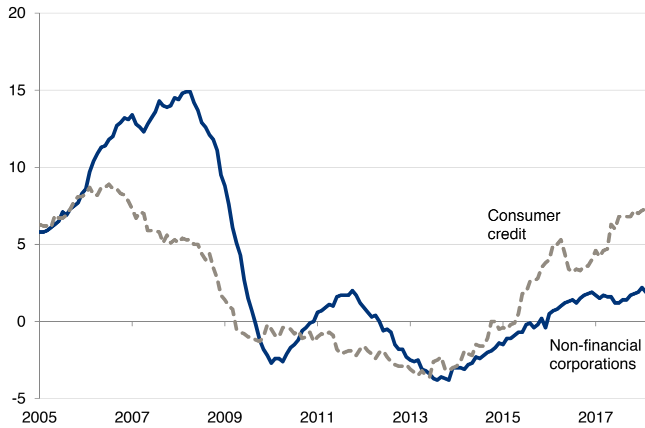
Employment and population, in millions, IMF data



Graphique 6

Eurozone: Credit cycle is accelerating

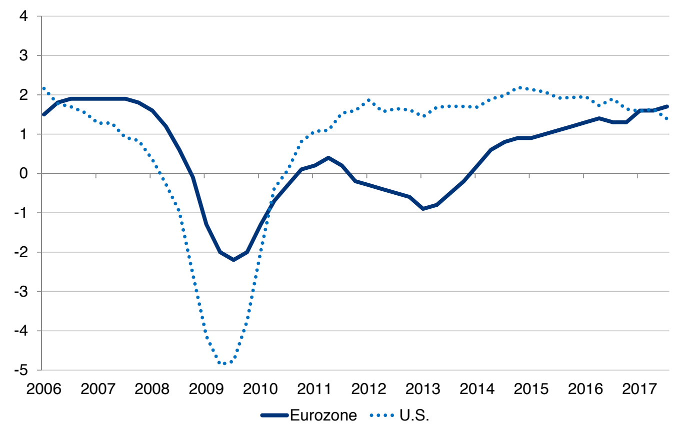
Loans by monetary and financial Institutions, YoY % change



Graph 7

Eurozone: Annual growth in total employment

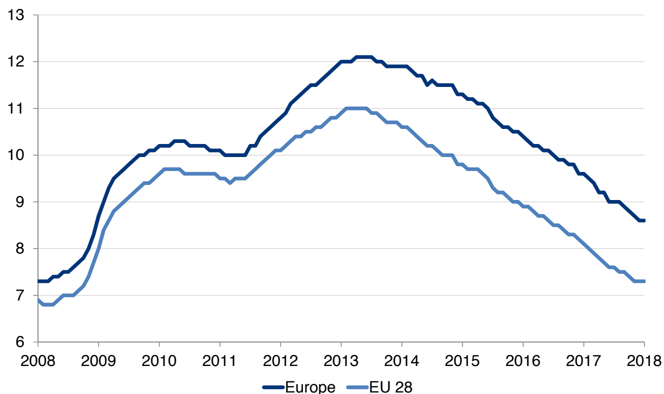
Annual growth rate, %



Graph 8

Europe: Unemployment sharply lower since the 2012 peak

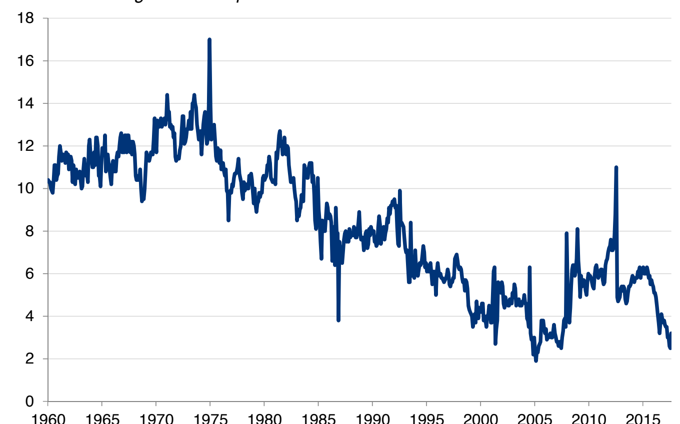
Unemployment rates, %



Graph 9

U.S.: Personal savings rate

Personal saving as % of disposable income

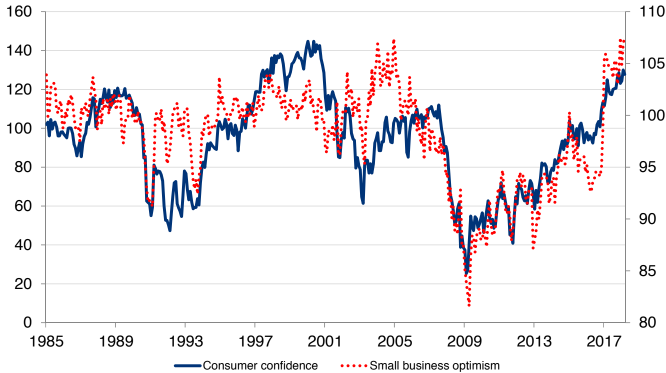


Economic and Financial Environment (continued)

Graph 10

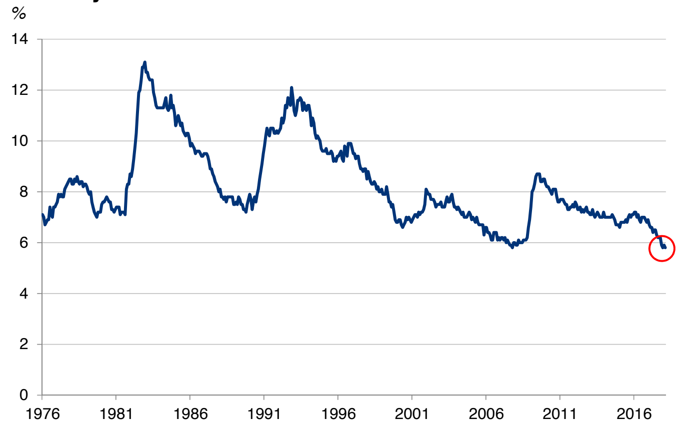
U.S.: Confidence runs high for consumers and small business owners

Conf board consumer confidence (lhs) and NFIB small business optimism (rhs) indices



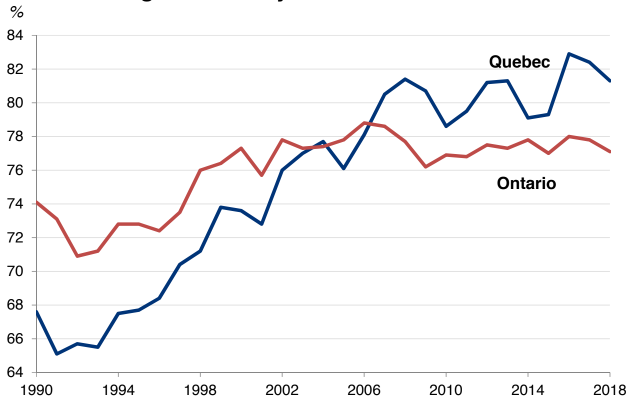
Graph 11

Canada: the unemployment rate is sitting at a 40-year low!



Graph 12

Quebec vs Ontario: Employment rate for women aged 25 to 44 years old



Graph 13

Equities: TSX, EAFE and EMs trading at relatively cheap levels vs S&P 500

Ratio of Fwd P/E, TSX, EAFE and EM vs S&P 500