GAVIN HOCKEY WEALTH SPECIALISTS

2019 Outlook

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Economic and Geopolitical Concerns Catch Up to Markets – The final quarter capped off a volatile 2018, with most asset classes producing negative returns for the year. Global equities fell sharply during the fourth quarter with some indexes entering bear market territory (20% or more below their 52-week high) in December. The one month drop in US stocks in December was the largest monthly decline since February 2009 and the worst December since the Great Depression. This shift was triggered by the base case economic outlook that a global recession was on the horizon as car sales fell 10%, crude retreated 45% from its recent peak and housing starts declined over 6%.

US government bonds and gold provided investors some insulation against the global selloff. The 10-Year US Treasury yield began the quarter around 3.07% but finished the quarter at just 2.69% while investment grade bond prices also turned higher after a difficult nine-month period.

INDEX TOTAL RETURN	4Q18	1-YEAR
MSCI All Country World Index (USD)	(12.75%)	(9.42%)
S&P 500 Index (USD)	(13.52%)	(4.38%)
S&P/TSX Compostie Index (CAD)	(10.11%)	(8.89%)
MSCI Emerging Markets (USD)	(7.47%)	(14.58%)
MSCI EAFE Index (USD)	(12.54%)	(13.79%)
Barclays Global Agg Bond Index (USD)	1.20%	(1.20%)
Barclays US Agg Bond Index (USD)	1.64%	0.01%

Source: Morningstar

Set-up More Positive Than 2018 But … – While forecasts are often a fool's game, particularly in the short-term, we can for the moment enjoy a victory lap on our 2018 predictions. In our outlook letter, we stated "a 10% setback is plausible if the Price-to-Earnings multiple backs up to 16.5x, even with a $150 earnings figure. However, at this point it appears that any pullback will be merely corrective as the emergence of a recession in 2018 is doubtful." With no recession emerging, the market experienced two 10% corrections, with new highs re-established following the February decline. Furthermore, our preference for bonds over stocks was also applicable, although our short duration did not result in a meaningful performance upgrade.

That was then, however, and this is now. Following a 20% decline in US equities from 09-Sep-18 to 24-Dec-18 and a solid corporate earnings year, valuations have been restored to more reasonable levels. The plunge also caused the State Street Investor Confidence Index to sink to its lowest level since 2012 and market breadth is at a level that is most often associated with turning points – the number of stocks trading above their 200-day average is just 20%. Nothing changes sentiment like price. This set-up bodes well for at least a short-term rally and we are slightly more constructive on US equities for 2019.

However, US stock valuations remain at the upper levels of historical ranges. The often cited cyclically-adjusted price-to-earnings (CAPE) multiple sits at 27.5x versus the 40-year average of 21.7x. Meanwhile, the Warren Buffett Yardstick (US equity market cap-to-gross national product) stands at 128%, well off its recent highs but nowhere near the 65%-75% range that has marked the last two major bottoms. Accordingly, valuations are not inexpensive and potential mean reversion in margins provide headwinds for material gains over the next four to five years.

After growing in sync for the last few years, economies around the world are now set for a downturn. Ned Davis Research, among a plethora of brokerage firms, are predicting a high probability of a global recession. Many international markets, particularly emerging markets, have already adjusted. Within our growth allocation, we prefer corporations with global exposure as well as commodity-linked equities given their favourable relative and absolute valuations, including energy, agriculture and precious metals.

GAVIN will maintain a disciplined and meaningful allocation of short-duration sovereign bonds as our bias is for a continued, albeit slow, cycle of rate increases over the next few years. US companies have ratcheted up $9 trillion in debt since 2008/09, or 46.2% of GDP, from about $5 trillion in 2007. There are $3 trillion of triple-B (BBB) bonds outstanding, comprising nearly half of the Investment Grade universe, up from about 20% a decade ago. If the cycle turns, investment grade corporate debt appears to be vulnerable.