Outlooks and insights

2018 Mid-Year Capital Market Outlook: Don’t overreach with aggressive, growth cycle positioning

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"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails."

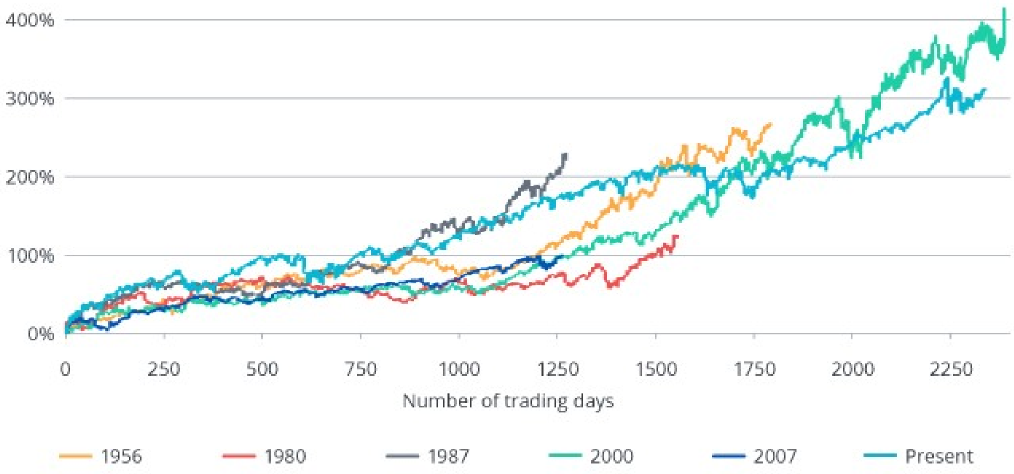
William Arthur Ward, American writer (1921-1994)

Time to adjust the sails

The world economy and financial markets continue to progress through the later stage of the business cycle.

This is not the time to overreach with aggressive, growth cycle positioning in an attempt to squeeze out every last drop of the ‘risk-on’ trade, which can put years of rationed, prudent financial planning at risk (see exhibit 1.1). We caution against extrapolating the trends of the past several years in the ‘darling’ sectors – things like emerging markets, information technology, or high yield bonds.

To view the full outlook report with all accompanying sections, tables and charts, please see the attached PDF reports at the bottom of this article.



Source: Bloomberg | 15-Jun-18

The late stage of the business cycle is often characterized by heightened volatility, the potential for sharp, short run-ups inequity prices, fast-moving price corrections, and rising bond yields. Any attempt to time each market gyration is a fool's game.

Although we see continued growth in corporate earnings, we expect the pace of earnings growth to slow. As such, **within equities, we recommend broad and diversified geographic and sector allocations – favouring Canadian and US equities over UK and emerging markets, and neutral exposure to Europe and Japan.**

Within fixed income we expect yields to move higher and continue to pressure overall bond returns. We anticipate the moves should take some time to unfold (4 to 6 quarters in our view), and will continue with the 'fits and starts' type of volatility we have seen thus far in 2018. As with equities, we see opportunities for investors to be selective in how they diversify their fixed income holdings. Given the mix of safety and yield enhancement, we recommend an overweight position in investment grade corporate bonds and alternative fixed income exposure (e.g. mortgages). High yield bonds as a whole do not look attractive to us and we suggest an underweight position. We view the current narrow level of high yield bond spreads (with very limited room for further tightening) and their lack of risk-mitigation characteristics as justification to avoid, or limit high yield bond exposure.

Bottom line: A neutral stance (risk tolerance aligned) is most appropriate for today's investors. A neutral stance provides exposure to participate in equity market growth without stretching one's risk tolerance. Our capital market outlook for the second half of 2018 calls for single digit equity price gains. For fixed income investors, we see flat to 1% total returns in the back half of the year.

GLC Outlook Summary

Fixed Income

Fixed income investors face a sideways market as slowly rising (normalizing) yields grind against the time required for higher coupons to make a positive contribution. Active management to navigate the yield curve and pick-up additional yield through credit instruments (e.g. provincials, mortgages and investment grade corporates) provides the opportunity for small, single digit positive gross returns.

Government Bonds

With rising yields, government bonds offer little upside, but their value as a risk-mitigation tool continues to rise the later in the market cycle we go.

Investment Grade Corporate Bonds
We see investment grade corporate bonds as most attractive given their mix of yield pick-up and modest safety. We expect investment grade corporate bonds to outperform governments, with less volatility than high yield bonds. Spreads have limited room for further tightening. Their generally shorter duration and higher running yield is a benefit in arising rate environment.

High yield Corporate Bonds
High yield spreads have moved down and we see very limited room for further tightening. 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 has enough momentum, and that inflation and financial conditions will remain accommodative long enough, that our near-term outlook for equities remains constructive. However, we believe we are in the late stage of the market cycle where increased volatility is to be expected and timing is extraordinarily tricky. On a risk-adjusted basis, a neutral stance is most appropriate.

Canada
Canada is a favoured market due to its greater sector leverage to global growth and firming commodity prices. Canada's valuations are more reasonable than their global peers. Trade, debt and sensitivity to higher interest rates remain risks.

US
We hold a more constructive view on US equities on improved valuations and earnings growth potential, but optimism is moderated by a number of factors: Rising bond yields will continue to weigh on valuation multiples; while we see demand remaining solid, we see a tougher environment ahead for corporate earnings growth as rising borrowing costs, wages and input prices erode profit margins; and finally, trade frictions remain a risk.

International
We hold a neutral view toward EAFE equities. With Europe (ex-UK) offering solid earnings growth, political risks linger and valuations offer little discount. UK equities are unattractive on earnings growth, valuations and Brexit risks. We hold a neutral view on Japan given muted earnings growth expectations and slowing economic growth in both Japan and China.

Emerging Markets
We recommend an underweight to emerging markets as they face headwinds from a firmer US dollar, global bond yields trending higher and moderating Chinese growth. The risk profile reinforces this underweight, as increased volatility and delicate timing provide incentive to underweight riskier, high-beta assets.

PDF documents

2018 Mid-Year Capital Market Outlook Executive Summary
pdf

2018 Mid-Year Capital Market Outlook Full

2018 Mid-Year Capital Market Outlook Full Report

pdf

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