A Bumpy Ride to the Finish Line

By Ian M. Riach

Equities worldwide experienced meaningful declines in the last quarter of 2018.[1] All major developed market indices fell by at least 10% (in local currency terms). Measured against the cyclical peaks reached a few months earlier, equity declines were even more significant and technically signalled a "market correction."[2] Concerns about trade relations with China, tightening US financial conditions and eurozone issues—including Brexit, Italy's budget deficit and "Yellow Vest" protests in France—combined to undermine investor confidence. In the face of this environment, bond prices rallied, sending yields down. The Government of Canada 10-year bond yield dropped from over 2.6% in October to under 2% at the quarter's end and the 10-year US Treasury yield fell to approximately 2.7% after rising above 3.2% during the period.

The S&P/TSX Composite Index's approximate 10% decline was fairly broad-based, with only three of 11 sectors posting gains. The largest contributors to the downward march were the heavily weighted Financial Services and Energy sectors, which fell about 11% and 17%, respectively. The flattening yield curve and concerns over high consumer debt loads negatively affected financial stocks. Oil and gas producers continued to be challenged by generally lower prices and, as importantly, faced wider price differentials—the gap between prices received in Canada and much higher world benchmark levels.

The US equity market decline was even more severe and more broadly based. The Utilities sector was the only one to post gains in the fourth quarter. President Trump's increased rhetoric about trade with China and his critical "tweets" of Federal Reserve Chairman, Jerome Powell, seemed to fuel already nervous investor sentiment regarding a US economic slowdown, which according to the speculations of many market pundits, could become a recession in 2019.

The situations in Italy and France added to political tensions in the European Union, already at acute levels due to the looming Brexit deadline. The general level of uneasiness, along with decelerating economic growth, contributed to a double-digit decline in the MSCI EAFE Index. The European Central Bank ending its quantitative easing program in December—implying inflation was appearing at a time when economic growth is decelerating—likely made matters worse. Broad economic and market weakness in Japan was also a factor.

Taking a Balanced Approach

It is at times like this that a balanced approach to investing proves its worth. While not immune from equity market declines, a portfolio that also holds bonds and cash can be somewhat buffered from the drops we experienced recently. While volatility is unnerving, it can present opportunities as asset prices drift from fair value. We will endeavour to use this mispricing to our advantage.

Market Performance (%)	Q4 2018	1-Year
S&P/TSX Composite Index	-10.1%	-8.9%
S&P 500 Index (CDN$)	-8.9%	4.0%
MSCI EAFE Index (CDN$)	-7.9%	-5.8%
FTSE TMX Canada Universe Bond Index	1.8%	1.4%
CDN$ Versus US$	-5.3%	-7.8%

The above Index reviews are calculated from external sources and, where applicable, reflect total returns. All figures are in Canadian dollars and are as at December 31, 2018.

1. All performance numbers sourced from Bloomberg Finance L.P. as at December 31, 2018.
2. A market correction is commonly defined as a decline of greater than 10% from a recent peak.