alizé capital

Gestion de portefeuilles / Portfolio management

La voie des Alizés

Navigating the Trade Winds

January 2019

In this issue:

- ***After the storm, a break in the clouds***
- ***The state of this economic cycle***
- ***The trade tensions***

Dear friends,

Stock markets fell abruptly and ended last year on a very sour note. The month of December was exceptionally brutal with a downdraft of 9.2% for the S&P 500, which was the worst performance since the 1930s. From the all time high of September to the trough of Christmas Eve, the pullback was a swift 19.8%, just shy of the infamous mythical bar of 20%. Luckily, the good performance of the greenback vs. our currency as limited the loss at 9.1% for the S&P 500 expressed in C$. In Canada, the S&P/TSX is down 10.9% for Q4, ending the year at -11.6%. The banking sector and the Oils did very poorly in the final quarter, the precipitous fall of the commodity accounting for the oils' patch bad performance. The year 2018 ended in a furious storm that must be placed in a proper context.

		Closing	Change**	
		31-Dec-18	Quarter	2018
Stock Indices *(% in C$)*				
S&P/TSX		14,323	-10.9%	-11.6%
S&P 500		2,507	-9.1%	1.7%
MSCI EAFE*		1,720	-7.9%	-9.1%
Currencies				
CAN$ (US$/C$)		0.7333	-5.4%	-7.8%
Euro (US$/EUR)		1.1471	-1.2%	-4.4%
Commodities (US$)				
Oil (WTI)	$	45.15	-38.3%	-25.3%
Gold	$	1,281	7.5%	-1.7%
Volatility Index				
VIX		25.42	+13.30	+14.38

** MSCI Europe, Australasia and Far East (US$)*
*** Changes are expressed in C$ for Stock Indices.*

We can now see a break in the clouds. The good news for 2019 is that the rebound could act like a slingshot. In this situation we must hold a steady course. After this correction, the bad news is already priced-in. The markets' valuation reverted to a certain mean that is attractive. In Canada, the price/earnings' contraction of 20% ranks among the three largest pullbacks over 40 years. At the start of 2019, the S&P/TSX was trading at 12 times projected earnings, the lowest level in 6 years. The Banks are even cheaper at 9 times 2019 earnings, a level not seen in 10 years. South of the border, the situation is similar with the S&P 500's P/E slipping at 14 times the profits of 2019. Projected earnings remain good for both the S&P 500 (7% and 11% for 2019 and 2020) and the S&P/TSX (11% for both 2019 and 2020). This coming year remains promising.

We believe that several factors came together to bring on this perfect storm. For example, disappointing economic data and ambiguous communication from the Fed did not help. But the main culprit was the clash of titans between President Trump and China. The ensuing panic brought on sizable losses for equities and an amplified volatility that also affected fixed income. This is true for corporate and international bonds as well as preferred shares that are perceived as riskier. Let's face it; there was no place to hide with almost all asset classes being affected. All this gloom convinced some investors that a recession is forthcoming and that the bull market was over. But is it really?

The state of the economic cycle and the next recession

In reality, a 20% correction does not always bring on a recession like a lot of detractors seem to think. Nobel economist Paul Samuelson had a saying back in 1966: Wall Street predicted nine out of the five last recessions. At present, it is the 14th time since 1957 that the S&P 500 drops more than 19%. Out of those, only seven recessions ensued. We think that the economy will slow down somewhat, but despite the correction and the flattening of the yield curve, it will not buckle. The Fed has finally admitted that it had some wiggle room after nine consecutive rate hikes and the quantitative easing regime. It is quite probable that we have seen the last rate hike or that we are one shy. Even though the present economic cycle is getting quite long and stretched, we are encouraged by the Fed's neutrality and by the fundamentals that are still sound in the economy. We believe that this year will bring a soft landing in North America and the rest of the world. History has thought us that in the absence of a recession, equities tend to recoup most of their losses within a year following the correction.

The trade tensions

After December's panic selling, it becomes imperative that we see a commercial conflict resolution between the two biggest trading partners of the world. The trade negotiations that started in early January in Beijing are still ongoing. The Chinese vice-president is also expected to visit Washington shortly. This was well received by the capital markets and it fuels the rebound. Our reading of the situation is that President Trump always applies maximum pressure to obtain results. We remain very positive about the negotiations, but they might last longer than we think. Patience is paramount. In the mean time, volatility could return with a vengeance if the markets perceive that it takes too long to resolve this conflict, or that on the cut-off date of March the 2nd, the US$200 billion punitive tariffs kick-in. A Chinese riposte could be worse for the stock market.

Conclusions and perspectives

If the panic accentuated the correction in December, the rebound was quick with the retracement of 40% of the loss as of January 11th. A combination of factors is helping the rally. First, the December's employment numbers were good in the US, the Fed has toned down the rhetoric and, finally, President Trump reassured the market players by stating that the negotiations were "going well". For all these reasons, the markets are again becoming attractive in early January. Looking back on this fateful December and the whole of 2018 specifically, we have to mention that almost all asset classes recorded losses. This was not seen in 10 years. Therefore, our fixed income portion, which is more aggressive and comprised corporate bonds and preferred stocks, did not perform well vs. the benchmarks or the safer government bonds. It works both ways in a rally where these assets comes faster out of the gate and outperforms once the bad news dissipate.

With a more resilient economy, decent earnings, a weaker greenback and an end to trade tensions, we believe that the coast is clear for a good year in equities and fixed income. The accepted wisdom is that bull markets don't necessarily die of old age; we expect a solid performance coming from good quality value stocks after these dark days. A few names in neglected sectors like the Oils and Industrials should rebound soundly in 2019, unless our main scenario is marred by unforeseen events of a geopolitical, or another nature.