Clearer days

Stop the madness: Closing out the first quarter with some clarity

Despite the elevated volatility that investors experienced in late 2018, our 2019 outlook remained relatively optimistic.

We expected the New Year to bring some clarity to the global picture for investors and remained overweight risk assets (particularly U.S. equities) as a result. During the first quarter of 2019, we received a clear answer to one of the underlying questions that had vexed markets (global central bank policy) and saw some progress on another (trade policy). These developments continue to support our overweight to equities. We think an upside surprise could be relatively easy to achieve, especially in the U.S., where the economic backdrop remains solid. In contrast, we think Canada will continue facing economic headwinds this year, weighing on the loonie, though we don't see a domestically-driven recession. Spring is certainly in the air, and warm weather is on the horizon.

ahead.

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Powell’s “put” and the song of the dove

A sharp dovish turn from the U.S. Federal Reserve (Fed) in January led to speculation about a “Powell Put” and echoed the expectations once placed on Janet Yellen, Ben Bernanke and Alan Greenspan (i.e., that the Fed would step in if equity markets fell sharply). In December, Fed chairman Jerome Powell was singing the economy’s praises and suggesting the Fed’s balance sheet runoff was on “auto-pilot.” By January, he was highlighting slowing global growth and indicating flexibility in the effort to reduce the balance sheet. The change of course culminated in a very cautious March meeting, where Fed members conveyed their expectation for no further rate hikes in 2019.

The Fed wasn’t the only central bank to change its tune. The European Central Bank (ECB) also surprised on the dovish side at its March meeting, extending forward guidance and announcing that another round of financing to banks called targeted long-term refinancing operations, or TLTROs, would begin in the fall. Markets responded in a risk-off fashion with the euro selling off, European government bond yields falling and Eurozone bank stocks dropping by nearly 5%.

Canada reeling against domestic and global headwinds

Since the summer of 2017, investors have looked at the Bank of Canada (BOC) as the leading central bank for monetary normalization outside of the U.S. as Canada experienced a transitory burst of growth. Now that interest rates are no longer at emergency levels, the elevated household debt has started being felt with rising debt-servicing costs, thereby causing an economic slowdown. Weaker oil prices added to those domestic headwinds. It’s therefore not a surprise the BOC joined the dovish chorus in March as well, dropping its pledge to continue raising rates into a neutral range while noting that the slowdown in the global economy has been “more pronounced and widespread” than the BOC had forecast. The Canadian economy grew just 0.4 percent in the fourth quarter of 2018 providing more evidence for those arguing that the BOC was out of tune with the slowdown.

While we think Canada will avoid a domestically-driven recession, the household debt overhang will continue to weigh on the outlook for a considerable period of time, which should leave monetary policy on an extended pause while weighing on the loonie.

The U.S. and China are getting closer, but to what exactly?

The early December trade truce agreed to by President Trump and President Xi Jinping was extended until at least April or possibly June, though timing remains highly fluid. Procedural questions remain for the U.S. relative to existing tariffs, which currently affect $250 billion in goods. The U.S. may remove the tariffs while maintaining the threat to reinstitute them if China does not accomplish certain reforms, or it may seek to maintain the tariffs until the reforms are in place. While we expect an agreement in the short-to-medium term, the role of tariffs in the negotiations and ultimate deal is likely to cause continued uncertainty.

Equity earnings: Expectations take a tumble but have they fallen too far?

While equity investors have grown accustomed to +20% earnings growth over the last few quarters, this figure will likely come back to earth in the first quarter. With negative earnings growth expected in the quarter (and very slight positive earnings growth expected in quarters two and three), investors may fear a repeat of 2015–2016, when the U.S. saw negative earnings growth for six consecutive quarters.

First-quarter earnings expectations for U.S. companies have been downgraded by 6.6% since the end of 2018, a steep drop that is much larger than the average decline. While we recognize the negative momentum behind earnings estimates, we think expectations have cratered to a point where it will not take much for companies to deliver an upside surprise. Moreover, U.S. companies should continue to benefit from an economic backdrop that remains solid.

Volatility has a wicked crossover

Coming into 2019, the expectation that volatility would remain elevated was very much a consensus view. In fact, volatility wrong-footed just about everyone in the first quarter by declining sharply and dipping to lows reached near the market peak last fall.

Chart 1 **CBOE Market Volatility Index (VIX)**

Source: Chicago Board Options Exchange, Bloomberg

Part of the explanation here is likely the clarity that investors received on key risks, as noted above. Additionally, economic growth is expected to pick up in the second half of 2019 and financial conditions have eased. While some uncertainty around a trade deal persists, policy easing in China has also contributed to the volatility decline, as policymakers there have taken a number of measures to stimulate growth, including lowering tax rates and reducing banks' reserve requirements.

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While the first quarter's drop in volatility was a surprise to many, we do not expect a consistent stretch of placidity such as we saw in 2017. This year is more likely to resemble 2018, with longer periods of low volatility interrupted by bouts of high volatility. Uncertainty about the U.S. business cycle, trade policy, the start of the 2020 U.S. election cycle and Brexit all continue to loom over the market.

Conclusion

The dovish shift by global central banks, combined with some positive developments on trade, supports our overweight to equities. We remain underweight to duration given the flat yield curve and our more constructive view on the economic outlook. The sudden selloff in the fourth quarter of 2018 illustrates how rapidly investor sentiment can change and highlights the benefit of diversified portfolios during these periods.

Developments in wage inflation and corporate earnings are likely to be among the most important factors in the coming quarters. The path of wage inflation will largely determine the Fed's actions and positive corporate earnings will have a large influence on investor sentiment.

Fred Demers
Director
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