FÉRIQUE
PRIVATE WEALTH

FINANCIAL LETTER

Market Review

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Fourth Quarter of 2018

SUMMARY

At the end of the third quarter, it already looked as if the returns for 2018 would be volatile and modest. Then, in the last quarter, most asset classes fell into negative territory. The outcome was a year completely opposite to 2017. Whereas last year, according to Deutsche Bank, 90% of asset classes generated positive results (in U.S. dollars), a peak since 1901, only 1% had the same success in 2018.

	Variation Q4-2018	Variation YTD
Indexes (%)		
Canadian equities		
MSCI Canada	-10.3	-9.0
U.S. equities (CA$)		
MSCI USA	-8.8	4.1
Global equities (CA$)		
MSCI Asia Pacific (all countries)	-5.9	-5.4
MSCI Europe	-7.7	-6.6
MSCI World (ex. Canada)	-8.3	0.4
MSCI Emerging Markets	-2.2	-6.5

Source: MSCI

	Closing 2018-12-31	Variation Q4-2018	Variation YTD
Interest rates (%)			
Canada			
Key rate	1.75	0.25	0.75
3 months	1.71	0.12	0.62
2 years	1.91	-0.28	0.25
5 years	1.93	-0.39	0.11
10 years	1.98	-0.44	0.00
30 years	2.15	-0.27	-0.05
Commodities (US$)			
Oil (WTI)	$45.15	-38.3%	-25.3%
Gold	$1,279.00	7.7%	-0.9%
Currencies			
EUR / CAD	0.64	-3.8%	-3.6%
JPY / CAD	80.58	-8.1%	-10.2%
USD / CAD	0.73	-5.1%	-8.0%

Sources : Bank of Canada, St.Louis Fed, U.S. Energy Information Administration

It was the worst result over the same period. Obviously, it was not what investors expected when the year began. This result is due partially to the strong U.S. dollar, but various unfortunate events aggravated the situation. The main ones were the escalation of trade tensions and imposition of tariffs, the falling oil price, Brexit, political crises in Italy, Turkey and Argentina, slowing economic growth in a number of countries and endless dysfunction at the White House.

To put the December decline in perspective, the table next page shows the price-earnings ratio of certain markets. These markets went from fairly expensive to very reasonable in the space of barely a quarter. Obviously, it's slightly discouraging because it shows their declines. But prices are back to levels that are attractive for the future.

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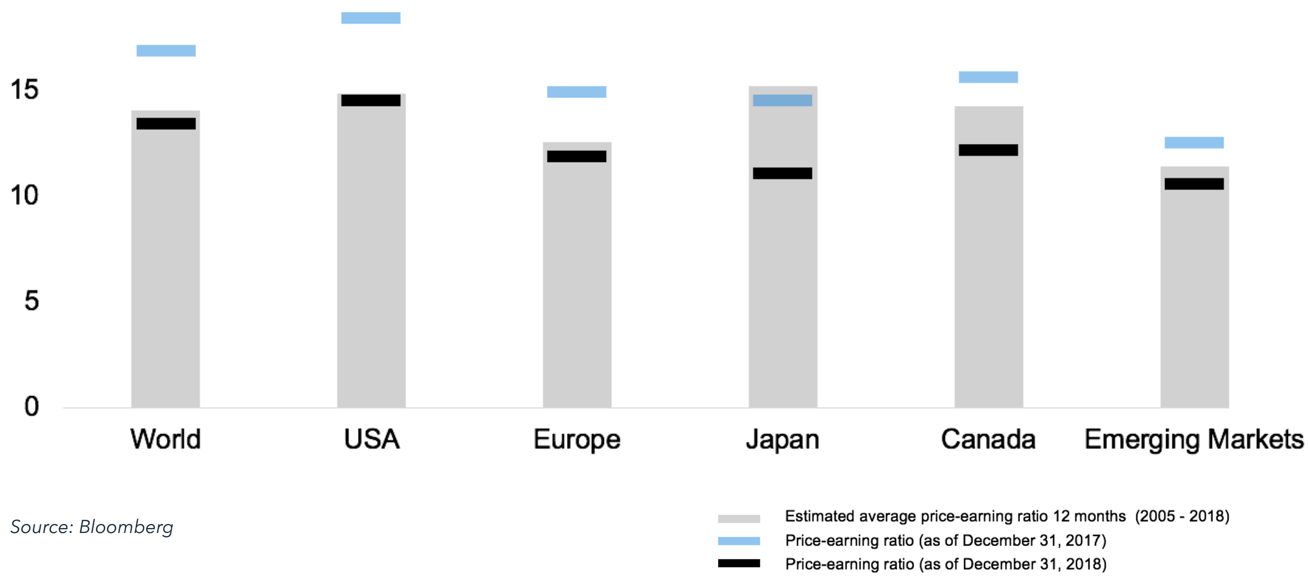
Price-earnings ratios of various markets



Source: Bloomberg

That being said, there were few ways to mitigate the losses. Only the Short-Term Income Fund and the Bond Fund obtained positive returns during the quarter.

	Returns as of December 31, 2018 (%)				
	Q4-2018	1 year	3 years	5 years	10 years
FÉRIQUE Portfolios					
Conservative	-0.6	-0.3	n/a	n/a	n/a
Moderate	-2.2	-1.4	2.3	3.2	n/a
Balanced	-5.2	-4.4	3.0	4.5	6.8
Growth	-6.3	-5.4	2.7	n/a	n/a
Aggressive Growth	-7.6	-6.8	n/a	n/a	n/a
FÉRIQUE Funds					
Short-Term Income	0.5	1.6	1.0	1.0	0.9
Bond	1.1	0.7	1.4	2.8	3.5
Diversified Income	-0.7	-1.9	n/a	n/a	n/a
Dividend	-8.5	-6.7	5.9	3.9	n/a
Equity	-10.9	-10.6	3.5	2.0	6.7
American	-8.6	-0.6	5.6	11.2	12.3
European	-12.1	-13.6	-3.1	3.2	6.3
Asian	-7.1	-8.4	4.9	7.5	8.5
Emerging Markets	-2.8	-12.7	n/a	n/a	n/a
World Dividend	-6.5	0.1	4.7	9.5	9.7

Source: Gestion FÉRIQUE

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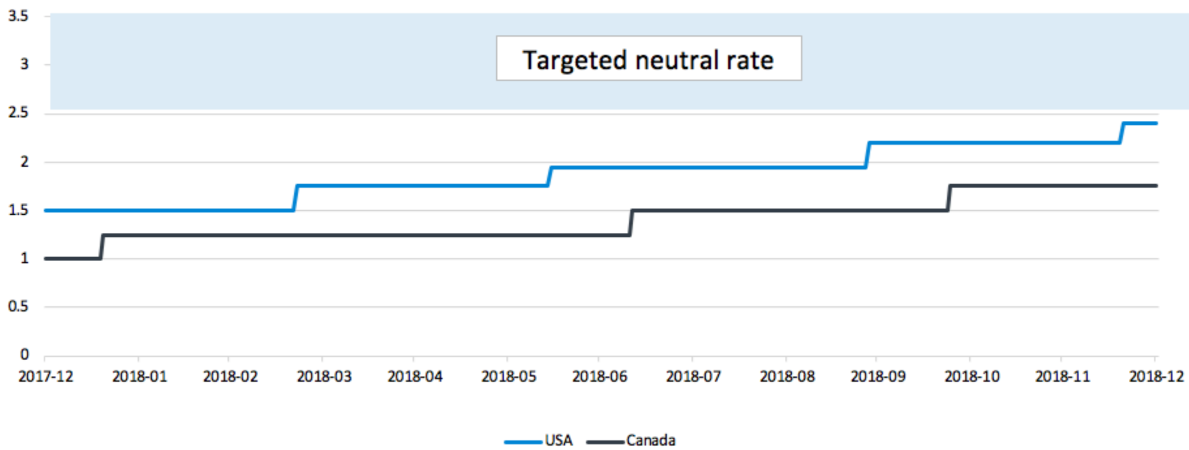
FIXED INCOME

RESULTS AND EXPLANATIONS

At a time when the monetary conditions set by the central banks in Europe and Asia were as accommodating as possible, the Bank of Canada (BoC) and the U.S. Federal Reserve (Fed) raised their key rates three and four times, respectively.

Canadian and U.S. key rates

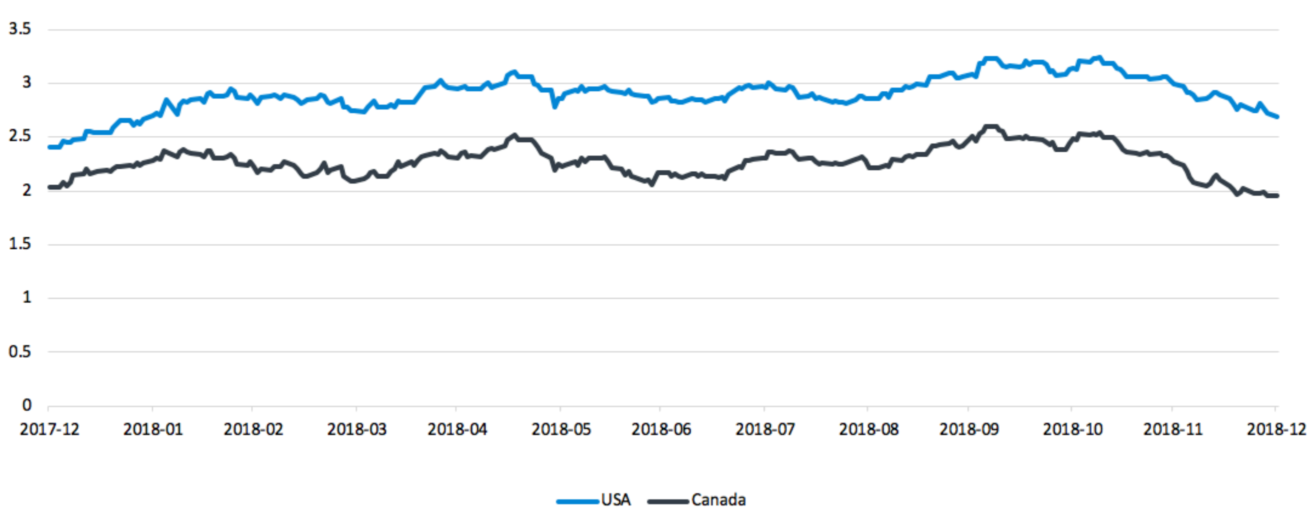


Sources: Bank of Canada, Bloomberg

The BoC, like the Fed, said it would be in data-dependent mode in 2019, which means the underlying economic data will guide its future decisions – which is usually the case. The underlying message is that their monetary policy decisions will be harder to predict.

As for 10-year bond yields, they rose gradually throughout the year before falling toward year-end.

Canadian and U.S. 10-year yields



Sources: Bank of Canada, Bloomberg

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FIXED INCOME

RESULTS AND EXPLANATIONS (continued)

As discussed in the third-quarter Financial Letter, an increase in this yield normally means that the economy is on a solid footing. Even so, beyond a certain threshold (3.75% to 4.00%), we have to expect that the various asset classes will be revalued. Conversely, a decrease in the 10-year yield may indicate that economic growth expectations are falling. And that is what happened at the end of the year.

In this context, the FÉRIQUE Bond Fund returned 1.1% on the quarter and the Diversified Income Fund returned -0.7%.

OUTLOOK AND ISSUES

The transition to so-called neutral rates continues. The recent statements by the BoC and the Fed were intended to be reassuring: they said that, after quite a few rate hikes over the past two years, further increases could be more spaced out. The challenge remains: to manage inflation without curtailing economic activity. Even so, we are close to the critical threshold where each increase brings us closer to restrictive monetary conditions. The Fed's two latest rate hikes caused the market corrections in October and at the end of December. The sharp decline of the oil price and, incidentally, the gasoline price affected the rate of inflation, which was weaker than expected toward year-end. As a result, both the BoC and the Fed had a little more leeway. We must keep in mind that central banks do not solely manage economic growth. They also try to give themselves enough latitude to respond in the event of a slowdown.

We should add a comment about a phenomenon referred to by the Governor of the BoC: stagflation. This is a situation in which inflation is above established targets, requiring an increase in key rates, but in the context of an economic slowdown. Why are we hearing about stagflation at this time? It's because of the escalating imposition of tariffs. These protectionist measures are slowing global trade and contributing to inflation.

The last time stagflation occurred in North America was in the 1970s. It was due to a combination of events, such as in the oil price shocks of 1973 and 1979, as well as U.S. political decisions, including measures taken by President Nixon. He wanted to stimulate the economy to get himself re-elected, notably by putting 10% tariffs on imports! Some of you will recall that the high inflation was tamed only when Federal Reserve Chair Paul Volker raised the key rate to 20%, causing the recession of the early 1980s. The current context is different but it's still another cloud on an already-dark horizon.

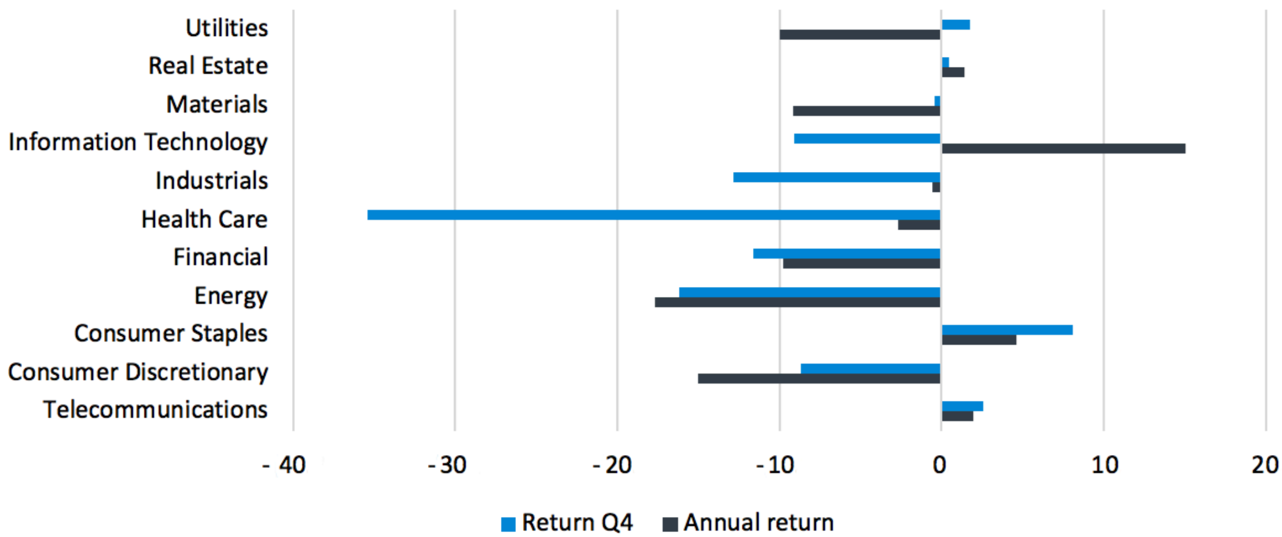
Another increasingly important issue is the high level of corporate debt. Low interest rates, combined with yield chasing by investors, have prompted many companies to finance themselves with debt. The problem is that, over many years, strong demand has enabled some companies with low credit ratings (less than BBB) to issue debt easily. The economy would not have to deteriorate much for them to encounter repayment problems. Currently, a great deal of caution is required for investments in high-yield vehicles. They offer high yields because they are risky products of lesser quality.

CANADIAN EQUITIES

RESULTS AND EXPLANATIONS

The Canadian stock market, as measured by the MSCI Canada Index, returned -10.3% in the fourth quarter. The two largest sectors, Energy and Finance, recorded substantial losses, dragging down the market as a whole.

Sector returns as at December 31, 2018



Source: Bloomberg

OUTLOOK AND ISSUES

Now that the free-trade agreement has been signed, does everything look fine for the Canadian market? In a word, no. The trade issues between the United States and China, as well as with Europe, are taking precedence over what happened in North America.

The Canadian market is intrinsically linked to world trade. Canada is a producer of natural resources, so its market tends to generate solid results when the global economy is growing. As a result, when the loonie appreciates, the Canadian stock market stands out.

So we have to ask ourselves whether global growth will be strong and will the Canadian dollar rise in 2019? It's a plausible scenario. One of the keys is crude oil. The current pessimism over its price is probably overdone. Its sharp decline in the second half of the year was caused by United States' decision to hold off on sanctions intended to limit Iran's oil exports. The result was surplus supply. Lower output by Saudi Arabia and by U.S. shale oil producers, which need a price of about $50 a barrel to be profitable, indicates that price will go back up. BCA Research is forecasting that WTI will exceed $70 a barrel in 2019.

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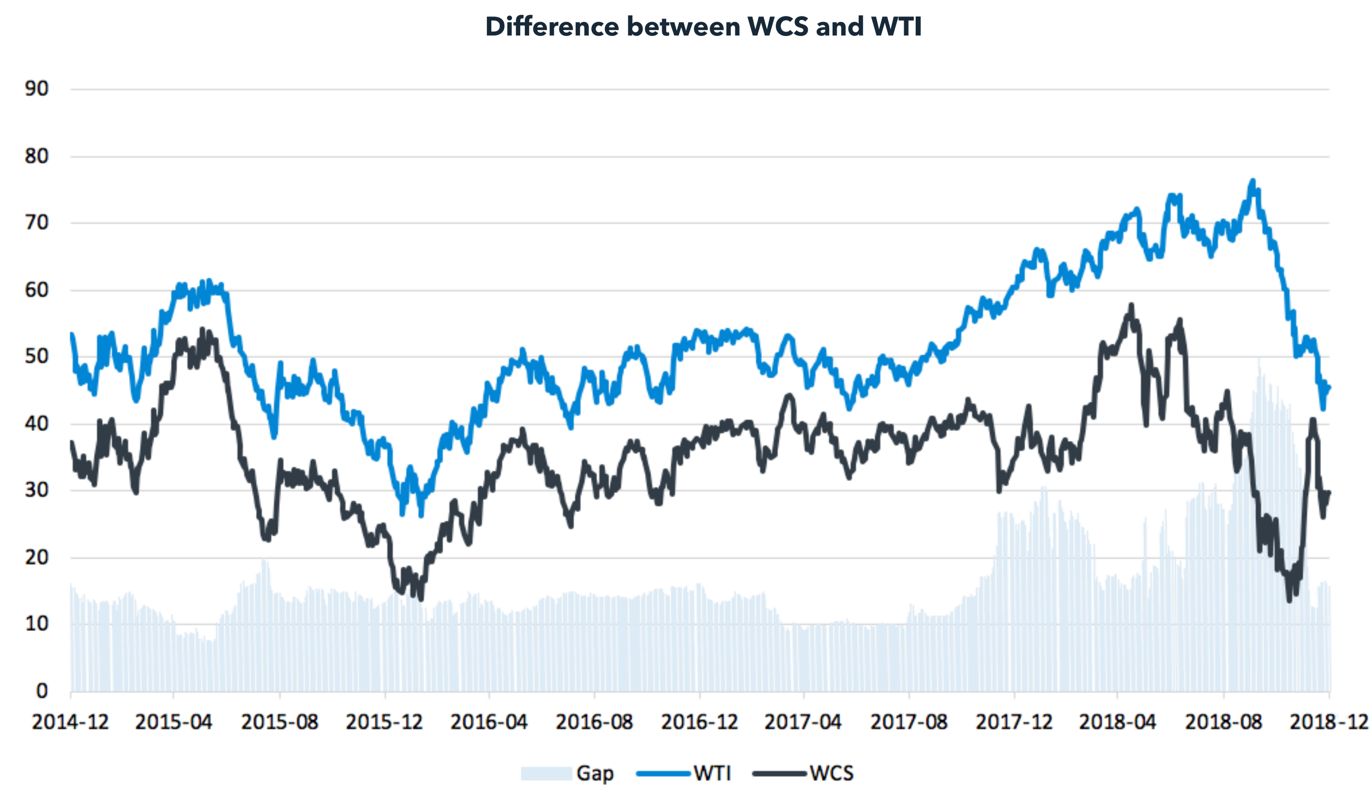
CANADIAN EQUITIES

OUTLOOK AND ISSUES (continued)

We should also point out the substantial difference between the price of Canadian oil (WCS) and U.S. oil (WTI), which is still due to transportation issues.



Sources: https://economicdashboard.alberta.ca/OilPrice and https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=rwtc&f=d

U.S. EQUITIES

RESULTS AND EXPLANATIONS

For a good portion of the year, the U.S. stock market was the global leader as a result of the strong greenback and political issues that held foreign markets back. But the fourth quarter was not kind to the United States, and its stock market declined sharply in October and December.

The U.S. stock market returned -8.8% (MSCI USA in Canadian dollars). The loonie's weakness against the greenback increased the return in Canadian currency by about 5%.

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U.S. EQUITIES

OUTLOOK AND ISSUES

As goes the U.S. Federal Reserve, so goes the stock markets. The impact of interest rate increases on the various asset classes has been cited many times. Recently there have been compelling examples of the scope of investor reactions to Fed decisions. These reactions may be the reason for the markets' sharp declines in October and at the end of December.

At the last meeting of the year, however, Fed Chair Jerome Powell said there would probably be fewer rate increases than expected in 2019 (two instead of three), because inflation had fallen slightly. But it was not enough to allay investor's fears about the fourth increase of the year. After all, what is the hurry to raise the key rate to 2.50%? Inflation still determines action on rates. In a sense, it's an irresistible force up against structural and often immutable changes.

The inflationary forces continue to gather strength:

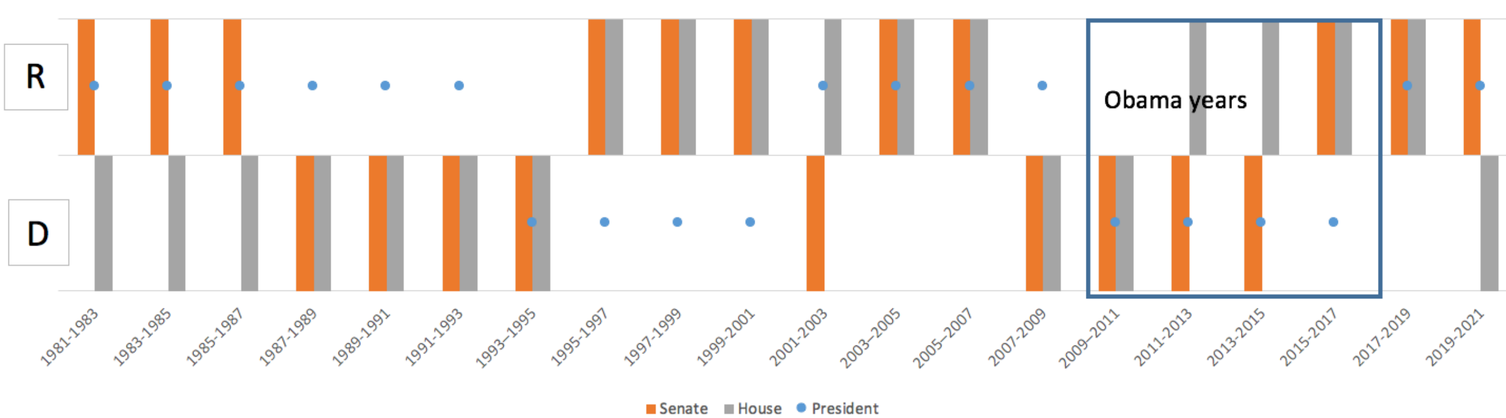
- Full employment leading to rising wages
- Imposition of tariffs and therefore higher prices in the global production chain

But deflationary structural changes run counter to the inflationary forecasts:

- Demographics
- The Amazon effect
- Technology
- And more recently the oil price

Another point is that the outcome of the mid-term elections created a sharing of power in Congress. The table below shows that, since the 1980s, this type of situation has been fairly common. For example, it paralyzed the Obama administration during most of his presidency.

Power division at Congress since 1981



Source: History, Art & Archives, Unites States House of Representatives

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U.S. EQUITIES

OUTLOOK AND ISSUES (continued)

Looking at each two-year segment, namely the term and mid-term elections, we can see that since 1980 the Republicans have dominated Congress seven times, the Democrats six times, and the two parties have shared control seven times.

That being said, what is the impact of the November 6 results? Until the next election, we can expect a great deal of dithering (the federal government shutdown at the end of December is the first example), but little change (legislation, budgets and so on). So there is no impeachment on the horizon (for it depends on the Senate) and there will be tight negotiations over the annual budget (for it depends on the House). However, the President can continue to manage tariffs as he sees fit and also propose deregulation.

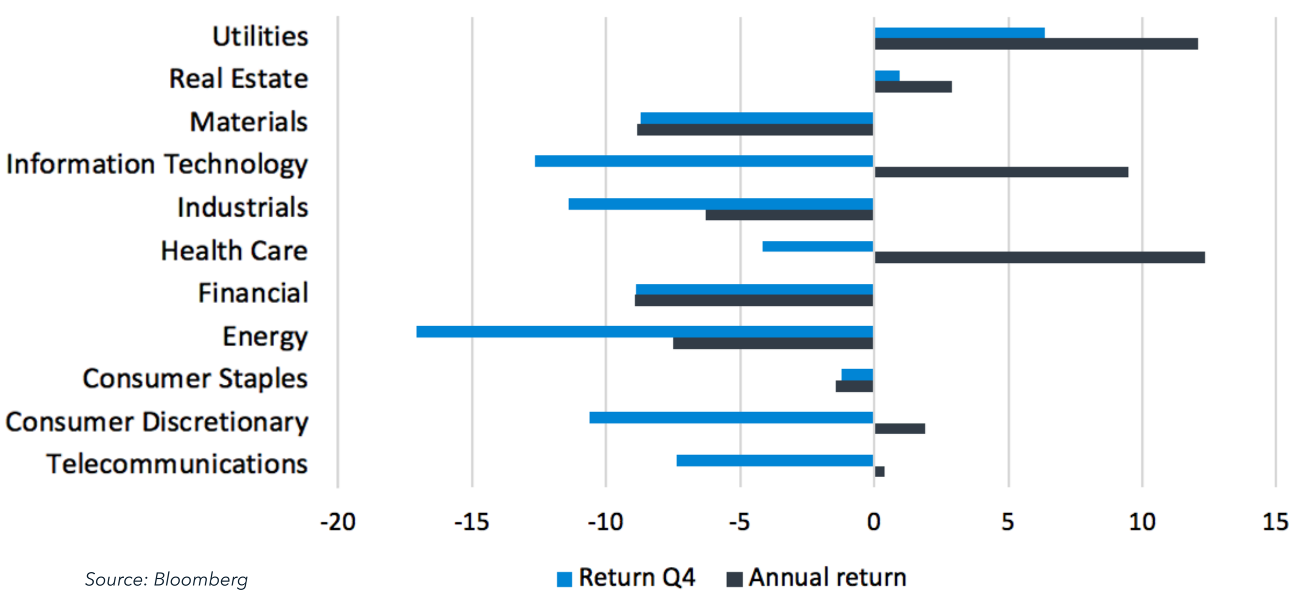
This constant gridlock in Congress can be perceived as positive because it lessens the risk of surprises. That being said, the possibility of further expansionary fiscal measures in 2019 has decreased significantly because the Democrats will not support this type of measure, which contributed to the markets' slide in the fourth quarter. Trump will have to use infrastructure investment to achieve economic growth objectives. Stay tuned.

GLOBAL EQUITIES

RESULTS AND EXPLANATIONS

As measured by the MSCI World Index, the fourth quarter of the year was the 11th-worst in 20 years, and December was the worst month since 2008. To say the least.

MSCI sector comparison



Source: Bloomberg

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GLOBAL EQUITIES

RESULTS AND EXPLANATIONS (continued)

This semester, the MSCI Europe Index, the MSCI AC Asia Pacific Index and the MSCI Emerging Markets Index returned -7.7%, -5.9% and -2.2%, respectively.

OUTLOOK AND ISSUES

Beyond the economic decoupling of the United States from the other developed countries, specific issues detracted from the results in various regions of the world.

Let’s start with Europe. The European markets again had a year of very negative returns as a result of concerns over the sustainability of the euro zone amid the Brexit and Italy sagas. The rise of populism is playing a role in these crises. Wealth disparity has increased in the developed countries and median wages have more or less been stagnant since 2008. Globalization is perceived as the main culprit. Of course, it’s more complex than that.

A Schroders article points out that technology and the impact of central-bank strategies on asset prices have also contributed to the malaise. Another factor is the ability of businesses to manage their earnings by taking advantage of countries or regions offering conditions that essentially enable them to avoid paying income taxes. This puts additional pressure on governments by depriving them of tax revenues. Such a context is conducive to policies calling for less globalization, less immigration and active regulation of fiscal optimization.

There seems to be some progress in the negotiations between the United States and China, but the issue goes beyond the trade imbalance. Pacific Investment Management Company (PIMCO) cites Thucydides’ trap to describe Sino-U.S. relations. The reference is to the powerful rise of one nation, originally Athens, which threatens an established power, namely Sparta. In short, it ends badly for both of them.

China has a strong leader whose ambition is to achieve the standard of living of the developed countries by 2035 and to become a fully developed nation by 2049, namely the 100th anniversary of the creation of the People’s Republic of China. What has rattled the Americans is the Made in China 2025 plan, which, among other things, calls for China to reach 70% self-sufficiency in technology by 2025. The plan assumes substantial financing of Chinese firms by the government, as well as other measures that will in no way tone down the accusations of mercantilism levelled against it.

The United States is led by a divided Congress and a White House whose disorganization is at an all-time high. Rightly or wrongly, the United States sees China’s rising power as a threat, and in the dispute President Trump has significant support from the people – Republicans and Democrats alike. So much the better if win-win solutions are gradually considered. But it appears this issue won’t be going away anytime soon.

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CONCLUSION

On the stock markets, 2018 was the opposite of 2017. A number of complicated situations took a bad turn, albeit in an economic context that continued to be rather favourable. It is therefore important to put the volatility we have just experienced into perspective, in other words to think about long-term performance.

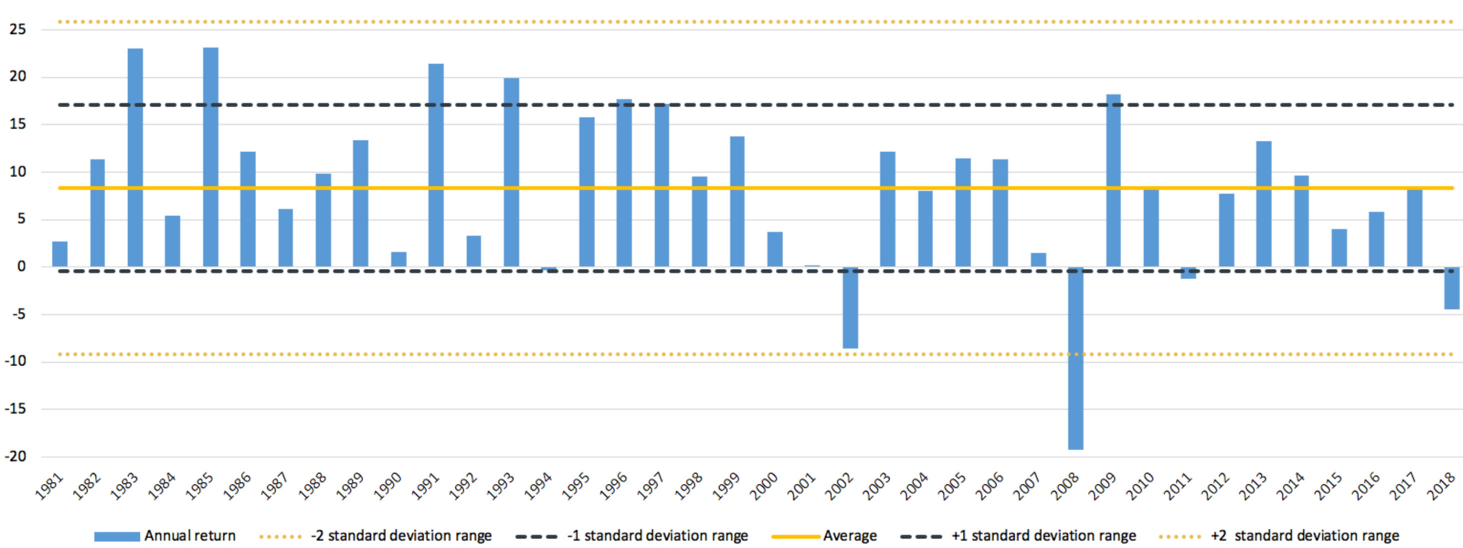
The table below shows the annual returns of the FÉRIQUE Balanced Portfolio. Clearly, 2018 was a down year that exceeded one standard deviation. We can see, however, that the preceding years were positive. Over 10 years, the annualized return was 6.8% as at December 31, 2018. Even though it seemed easy to obtain solid returns for several years, given the large number of asset classes with high returns, now we will have to be increasingly selective.

A fundamental change is the gradual end of asset purchases by central banks. The direction of the financial markets will be back in the hands of investors, potentially with the outcome that better-quality securities will be rewarded. Again, we will have to be selective.

What are the asset classes we should be emphasizing? It's not really clear. On the one hand, equity returns could be very appealing if certain worrisome disputes are resolved favourably (United States versus China) in a context in which the markets have suddenly become attractive again from the valuation standpoint. On the other hand, the decline could continue if, for example, global economic growth continues to slow or U.S. businesses report disappointing earnings. Ultimately, everything depends on the level of risk we can tolerate. It's unpleasant to see investments lose value, but the past has shown many times that it's best to stay the course.

Cheers!

Annual returns of the FÉRIQUE Balanced Portfolio



Sources: Gestion FÉRIQUE, TBN

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To discuss the markets and your investment strategy, contact your Financial Planner and Mutual Fund Representative of FÉRIQUE Investment Services.

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