FÉRIQUE PRIVATE WEALTH

FINANCIAL LETTER

Market Review

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Third Quarter of 2018

SUMMARY

With the third quarter already over, what conclusions can we draw? The global synchronization of 2017 has given way to desynchronization. The U.S. economy continued to experience smooth sailing as storm clouds gathered in the rest of the world. The stock market performances reflected this trend, as U.S. companies continued to rack up record earnings.

	Variation Q3-2018	Variation YTD
Indexes (%)		
Canadian equities		
MSCI Canada	-0.8	1.4
U.S. equities (CA$)		
MSCI USA	5.6	14.1
Global equities (CA$)		
MSCI Asia Pacific (all countries)	-1.2	0.5
MSCI Europe	-0.9	1.1
MSCI World (ex. Canada)	3.4	9.5
MSCI Emerging Markets	-2.7	-4.6

Source: MSCI

	Closing 18-09-30	Variation Q3-2018	Variation YTD
Interest rates (%)			
Canada			
Key rate	1.50	0.25	0.50
3 months	1.51	0.30	0.50
2 years	2.21	0.44	0.55
5 years	2.33	0.40	0.51
10 years	2.42	0.36	0.44
30 years	2.41	0.25	0.21
Commodities (US$)			
Oil (WTI)	$73.16	-1.3%	21.0%
Gold	$1 187,25	-5.1%	-8.0%
Currencies			
EUR / CAD	0.67	2.3%	0.2%
JPY / CAD	87.72	4.3%	-2.3%
USD / CAD	0.77	1.7%	-3.1%

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

An important issue during the quarter was the escalating trade tensions. Even though the direct impacts on the various economies are still limited, the message conveyed and the uncertainty it generated could cause more harm over the long term. We must keep in mind that globalization, especially since the start of the 1990s, has been strongly deflationary because it has brought into the global production chain large numbers of low-wage workers in emerging countries. Tariffs and other protectionist measures would have the opposite effect, possibly causing a sharp increase in inflation.

At the start of the year, management consultants, economists and strategists were all firmly convinced that the global economy was in a favourable synchronized state and that earnings would be within historical averages. Interestingly, their tune has started to change.

SUMMARY

A certain polarization of opinion is becoming apparent, especially concerning the outlook for the U.S. stock market and emerging markets.

It is therefore not surprising that the returns on the various asset classes varied considerably during the quarter.

	Returns as of September 30, 2018 (%)				
	Q3-2018	1 year	3 years	5 years	10 years
FÉRIQUE Portfolios					
Conservative	-0.1	2.1	n/a	n/a	n/a
Moderate	0.1	3.0	3.4	4.2	n/a
Balanced	0.0	4.1	5.8	6.8	6.2
Growth	0.6	5.5	6.5	n/a	n/a
Aggressive Growth	-0.1	5.1	n/a	n/a	n/a
FÉRIQUE Funds					
Short-Term Income	0.4	1.4	0.9	0.9	0.9
Bond	-0.8	1.5	1.3	2.6	3.7
Diversified Income	0.3	-0.1	n/a	n/a	n/a
Dividend	1.1	4.9	8.7	7.4	n/a
Equity	-0.9	4.0	7.1	5.7	5.8
American	5.0	14.8	12.5	16.0	11.5
European	-2.5	0.6	3.3	7.9	6.6
Asian	-1.9	5.5	10.5	10.8	8.6
Emerging Markets	-5.3	-3.8	n/a	n/a	n/a
World Dividend	4.1	12.3	10.2	13.1	9.4

Source: FERIQUE Fund Management

FIXED INCOME

RESULTS AND EXPLANATIONS

With economic growth continuing, the central banks in Canada and United States again raised their key rates – the U.S. Federal Reserve (Fed) in June and September, and the Bank of Canada (BoC) in July.

The BoC cannot allow the spread between its key rate and that of the United States to widen because the loonie would depreciate, adding to inflationary pressures.

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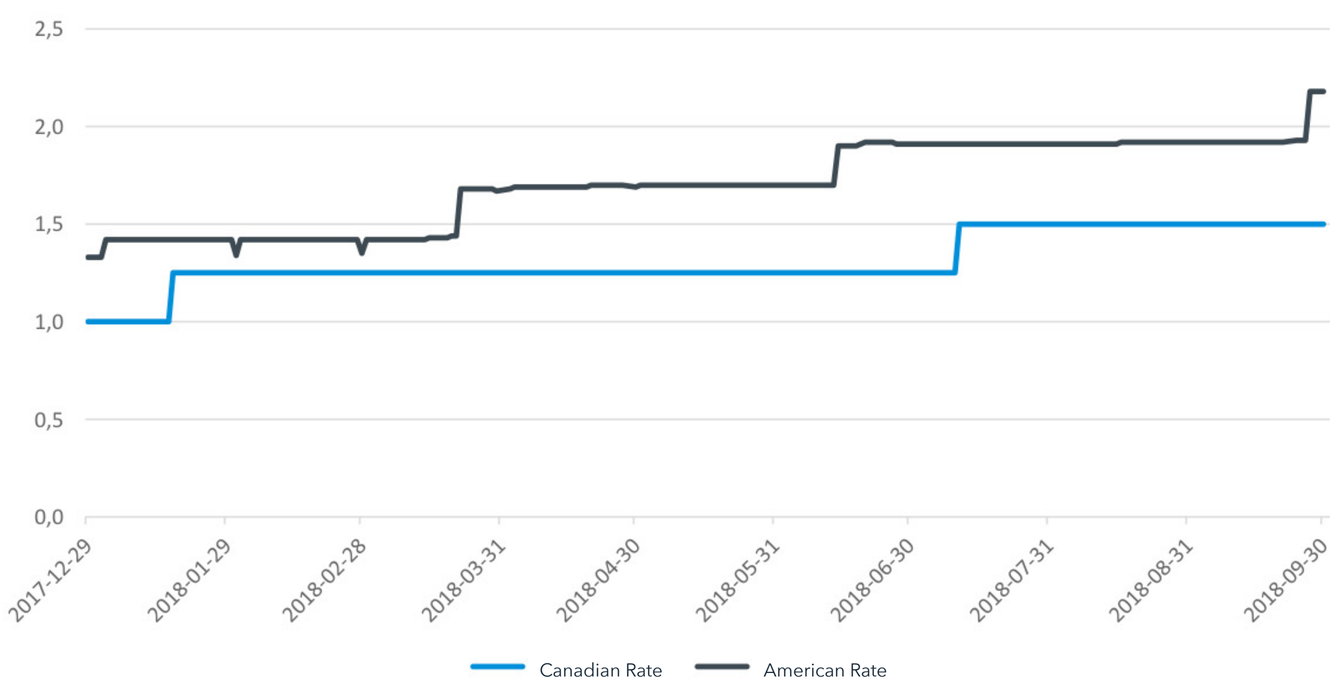
FIXED INCOME

RESULTS AND EXPLANATIONS (continued)

Even though the Canadian economy is slowing somewhat, longer-term interest rates are up in Canada as a result of the central bank's rather optimistic tone.

In this context, the FERIQUE Bond Fund returned -0.8% for the quarter. As for the Diversified Income Fund, its return was 0.3%.

Canadian and U.S. key interest rates



Source: FERIQUE Fund Management

OUTLOOK AND ISSUES

As a reminder, the key rate established by the central bank in line with its monetary policy is the starting point for the rest of the yield curve. To a degree, longer-term rates reflect the interplay of supply and demand on the market and have a direct impact on the cost of credit, as well as on the prices of other asset classes, such as equities. Moreover, a degree of volatility has been much in evidence on the equity markets since the beginning of October as a result of the increase in interest rates.

As we explained in a previous Financial Letter, discounted future earnings are used to estimate a company's worth. Higher rates mean a lower discounted value. Thus companies whose shares are currently considered expensive are at a greater risk of being revalued. That being said, just how high will the key rate go?

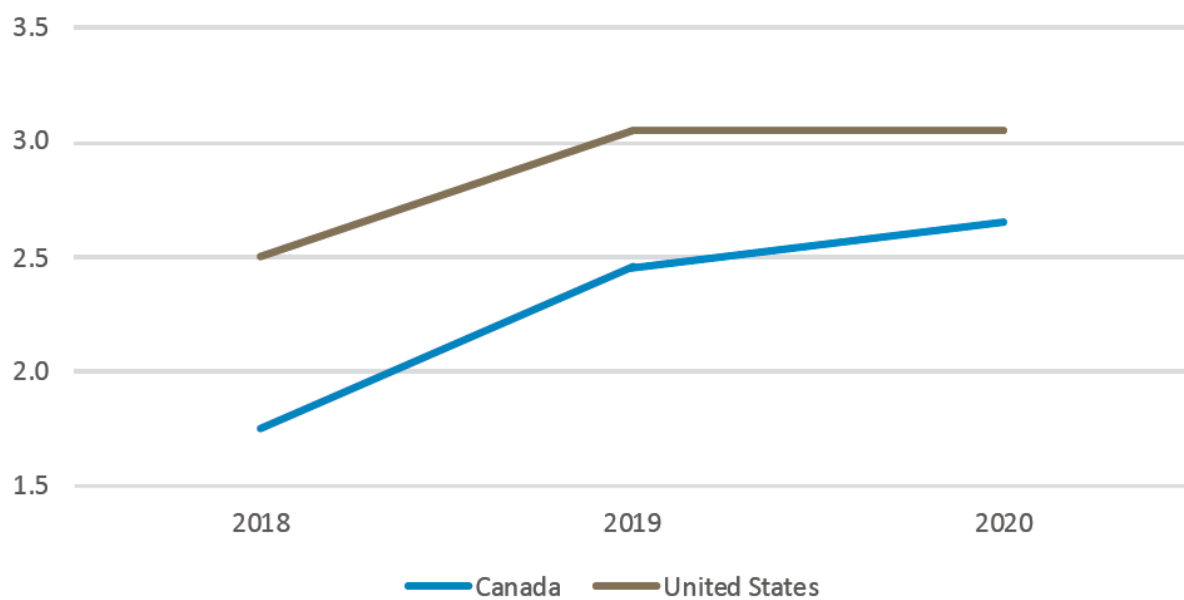
FIXED INCOME

OUTLOOK AND ISSUES (continued)

The tightening phase has begun, and central bankers would like to eventually reach a so-called neutral rate, namely an equilibrium rate that allows an economy to grow at a steady pace over the long term. The exact percentage is difficult to identify but the central banks and their legions of economists constantly estimate and revise it, knowing that the effectiveness of their monetary policies depends on it. Both the BoC and the Fed currently estimate it to be 3%. Monetary policy can therefore be considered accommodative as long as the key rate is below this level.

Provided that the economy is growing and inflation is tame, we should see rates gradually move toward 3%. The Fed's published projections show that, as a result of the economy's strong performance, the neutral rate could be reached toward the end of 2019.

Key rates in Canada and United States



Source: Bloomberg

The BoC does not publish its projections. From investors' current expectations, which are priced into the markets, it's possible to conclude that the neutral rate will not be reached as quickly. Even so, the Bank's patience will be tried as a result of the new North American trade deal (USMCA). Citing uncertainty as the reason for not raising rates no longer holds!

In addition, the yield curve and the Canadian dollar have adjusted quickly to this reality. Now it is simply a matter of managing the level of inflation and Canadians' ability to repay their debts.

Ultimately, the two central banks want to "neutralize" their monetary policies but, above all, give themselves enough leeway to respond when times get tough.

CANADIAN EQUITIES

RESULTS AND EXPLANATIONS

The Canadian stock market, as measured by the MSCI Canada Index, returned -0.8% in the third quarter. Since the start of the year, the best-performing sector has been health care, but there's nothing too healthy about the stocks that have contributed to these results; they seem to be on a high, driven by expectations that a large number of Canadians will want to consume marihuana once it becomes legal. Let's just say that Canadian productivity may suffer if that is the case.

OUTLOOK AND ISSUES

As for the United States-Mexico-Canada Agreement (USMCA), our first comment is that it's harder to pronounce than the now defunct NAFTA! At the time of writing, little is known about its clauses and their impacts. We do know that supply management has been maintained but not in its entirety, because the concessions are the same as for the Transpacific Partnership Agreement, which the United States ultimately did not ratify. As well, the USMCA will be in effect for 16 years, but will have to be reviewed every six years.

Generally speaking, it is a good deal for Canada in that the Americans ultimately abandoned their most extreme demands, such as expiry of the agreement after five years, abolition of supply management and scrapping of Chapter 19 of NAFTA. Importing and exporting companies can now make plans. Moreover, the absence of an agreement probably would have been worse, given the permanent uncertainty it would have created, which we will never know.

That being said, little has changed for Canada in terms of economic growth forecasts, given that most economists were counting on a successful outcome to the talks. The Bank of Canada no longer has a reason not to raise its key rate in October and possibly in December too.

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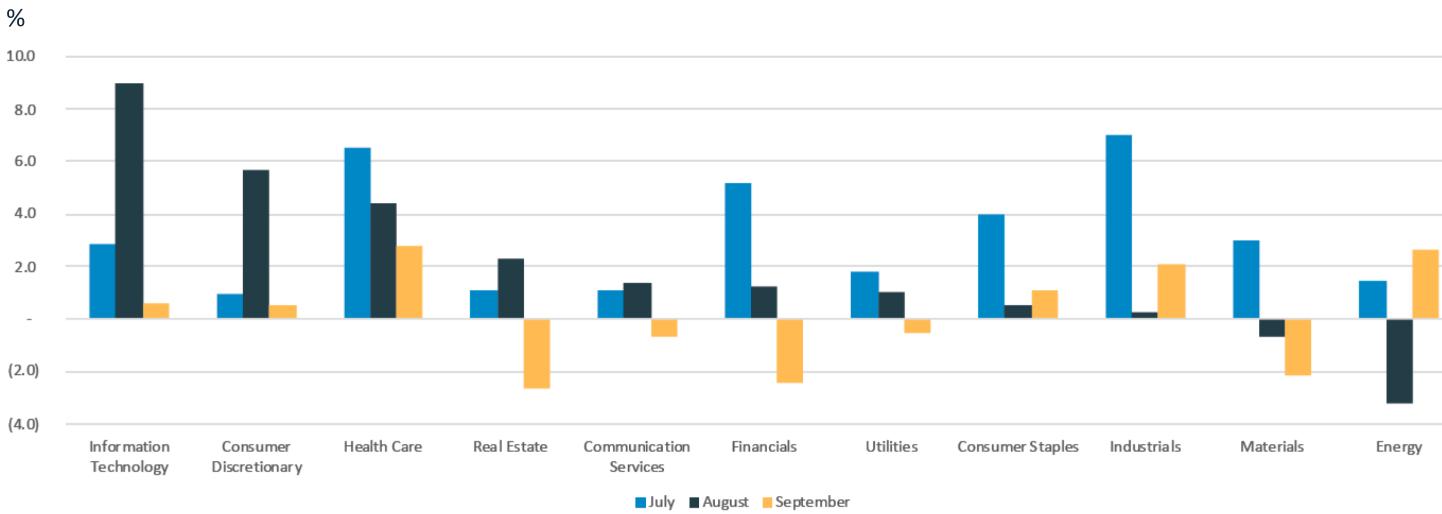
AMERICAN EQUITIES

RESULTS AND EXPLANATIONS

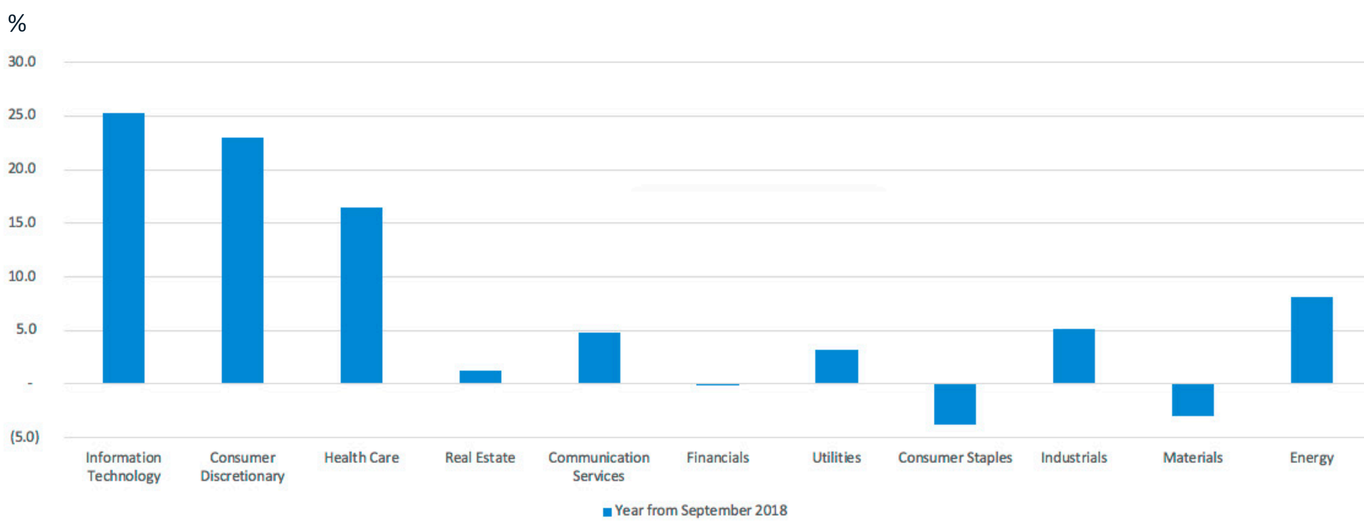
As in 2017, the Information Technology (IT) sector has been leading the parade since the start of the year, despite a better performance by the more defensive securities in July and again in September, which reflects a certain disparity between the months in the quarter.

Sector returns from July to September (MSCI USA)



Source: MSCI

Sector returns to September 30 (MSCI USA)



Source: MSCI

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AMERICAN EQUITIES

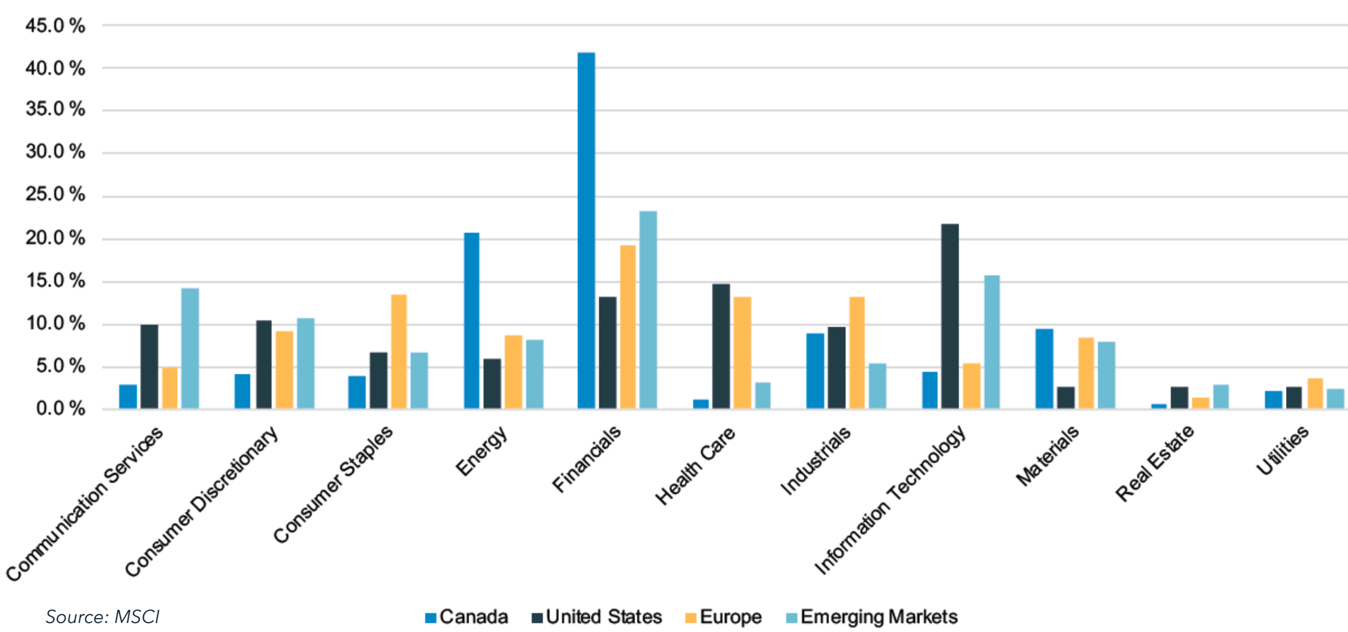
RESULTS AND EXPLANATIONS (continued)

The U.S. stock market returned 5.6% (MSCI USA Index in Canadian currency). The Canadian dollar's strength against the U.S. dollar subtracted about 2% from the return.

OUTLOOK AND ISSUES

The U.S. stock market has stood out clearly from the other markets since 2017 for a simple reason: companies in the IT and Consumer Discretionary sectors are dominant in terms of earnings and enthusiasm, and these sectors are overrepresented in the U.S. stock market. In contrast, the global markets have a larger Financial sector, as does Canada.

Sector Breakdown as of September 30, 2018



Source: MSCI

It should be noted that the sector composition has been changed for all equity indexes. Companies such as Facebook and Google's Alphabet have been moved from the IT sector into the Communication Services sector, which has increased in size accordingly.

Many experts think the market could stay positive for some time, owing to the impetus of the tax cuts introduced at the start of the year. Considering the very high expectations, how things play out will depend on corporate earnings, especially because of the rising headwinds that will ultimately have significant consequences:

- Wages are finally going up! It's super for workers, but less so for business payrolls and inflation;

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AMERICAN EQUITIES

OUTLOOK AND ISSUES (continued)

- The U.S. dollar is up. It's super for returns in Canadian currency, but less so for exporters and inflation;
- Interest rates are rising. The cost of money is going up and, above all, the discount rate for future earnings is going up too. At the same time, the present value of businesses is decreasing. According to BCA Research, the critical threshold that could bring about a wave of revaluations on the market is a 10-year U.S. Treasury yield of 3.75% to 4.00%. The yield was 3.2% on October 10.

The good news is that interest rates are going up because economic growth is expected to rise, but there is a limit.

WORLD EQUITIES

RESULTS AND EXPLANATIONS

The Canadian dollar's strength during the quarter, particularly against the yen (4.3%) and the euro (2.3%), reduced the returns on these markets.

The MSCI Europe Index, the MSCI All Country Asia Pacific Index and the MSCI Emerging Markets Index returned -0.9%, -1.2% and -2.7%, respectively.

OUTLOOK AND ISSUES

In recent years, we have seen a good diversity of leaders in terms of market returns on a geographic basis. Yes, U.S. equities have led in 2018, but the graph on page 9 shows that the holder of the pole position changes every year.

As for Europe, after a positive 2017, when returns were sustained by the increase in the euro, the results are more modest this year. Political issues (such as Italy and Brexit) and Turkey's difficulties are weighing on the European market. Even though their stocks are trading at attractive multiples, the impact can be seen above all on European banks, which are concerned about their current exposure to risky areas, such as emerging markets (Turkey) and Italy.

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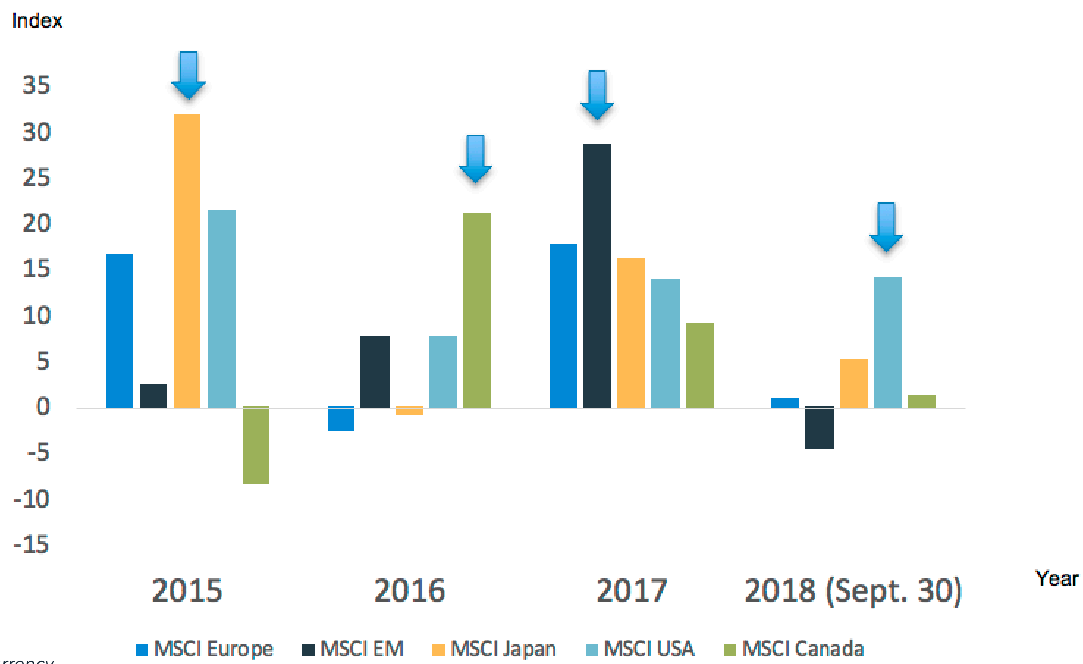
WORLD EQUITIES

OUTLOOK AND ISSUES (continued)

As for Japan, apart from the fact that the country is highly dependent on world trade, the quarter was positive, thanks to such factors as Prime Minister Abe's confirmation as leader of the Liberal Democrat Party. Where things get dicey is in emerging market equities. Since the start of the year, they have suffered because of the rising U.S. dollar and uncertainties surrounding world trade.

MSCI comparison by region



Source: MSCI
Note: In Canadian currency

As we stated in the introduction, there are diverging views of the outlook for emerging markets and the United States. Some believe the U.S. will continue to dominate for some time, for the reasons cited above and also because the greenback will continue to be strong. Others think the U.S. market is expensive. The observers who are most favourable to emerging markets think the U.S. dollar has peaked and already reflects the four rate hikes that the Fed forecasts between now and the end of 2019. Absent other factors, such as spiralling inflation, the dollar should remain at its current level and give emerging market equities a bit of breathing room.

Ultimately, much depends on China, which is trying to decrease its debt while making significant structural reforms. Will the Chinese authorities intervene massively to support their economy as they did in 2009 and 2015? And what about tariffs? Certainly, President Trump will try to resolve the dispute (or win it as the case may be) before the mid-term elections, but China can afford to stand up to the Americans. The fact that President Trump is negotiating through the media and openly confronting the Chinese leaders seems to have antagonized them. Obviously, given China's ambition of becoming the economic power of the future, they will not want to lose face.

CONCLUSION

What is generally considered the end of the cycle in the United States could continue for some time. Traditionally, this environment is rather positive for stock market returns.

Some think U.S. equities will continue to outperform, whereas others think emerging markets offer a fine buying opportunity.

Nonetheless, rising interest rates and the revaluation of some securities or sectors will have to be monitored.

If we go by the trend of recent years, the best asset class is different each year. But this observation is in no way scientific and we are still looking for indicators of an eventual recession. Why? Because a recession goes hand in hand with a down market. According to BCA Research, the combination of the three following indicators has predicted all the recessions since the 1950s:

- An inverted yield curve;
- A decline of the LEI[1]; and
- A Fed key rate above the neutral rate (restrictive monetary policy).

The verdict? None of these signals is currently in the critical zone.
Cheers!

[1] *The Conference Board Leading Economic Index for the United States.*

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