FÉRIQUE PRIVATE WEALTH

FINANCIAL LETTER

Market Review

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Third Quarter of 2019

SUMMARY

The quarter was packed with news that contributed to the polarization of the expected return scenarios: bond market investors saw low growth on the horizon, whereas the stock markets generally continued to levitate.

In analyzing possible medium-term scenarios for stock market returns in general, we would refer, in statistical terms, to a normal curve with a higher probability of a fat-tail distribution. See the chart "Illustration of Return Distributions" on page 2.

	Variation Q3-2019	Variation YTD
Indexes (%)		
Canadian equities		
MSCI Canada	2.0	18.6
U.S. equities (CA$)		
MSCI USA	2.9	16.9
Global equities (CA$)		
MSCI Asia Pacific (all countries)	-0.1	6.0
MSCI Europe	-0.5	10.9
MSCI World (ex. Canada)	2.1	14.4
MSCI Emerging Markets	-2.9	2.9

Source: MSCI

	Closing 2019-09-30	Variation Q3-2019	Variation YTD
Interest rates (%)			
Canada			
Key rate	1.75	0.00	0.00
3 months	1.69	-0.04	-0.05
2 years	1.58	0.12	-0.33
5 years	1.42	0.02	-0.51
10 years	1.39	-0.11	-0.59
30 years	1.57	-0.16	-0.58
Commodities (US$)			
Oil (WTI)	$54.09	-7.1%	19.8%
Gold	$1485.30	5.4%	16.1%
Currencies			
EUR / CAD	0.69	3.1%	8.1%
JPY / CAD	81.63	-0.9%	1.3%
USD / CAD	0.76	-1.2%	3.0%

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

Thus the probability of a shock in either direction is greater.

- Negative-return scenario (to the left):
  - o Impact of the trade war (less business spending)
  - o Worsening geopolitical crises (oil shock)
  - o Global recession

- Positive-return scenario (to the right):
  - o Agreement between China and the United States
  - o Fiscal measures (Europe and China)
  - o Rebound of leading indicators (manufacturing)

Despite the volatility, returns have been very attractive since the start of the year. Let's take a closer look.

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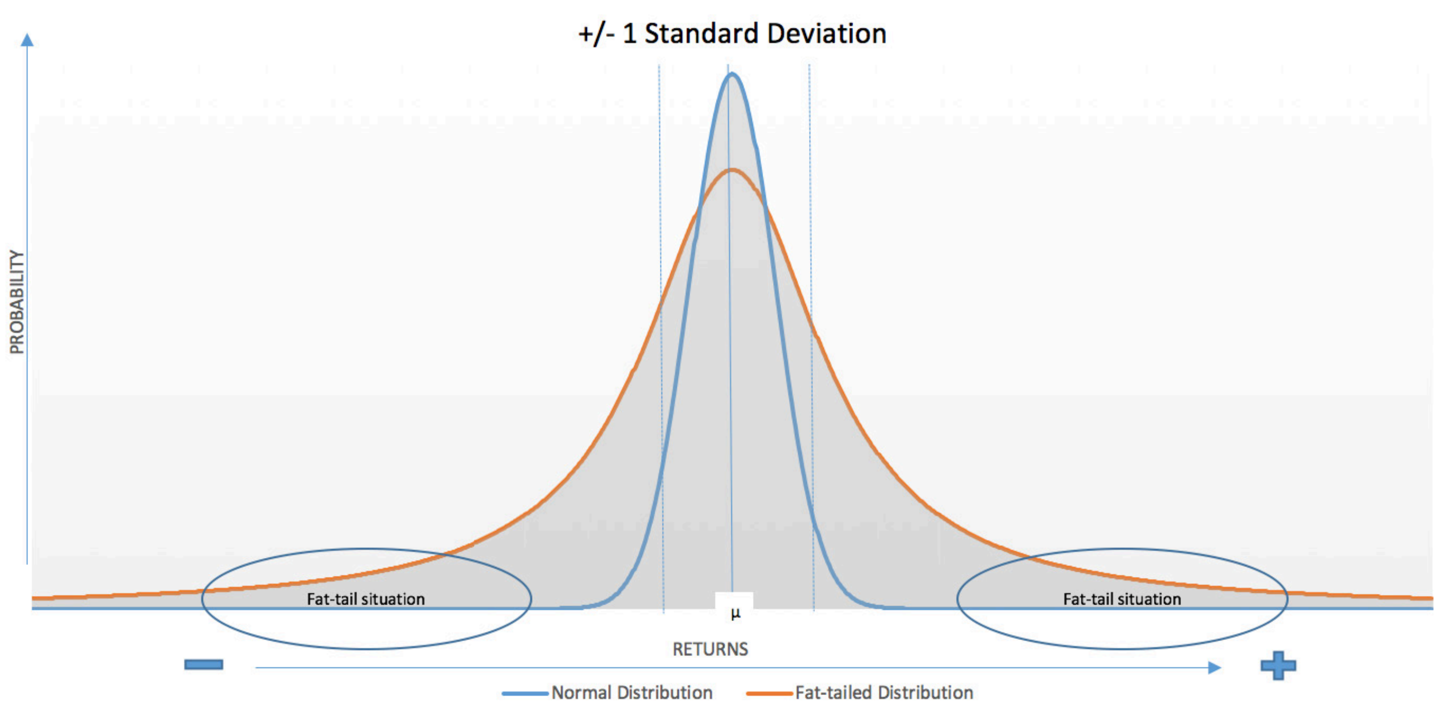
SUMMARY

	Returns as of September 30, 2019 (%)					
	Q3-2019	YTD	1 year	3 years	5 years	10 years
FÉRIQUE Portfolios						
Conservative	1.3	6.6	6.0	n/a	n/a	n/a
Moderate	1.6	8.4	6.1	3.5	3.7	4.5
Balanced	1.5	10.5	4.8	4.8	5.1	6.2
Growth	1.2	11.3	4.2	5.1	5.6	n/a
Aggressive Growth	1.3	12.5	3.9	n/a	n/a	n/a
FÉRIQUE Funds						
Short-Term Income	0.4	1.3	1.8	1.3	1.1	1.0
Canadian Bond	0.8	6.2	7.3	2.0	2.9	3.6
Globally Diversified Income	1.6	7.6	6.8	2.6	n/a	n/a
Canadian Dividend Equity	3.4	13.3	3.7	5.9	4.4	7.3
Canadian Equity	3.1	19.0	6.0	5.6	3.7	5.7
American Equity	3.2	16.3	6.3	10.1	12.0	13.0
European Equity	-1.7	10.5	-2.8	3.2	4.5	5.4
Asian Equity	-0.3	6.7	-0.9	5.8	7.6	7.2
Emerging Markets	-1.1	7.1	4.1	n/a	n/a	n/a
World Dividend Equity	4.1	14.9	7.5	10.4	11.3	10.1

Source: National Bank Trust

Illustration of Return Distributions



Source: FÉRIQUE Fund Management

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FIXED INCOME

RESULTS AND EXPLANATIONS

The support expected from central banks materialized in the third quarter. The U.S. Federal Reserve (Fed) lowered its key interest rate twice, while the European Central Bank (ECB) confirmed a return to quantitative easing at the end of Mr Draghi's tenure and at the start of Christine Lagarde's (it should be noted that she is the first woman to hold this position).

Comparison of key interest rates

Key rate	Canada	United States	Japan	European Union
31-Dec-17	1.00	1.50	-0.10	0.00
31-Dec-18	1.75	2.50	-0.10	0.00
30-June-19	1.75	2.50	-0.10	0.00
30-Sept-19	1.75	2.00	-0.10	0.00

Source: Bloomberg

Looking at longer-term yields, we see that the benchmark 10-year yields are still falling.

Comparison of long term interest rates

10-year bond yield	Canada	United States	Japan	Germany	France
31-Dec-17	2.04	2.41	0.04	0.42	0.78
31-Dec-18	1.96	2.69	0.00	0.24	0.70
30-June-19	1.46	2.00	-0.16	-0.33	-0.01
30-Sept-19	1.35	1.67	-0.23	-0.58	-0.27

Source: Bloomberg

In this context, FÉRIQUE's Canadian Bond Fund and Globally Diversified Income Fund returned 0.8% and 1.6%, respectively.

OUTLOOK AND ISSUES

What does these results tell us, apart from explaining why bond returns have been substantial this year? Many think it signals weak economic growth or even a recession.

At this writing, the markets are expecting the Fed to lower its key rate three more times in the next 12 months. Three cuts are a lot when the country is not in a recession and does not seem likely to go into one in the short term.

In Germany, the government issued 30-year bonds with a negative yield to maturity; in other words, anyone who buys the bonds will lose money. Moreover, Germany's central bank, the Bundesbank, had to buy about 60% of the bond issue. This anecdotal evidence is very revealing in that central banks are now obliged to use extreme measures that tend to distort the markets.

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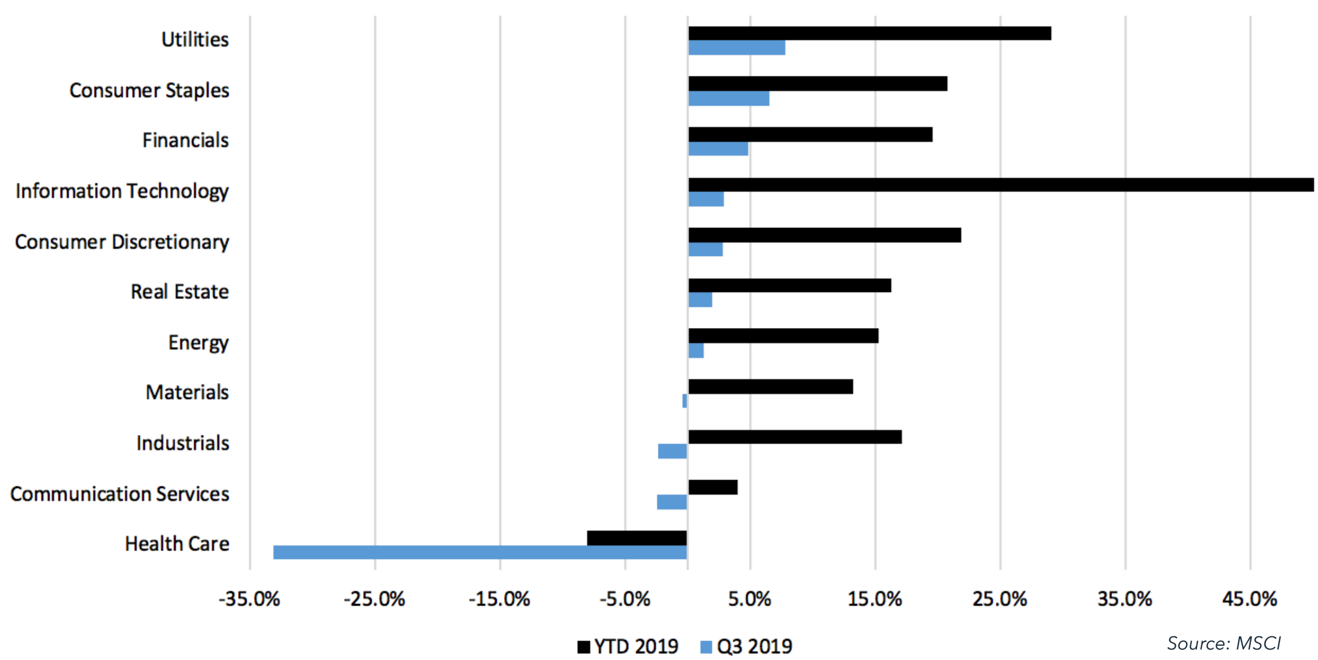
CANADIAN EQUITIES

RESULTS AND EXPLANATIONS

During the quarter, the traditionally defensive sectors led, while sectors that are more sensitive to world trade lagged. In Canada, the sector with the weakest performance was health care, dragged down by cannabis stocks.

Canadian market returns: year to date versus third quarter of 2019



Source: MSCI

The Canadian stock market, as measured by the MSCI Canada Index, returned 2.0% in the third quarter.

OUTLOOK AND ISSUES

The economic data continued to be pleasantly positive in Canada. The most recent employment figures are the best since 2002 for the country as a whole. As for Quebec, it had the lowest unemployment rate in its history!

At the global level, however, the rather uncertain economic data have released gold from its torpor. We know that the yellow metal does not generate any income, because holding a large amount of it involves a storage cost. That's why in a "normal" economic environment, there aren't many good reasons to hold gold. But there is currently nearly US$15 trillion of negative-yielding bonds outstanding. What is the connection with gold? Gold becomes attractive as a store of value if one expects a recession and a significant market downturn in a context where the traditional safe-haven investments (bonds issued by Germany, Switzerland, Japan, etc.) have a negative yield.

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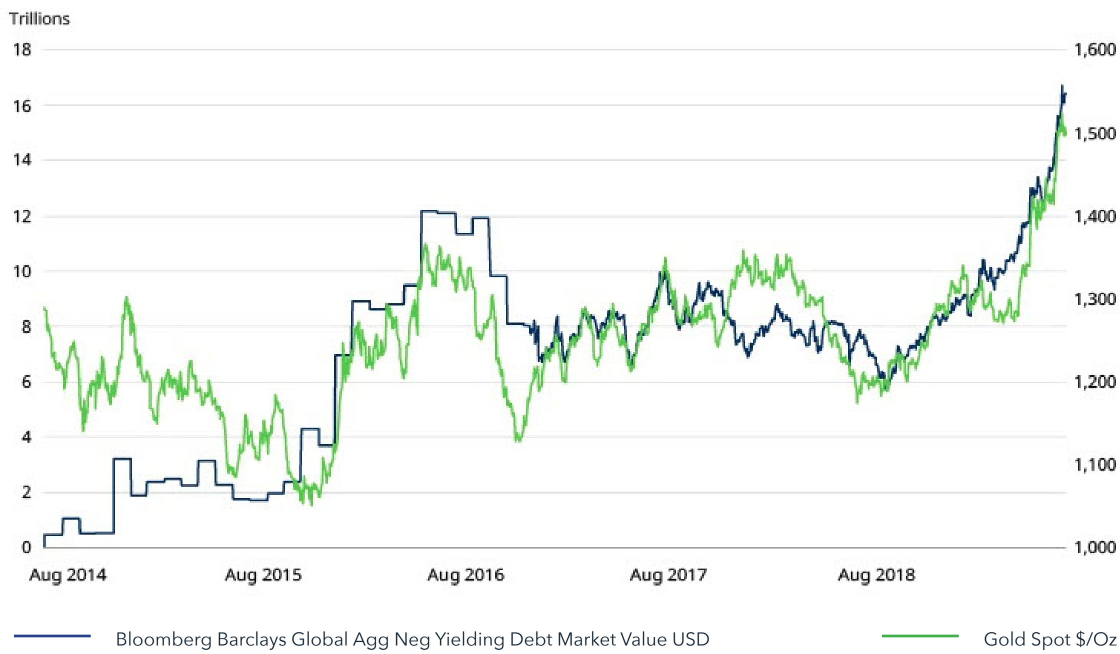
CANADIAN EQUITIES

OUTLOOK AND ISSUES (continued)

The following graph, from Schroders, shows changes in the price of gold and the amount of negative-yielding bonds.

Changes in the gold price versus amount of negative-yielding bonds



Source: Schroder, Bloomberg CS1854

Gold producers are therefore the big winners this year. In Canada, for example, five of the 10 stocks with the best performance in 2019 are gold producers. We're talking about companies with very high returns, such as Eldorado Gold with 168%, Alacer Gold with 117% and Centerra Gold with 94%. Of course, it must be noted that this sector has experienced its share of issues in recent years. Eldorado Gold lost almost 90% of its value from January 2015 to November 2018. Much the same thing happened to the other two companies; their share prices declined by about 30% during the same period. It is an eminently cyclical industry, as reflected in its stock market history.

In contrast, the health care sector has had its wings clipped in 2019. The sharp decline of two stocks in particular illustrates the problems facing the fledgling cannabis industry. In the case of HEXO Corp., the company has still not reported profits despite rising revenues. As for CannTrust, investors got burned as a result of its legal and governance issues. Again, the earnings potential is attractive but you have to understand the risk inherent in this type of investment.

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U.S. EQUITIES

RESULTS AND EXPLANATIONS

It’s hard to figure out what is going on between China and the United States. The yield curve inverted again, and the Democrats finally decided to try to impeach President Trump, so it was a rather volatile quarter in the United States. As in Canada, the more defensive sectors, such as consumer staples and utilities, were the best performers. The health care sector continued to lag, but not for the same reasons as in Canada. Rather, many of the election issues involve this sector and are therefore creating uncertainty.

The MSCI USA Index returned 2.9% in Canadian currency. The strength of the greenback against the loonie increased the Canadian-dollar return by about 1.3%.

OUTLOOK AND ISSUES

We should start by discussing the topic du jour at the time of writing: the impeachment procedure.

Since President Trump was elected, the Democrats have been threatening him with impeachment. Except that it has now become a reality. On September 24, the Democratic Speaker of the House of Representatives, Nancy Pelosi, announced the launch of a formal impeachment inquiry.

Given that this process is political rather than legal, it is unlikely that the President will be impeached unless he wins the election in 2020 and the Democrats gain a majority in the Senate. In short, the Democrats (with a majority in the House of Representatives) are responsible for initiating the process but the Senate (where the Republicans are in the majority) decides the matter. Moreover, a two-thirds majority of the votes is required for the President to be removed from office.

Since President Trump still enjoys strong support from his base, irrefutable evidence of malfeasance would be needed for enough Republican senators to support impeachment.

By quickly disclosing the details of his phone call with President of Ukraine, he seems to be betting that he has done nothing wrong and that the Democrats are shooting themselves in the foot with their partisan efforts for impeachment. The allegations against Joe Biden (and his son), the Democratic candidate who is most likely to defeat President Trump in the 2020 election, are also obviously getting good press in the Republican camp. In fact, Elizabeth Warren is now leading the Democratic race in the polls.

What is the effect of this outlook on the stock markets? Aside from the uncertainty it creates, it should be noted that, in similar situations in the past, the economy has superseded politics in terms of influence on the stock markets.

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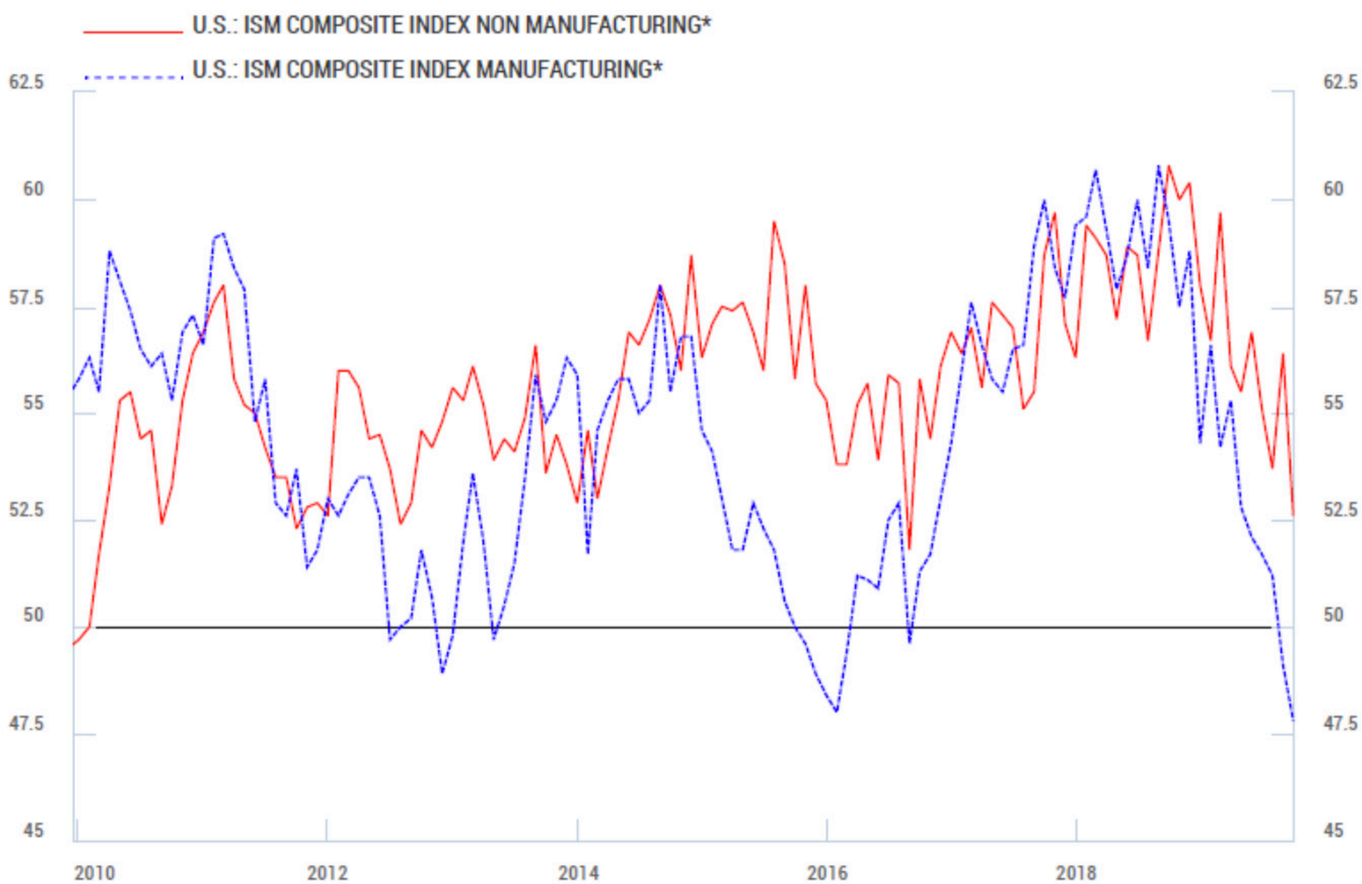
U.S. EQUITIES

OUTLOOK AND ISSUES (continued)

This leads us to a discussion of the global economy, which continues to slow gradually. For several months, we have been seeing a sharp decline in the manufacturing sector. We can make a clear link to the uncertainty arising from the prevailing protectionism and the current and potential tariffs. I will return to the impact of this matter on the rest of the world, but in the United States this situation was not an issue until the third quarter. This is now the case; not only has the PMI manufacturing index fallen below the threshold of 50, indicating pessimism on the part of survey respondents, but the non-manufacturing index (services) has also started to decline and is approaching 50.

Manufacturing and non-manufacturing PMI indexes



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Source: BCA Research

The fact that the utilities sector has held up is reassuring, for it represents a considerable portion of the developed countries' economies. This context has reduced investor expectations of U.S. corporate earnings. As the expression goes, the bar is low, which has left room for positive surprises in the last quarter – unless the leading indicators continue to deteriorate.

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U.S. EQUITIES

OUTLOOK AND ISSUES (continued)

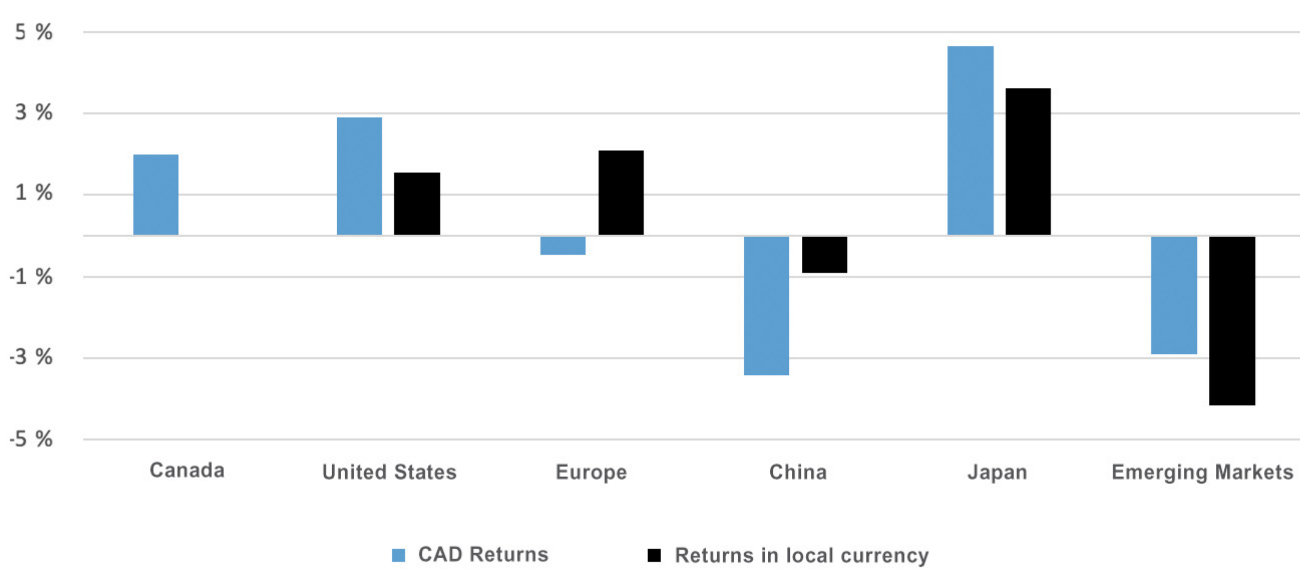
Finally, a BCA Research study shows that each time a U.S. president seeks a second term during a recession, he loses the election. Mr. Trump is undoubtedly aware of this statistic and is expected to take action or introduce measures by the fall of 2020.

GLOBAL EQUITIES

RESULTS AND EXPLANATIONS

Despite the ups and downs of the oil price, the Canadian dollar fell against the U.S. dollar and the yen, causing returns to be slightly higher when translated into Canadian currency. But the euro was down almost 3% against the loonie, reducing the returns on securities in this region. The result was a rather timid quarter in terms of international equity returns.

Returns on various MSCI indexes for the third quarter of 2019



Source : MSCI

The MSCI Europe Index, the MSCI All Country Asia Pacific Index and MSCI Emerging Markets Index returned -0.5%, -0.1% and -2.9%, respectively, in Canadian dollars.

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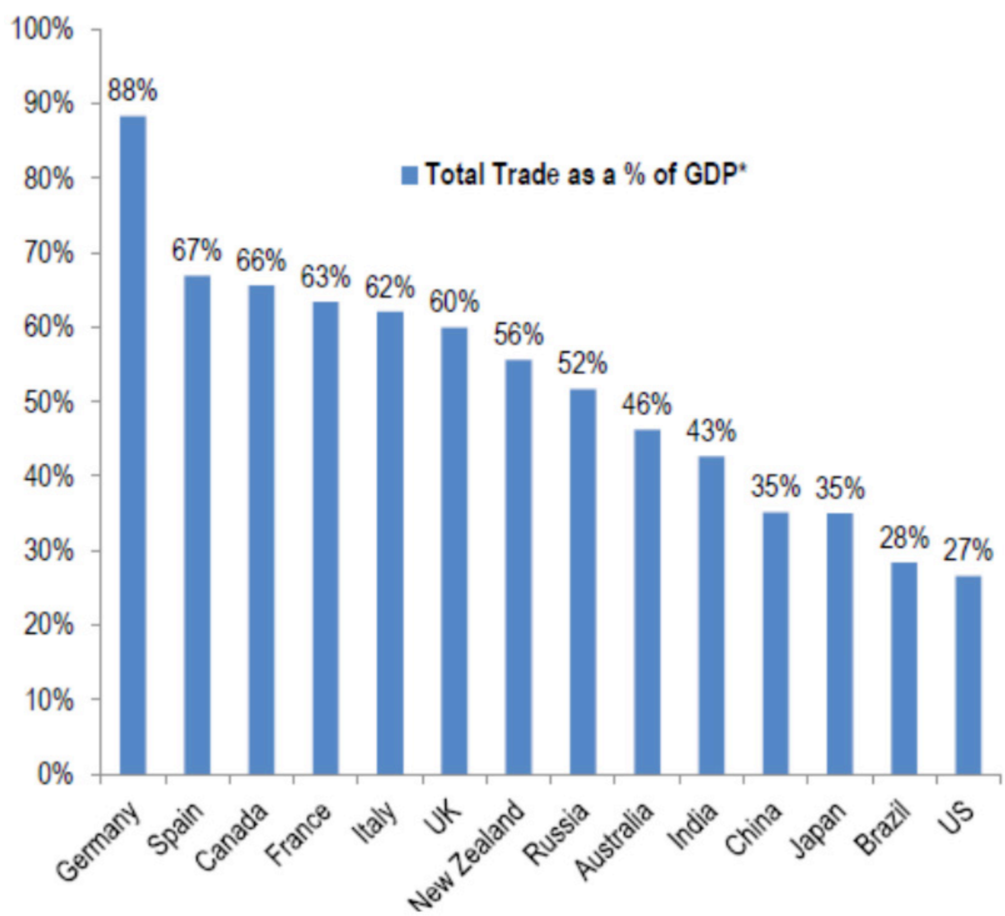
GLOBAL EQUITIES

OUTLOOK AND ISSUES

The economic signals from Europe continue to be a concern, especially in the case of Germany, which is the largest economy in the euro zone with a stock market representing about 27% of the MSCI Europe Index.

As already noted, the main factor at play is the slowdown in world trade, which continues inexorably as a result of the U.S.-China trade dispute. Clearly, some countries are more affected than others, as the following graph shows.

Exposure to world trade by country



Sources: Dynamics, OECD and IMF

**Total trade = Exports + Imports (goods & services). Note that China's only includes goods.*

GLOBAL EQUITIES

OUTLOOK AND ISSUES (continued)

As Germany has a very open economy, its sensitivity to trade issues is considerable. Moreover, the global automotive sector continues to come under pressure, affecting not only Germany but also Japan. Car sales in China fell sharply earlier in the year, and automakers in general must meet stricter environmental standards. In Germany as in Japan, this context is essentially referred to as a “manufacturing recession.”

During the quarter, crises persisted and geopolitical risk was widespread. The attack on Saudi oil infrastructure has worrisome economic implications. The gradual escalation of tensions between the United States (and its allies) and Iran has intensified as a result of this untoward event. The headlines mainly concerned the potential impact on the price of oil. It surged temporarily, but fell because of the substantial U.S. inventories. Even so, we must not ignore the impact that this disaster has on the civilian populations caught in the conflict, as in Yemen.

As for China, many think its negotiators are trying to drag out the negotiations with President Trump in the hope that he will lose the election and that it will be easier to negotiate with his successor. Of course, everything will depend on the individual, but it is important to note that Elizabeth Warren’s positions on human rights and environmental issues are not likely to simplify the negotiations.

CONCLUSION

The gains recorded in 2019 are still significant. The economic signals continue to point to a slowdown and for some countries recession is just around the corner. That being said, central banks are making significant efforts, and expansionary fiscal measures are under discussion in a number of regions.

How can we navigate the current environment, which could lead to significant increases as well as significant declines on the markets? The answer is not simple. But it is a given that the decisions of investors who have opted for a long-term strategy should not be excessively influenced by the current context.

Several strategies can be adopted, depending on one’s situation. It may be worthwhile to raise some cash while maintaining exposure to equities. In this way, we can take advantage of market strength while holding cash that can be invested in the event of a correction.

Ultimately, it is important to review our objectives and constraints (time horizon, risk tolerance, etc.) and ensure that we have an appropriate strategy in place or that we rebalance our assets to bring them back into alignment with it.

Until next time, cheers!

TO JOIN US

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

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