QV UPDATE
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# A Nearly Perfect Combination

2017 marks yet another win for equity investors. Global stock markets generated robust gains, with many indices posting double digit returns. GDP growth rates topped expectations as the world economy continued to strengthen. More importantly, growth was broad-based, with even the struggling economies of Japan, Europe, Brazil, and Russia contributing positively. This is the first time since 2010 that we have seen synchronized expansion and it seems reasonable to expect it to continue. This strong tailwind resulted in comparatively low volatility and high investor confidence throughout the year. The momentum continued to gain traction thanks to the all but perfect combination of increasingly healthy global corporate profits and monetary policy held at near-crisis levels. These factors are contradictory. Global monetary policy remains too stimulative given the considerable improvement in economic conditions. For example, the U.S. economy is better than *just ok*, with employment and consumer confidence approaching 20-year highs. Bank of Canada governor Stephen Poloz recently stated, "we are at a point in the economic cycle that I think of as the sweet spot. We know that a majority of Canadian companies are running flat out." In Europe, Mario Draghi raised growth projections in acknowledgement of the broad economic data points that continue to surpass expectations.

Central bankers have been in crisis fighting mode for nearly a decade. Although the crisis is over, the world is awash in debt from the policies of the past, at interest rates that are abnormally low. While investors have been comfortably focused on positive economic results, the reality is they have been super-charged by unsustainably aggressive monetary policy. However, policy is changing. And the risks to equity markets are growing. We see two likely scenarios as global monetary policy normalizes – rates catch up to a global economy that continues to improve faster than expected after years of fits and starts, or, it's possible the global economy weakens as rates increase, demonstrating that low rates have been propping up the system.

Although Canada led the developed world in GDP growth over the past year, its stock market was one of the weakest (still, we shouldn't forget that in 2016 the Canadian market posted 20%+ gains). The U.S. market, on the other hand, had an incredibly strong year, with the S&P 500 gaining 21.8% in USD. Outsized returns like these are more typical of post-recession recoveries than they are in the 9th year of a bull market.

The biggest driver, aside from healthy corporate profits, was the much-anticipated tax reform enacted toward year end. With the U.S. performing well, the tax cuts have the potential to over-stimulate the economy. Never before has tax reform occurred this late in an economic cycle. We expect a positive growth impact on the U.S. economy which may accelerate inflationary pressures and exacerbate the need for the Federal Reserve to tighten policy. This year's nearly perfect combination of growth with no material monetary pressure will be a tough act to follow. While the market is squarely focused on the positive outcomes of the tax reform, it is yet one more policy that results in greater levels of debt to support it. With markets ending the year at record highs, nobody wants to consider how it all gets paid for in the end.

For all the hand-wringing surrounding NAFTA, nothing has been solved. We suspect that if global economic growth shows another year of positive gains, the Canadian stock market will become more attractive to investors. Late cycle industries such as commodity producing regions tend to do well in this environment. Canadian banks and insurance companies should also get a boost from higher interest rates, with the caveat that too quick a move may threaten the consumer given the record levels of debt. Cyclical and financial sectors dominate the Canadian market.

Elevated equity and bond valuations have reduced our long-term return expectations. Instead of reaching for a higher return by increasing risk levels (i.e. speculating in cannabis stocks, cryptocurrencies, etc.) we remain disciplined in our risk management process. At the risk of short-term underperformance, our philosophy for long-term success prioritizes capital preservation on the downside. As markets transition, new opportunities will make themselves available to us. Over time, our nearly perfect combination of quality and more attractive value will reappear again.