ECONOMIC OVERVIEW

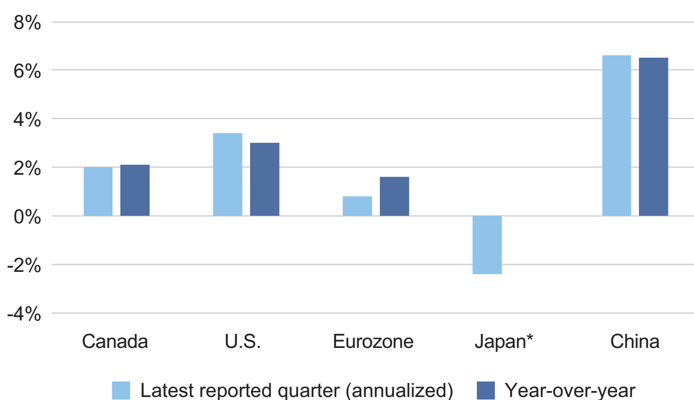
December 31, 2018

Economically speaking, compared with other developed market economies, the U.S. was a standout for most of 2018. U.S. tax cuts and a large fiscal expansion improved GDP growth while most other developed economies slowed. Core U.S. inflation accelerated to the U.S. Federal Reserve's (Fed) 2% target for the first time in six years, while inflation remained far below central banks' targets in Europe and Japan.

The combined weight of North American and select foreign central bank interest rate increases, global trade tensions, a wave of geopolitical concerns (Brexit and Italy), and a collapse in oil prices are all combining to alter the outlook for the global economy heading into 2019. The Organization for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF), and the World Bank all reduced their world economic growth targets on average by 0.5%. The average world economies' expected growth rate is now approximately 3% to 3.5%.

The Fed raised its Fed Fund's target by 25 basis points each quarter in 2018 and reduced its bond holdings. The European Central Bank (ECB) and the Bank of Japan continued with their monetary stimulation (quantitative easing, or QE), but the ECB announced it would stop its QE at the end of 2018. The U.S. stock market generally outperformed most other countries' markets until some substantial weakening late in the quarter. Wider GDP growth and interest rate differentials resulted in a higher valuation for the U.S. dollar with an adverse effect on emerging markets.

Real GDP Growth



Source: Bloomberg *Japan's year-over-year GDP growth was 0%.

Canada

Normally at this point in the economic cycle, it would be Canada's time to shine as the country would typically benefit from rising commodity prices and solid global economic growth. But, given the openness of our economy, Canadian economic growth has been negatively impacted by global trade tensions and weak oil prices and other commodity prices. Domestic housing market activity, a dominant force in economic growth, continues to wane. Heading into the new year, Canadian growth should be weighed down by the impacts of a further slowing in housing, the overhang of consumer debt, oil production cuts in Alberta, and moderating U.S. economic growth. Trade wars and delays in the signing of the United States-Mexico-Canada Agreement (USMCA) remain economic concerns.

The latest Canadian inflation rate, from November, came in at an 18-month low of 1.7% while other inflation measures remained around the BoC's target of 2%. Continued restraint in wage growth also implies that there remains some slack in the economy. Canadian economic growth in 2018 was about 2% and is not expected to be much lower than that in 2019. Indeed, with hopefully more certainty on the North American trade front and an expectation of some stimulative fiscal policy measures leading up to the October federal election, growth may not be quite as gloomy as the market is now forecasting.

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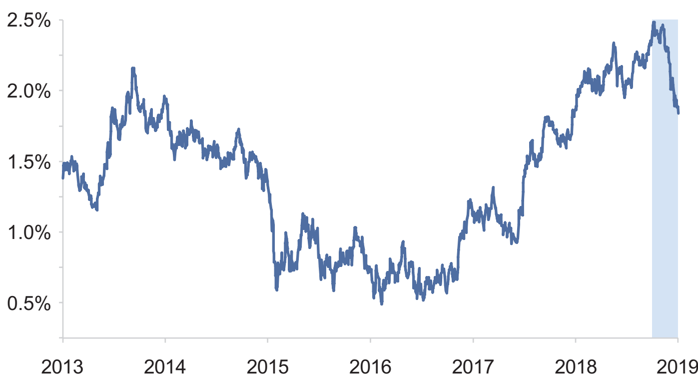
Following the direction of interest rates in the U.S., yields in the domestic bond market fell substantially across the curve throughout the quarter. Short-end yields fell at roughly the same pace as long-end yields, thus there was little change in the shape of the full yield curve. The curve remains positively sloped, but only marginally so with about 25 basis points of yield separating two-year and thirty-year maturities. This trend matched the move in the U.S.

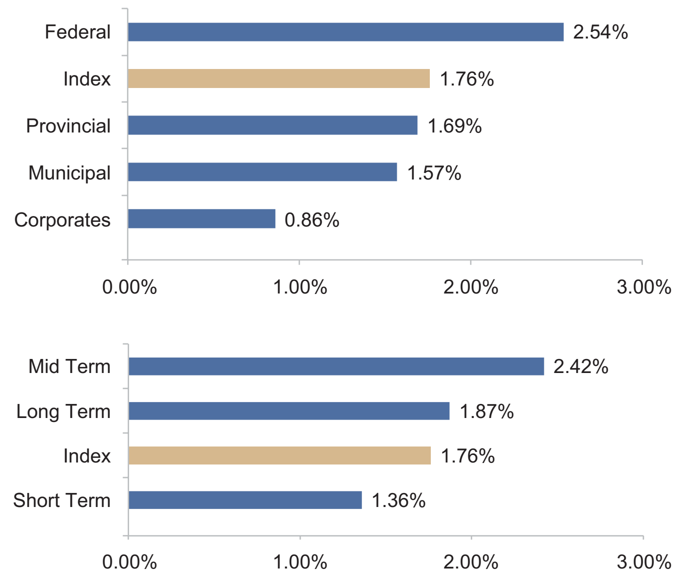
Five-year Government of Canada Bond Yield



Source: Bloomberg

Performance of FTSE Canada Universe Bond Index Sectors and Term Structure

(Three months ending December 31, 2018)



Source for both graphs: FTSE Canada

Corporate bond markets became unsettled this quarter as corporate yield spreads relative to Government of Canada bond yields moved noticeably wider to levels not seen since the summer of 2016. Lower investment-grade and high-yield corporate borrowers fared more poorly than higher-grade borrowers. By sector, and on a duration-adjusted basis, this was the key theme throughout the corporate bond market.

Similar to the corporate bond market, provincial spreads ended the quarter wider than three months earlier. Driven by a weaker price for a barrel of oil, the Province of Alberta performed relatively poorly. Due to a credit rating downgrade from rating agency Moody's, the Province of Ontario also performed poorly.

U.S.

For most of 2018, the U.S. economic situation might be described as exceptional. Tax cuts and other fiscal government initiatives accelerated growth while other countries' economies slowed. This exceptionalism is set to fade in 2019 as the growth spread between the U.S. and the rest of the world is expected to narrow. This change would result from the waning effects of tax cuts, congressional gridlock, and tightening financial conditions as the delayed effect of quantitative tightening takes hold. Furthermore, President Donald Trump's ill-advised trade wars, especially with China, and his shutdown of the U.S. government over the border wall with Mexico create additional financial and business uncertainty.

The decline in oil prices adds a further growth impediment as the European and Japanese economies, as net oil

importers, benefit more than the U.S. What the U.S. consumer gains from lower energy prices may be more than offset by losses for domestic oil producers. This slowdown, combined with tame inflation, may pressure the Fed to stop raising the Fed Funds rate or at least reduce the number of rate hikes in 2019. As Fed Chair Jerome Powell has implied, further Fed monetary actions remain dependent on economic data.

Euro area

Eurozone economic growth slowed notably in the third quarter, hitting a four-year low as export growth declined amid global trade wars. In the industrial sector, the auto industry was also impacted by new emissions tests. Recent economic data releases showed mixed results. October industrial production increased and employment remained stable. November consumer and business sentiment indices declined, with the Purchasing Managers' Index (PMI) reaching a four-year low.

On the political front there were signs of vague but potential cooperation between heads of state. In December, European leaders accepted a slimmed-down version of French President Emmanuel Macron's unified budget proposal. These Eurozone proposals were targeted at spurring investment and reducing economic disparities among EU economies. These initiatives may revive overall Eurozone reforms. However, major challenges remain as difficult decisions regarding the size of the budget awaits further discussion. As history would suggest, this process could be lengthy as EU member countries have unique political agendas.

Growth could improve into the 1.5% range in 2019, compared with recent annualized quarterly GDP growth of 0.8%, but overshadowing such optimism is the rising threat of trade protectionism and internal populist politics.

U.K.

The U.K. economy lost momentum in the quarter. Retail sales declined in October for the second month in a row. Lower car sales and a softening pharmaceutical sector added to the economic pressure. The November services PMI sank below a two-year low due to weak new orders and declining consumer sentiment. On a more positive note, employment growth, while slowing, was solid and wage increases reached close to a 10-year high.

Looser fiscal policy and higher wages could boost 2019 private consumption. However, until there is a final result on Brexit, private fixed investment will remain subdued. The main risk and uncertainty from an economic and investment basis still surrounds whether, and how, the U.K. departs from the EU in March. The jury is still out on whether the above offsetting positive and negative factors will cause a minor or major effect on the overall U.K. economy.

Japan

The Japanese economy is expected to continue to rebound slightly as it recovers from the strong typhoons and a powerful earthquake in the third quarter of 2018 that severely disrupted supply chains and resulting economic activity. The manufacturing PMI increased slightly in the latest quarter. The Tankan Survey of Japanese business plans showed that large firms were planning to increase capital spending in the first quarter of 2019. Continued stimulative monetary and fiscal policies, a tight labour market and construction work related to the 2020 Tokyo Olympics should support GDP growth in the 0.5% to 1% range, despite a consumption tax hike coming into effect in October and the wild card of potentially rising global trade protectionism.

Emerging Markets

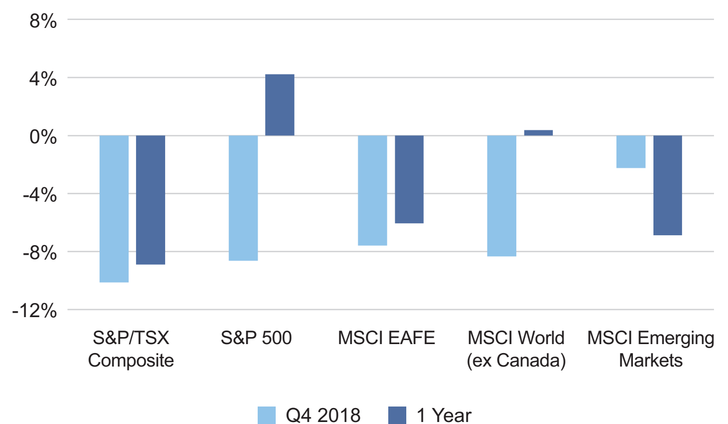
Despite market turmoil in emerging markets caused by trade wars and a high valuation for the U.S. dollar, many emerging market economies are growing twice as fast as developed economies. Overall economic management in most emerging markets is reasonably solid, with subdued inflation and sovereign debt burdens lighter than U.S., European and Japanese measures. An added bonus for investors is that emerging market stock market valuations are considerably cheaper that those of developed markets.

However, according to third quarter 2018 GDP data, emerging markets, like developed economies, are losing momentum as trade war concerns escalate and commodity prices weaken.

Weaker growth in regional powerhouses Turkey and Russia, and slower growth in the Eurozone, put downward pressure on economic activity in Eastern Europe. Latin American growth was meager due to softening economic activity in several key economies. However, in Brazil, hope springs eternal with the new controversial president's pledge to reverse socialism and become more democratic. Stronger growth in agricultural production improved the prospects for the sub-Saharan region, especially Nigeria and South Africa. The Middle East and North Africa benefited earlier in the year as oil prices strengthened but this tail wind has become a headwind with the significant deterioration in oil prices since September.

China, the dominant emerging market, has shown signs of economic weakness. The country is the major combatant in the trade wars with the U.S. president and the Bank of China reduced credit growth. GDP growth slowed from an enviable 6.6% to 6.2% by year-end 2018 market forecasts, still substantial by developed world standards. There is some hope for a future resolution on the trade front, but this varies daily. At the G20 summit in Buenos Aires in December, the U.S. and China agreed not to increase tariffs for 90 days to allow time for further negotiations. The worst-case scenario is that the situation deteriorates and impacts U.S. growth by 1% and Chinese growth by 1.6%. Obviously, this scenario would have negative overall effects on many other world economies.

Equity Index Performance (CAD)
at December 31, 2018



Source: TD Securities, MSCI

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