2019 Canadian Investment Outlook

FRANKLIN TEMPLETON THINKS™ GLOBAL INVESTMENT OUTLOOK

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FRANKLIN TEMPLETON INVESTMENTS

Canadian equities: Faltering but not fallen

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The bull market in Canadian equities that began on March 9, 2009 is now in its tenth year. During this period, the market has experienced corrections three times: in 2011, 2014 and 2016. In the fall of 2018, the S&P/TSX Composite Index reached correction territory—which we define as a pullback of 10% or more—for the fourth time.

In most industrialized countries, we are seeing a gradual moderation of growth as economies and industries begin to feel the effects of protectionist policies, trade wars, rising interest rates and geopolitical tensions. Despite general optimism regarding the US economy, economic storm clouds in some jurisdictions outside North America could dampen broader global economic growth in 2019.

Will Canada be one of the brighter lights?

The Organisation for Economic Cooperation and Development (OECD) recently projected a 2019 annual Gross Domestic Product rate of 2.2%. While we believe protectionism will remain a critical issue worldwide, the successful conclusion to the United States-Mexico-Canada Agreement (USMCA) negotiations has brought a measure of increased clarity, although US steel, aluminum and lumber tariffs remain in place.

Growth versus value: Is the tide changing?

Especially over the last five years, we have noticed a clear dynamic in which growth stocks have outperformed value stocks. Valuations and business fundamentals have had less influence on equities while momentum and potential have gained in influence. Accommodative monetary policies keeping markets liquid and the popularity of passive investing have helped extend that outperformance period. Falling bond yields have also supported demand for stocks.

It is at times like these, when so many investors are concerning themselves with potential and disregarding fundamentals, that our long-term perspective and discerning approach can take advantage of the opportunities that present themselves today and set the stage for strong and differentiated performance tomorrow.

It's still the same old (sector) story

Although we take market trends into consideration, as fundamental equity analysts our focus is primarily on the extent to which these larger trends have been priced into the market. While some areas of the equity market seem overly exuberant, presenting opportunities to trim or eliminate positions, we also continue to find attractive opportunities in sectors and securities that have not kept pace with the more favoured parts of the market.

Energy in the crosshairs

Oil is one of Canada's largest exports, and the state of the energy industry has a significant impact on the economy and the stock market. Following a reasonable recovery through the first nine months of 2018, in October we saw oil enter a bear market on oversupply concerns and rising US inventories. In response, members of the Organization of the Petroleum Exporting Countries (OPEC) as well as Russia, Europe's largest oil exporter, agreed to production cuts to take effect in January.

In addition to the broader industry dynamics, western Canadian producers have faced two additional home-grown challenges: a lack of pipeline export capacity and a sizable price gap between US West Texas Intermediate crude oil and Western Canadian Select crude. In December, the Alberta government introduced mandatory production cuts to support Canadian crude prices and producers turned to the railways to ease the shipping dilemma.

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The effect of these measures on prices has been immediate and positive. Whether the improvement will continue into 2019 is an open question.

Overall, energy sector valuations have declined to reasonable levels and we have been capitalizing on the weakness to buy shares or add to existing positions in what we consider good businesses at great prices.

Which sectors benefit from rising rates

The direction of interest rates has an enormous influence on the value of equities. Rising rates can hurt businesses with long-duration assets, such as real estate, and those with levered capital structures. Yield-oriented equities of companies that pay out high dividends may also be vulnerable. On the other hand, rising rates can be positive for some financials, especially banks and insurance companies.

A stock picker’s market in 2019

Ultimately, equity market returns not rooted in the fundamental progress of the underlying business are generally unsustainable. While impressive progress has been made by many companies in the Canadian equity marketplace through the current market cycle, we also have seen many cases of equity returns far exceeding the progress of the underlying business. Based on a philosophy that market returns ultimately reflect the underlying intrinsic value growth of constituent businesses, we expect returns and fundamental progress to roughly equate over time; but the ebb and flow of market sentiment is much less predictable.

We continue to believe in the potential for the Canadian equity market to be an excellent source of returns. Meanwhile, we remain mindful of developing trends and the changing dynamics for Canadian equities. As such, we believe now is an important time to be increasingly discerning and active, not more complacent.

SECTORS TELL THE STORY

S&P/TSX Composite Total Return Index
Annualized Return
March 9, 2009 to November 30, 2018

	Current Weight (%) As of 11/30/18	Annualized Return (%) 3/9/09 – 11/30/18
Communication Services	5.87	14.89
Consumer Discretionary	4.39	15.54
Consumer Staples	3.85	15.58
Energy	17.81	4.12
Financials	34.23	17.07
Health Care	1.65	7.93
Industrials	10.74	18.91
Info Tech	4.07	7.29
Materials	10.22	0.18
Real Estate	3.16	18.75
Utilities	4.01	9.00
S&P/TSX Composite TR	100.00	10.59

Source: S&P/TSX, Franklin Templeton Investments.

Canadian fixed income: Preparing for winter

Tom O'Gorman
Director of Fixed Income
Franklin Bissett Investment Management

In the face of tightening monetary conditions, rising yields and lower bond prices, Canadian fixed income largely fulfilled its promise as a stabilizing counterpoint to equity market volatility in 2018. We say "largely" because fixed income has only generated a few basis points of performance year to date through November. This result, however, must be considered in the context of monetary policy tightening─the Bank of Canada (BoC) has raised the overnight rate five times, or 1.25%─and the fact that we are coming off historically low interest rates. In reality, muted inflation has contained the rise in interest rates to the short end of the yield curve, as longer-term rates have risen approximately 20-30 basis points (bps) year to date.

Since September, financial market volatility has increased, noticeably weighing on risk assets and investor sentiment and accentuating downdrafts in the equity market. Both globally and south of the border, the backdrop has been similar. US equity markets have fared slightly better; the S&P 500 has posted positive returns in Canadian dollars, helped by an increase of over 6.0% in the US currency against the Canadian loonie.

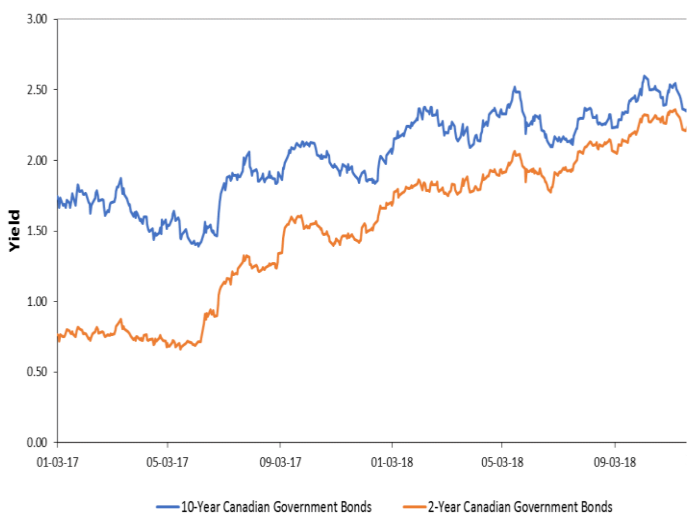
US fixed income has performed worse than Canadian fixed income, with the Bloomberg Barclays Capital US Aggregate Index down 1.0% and investment-grade corporate bonds down nearly 4.0% (both in US - dollar terms).

The last sharp increases in volatility appear to have halted bearish bond sentiment, reasserting fixed income's traditionally negative correlations with equities.

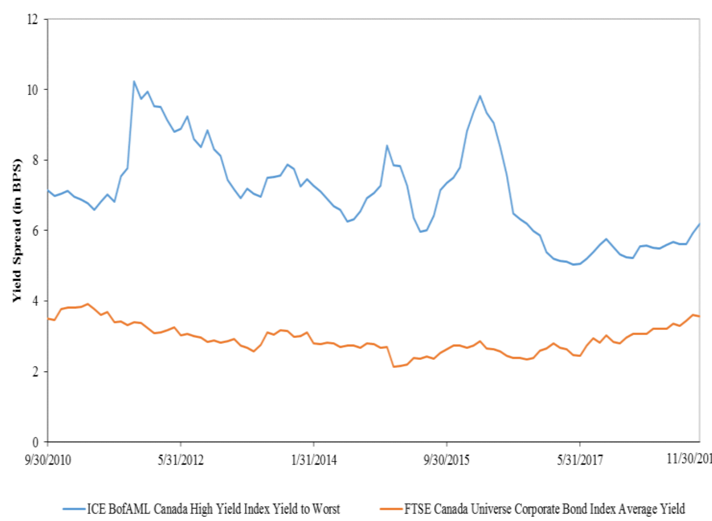
There is a lot to think about as we enter 2019. Will central banks continue to tighten? Will the inflation genie finally show itself? How much will economic growth slow, and what will be the impact of trade policy and geopolitical uncertainties? We think some of the market equanimity witnessed over the last few years could be shaken in 2019 as the full effects of these risks take hold in a business cycle beginning to show its age.

FLATTENING YIELD CURVES AND SHRINKING SPREADS

2-Year and 10-Year Canadian Government Bonds Yields
January 3, 2017 - December 18, 2018



High Yield vs. Investment Grade Corporate Bond Yields
September 30, 2010 – November 30,2018



Source: FactSet, Franklin Templeton Investments

> Overall, we expect Canadian economic growth to continue to slow."

The global economy: slowing but still growing

Although the "Goldilocks" environment of synchronized global growth and low volatility faded as 2018 progressed, global Gross Domestic Product (GDP) has been running in line with its long-term average of 3.5%. But in its most recent outlook, the OECD stated that overall, world economic growth had peaked. Risks are to the downside.

Stronger economic growth was the catalyst for many central banks to slowly begin tightening monetary policy, although the process has been so gradual that considerable liquidity remains in the markets today. Absent data surprises or unexpected policy announcements, we expect global central bank liquidity will continue to be supportive of financial markets in 2019, though this support will decline as quantitative easing is gradually replaced by quantitative tightening.

Canadian economic growth may disappoint optimists

Canada's economic growth beat expectations in 2018, which we attribute partly to piggybacking on US economic and tax-cut tailwinds as well as increased economic activity ahead of imposition of US tariffs on some Canadian imports.

The OECD predicts that the domestic economy will grow slightly faster next year, with GDP in 2019 rising 2.2% following an expected 2.1% growth rate in 2018. We believe there is a reasonable chance that growth will be below 2%; at a minimum, we believe the risks are to the downside. The successful conclusion to the USMCA trade negotiations has removed some trade uncertainty, but tighter mortgage rules and higher mortgage rates are likely to intensify as the year progresses. Business managers report high uncertainty surrounding both international event risk and domestic public policy, which could restrain investment spending. Overall, we expect Canadian economic growth to continue to slow.

Will the BoC and Fed pause in 2019?

The BoC has raised rates five times since 2017; four of those hikes occurred in 2018. Although the BoC has hinted at more hikes in 2019, we would argue that it is possible—given the inflationary backdrop, lower oil prices and the lagged effect of higher policy rates—that the BoC could be done, or at most would have one more hike in store before a long pause.

Given the strong trade and financial ties with our neighbour to the south, Canadian central bank movements are inevitably influenced by developments in the United States. In 2018, US economic strength was boosted by tax cuts, but we expect those effects to dissipate heading into 2019. Moreover, while trade tensions between the United States and Canada may have eased with the signing of the USMCA, US-China and US-European Union trade frictions remain a concern.

The Fed was the first central bank to start the process of normalizing interest rates and reducing its balance sheet assets by reversing quantitative easing. Given typical lags, we expect tighter financial conditions to really begin to bite in 2019. While there has been much discussion about the flattening of the yield curve and the possibility of an inverted curve, we do not subscribe to the notion that "this time is different". In our view, an inverted yield curve is another form of tighter financial conditions and doesn't matter. At some point, we believe the Fed will be forced to pause as it becomes clear that growth is slowing and inflation expectations are well anchored.

Volatility likely to stay elevated

Increased volatility is reflective of an increase in uncertainty globally and unwinding of very easy financial conditions, both of which we expect will be increasing over the next year. Several

> “Despite nearly 10 years of positive economic growth, system-wide leverage has not declined. On the contrary, it is higher now than prior to the financial crisis.”

sources of potential market risk exist, the primary one being the risk that central banks take the current tightening paths too far, leading to a major slowdown. It’s a significant concern. Despite nearly 10 years of positive economic growth, total leverage is higher now than prior to the 2008 financial crisis. In this environment, the impacts from higher interest rates would be felt more quickly than in the past.

Political and geopolitical risks have continued to rise after a period of remission. We expect global trade tensions to remain elevated despite the current truce postponing implementation of new tariffs to the end of March 2019. The overhang of future tariffs is likely to remain an area of near-term consternation for markets. Additionally, early interaction between the current US administration and newly elected Congressional leadership has proven acrimonious. While markets generally like gridlock, this time may prove different given the parties involved.

Flattening yield curves, fluctuating currency…

With short-term rates near 10-year peaks and the Canadian yield curve at its flattest since 2007, we see the potential for unwanted surprises to push Canadian longer-maturity bond yields and the Canadian dollar lower against the US dollar. While a weaker Canadian dollar would be positive for exports, it would place additional price pressure on companies and consumers purchasing imported goods and services.

…and fully valued credit

Given the recent backup in credit spreads and the aging business cycle, we view credit valuations as being fairly valued..

Fundamental credit quality remains supportive; however, the positive sentiment and supply-demand backdrop may be waning as we approach 2019

We continue to favour corporate bonds. Our preference is for higher-quality credits, given the yield cushion they provide against any sharp and/or unexpected increase in government rates.

In the current macroeconomic environment, we expect credit spreads to remain range-bound, with a risk that they could still widen. Much will depend on the macroeconomic backdrop and the pace of central bank normalization.

More 2019 viewpoints

Visit our web site to check out more in-depth asset allocation research to help you consider portfolio-level decisions.

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