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TOP BUSINESS STORIES OF 2018

THE FED KEPT ITS PEDAL TO THE METAL

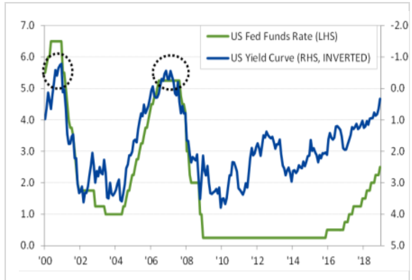
The US Federal Reserve raised interest rates four times in 2018 taking the Fed funds rate up to 2.5%. The Fed raising short-term rates caused the US yield curve (the difference between long- and short-term Treasury bond yields) to flatten, compounding investor concerns that the rate hikes would lead to slower economic growth. A potential *inverted* yield curve, where long-term interest rates dip below short-term rates, also received a lot of attention 2018, as it has an accurate historical track record of predicting recessions.

The US yield curve came close to inverting, but fortunately didn't. The spread between US 10-year and 2-year Treasury yields closed to as little as 11 basis points after beginning the year at almost 60 basis points.

Our Take for 2019

We see the Fed moderating its tightening policy and forecast only one rate hike (two at the most) in 2019. Raymond James Chief Economist Scott Brown had this to say following the last Fed meeting: "there was ample discussion of downside risks to the economic outlook—and while most still expect [an increase in] short-term interest rates in 2019, the appropriate extent and timing was "less clear." Low inflation allows the Fed to be "patient" in deciding when to raise rates…."

One Fed hike unlikely to invert the yield curve in 2019



Source: Bloomberg, Turner Investments

"Patient" to us suggests a slowdown in rate increases. If we're correct and only see one hike in 2019, the US yield curve is unlikely to invert, which should alleviate investor recession concerns. But whether it's one or two hikes, slower rate increases overall will likely be positive for equity markets.

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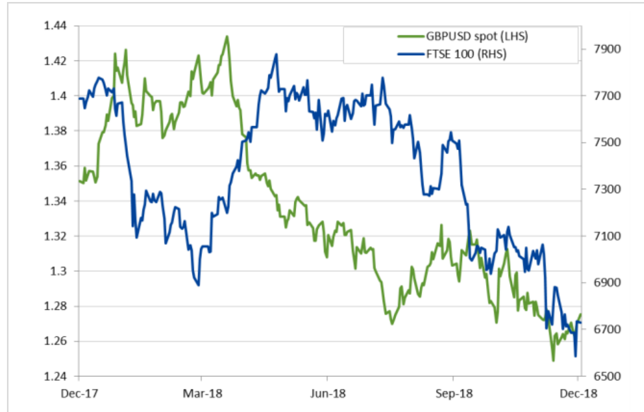
BREXIT: NO END IN SIGHT

It's hard to believe that this whole mess started way back in 2016 and yet by the end of 2018 we still had no more certainty regarding the future of the United Kingdom's trade relationship with Europe. Prime Minister Theresa May fought throughout 2018 to rally support for her Brexit proposals, but in the end faced bitter resistance from all sides: the European Union (EU), opposition parties and even from within her own party. No deal was reached and her political future seemed more in jeopardy with each passing week. She survived the year, but the biggest worry for investors remains a so-called 'hard Brexit', in which the UK leaves the EU with no trade arrangement, possibly creating chaos as each individual trade deal between the two regions would have to be renegotiated separately.

The FTSE 100 and GBP plunged in tandem throughout most of 2018



Source: Bloomberg, Turner Investments

Investors took the uncertainty out on both the British pound and the FTSE 100 (London) as they fell 5.6% and 12.5%, respectively, in 2018 (see chart).

Our Take for 2019

Jeremy Corbyn, leader of the Labour Party opposition, has warned that no deal would be "catastrophic" for the UK economy. Though they don't agree on any of the particulars of the deal, in this respect, both he and Theresa May are aligned. Add in the Bank of England's late 2018 warning that no deal could result in a 30% collapse in UK house prices and the unemployment rate jumping from 4.1% to about 7.5%, we feel that the stakes are sufficiently high that a compromise will be reached. Further, forcing a change of leadership of May's Conservative party or forcing a new general election at this late stage almost certainly means that the end-March 2019 Brexit deadline will be missed, worsening the crisis.

We believe that the pressure of a looming deadline will ultimately provide the motivation for compromise, not unlike how we all study harder when an exam deadline nears; however, we recognize that failure to reach a deal is a legitimate market risk. We have minimal UK equity market exposure in our client portfolios.

NOT SO EASY TO WIN AFTER ALL: TRUMP'S TRADE WAR WITH CHINA GOT UGLY

It started with months of Trump threats, but by the summer the US had actually begun to slap tariffs on Chinese goods and thus a trade war between the world's two largest economies officially began. Near year-end, both countries had agreed to a temporary truce, but by that time the US had already imposed tariffs on roughly US$250 billion worth of Chinese products with threats of US$260+ billion more to come. China meanwhile had responded with roughly US$110 billion of its own tariffs on US goods.

Needless to say, the escalating trade war was one of the key reasons why global equities dropped sharply in 2018. The MSCI World Index finished 10.4% lower y-o-y, with the US-China trade war taking the brunt of the blame.

US markets fell but still maintained the upper hand against China

Source: Bloomberg, Turner Investments.

Our Take for 2019

US and Chinese trade negotiators continue to try to hash out a new deal, which could see China not only buy more US goods but also address concerns over its unfair business practices (e.g., intellectual property theft and forced technology transfers in exchange for China market access). It will likely be a bumpy ride with occasional setbacks, but we expect that a deal will be signed this year.

One key reason for our optimism is simply Trump's obsession with the stock market, which he views as a barometer of his presidential success. His tough approach with China, of course, has weighed on US equities and we believe that 2018's market weakness (and any future weakness) will incent him to finalize a deal. Trump himself acknowledged that the December market decline was a "glitch" and that markets would "go up once we settle trade issues."

WHITE HOUSE CHAOS

Working for Donald Trump isn't easy. Just ask former Chief of Staff Reince Priebus who was one of the first major White House departures, replaced in 2017 by John Kelly. Since then, the parade of leavers has continued unabated and many of those exiting have held key, senior positions including: Press Secretary, National Security Advisor, White House Counsel and Chair of the Council of Economic Advisors. What's also unusual about the turnover is Trump's frequent replacement of many of his own appointees. He's on his third press secretary, for example. According to Brookings, Trump is setting new records for White House staff turnover.

You're fired! Trump's White House turnover setting records

	Year 1 (%)	Year 2 (%)	Total (%)
Regan	17	42	59
Bush I	0	17	17
Clinton	25	33	58
Bush II	0	17	17
Obama	8	33	41
Trump	50	33	83

Source: Brookings; 'Tier one' staff turnover during first two years of presidency.

Through the first two years of his presidency ‘tier one’ turnover has been a staggering 83%—more than double Barack Obama’s turnover rate in his first two years as president (see table above).

Since Trump took office, investors had largely ignored the White House firings and departures, but in 2018, a kind of ‘critical mass’ occurred and investors began to pay attention. An inflection point may have taken place near year-end, when Defense Secretary James Mattis resigned and released a letter that was highly critical of Trump’s decision to remove US troops from Syria. Tellingly, Russian President Vladimir Putin supported Trump’s decision, saying it was “correct”. The S&P 500 fell for three consecutive days following Mattis’s resignation, losing more than 6%.

Our Take for 2019

We believe that White House departures, which equity markets usually ignore, now have the potential to cause disruption and add to volatility. The number of senior staff heading for the exits is so vast that the market is beginning to conclude that the turnover is actually impairing economic growth and national security. Special counsel Robert Mueller’s investigation also looms over Donald Trump. While the available evidence suggests that the outcome won’t be favourable for Trump—thus far, more than 30 people have entered guilty pleas including five former Trump advisers—we acknowledge that, as a Trump replacement, Vice President Mike Pence shares a similar economic agenda and we suspect that the investigation results (for or against Trump) are unlikely to negatively impact markets for long. In fact, the market may appreciate the certainty of finally knowing what Mueller has discovered.

More concerning is the White House staff turnover. Firings and resignations are now being scrutinized by investors. If the market sees a deceleration in US economic growth, we believe that it will draw a direct line to Trump and conclude that it’s due, at least in part, to his inconsistent staffing.

VOLATILITY JUMPED

While we certainly didn’t get all of our forecasts correct last year, we definitely nailed our prediction on volatility. Here’s what we said in January 2018:

> Volatility has now declined for three consecutive years, which is unusual; sits at roughly *half* its long-term average; and, except for a brief period in 2015 and 2016 has been subdued for roughly six years. Historically, 5–7 years is close to the maximum length of time for volatility to remain low. The pattern suggests to us that volatility is likely to begin rising, perhaps this year. What will cause the rise is uncertain (A Trump indictment? Trump’s unpredictable foreign policy? Interest rate increases?), but an emphasis on ETFs that control volatility without significantly limiting upside potential will be a priority throughout the year.

A Trump indictment, of course, didn’t occur, but volatility definitely roared back. After averaging a measly 11.1 in 2017, the Cboe Volatility Index shot up to average 16.6 in 2018 and spiked at the end of the year to more than 35. Rising interest rates, turnover at the White House, rumblings about the outcome of special counsel Robert Mueller’s investigation, Brexit, plummeting commodity prices, the US trade war with China and Italy’s head-to-head battle with the European Union, all converged to make 2018 a far riskier year for equities.

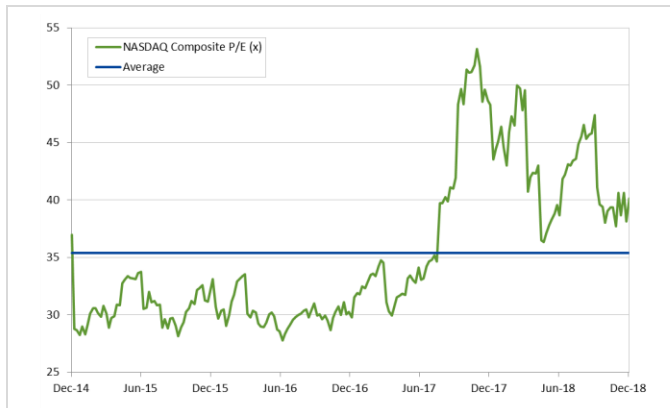
Our Take for 2019

With no immediate resolution in sight for either the US-China trade war or Brexit, it's likely that volatility will remain elevated at least throughout the first half of 2019. There are also new anxiety-causing developments that weren't, for the most part, present last year, including a US government shutdown, a divided US Congress and a troubled technology sector. Last year, we stated that we would place "an emphasis on ETFs that control volatility without significantly limiting upside potential". This will be our same focus this year. However, it's important to emphasize that, even though volatility spiked more than 130% last year, it was coming off a low base. Volatility levels are actually still in-line with long-term averages. We are not in crisis. Therefore, controlling risk will likely be done gradually at the individual ETF level versus making large, defensive shifts in overall asset mix. We expect markets will remain choppy, but our outlook is still favourable. Becoming too defensive, too early, can significantly blunt upside.

TECHNOLOGY STOCKS PLAYED ICARUS: FAANGs SOARED…THEN PLUMMETTED

Sunny. Throughout the first nine months of 2018, this would be the best way to describe the performance and outlook for Facebook, Amazon.com, Apple, Netflix and Alphabet (Google)—the FAANGs. Buoyed by the market's love affair with all things technology related, strong earnings growth and the tailwinds of the 2017 Republican corporate tax reform, FAANGs could do no wrong throughout the first three quarters. In fact, Netflix, which led the pack, was up an astonishing 95% by the end of Q3 and Amazon.com wasn't far behind with a 71% gain.

NASDAQ valuations reached unsustainable levels at start 2018



Source: Bloomberg, Turner Investments

Then the sun became too hot. Halfway through the year, Facebook faced massive criticism and CEO Mark Zuckerberg appeared before Congress after the company was accused of selling data from roughly 50 million users so data-analytics firm Cambridge Analytica could better profile US voters. This sent a chill throughout the technology sector. Shortly after, it became apparent that Trump's China trade war (see page 3) was finally starting to negatively impact technology companies' operations and revenue as many technology companies either manufacture in, or source product from, China. Further, many of these companies also rely on the Chinese consumer as a key sales driver. And, finally, valuations had reached such elevated levels that it became easy for investors to justify taking profits (see chart above). In the fourth quarter, every single FAANG stock was down double-digits and many (Amazon.com, Apple and Netflix) ended the quarter down by 25% or more.

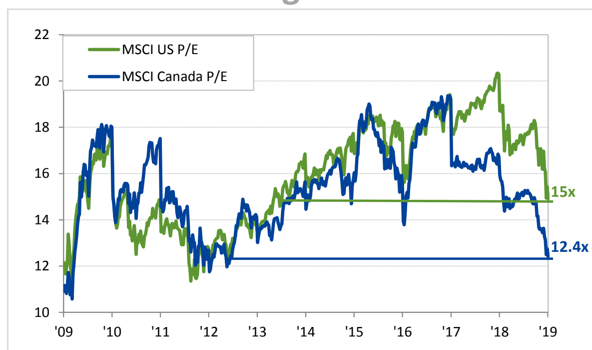
Our Take for 2019

Throughout 2018, for many of our clients, we lowered the growth focus of their US equity exposure by adding the Vanguard Value ETF (VTV). Our concern with US growth equities was primarily centred on their expensive valuations and the addition of VTV helped limit downside during the Q4 sell-off. At one point last year, the tech-heavy NASDAQ had reached a price-to-earnings (P/E) ratio of more than 50x, which we didn't believe was sustainable. The NASDAQ's five-year average P/E, as a point of comparison, sits closer to 36x. While the Q4 sell-off certainly made the growth/technology space less expensive, valuations are not yet compelling and Trump's trade war with China continues. Therefore we remain comfortable with the addition of VTV and have no immediate plans to increase the US-equity growth weighting in client portfolios.

VALUATIONS: TO THE MOON AND BACK

2017 was a great year for US equities with the S&P 500 returning more than 19%. However, with the big price gains, equity valuations became stretched coming into 2018. The S&P 500 started the year trading at a forward price-to-earnings (P/E) multiple of 20x, which equated to a 25% premium to the long-term average of 16x. As we enter 2019, the story is quite different with equity valuations at the most attractive levels in years.

Valuations looking more attractive



Source: Bloomberg, Turner Investments

Our Take for 2019

Currently, the S&P 500 is trading at an attractive 15x P/E, which is a discount to its long-term average. The P/E contracting from 20x last year to 15x currently is a result of both the huge increase in 2018 US corporate earnings (earnings rose an estimated 25% y-o-y last year) and lower stock prices following the Q4 correction.

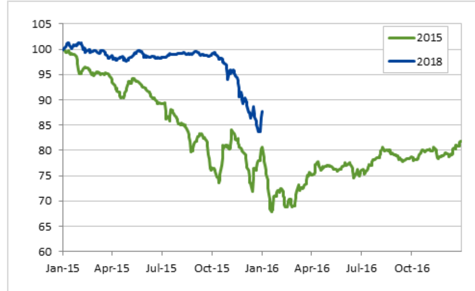
Another way to think about this is that the S&P 500 is now trading back at 2013 valuation levels when the index was trading at just 1,600. Today, the S&P 500 is trading at roughly 2,500 (more than 50% higher than in 2013) but is trading at the same valuations. In short, US stocks are attractively valued in our view.

Provided the global economy and corporate profits hold up this year, these attractive valuations could help propel US and global equity markets higher in 2019.

CANADIAN PREFERRED SHARES TANKED

The Canadian preferred share market was doing just fine last year—until the fourth quarter: then all heck broke loose. Risk assets, of course, plunged in Q4 on Fed rate hike concerns, the US-China trade war escalation and the general chaos emanating from 1600 Pennsylvania Avenue. During these sharp risk-off periods, equities, high-risk bonds and preferred shares tend to decline in tandem. For Canadian preferred shares, the sell-off can be made worse because of their lack of liquidity and heavy retail-investor ownership (retail investors tend to overreact to prevailing market conditions). Tax-loss selling in November and December also compounded the problem.

2019 Canadian preferred recovery could mirror 2016



Source: Bloomberg, Turner Investments

Ultimately, the S&P/TSX Canadian Preferred Share Index fell by 7.9% y-o-y (including dividends) in 2018.

Our Take for 2019

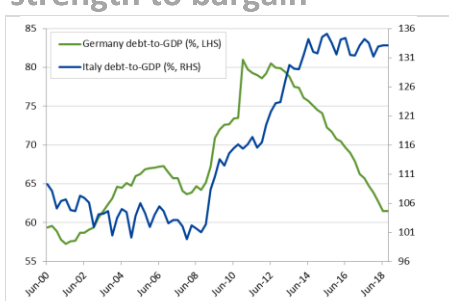
When preferred shares suffer a down year the decline tends to be worse in December as investors sell to generate tax losses. However, this often results in an oversold market with buyers rushing back in to scoop up bargains in the early months of the following year. We believe this could occur again and see a better overall year for the Canadian preferred share market in 2019.

The Canadian preferred share market also now yields more than 4.5%, which is more than 250 bps higher than the GoC 5-year bond yield—the highest spread since 2017. We also see the Canadian economy holding up reasonably well in 2019, which should support investor sentiment towards the preferred share market. Lastly, we see the GoC 5-year yield (the main driver of Canadian preferred share prices) moving higher, which could be another positive for preferred shares.

QUITALY?

It began with a messy general election in March, which resulted in the populist Five Star Movement party winning the greatest number of seats in the Italian parliament but still lacking the numbers to form a majority government. After long and bitter negotiations, the Five Star Movement eventually formed a shaky collation government with the right-wing League party. European markets were immediately on edge as Italy's exit from the European Union (EU) suddenly became a possibility.

Italy lacks the economic strength to bargain



Source: Bloomberg, Turner Investments

Things got worse from here as the proposed budget from the coalition government was free spending, offered massive tax breaks that favoured the bases of both coalition parties, lowered the retirement age and generally flaunted the laws of the EU. The EU immediately objected and after an epic battle that lasted almost the entire year, the Five Star/League coalition finally conceded and rolled back much of its budget excess.

Italian equity markets plunged 16.2% in 2018, but interestingly it was Germany's equity market that fared the worst, dropping more than 18%. Germany's underperformance was due in part to its perceived role as the 'bailer out' of Europe's economically weaker countries. Germany's equity market typically underperforms during times of EU economic stress because Germany is seen as the country that will have to sacrifice the most to rescue everyone else.

Our Take for 2019

The combative and strident approach of Italy's coalition government is an ongoing concern, but we were pleased that the EU was eventually able to prevail. Italy's economic realities were what ultimately forced the coalition government's hand. The chart above illustrates Italy's debt as a percentage of GDP compared to Germany. The situation is fragile, but a precedent has been set: the EU will not cave to Italy's demands and Italy lacks the economic strength to bargain. While all of Europe would suffer economically if Italy left the EU, it's the Italians who would suffer most. And, in the end, the coalition government knew it.

EU GDP growth was negative in 2012 as the region struggled with the Greece crisis. Thus far, the problems in Italy have not escalated to the same level. EU 2018 GDP growth will likely come in in the 2% range and consensus expects 1.6% growth in 2019. Europe isn't perfect, but we believe it will continue to limp along and avoid crisis this year.

A TOUGH YEAR FOR EQUITIES, BUT UNDERLYING ECONOMIES REMAINED STRONG

You wouldn't have known it to look at equity market performance, but 2018 was a solid year for US and global economies. In particular, the US economy stood out as its GDP grew by roughly 3%, a noticeable pickup from the 2.2% growth of 2017. The US economy continues to be buoyed by a strong labour market as the country added 2.6 million jobs last year helping push the unemployment rate to a 50-year low of 3.7%. The US economy also got a big boost from the Republican government's fiscal stimulus, which included historic tax cuts for corporations and individuals, and an increase in government spending. China's economy also performed well last year growing at roughly 6.5%, though we have seen a moderation of growth recently due in part to Trump's trade war. Canada, meanwhile, muddled along, growing around 2% last year despite the 25% decline in the WTI oil price. Overall, the global economy grew a solid 3.7% in 2018, which matched 2017's growth rate.

Forecasted GDP growth rates (%)

Consensus GDP Outlook				
Country/Region	2016	2017	2018E	2019E
Global	3.3	3.7	3.7	3.5
US	1.6	2.2	2.9	2.6
Canada	1.1	3.0	2.1	1.9
Eurozone	1.9	2.4	1.9	1.6
United Kingdom	1.8	1.7	1.3	1.5
Japan	0.6	1.9	0.9	0.9
China	6.7	6.9	6.6	6.2

Source: Bloomberg, Turner Investments

Our Take for 2019

While we expect growth to moderate this year, we still remain upbeat regarding the US and global economies. Critically, we believe recession odds are low. The US economy is likely to slow from the roughly 3% growth seen in 2018, as the government's one-time fiscal stimulus rolls off, but we see the US economy still growing at a decent 2.5% pace in 2019. As seen in the above table, China's economic growth is expected to slow from 6.6% to 6.2%, and the overall global economy is expected to slow from 3.7% to 3.5% this year, based on consensus estimates. However, this is hardly a major contraction.

Most bear markets are brought on by a US or global recession, which, we believe, remains very unlikely in 2019.

CONCLUSION: THE TRUMP ERA CONTINUES

Observant readers will note that this was our concluding header last year as well. What else can we say? Normally, a president's actions wouldn't have this much influence over markets, but these aren't normal times. We didn't foresee an all-out trade war with China last year and it seems certain that Trump will pursue some kind of unexpected and disruptive foreign or domestic policy this year as well. While we focus on the market positives—global economic strength, still-robust corporate profit growth, fewer interest rate increases and more attractive valuations—we recognize that there are still risks to our favourable outlook. And, it certainly isn't just Trump's unpredictability that's creating this risk—the Brexit deadline, for example, also looms on the horizon.

So, there's much uncertainty in the world. Trump's response when asked if he would declare a national emergency to end the US government shutdown illustrates this perfectly: "I'll probably do it. Maybe definitely."

Now more than ever, a balanced and diversified investment portfolio is essential.

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