May 29, 2019

## Caution; Trade Clash Ahead

While global stock markets are up about 11% this year, the US-China trade negotiations have derailed with both sides initiating higher tariffs. This is adding a significant level of uncertainty and equity markets have pulled back from earlier highs. China is unwilling to be bullied, while Trump seems now content to delay the outcome into the next US election. Left unchecked, it is projected these new tariffs could reduce global growth by up to 1% by the end of 2020. That would bring the global economy down to near recession level.

Trump is certainly playing many cards in this trade game. It includes banishing Huwaii as a US supplier of telecommunication equipment and services and pressuring other countries to do the same, all of which seem to be working. China is reportedly looking to restrict its exports of rare earth supplies that are paramount to electronic manufacturing; Tit for Tat!

Under the earlier 10% US tariffs on Chinese imports introduced last year, it is fair to say that it was American businesses and consumers who (indirectly) picked up the costs since China was able to maintain its US bound export volumes. At 25%, the Chinese economy will be tested far more seriously. Chinese officials are showing lots of bravado in stating that they are up for a prolonged tariff and trade war. The weakness in their stock market and Yuan currency over the past month indicates they are so far on the losing end of market perception.

On the domestic front, Trump appears to have effectively deflected, for now at least, the impact of the Mueller report. Congress, under Democrat control, remains steadfast in their pursuit. Eventually Trump will have to deal with the powerful Southern District court of New York and its power to subpoena whoever, though this is probably one year away. In terms of presidential election, the Democrats with over 20 candidates, are looking rather disorganized as they attempt to take back the White House in 2020.

Meanwhile the US Federal Reserve is indicating it will keep interest rates on hold for the remainder of 2019. Despite full US employment, inflation remains subdued and this just as we are entering an era of heightened job displacements as cheaper and more efficient service models replace old ones. Transport, lodging and customer shopping certainly are the first sectors that come to mind. We are entering a paradigm change not dissimilar to the industrial revolution and one that the FED seems to be paying attention to. In halting rate increases, the FEDs are back to stimulating the domestic economy. Meanwhile the bond market has reacted positively with 10-year US treasury yields sliding back to below 2.3% (from 2.8% at the start of the year). This market is now pricing in a Fed cut for later in 2019 and more in 2020.

Fair to say that the nearer term stock market outlook hinges largely on how long the trade dispute will last. Trump with a strong economy and near record US stock market levels, has all the incentives to stretch out any resolution into the 2020 election. His actions are clearly driven by his reelection strategy.

At home, the Bank of Canada is also holding its bank rate at 1.75%. While a bit downcast in its forecast on the Canadian economy, the recent removal of tariffs on Canadian (and Mexican) steel and aluminum should provide a boost. Trump cancelled these tariffs in order to ensure congress approves the USMC trade deal. In effect he just pulled in this chip, for now at least.

Despite all the headline news regarding Iran, tightening US sanctions and unsubstantiated military rumors, the oil markets have remained relatively stable with WTI prices hovering in the $60-63 range since the start of 2019. This stable pricing is allowing US shale oil production to grow further thereby replacing curtailed outputs from Venezuela, Iran and Libya. We note that low North American natural gas prices continue to put much of Canadian production at a loss, thereby keeping in check an important economic stimulus out of Western Canada.

**Portfolio Strategy:** Our recommended asset mix strategy, has not changed. We recommend a small overall equity overweight that favours US equities and the Far East Emerging markets. This cautionary strategy is reflected in portfolios where we are closer to neutral. We are also recommending a large underweight in government bonds while they have turned more positive toward the US high yield bond market in which portfolios have a small exposure.

Perhaps, the most surprising occurrence in 2019 was the pullback of bond yields to very low levels. This has led to bond returns of 5.0% so far this year. By contrast the GWL Real Estate Fund in which all portfolios have a high exposure is up 3.5%, not too far off. Going forward we expect more of the same from this Real Estate Fund while the outlook for bonds is far less certain. It is difficult to justify investing in an asset class that will provide a 1.5% after fee return if nothing changes. Any sign of a trade deal or of inflation, would push yields right back up and erase earlier 2019 bond returns.

The risk regime indicator has been quite volatile over the past few months, largely due to the currency volatility of the British pound around the Brexit fiasco. PM Theresa May will be stepping down. Ultimately it has always been our view that there are strong forces at play in the background that will push Brexit to a 2nd referendum. Let's see. What is clear though, is that the UK economy has suffered badly and will continue to suffer self-inflicted losses, largely for the benefit of other European cities.

Overall Europe's growth is flat lining at about 1%, which is not very attractive. Early results of the European election appear to have contained the populist movement, which is positive. Nevertheless, it is difficult to make a strong case for investing in the European markets other than valuation and of course valuations can remain cheap for a long time. We are underweighted in this market.

Contrary to 2018 when most of the actively managed Funds within Benchmark portfolios underperformed their respective indices, an unusual occurrence, 2019 is proving far more positive with all the actively managed US and International Funds nicely outperforming their indices. Over the mid to longer term, all the actively managed funds utilized by Benchmark have had superior net of fee returns. Benchmark combines these funds with lower-fee US and (to a lesser extent) EAFE indexed funds in order to ensure more stability in the return. Most Canadian equity managers on the other hand, tend to outperform the TSX index over time, justifying the use of actively managed funds in this asset class.

As clients will note we have gradually reduced exposure to the Precious (gold) Metal Fund from about a 4% position over the past few years to near 2% since mid-March. The reasons are that the Fund has been trading less as an insurance policy to equity risk which was the main purpose. This said its underlying gold stocks remain undervalued and gold does become attractive once again under a very low interest rate environment.

As usual please do not hesitate to contact me on any matter.

All the best,

*Marc*

Marc Lalonde
Partner/Partenaire
**Benchmark Investment Consulting**
Off: 506-381-0932