“Good” News vs. “Bad” News

QPW Perspectives – October 2019

The third quarter of 2019 experienced heightened volatility within global equity markets and broadly positive performance from fixed income markets. As has been the case for many quarters in recent memory, central bank policy and geopolitics continue to be major influences in the financial markets.

Geopolitical themes including trade war concerns (particularly the United States vs. China), uncertainty around the ratification of the United States-Mexico-Canada Agreement (USMCA), and Brexit are ongoing issues with no clear end in sight, resulting in a lingering environment of economic uncertainty. This general uncertainty regarding future trade conditions combined with the negative impact existing tariffs are having on global manufacturers has resulted in expectations for reduced global growth and increased odds of a potential recession. Adding to the uncertainty is the growing unrest in Hong Kong and a formal impeachment inquiry against President Trump.

Central banks around the world remain in favour of lower interest rates at this time given economic conditions and the level of uncertainty. The U.S. Federal Reserve reduced its benchmark policy rate by 0.25% twice during the third quarter and once again in October (target range is now 1.25% - 1.50%, down from 2.00% - 2.25%). These reductions follow a “tightening” period beginning in December 2015 which saw the Federal Reserve increase interest rates eight times, and they represent the first interest rate cuts since the 2008 financial crisis period. The Bank of Canada has held its policy rate steady during 2019 so far but is widely expected to reduce in 2020 at this time.

Q3 2019 Financial Market Breakdown

Returns **As of September 30, 2019**	**Q3**	**YTD**
Canadian equities (S&P/TSX Index) CAD$	2.48%	19.07%
U.S. equities (S&P 500 Index) USD$	1.70%	20.55%
International equities (MSCI EAFE Index) USD$	-1.07%	12.80%
Canadian Fixed Income (FTSE Canada Universe Bond Index) CAD$	1.20%	7.79%

Canadian large cap equities, represented by the S&P/TSX Composite Index, returned 2.48% during the third quarter of 2019. The Utilities and Real Estate sectors were top performers as they are typically beneficiaries of lower interest rates. In stark contrast to the first half of 2019, the Health Care sector in Canada, which is almost entirely composed of cannabis related companies, declined by 30% during the quarter as earnings disappointed and valuations began to come back down to earth. The Financials sector in Canada contributed the most to overall performance given its sizeable weight in the index of over 30%.

U.S. large cap equities, represented by the S&P 500 Index, returned 1.70% in U.S. dollar terms during the third quarter of 2019. This translates to a return of 2.85% denominated in Canadian dollars (the U.S. dollar appreciated relative to the Canadian dollar). As with the Canadian equity market, the Utilities and Real Estate sectors were top performers. The Energy sector remained under pressure against a backdrop of declining oil prices. From a valuation perspective, the U.S. equity market continues to be expensive relative to its own history and relative to other developed markets. Positive performance during the quarter and for 2019 as a whole has been mostly driven by price appreciation with minimal fundamental earnings growth to support it.

International large cap equities, represented by the MSCI EAFE Index, returned -1.07% in U.S. dollar terms during the third quarter of 2019 (0.05% in Canadian dollars). The defensive Consumer Staples sector was the strongest performer while the Financials sector weighed on the market. Brexit remains a hot button issue in the United Kingdom as the details surrounding the decision are still highly uncertain. Boris Johnson took over as U.K. Prime Minister in July and has attempted to renegotiate a better exit deal with the European Union, but details on what the path forward looks like remain unclear.

The broad Canadian fixed income market, represented by the FTSE Canada Universe Bond Index, returned 1.20% during the third quarter of 2019. Positive performance was driven by declining interest rates (bond prices increase when interest rates fall). As mentioned, the Bank of Canada held its policy rate steady during the quarter while the U.S. Federal Reserve reduced rates twice – both policy decisions were widely expected. Declining interest rates around the world have fueled the unusual phenomenon of negative yielding debt (i.e. bonds with negative interest rates), pushing the global total of negative yielding debt to approximately $15 trillion – the highest levels in history. The U.K., Australia, Canada, and the U.S. are the only major economies that currently have positive interest rates across the entire maturity spectrum. We are currently in uncharted waters with respect to negative yielding debt and it remains to be seen how the borrowing activity of governments and corporations will be influenced and what the ultimate ripple effects will be.

Tug-of-War

These two themes – geopolitics and central bank policy – have been seemingly pulling financial markets in opposite directions. The negatives of the current geopolitical and economic situation are attempting to be counter balanced by lower interest rates, courtesy of central bank monetary policy, which has the effect of boosting economic activity and inflating asset prices.

In a sense, it appears that bad news (trade war, political uncertainty, slower growth) is good news (lower interest rates reduce cost of debt and inflate asset prices) as far as financial markets are concerned – as can be evidenced by the strong performance from both equity and fixed income markets in 2019.

This begs the question – as we move forward and these underlying issues eventually get resolved, will good news be bad news? Or will good news be good news again?

While it is an interesting question, it is impossible to predict how financial markets will behave in the future as there are countless variables at play, including inherently unpredictable human behavior. Given this reality, it is important to structure your portfolio in a globally diversified manner and focus on risk management. Macro themes and emotional market sentiment have been the main drivers of financial markets in recent periods. That said, there is evidence that the pendulum is swinging and fundamentals are gaining importance to investors’ decision making. At Quadrant, we diligently manage asset mix and investment manager selection in order to provide high level diversification and asset class expertise. We look to our asset class investment managers as experts in their respective niches to manage risk at the individual security level.

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All returns and figures sourced from Bloomberg.