Known Uncertainties

QPW Perspectives – February 2020

To “know” something means to have information in your mind as a result of an experience or because you have learned or been told it (Oxford Dictionary). “Uncertainty” refers to something you can’t be sure about. Putting the two together equals what 2020 is feeling like, a year of known uncertainties with unknown outcomes.

Uncertainty, although a normal part of the financial markets, has been magnified for an extended period of time. Progress was made on some of the larger uncertainties facing the global economy in the fourth quarter of 2019, which resulted in positive performance.

Returns **As of December 31, 2019**	**Q4**	**YTD**	**YTD CAD$**
Canadian equities (S&P/TSX Index) CAD$	3.2%	22.8%	22.8%
U.S. equities (S&P 500 Index) USD$	9.1%	31.5%	25.2%
International equities (MSCI EAFE Index) USD$	8.2%	22.0%	16.2%
Canadian fixed income (FTSE Canada Universe Bond Index) CAD$	-0.9%	6.9%	6.9%

Source: Bloomberg

The fourth quarter of 2019 was an optimistic time based on positive trade talk progress between the U.S. and China, further clarity regarding Brexit and forward movement in the process to ratify the U.S.-Mexico-Canada Agreement (USMCA).

Equity markets experienced positive returns with U.S. equities experiencing the largest gains. Based on equity valuation levels, it appears that price appreciation was mostly driven by positive investor sentiment, as opposed to actual earnings growth. The Canadian dollar appreciated versus the U.S. dollar over the past quarter and year, meaning that U.S. dollar-based holdings’ returns are lower once translated into Canadian dollar-based returns.

The broad Canadian fixed income market experienced slightly negative returns for the fourth quarter of 2019, giving back some of the positive gains from the first three quarters of 2019. The Bank of Canada held its key lending rate steady during the fourth quarter and 2019 as a whole. In the U.S., interest rates edged lower during the past quarter. This led to bond price appreciation and a muted positive quarterly return on a U.S. dollar basis, and a slightly negative return in Canadian dollar terms. During the fourth quarter of 2019 the U.S. Federal Reserve lowered its key lending rate by 0.25%, which was widely expected by market participants. Most market participants are not expecting any further interest rate changes over the medium term in either Canada or the U.S.

Going forward, the same topics which were perceived by the market to progress during the fourth quarter, remain as uncertainties that will influence 2020 financial markets.

U.S. – China Trade Relations

The Phase One trade deal between the U.S. and China was viewed as a positive step towards easing global trade tensions. The key aspects of the deal are:

- China will increase imports of U.S. agricultural, industrial and energy products/services by approximately $200 billion over the next two years ($50 billion in energy, $40 billion in agriculture, $35-40 billion in services and $75 billion of manufactured products);
- U.S. will reduce tariffs from 15% to 7.5% on $120 billion in Chinese goods and forgo other planned tariffs;
- China has made some promises to better protect U.S. intellectual property and open up its financial services market to U.S. firms;
- Any disputes with regards to this agreement will be resolved through direct talks which is contrary to the current practice of using arbitration or the World Trade Organization (WTO) for resolution.

Overall, the Phase One deal is just that – the first phase of what will likely be a series of agreements as further trade issues are resolved. Key trade issues of contention that were deferred include disputes over cybersecurity, technology theft, and the subsidization of Chinese state-run companies.

For China, increasing U.S. imports by $200 billion over the next 2 years may be challenging, especially if the impact of the coronavirus is material to China's economy. Regardless, in order for China to meet these targets, imports from other countries to China will be reduced, implying that this agreement is putting other countries' economies at a disadvantage, including Canada.

The U.S. tariff reduction from 15% to 7.5% on $120 billion in Chinese goods is progress towards de-escalating tariffs but remains well in excess of pre-trade war tariff levels as there are still 25% tariffs on $250 billion worth of Chinese goods. According to the Peterson Institute for International Economics, "the average U.S. tariff rate on imports from China will edge down to 19.3% from 20.9%. Without the agreement, U.S. tariffs would have climbed to 25%, compared to just 3% prior to the trade war."

As much as the Phase One trade deal is encouraging, its implementation and global impacts are uncertain and there are still several trade issues to resolve. It will be interesting to see how events unfold between the U.S. and China this year.

Brexit

On January 31, 2020, the U.K. officially left the European Union (EU), approximately 3 ½ years after the historic referendum vote. Departure certainty has clarified Brexit to a certain degree but now begins the challenge of understanding what this separation will really look like. Under the terms of the separation, the U.K. has until the end of 2020 to negotiate and finalize a comprehensive trade agreement with the EU. There is the option to request an extension prior to June 30, 2020, although U.K. Prime Minister Boris Johnson is adamant that there will be no extension. This means that there is the risk of a "hard" Brexit, should no trade agreement be in place by the end of 2020. A "hard" Brexit would entail the U.K. giving up membership in the EU without having any free trade or tariff exemption relief arrangements in place with its European trading partners. Given how long it has taken for the U.K. to formally exit the EU, the likelihood of reaching a finalized trade agreement within the current year appears highly doubtful; hence a known uncertainty with an unknown outcome.

President Trump and the 2020 Election

Now that President Trump has been acquitted in the impeachment process, the 2020 U.S. presidential election which takes place on November 3, 2020 will dominate the news. The results of the election will set the tone for trade relations and economic growth going forward for the U.S. and its largest trading partners.

Responding to Known Uncertainties

We know that trade negotiations will dominate 2020 whether it be the U.S. and China or the U.K. and the EU. We also know that the upcoming 2020 presidential election in the U.S. will take center stage. What we don't know is how these events will ultimately impact world economies and financial markets (a.k.a. known uncertainties).

From a portfolio management perspective, predicting the outcomes of these events should not be the focus. Instead, short-term market volatility should be used opportunistically for rebalancing purposes. A comprehensive, well-constructed portfolio is built for the long term and should not undergo major changes in response to short-term periods of volatility. These times serve as a reminder that portfolios should be positioned for the long term. Quadrant continues to maintain a long term view and focuses its efforts on asset allocation policy, manager selection, and systematic rebalancing in light of each client's individual financial circumstances. This is a known certainty.

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Quadrant Private Wealth
Suite 720, One Lombard Pl
Winnipeg, MB
Ph: (204) 944-8124
email: inquiries@quadrantprivate.com
web: www.quadrantprivate.com

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadrantprivate.com.

All returns and figures sourced from Bloomberg.