

Q4 2018

## View Holiday Markdowns With Some Cheer

### Equity Markets

Developed equity markets were very weak around the globe in the fourth quarter, bringing full year returns into negative territory in every region. The domestic S&P/TSX Composite index dropped 10.1%, bringing local market losses to 8.9% for the full year. In US dollar terms, the MSCI EAFE index fell 12.5% and the S&P 500 index fell 13.5% in the quarter, although weakness in the Canadian dollar reduced this to losses of 7.6% and 8.6%, respectively, for Canadian investors. In Canada, the Consumer Staples and Telecommunications groups managed to post a slight gain in the quarter, though Utilities, the other classically defensive sector, recorded a decline in value. At the other end of the spectrum, the domestic Health Care sector dropped 35.3% in the quarter, perhaps a “sell the news” response following the legalization of cannabis nationwide. Internationally the weakness was unsparing, with every sector in the EAFE markets, and all except Utilities in the US, posting losses. In particular, Energy stocks in all regions had a dismal quarter in response to the price of West Texas crude experiencing a sharp 38.0% price decline, and Information Technology stocks, long a darling sector for investors, reversed course across all markets, as signs of a slowdown in items such as smartphones and semiconductors became more evident.

Although the Trump government used a G20 meeting during the quarter to delay their threatened tariff increases on China, the extension of this possible action until spring of 2019 might serve to continue a pause in business investment that looks to be underway in China. This backdrop might require a level of consideration from the world’s major central banks, most of whom have thus far held true to reversing the economic stimulus of years ago. In the coming months investors will need to measure the current subdued industrial environment against a backdrop of considerably improved equity valuation levels and still reasonably healthy data from the Canadian, US and European economies.

### Fixed Income Markets

North American Investment Grade fixed income offered mixed returns in the fourth quarter. While both the US Federal Reserve and the Bank of Canada took their policy rates higher in the quarter, Government bonds reversed their widening course, with yields pushing lower on both Canadian and US Government-backed bonds. The Canadian yield curve continued to flatten, though maintaining a positive slope, while at the close of the quarter there was a mild inversion in the US yield curve, with one-year bonds offering a higher all-in yield than debts shorter than seven years. Since 1945, yield curve inversions have always preceded recessions, leaving many to wonder how much more hiking the Bank of Canada and the Federal Reserve are prepared to do.

Canadian corporate credit returns were positive in absolute terms, with the combination of prices moving higher alongside coupon payments, though spreads — the premium demanded for owning corporate debt rather than risk-free government bonds — widened. Corporate credits moved wider in anticipation of economic slowing, and also on tax-loss selling, as the Banks were forced to expand their balance sheets to make markets in corporate debt. Demand remains strong for high quality corporate bonds, and “AA” and “A”-rated corporate bonds moved modestly tighter in tandem over the quarter.

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Over the course of the past year, however, rates have moved upwards significantly, making debt issuance considerably more costly. Lower-rated “BBB” debt remained wide throughout the quarter with no real tightening through the period, and High Yield bonds laboured over the same interval, maintaining a reasonable spread but displaying their economic sensitivity. A similar flight to quality pattern was seen in the US fixed income market, with Treasury bonds rallying more than corporate bonds, “AA” and “A”-rated bonds largely held their ground, while the “BBB” segment of the market widened out.

The Bank of Canada seems set to slow their course in 2019, with action being almost entirely data-driven at this time. While the Federal Reserve express a keenness to take rates higher, in pursuit of “normal” rates, it is possible that they will slow or stall their pursuit of higher rates if there are more signs of a recession fomenting. Data continues to be reasonably supportive of policy action, though both central banks are aware that this expansion — while slow compared to other post-recession bounces — is long in the tooth.

## Commentary

The weakness in equity markets in the last three months of 2018 releases some stresses that have been building in the financial system for some time. Growing US trade tensions, a slowing Canadian housing market, rising interest rates and a prolonged expansion of credit on increasingly liberal terms all are factors that were shrugged off by investors until a sharp reversal in the last couple of months of 2018.

With markets approaching a 20% decline from their highs just a few months prior, chatter is pervasive about the onset of a “bear” market, with ominous tones for 2019 in the business media. Comparisons are starting to eke out that, while factually true (“the worst December decline since the Great Depression!”) can provide a misleading impression if taken solely at face value.

It is natural for investors to feel some concern at times like this, but the reality is that the current environment is not particularly unusual. A study in 2015<sup>1</sup> reviewing 180 years of market returns highlights that, since markets never continually go up on a daily basis, they frequently trade below their prior peak levels in some degree of “drawdown”, as is currently the case. In fact, if you randomly picked a month from any of the past 180 years to start investing, there is a greater than 50% chance that you’d be putting your money to work in a “drawdown state”. This occurs despite that fact that developed markets have posted healthy investor returns over the long term.

Put differently: it is the norm, rather than the exception, for investors to be feeling a level of regret in the markets at any point in time because markets are trading below a previous peak level.

What makes the onset of these drawdowns feel lousy is a behavioral characteristic innate to humans known as “Recency Bias”, where market moves are viewed solely in the context of very recent history. This Recency Bias results in investors extrapolating the recent market declines into expected future stock market returns, even though these drawdowns are normal intervals in long term market performance.

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As the duration of these market drawdowns is impossible to predict, at Guardian we aim to move with prudence at periodically rebalancing client accounts to protect capital and avoid Recency Bias. In recent years, this has meant trimming equity positions and adding money to fixed income securities as stock markets have rallied, although going forward, a continuation of the recent stock market weakness will eventually lead to a reversal in this process, steering back into equities as opportunities arise.

Rather than the exception, market drawdowns are a common circumstance in investing, part of the normal course of healthy long term investor returns; holiday markdowns should be viewed by investors with a level of cheer for those with this in mind.

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<sup>1</sup>Robert Frey, “An Analysis of 180 Years of Market Drawdowns”

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