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Stewart Thomas Wealth Management — Estate Planning Professionals

Keeping In Touch

As we head into the summer months, I wanted to touch base and provide an update on what is happening in the equity and bond markets, how this has been affecting investment returns this year and what we may expect for the remainder of the year. My commentary in April discussed a rising interest rate environment, volatility due to geopolitical risk in North Korea and Syria and increasing trade wars. Rising interest rates are almost a certainty, economic risk from North Korea and Syria has abated and economic risk from trade wars has increased in the last two months.

Generally speaking economic growth in most economies is sound. Europe and Asia are seeing solid growth and their equity markets are relatively inexpensive compared to North American markets. (1) The US economy continues to grow and Canada's economy is somewhat held hostage pending NAFTA negotiations and tariffs. As I noted in April, growth will spur inflation and higher interest rates. Higher rates will likely lead to an economic slowdown in 2019 as the yield curve flattens (longer term rates are equal to shorter term rates) or an inverted yield curve (longer term rates are less than shorter term rates) and the result could be a recession. A recession is defined as two quarters whereby growth is less than the previous quarter. Bare in mind, this is contracting growth and not necessarily negative growth. This is typical of transitioning from late stage economic expansion and entering into a contraction stage. I included the chart on this in my last communication.

As we go through the Contraction stage in the economy, we typically see Central banks begin to lower interest rates to stimulate the economy, which again is typical of this cycle. The difference this time may be an acceleration of the timing of raising interest rates to control inflation. Inflation could accelerate faster than anticipated due to stimulus spending in the US, tax cuts in the US and higher costs due to tariffs. (1) Higher costs will affect all economies on which tariffs are imposed. Offsetting the need to increase interest rates could very well be a slowing of the economic growth due to job losses caused by these tariffs. This is the uncertainty that we face currently and all Central Banks are adjusting their strategies accordingly. I do expect, however that we will see Central Banks being proactive in raising rates as inflation is a fundamental issue and tariffs are a political issue which are out of their control. Central banks policies are based on pure analysis of economic fundamentals.

Speaking of "Out of Control", the current administration in the United States is determined to create a global trade environment whereby they can bully their trade partners into giving some leeway to help reduce the US trade deficit. In my opinion, the reality is that Trump has been taking all the credit for the low unemployment in the US, the rebound in equity markets in the US and the economic growth in the US. They know very well that tariffs at these proposed levels will derail all of these gains. This was evident lately when the markets were off significantly in the morning after Trump announced larger trade tariffs on China and later in the day the Administration backed off. (1) As always, the Trump administration speaks before they think. I expect this will be the case in most of their trade negotiations.

In the meantime, we will continue to have market volatility due to the trade issues, a rising interest rate environment and somewhat just due to the lower trading volumes typical in the summer. As I noted in my April correspondence, for 2018, we are in a transition period as we in a late expansionary phase and historically in this economic phase we can expect both the bond and the equity markets to underperform their longer term historical averages. Our investment strategy remains to be invested in quality investments and funds, be diversified and continue to collect dividends and fixed income. Companies are continuing to report good earnings growth and Price-Earnings multiples are now more in line with historical multiples. My belief is that interest rates will reset over the next 12 months as we transition through the late expansion cycle and provide more stability in the bond markets going forward and therefore a more stable base for the equity markets going forward.

Thank you for the confidence that you place in us to work with you and your family in your investment, retirement and estate planning. We truly value you as a client. In the meantime, if you have any questions or comments on the enclosed or your portfolio, please give me a call or send me an email.

All the best for the summer. I will update you on any events that may occur over the next few months.

Take care

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 Footnote (1) Quoted Philip Petursson Chief Investment Strategist, Manulife Investments