SSQ Financial Group

Values in the right place

2018 ECONOMIC PERSPECTIVES

Interview with Hexavest Asset Management

HEXAVEST ASSET MANAGEMENT

What do you expect global GDP growth to be in 2018?

Following an economic growth of 3.25% in 2017, many forecasters believe that global growth will see acceleration in 2018. We do not agree with this forecast as we see the 2 largest economies of the world, China and the U.S., slowing down in 2018.

First, the strong stimulus that we observed in China in 2016 will not be repeated, and we are already seeing signs of a slowdown in credit growth and in real estate and infrastructure spending.

Secondly, as American consumers have been the largest contributor to growth over the last 2 years, the Federal Reserve's last report shows that Americans' indebtedness has reached Pre- GFC levels. They are spending almost everything they earn and are saving very little. If they have contributed so much, it is because they have spent without regard and bought on credit.

In the end, we believe that the end of the economic cycle in the U.S is closing in, combined with an economic slowdown in China, global GDP in 2018 should disappoint investors.

What are the biggest threats for investors in 2018 and what strategy would you recommend in order to minimize their impact?

We believe the biggest risk is the increasingly strong appetite for riskier assets by investors and also the amount that they have bought over the last years. Usually, investors have been reluctant to admit such a behavior, but it is now clear that a record proportion of investors are heavily invested in equities, with a bias towards cyclical sectors like Financials and Technology. As such, should volatility in the market surge, we could see a quick and violent reversal of this complacency and investors may be forced to sell in unison.

In this environment, we privilege a defensive portfolio in stable sectors such as Telecom, Consumer Staples, Utilities and Healthcare. We also own some gold stocks.

Following a strong rally in oil prices in 2017, where do you see the price of oil at the end of 2018?

Following the announcement by OPEC to cut oil production for 2017 and 2018, we believe that they will continue to be disciplined and maintain those cuts, at least in the short term. This should have a positive effect for oil prices in the first half of 2018, but we are less bullish beyond that as U.S. shale producers may be enticed to increase production as prices stabilize. The U.S. currently produces close to 10 million barrels of oil and we expect that they could increase that further due to their low cost structure and rapidity to extract shale oil. We could see an increase of supply globally in the latter part of the year, and in turn lower oil prices. For these reasons, we have tactically increased the weight in the Energy sector, focusing on oil producers that have a stronger correlation to oil prices. We will monitor this position as the year goes on.

Which regions (Canada, U.S., Europe, Developed Asia, Emerging Markets) do you expect to outperform in 2018?

As we assess each of our 3 pillars (macroeconomic environment, valuation and investor sentiment), we currently favor a portfolio with defensive qualities, which would protect capital well in a market downturn. As such, we hold a higher level of cash and some gold stocks. Regionally, we prefer the Euro Zone and Japan and shy away from U.S. equities, mostly due to higher valuations and stretched sentiment. We have an exposure to Emerging Markets, however we remain cautious on China, and we favor India, Malaysia, Russia and Mexico.

What are your thoughts on U.S. equities, given that the P/E on the S&P 500 is very high versus its historical average?

We believe U.S. equities are currently in the bubble phase, as they have been more expensive only 3% of the time since 1900. Even if a tax reform will benefit companies in 2018, this positive contribution is more than reflected in equity prices. Here are a few compelling statistics on how U.S. equities have thrived in 2017:

- 14 consecutive months of positive returns, a record;
- 289 markets sessions without a cumulative drawdown of 3%, a record;
- Maximum cumulative drawdown of 2.8% in 2017, the annual average is 16.4%;
- Record ratio of days of more than 0.5% return vs. number of days going down more than 0.5%

S&P 500 Valuation

Metric	December 2017	Historical Decile	Since
Price / forward Earnings	18.5	**9th**	1985
Price / trailing Earnings	22.5	**9th**	1954
Price-to-Book	3.3	**9th**	1980
Price-to-cash flow	14.5	**9th**	1973
EV / EBITDA	13.4	**10th**	1990
Cyclically adjusted P/E (CAPE)	32.4	**10th**	1881
PEG ratio	1.6	**9th**	1985
Average decile		**9th**	

Sources: Hexavest, MSCI, IBES, Datastream, Bloomberg, Robert Shiller

Without saying that other regions are a bargain, it seems that better investment opportunities lie overseas, where equities trade at cheaper valuations.

The Canadian housing market has been on a tear for a few years now, as has household credit growth. Are you worried about this trend and do you foresee an impact on Canadian banks, which represent a good portion of the S&P/TSX index?

No doubt that we see risks associated to the housing market and excessive consumer spending. We believe Canadian banks are much more at risk than what people think. Canadian banks fared very well during the Great Financial Crisis, however today they are among the most expensive banks in the world. A good portion of their revenues comes from the mortgage unit, as such the new measures implemented like the special tax on foreigners or the newly imposed qualification measures at higher-than-posted rates will have an impact on banks' profitability. The housing price growth that we observed in some markets accelerated even further, and combining these measures to higher interest rates, we feels that a price drop in residential housing could continue in certain regions of the country.

Canada was the darling in 2017, posting the best economic growth among all developed countries, while seeing unemployment drop to record lows. On the flip side, Canada's household debt ranks second highest in the World. This shows how much Canadians have consumed goods and services on credit. A slowdown in China and the soon ending cycle of the U.S. economy, combined with harsh negotiations to come on a new NAFTA deal, could hurt the Canadian economic momentum and in turn would expose bank stocks.

Which sectors offer the best investment opportunities for 2018?

Institutional and retail investors are currently heavily positioned in Financial and Tech stocks. Investors are also looking for the next blockchain/cryptocurrency superstar or the next major cannabis company to emerge. This positioning is a demonstration that investors are seeking strong returns without considering the risks. We, as contrarian investors, tend to privilege out-of-favor sectors, such as Telecoms, Utilities and Consumer Staples stocks which continue to be out of favor. We also like Healthcare due to its defensive and stable qualities.

Growth stocks outperformed by 20% value stocks in 2017, as the Russell 1000 Growth posted a 30% return vs. 10% for the Russell 1000 Value. Do you believe that this trend will continue?

Value stocks are currently on their worst streak ever, underperforming growth stocks in 8 of the last 9 years. Euphoria and the quest for speculative stocks with high return profiles, such as technology and in consumer discretionary, have been the darlings of the market in 2017, and the new euphoria seems to be heading towards cannabis and cryptocurrency companies. Such euphoric episodes usually (to not say always) end badly. We are convinced that this reversal is at our door, and those who have held on to quality value companies that generate a good dividend and have strong balance sheets, will be soon rewarded.

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