The Beacon

Timely Market Monitoring from Lighthouse Wealth Management

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Canada

- The Canadian economy continues to slow due to long-term structural issues and short-term cyclical factors.

- Further slowing of Canada's housing market, and further price reductions, is a key risk because of its impact on Canadian household spending and real estate related economic activity which has increased in importance in recent years.

- Beginning in 2017, the Bank of Canada has increased interest rates 5 times. The Bank has now moved to a "wait and see" approach for future rate increases. The Bank's original plan was to raise interest rates to neutral (~ 3.0%). Current economic conditions warrant a sustained pause at 1.75%, and rate cuts now cannot be ruled out, especially if the Canadian economy slows further.

- Falling interest rates and a potential loosening of housing regulations could give the housing market a near-term boost, but affordability issues, high household debt levels, and slowing momentum are likely to keep house prices under pressure over the medium- to long-term.

- Political uncertainty, a dovish Bank of Canada, and an economy that lags the US are likely to cause the Loonie to weaken against the USD.

- Canadian equity market valuations appear reasonable, and perhaps even discounted against the US market, but key risks remain in the Canadian market and, absent a lower Canadian dollar, we believe growth opportunities will be scarce.

- A weakening Canadian economy is likely to exert downward pressure across the yield curve, offering further opportunities in government bonds.

United States

- While the US economy remains robust compared to others, it too has slowed in recent months because of efforts by the US Federal Reserve to normalize interest rates and reduce the size of its balance sheet. Political uncertainties, a dysfunctional US government, and the US - China trade war have also contributed to the loss of economic momentum in the US.

- The US Federal Reserve has responded to a slowing economy by pausing its plans to increase interest rates and stating it will be flexible in reducing the size of its balance sheet. Equity markets, after responding poorly to the Fed's tightening plans have rebounded strongly to start 2019 as it became apparent that monetary policy would remain accommodative for at least a while longer.

- Political, economic, and social issues, both domestic and abroad, are likely to create greater market volatility compared to prior years. In our view, US equity valuations, while not appearing grossly expensive, are not as attractive as other markets.

- The US economy should grow this year which will allow equity markets to earn positive returns. There is potential for some upside surprises. We believe, however, that US equities have already priced in many good outcomes, and do not offer an attractive entry point at this time. We believe better entry points are likely to appear later in the year.

International

- Like the US, international equity markets have performed well year-to-date. These markets were coming off a much lower base than US markets as recent economic concerns had a greater impact on their valuations.
- The US - China trade war, combined with rising interest rates in the US, led to sharp declines in Chinese and emerging market equities as Chinese growth started to slow in the latter part of 2018. Europe, not without its own issues, was further impacted by a slowing Chinese economy as China is a major importer of European goods and services.
- The European Central Bank loosened policy last week announcing another round of stimulus designed to keep interest rates low and boost a weak economy.
- In China, where economic growth remains robust by North American standards, the government is deeply concerned by slowing growth rates that are barely at the official growth target and has enacted several fiscal measures designed to stimulate consumption and credit growth. We expect both the US and Chinese governments will be very interested in keeping their economies robust as they continue to fight for leverage in what has turned into a bitter and lengthy trade war.

Investment Implications

- Many of the positive surprises that we discussed in our Winter 2019 newsletter have taken place. Equity markets around the globe have responded positively to the change in direction for interest rates, creating the potential for a cooling off period while waiting for resolutions to other outstanding issues.
- Material economic risks remain as indicated by falling yields (rising prices) for government bonds. It's not clear that equity markets are accurately pricing in these risks, especially in the US.
- Uncertainty remains elevated and underscores the importance of a balanced and diversified portfolio.
- Valuations are more attractive outside North America and international equities offer better risk-return trade-offs in our view. Canadian equities remain inexpensive compared to US markets but come with significant domestic risks.

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