Foresights from Foresters Asset Management Inc.

CIO's Market Perspective for 2018

December 2017

Summary

- As 2017 draws to a close, we remain optimistic that equity markets can continue their bull run into the new year.
- In short, the macro setup is arguably the strongest it's ever been, despite the U.S. economy only growing at a modest rate by historical standards.
- Global growth is finally synchronized, inflation remains muted and central banks are still broadly supportive, providing foundation for continued growth in risk assets.
- Add to all this, the prospect for meaningful tax reform and deregulation south of the border and you get a powerfully bullish case for 2018.
- Stock picking, even within sectors, is much more important in this later stage of the cycle. Foresters' portfolios are positioned to benefit while ensuring risk mitigation strategies are in place.

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Chief Investment Officer
Foresters Asset Management

Ms. Pennington is responsible for overseeing the equity, fixed income, asset allocation and alternative investment strategies for the group. In total, Ms Pennington is responsible for managing over $10billion CAD in assets under management. Ms. Pennington was previously Chief Investment Officer, Managing Director, and Head of Equities at CIBC Global Asset Management Inc, overseeing all portfolio management and research efforts and managed the Canadian all-cap equity mandates. Ms. Pennington has also held various senior roles at Mackenzie Financial Corp including Chief Investment Officer at Howson Tattersall Investment Counsel, and was a founding partner of Synergy Mutual Funds.

Foresters Financial

State of the market

All the major world economies are growing in tandem. At over 3.0% in each of the second and third quarters, real U.S. GDP growth was the fastest in three years, easily beating consensus estimates of 2.5%. Capital expenditures are gaining steam, fuelled by accelerating growth in global equipment purchases. The surge in capex is consistent with strong Purchasing Manager Index (PMI) surveys around the globe and robust readings on durable goods orders. Not only is higher capital spending positive for U.S. growth, it also takes some of the burden off of the U.S. consumer.

Europe and China are also witnessing accelerating economic growth. In Europe, PMI reports are beating expectations and the German Ifo survey recently rose to its highest level in history. As it happens, a survey of European company sales just hit its best level since January 2014. Turning to China, we note that company sales have been in a steady upswing all year, lately reaching their highest figure since September 2011 and PMI is consistently well above 50 – an indication of continued economic strength. All in, between the U.S., Europe and China, growth is finally in sync.

Crucially for investors, global corporate profit growth is also synchronized, and in fact is likely to grow faster than the underlying economies. A larger number of S&P 500 companies are beating EPS estimates, the best rate in three years, and 67% are surpassing consensus revenue numbers, the highest since the second quarter of 2011. The largest technology companies continue to post better than expected earnings growth, and we don't think this outperformance will be threatened until either inflation rises or there is a much greater risk of a U.S. recession.

Stars are Aligned in the Short Term

Our base case is that despite strong growth, there is no indication that central banks intend to be overly hawkish. The combined balance sheets of the U.S. Federal Reserve, European Central Bank and the Bank of Japan should hit close to US$15 trillion before peaking in 2018. And per consensus numbers, the average policy rate 12 months out for these three big central banks is still under 1.0%, with the Fed expected to raise rates three times next year.

We believe the risk is to the upside. Relatively speaking, the Fed is the least dovish of the developed central banks, and with the added fuel of tax cuts to an already hot economy additional hikes are possible. We don't think these hikes will be enough to derail the U.S. expansion in 2018 but will watch carefully for the longer term impact. As for the much talked about contraction of the Fed's balance sheet, it's important to note how slow a process this will be. Under Janet Yellen, the Fed designed the unwind of quantitative easing to be very predictable, so as not to disrupt markets. There is no indication that this will change under new chair, Jerome Powell.

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European Central Bank policy is plainly dovish, which is bullish for eurozone risk assets and particularly equities. As it stands, the ECB should very slowly cease its own QE program by the latter part of 2018. Nonetheless, there probably will not be any material rate hikes until 2019, and the option to extend QE in the future has not been removed by the Governing Council. We again believe the risk to this scenario is to the upside, with continued strong economic numbers potentially nudging the ECB into action sooner than the market is expecting.

Finally, the Bank of Japan is also in no hurry to take the punch bowl away, as it maintains a policy of targeting a 0% yield on 10-year Japanese government bonds. We see this as bearish for the yen and thus bullish for risk assets. Of note, Japanese equities have been very strong in the second half of 2017, and a weaker yen plus strong global growth is cause for this outperformance to continue.

Not only does monetary policy continue to provide a tailwind for investors, but now deregulation and fiscal policy — tax cuts, accelerated depreciation expensing, repatriation of overseas assets — are providing additional short term bullish catalysts to corporate profits and therefore equities. Any large-scale infrastructure spending boost or additional deregulation would simply be icing on the cake.

Factoring in the risks

Of course, as always, there are risks to the bullish outlook: Increased protectionist policies and the risk of the dismantling of NAFTA remains one of the largest risks facing Canadian investors. Fiscal policy is stimulative in the immediate term but the U.S. dollar weakness is partly a response to concerns of higher U.S. deficits and increased geopolitical tensions. Elevated global tensions and deeper political lines appear to be increasing the risk premium associated with oil, pushing prices above supply/demand fundamentals.

In addition China's growth is slowing, debt levels in both China and Canada are worrisome, and the election-related investigations south of the border could accelerate, thereby alarming investors. We remain cognizant of these potential headwinds and will adjust our views as the facts change. Nonetheless, the evidence at the moment points to a strong impetus to broad-based global reflation. We remain optimistic regarding global equities and believe corrections will be buying opportunities.

A ubiquitous question is whether stock valuations are currently too high? Stock valuations are somewhat elevated, but are supported by strong profit growth and low rates. The U.S. tax reforms are expected to add an additional 10% to already strong profits resulting in a 2018 S&P500 corporate profit growth of ~16%! In Canada, corporate profits are heavily influenced by three factors: i/ commodity prices – which are rising with global growth rates ii/ exports, especially to our largest trading partner, the U.S. – which should benefit from increased U.S. growth rates as long as NAFTA is retained, and iii/ Canadian housing market and consumer spending – which we see as a risk. Bear markets are rarely caused by stock valuations, but high valuations may result in deeper declines when the bull market eventually comes to an end.

Fund positioning

Foresters Asset Management's funds are well positioned to capitalize on the current market conditions. Canada, as an investment geography, is suited to benefit from global growth conditions, where demand for energy and materials provide a solid foundation for Canadian equities and bonds alike in 2018. Where possible, our portfolios are augmented by securities and sectors not typically present here, but found in abundance in the U.S., namely technology, healthcare and consumer.