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December 2018

*The capital markets have been challenged throughout the Fall of 2018. Both stock and bond markets were impacted resulting in falling stock prices and falling bond prices (caused by rising interest rates), although there was some relief in November and early December. In the first of a two-part communication with you, we asked the investment sub-adviser for the **Social Housing Canadian Equity Fund**, **Genus Capital Management**, to comment on the recent volatility in the equity (stock) markets and their outlook as we head into 2019. (Please note that while the commentary below might seem focused on the US market, as we know all too well in Canada, when the US sneezes Canada catches a cold - our economies are intimately tied to each other.)*

Social Housing Canadian Equity Fund
Market Commentary
From
Genus Capital Management

It's All About the Business Cycle

As stocks look poised to head into negative territory toward the end of 2018, investors could be excused for feeling somewhat uneasy. However, we would characterize the recent downturn as a correction, not the beginning of a bear market.

The sort of correction we've been seeing lately is typical of the volatile last stages of the business cycle, when central banks begin to raise interest rates. The business cycle is the natural rise and fall of economic growth—from expansion to peak to contraction to trough—that happens over time. In the current environment, worries over volatility are being amplified by the escalating trade war between the US and China, Brexit misgivings, the Italian budget, and investors' concerns about a potential economic slowdown in Asia. As you might expect, commodity prices in general have suffered in the face of these uncertainties.

Assessing the impact of oil prices

But the biggest impact has been on oil prices, which have been dropping steadily for seven weeks—losing 32%—thanks to worries over a possible slowdown coupled with the growing supply glut and geopolitical tensions.

While this drop is not particularly favourable for the Canadian economy, companies elsewhere in the world may profit from cheaper input costs. Despite oil prices' recent behaviour, we still think Canada is in a position to benefit from the last stages of the current business cycle as US economic strength spills into Ontario and global demand drives Canadian Western oil prices up. For example, thanks to its attractive price and richness in bitumen, we are seeing more demand for Canadian oil from China. Bitumen is used to develop roads and other infrastructure.

Factoring in interest rates

With regards to the rising interest rate environment, US equity investors have gradually lowered their projections for 2019, pricing in two rate hikes even though the US Federal Reserve (the Fed) has projected three. We agree that a weakening global outlook (caused in part by trade wars) will prevent the Fed from raising rates as quickly as it might have liked. As trade integration peaks around the world, US corporations and the economy will start to feel the impacts of diminishing global demand.

<u>Despite all this, the business cycle still has room to run</u>. Cycles typically end when central banks cut off liquidity to the markets (interest rate increases in conjunction with reductions in money supply), making borrowing costlier. But we still see ample liquidity in the world's major economies, with the money supply continuing to grow at 4% to 7% in the US, China, Japan and Europe. Looking at central bank balance sheets, only the Fed has begun to unwind its record-high asset holdings—and marginally at that, with the other central banks showing no signs of starting any time soon.

The longer-term outlook

Looking beyond all the noise, valuations should remain fair throughout 2019, with US equities trading at 15 to 17 times price-to-earnings (P/E). Strong corporate earnings fuelled by this year's tax cuts have matched the appreciation in stock prices and the recent downturn has lowered these multiples slightly.

As we enter the homestretch for 2018, the corporate benefits of the tax cuts are starting to wane, but there are still benefits to be found in the consumer space. We expect these to come into play during next year's tax season and boost the US economy throughout 2019. Given the current economic momentum, we don't see a recession until at least mid-2020.

In our next commentary early in January 2019, we will look at the recent volatility in bond markets that has impacted the Social Housing Short Term Canadian Bond Fund and the Social Housing Canadian Bond Fund.

Encasa Financial Inc.

Sincerely,

Derek Ballantyne
Chief Executive Officer,
Encasa Financial Inc.