Where are the equity markets headed in 2019?

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Any of you who are currently using an advisor are most likely getting the same message from them – "Do not make any changes to your investments; everything will be fine in the long run."

It is not in their best interest to change your investments' asset mix or holdings. Their principal objective is to gather more assets from you. This is what their bosses stress and how they receive their annual bonuses. Unfortunately very little of their bonuses are tied to how well their clients' performance is.

Taking this into consideration, it is imperative that you take ownership and responsibility for your retirement funds to ensure that you are protected if there is a more serious market correction.

2018 has been a particularly harsh year for Canadian investors invested in domestic stocks.
Over the last several market corrections the best strategy has always been to buy the dip and reinvest any spare cash available back into the equity markets.

Before robotically following the same strategy, I would like you to step back and evaluate the current economic situation in more detail.

On a positive front the new NAFTA, called USMCA, is expected to be approved by Congress with minor changes. This is most definitely a positive for Canada. There are still US import tariffs on Canadian steel and aluminium but for the most part the new agreement is good for all three countries.

The current expectation from the Central Banks is for a less hawkish stance on US and Canadian interest rates leading to only a few more increases in both countries. However the rate and amount of future increases will remain data dependent and could change if the economies and the inflationary expectations rise too quickly above trend. Once again this is a positive development.

While the ongoing trade war continues between China and the US, there appears to be some possibility of reaching a compromise on some issues at least. Trump is expected to meet with the Chinese President and it is really in both their best interests to come to some type of agreement. Trump's popularity is at the lowest point in his Presidency and he needs to do something positive for his future prospects of re-election in two years.

Domestically the large crude oil discount between Western Canada Select crude and WTI crude has sharply diminished over the last month from a high around $45 to the current level of under $15 per barrel. This has largely occurred from the Alberta's premier's restricting provincial production by 325, 000 barrels per day and her request to purchase rail cars to transport the crude oil that is trapped in the province without sufficient new pipeline capacity. While these measures are short term in nature, they still have resulted in a significant improvement in domestic crude prices.

Lastly the recent OPEC and Russian agreement to curtail production by 1.2 million barrels per day has also been viewed favourably by a rise in world crude prices.

On a negative front, the US bond market is very close to having an inverted yield curve where short rates go above long rates. In the past this has frequently resulted in an economic recession with the banks not encouraged to lend money where the interest rate spread is negative.

US corporate credit bond spreads over US treasuries are now increasing materially after a long period of decline. Historically investors purchase corporate bonds when the economic outlook is improving and sell corporate bonds when the economy is expected to decline. An increase in corporate bond spreads implies that investors are dumping corporate bonds for fear of an economic downturn.

The growth rates of most global economies are weakening sharply especially in China, European Union, Emerging Markets and Japan. The strong US dollar internationally continues to put enormous pressure on Emerging Market economies whose debt is payable in US dollars.

After a very strong growth of 20% plus in US corporate profits in 2018 largely as a result of the tax cuts, 2019 is not looking nearly as positive. Profit growth is expected to go down to 10% which is a significant reduction from this year, but is still a respectable number in any case. Rising labour costs, higher materials costs, rising interest expenses combined with a slowdown in revenue growth will hurt profit margins next year.

Many strategists point out the decline in PE multiples from over 18 times to about 16.5 times in 2019 as a reason to be positive on the markets. However EPS estimates continue to come down even more than the recent share price decline of 10%. This is causing a lot of uncertainty in the market.

The US Federal Reserve continues to increase rates albeit at an expected slower pace than over the last 12 months. This is still causing a lot of uncertainty as investors are not absolutely sure that the Federal Reserve will not make a policy error and increase rates at a time that they should really be doing nothing.

Until the US / Chinese trade dispute gets resolved in a meaningful way equity markets will remain volatile.

Reuters just came out with a global poll of money managers indicating that there is a 40% chance of an economic recession within the next two years.

Equity markets have already corrected 10% and are now officially in a correction phase. In the past major bear markets have declined up to 50% but those type of declines occurred in the midst of an economic recession. The worst case scenario remains an economic recession where markets can drop in the range of 30-50%.

Conclusion

Equity PE valuations have come down but earnings expectations are coming down sharply as well.

You should expect continuing market volatility until the trade situation between the US and China is resolved.

Assuming the Federal Reserve pauses in its current tightening phase, this may ultimately help to avoid a major economic downturn.

I am increasing my cash weight by 5% for both portfolios. The new cash position is 42.5% and 37.5% for my Income and Growth portfolios respectively. The high cash position will enable you to purchase quality companies when opportunities present themselves.