# 2018 Mid-Year Economic and Market Outlook Conference Call

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*The following is a summary of the views expressed by Empire Life Investments during a conference call on July 17, 2018:*

It's been an interesting 2018 so far for Canadian equities. In February, at its lowest point, the S&P/TSX Composite Index faced a year-to-date deficit of about 7%. This was part of a global market sell-off triggered by sharply rising bond yields on strong U.S. economic data. As oil prices steadily moved higher, and bond yields drifted lower on increased trade concerns, the Canadian equity benchmark index recovered to close the first half of the year with about a 2% return.

Sector performance has been mixed, with about half of the sectors experiencing losses and the other half advancing. The clear winner was the relatively small Information Technology sector, with a gain of 22%. The laggards were the more defensive sectors, such as Utilities, Telecommunication Services and Consumer Staples. Financials lost about 2.5% (mainly due to insurance companies), while Materials gained 3% and Energy gained almost 5%.

In the Energy sector, oil fundamentals remain strong. Global oil demand remains very robust, and inventory levels are below their five-year averages. Capital expenditures and investment in international oil projects have been fairly stagnant for a protracted period, so the sector's ability to increase production is likely to be limited – for example, we have even recently seen production declines in Venezuela. The transportation challenges that faced Canadian oil producers earlier in the year will likely ease, as crude-by-rail capacity is expected to increase in the short term, and the recent approval of Enbridge's Line 3 pipeline replacement leads will increase future pipeline capacity.

U.S. equities have been the best-performing asset class, gaining 7.7%, in Canadian dollar, terms over the first half of the year. Much of that, however, has to do with a strong U.S. dollar. Without U.S. dollar appreciation of about 5% over the Canadian dollar, the S&P 500's first-half return would have been close to that of the S&P/TSX Composite. From an earnings standpoint, last quarter's announcements were very strong overall, boosted by lower tax rates. Earnings growth was 25% – this is the first time it has topped 20% since 2010. Also, 77% of S&P 500 companies beat analyst estimates for earnings and revenues. And economic data seem to indicate the macro economy remains strong.

Headwinds for U.S. equities include a lack of breadth in drivers moving the market higher, the Federal Reserve's continuing efforts to increase interest rates and reduce its balance sheet, the diminishing marginal boost from the corporate tax cuts and the length of the current bull market.

International equities were negatively affected by March's Italian elections, which eventually led to the formation of a populist coalition government. Investor concerns were related not only to the threat of an Italian exit from the eurozone but also to populist contagion that might extend to other larger countries, particularly Germany. The MSCI EAFE Index returned 2.5%, in Canadian dollar terms, for the first half of the year, but would have seen a negative result had it not been for Canadian dollar weakness.

Anti-trade rhetoric – along with some anti-trade action – was a dominant headline theme in the first half of 2018. The U.S. mainly targeted China, citing the country's unfair trade practices and violations of intellectual property rights. Words turned into action when the U.S. imposed 25% duties on $34 billion worth of Chinese goods, prompting China to counter with retaliatory duties of equal magnitude, and in turn prompting threats of more tariffs from both sides. China was not the only target of U.S. action, however, as the U.S. also imposed duties on all foreign steel and aluminum imports. Initially, certain allies and NAFTA members were temporarily exempt from these duties. When these exemptions expired without renewal, however, retaliatory tariffs were imposed by certain countries, including Canada. The tariffs currently imposed on Canadian goods seem to be manageable, but that will likely not be the case should the U.S. deliver on its threat to impose duties on imported automobiles. The trade situation is fluid and can change very quickly, and basing any investment-related decisions on rumours would likely be unwise.

Bond markets were challenged by higher interest rates. Both the U.S. Federal Reserve and the Bank of Canada have increased interest rates twice so far this year. Markets expect another two increases in the U.S. this year, and are currently placing just over 50% odds of another in Canada. The FTSE TMX Canada Universe Bond Index advanced 0.6% in the first half of the year. With rates and bond yields expected to be higher, a fixed-income strategy oriented toward lower interest rate risk will likely outperform.

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