TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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Stock Market Development

In the third quarter of 2019, the performance of most asset classes slowed down, with only fixed income and cash posting positive average improvement. The S&P 500 total return Index was up 1.7% for the quarter and up 20.55% year-to-date. Utilities (8.4), real estate (6.9%) and consumer staples (5.36%) were the leaders, energy (-7.25%) and healthcare (-2.71%) laggards. Fixed income had the largest Q3 gain with an average return of 2.26% and 8.5% year-to-date. Losses in commodities and currencies were relatively small with average negative returns of 0.40% and 0.15% respectively. Gold and the U.S. dollar showed the most improvement in their respective asset classes both with gains in excess of 4%.

Fixed Income Market Developments

The fixed-income market generated relatively strong returns in the third quarter driven mainly by the continued decrease in interest rates, which pushed bond prices higher across the board. In the U.S. Treasury bond market, the overall yield curve declined, but the curve also flattened as interest rates on the longer end of the curve fell further than the shorter end. In the short end of the curve, the 2-year declined by only 13 basis points to 1.62%, whereas in the longer end, the 10-year declined 35 basis points to 1.66%, close to its multiyear lows. Among corporate bonds, the investment-grade market outperformed high yield this past quarter, as investment-grade bonds generally have a longer duration than high yield. The average credit spread in the investment-grade market was unchanged at a spread of 119 basis points over Treasuries and high yield only tightened five basis points to a spread of 402 basis points over Treasuries. Typically, over the short term, the movement in the investment-grade market is more closely correlated with movements in the U.S. Treasury bond market. Between the volatility in the stock market and the calls for impeachment, Treasuries prices rose as some investors decided to head for the sidelines. In the high-yield market, over the short term, credit spreads are typically more correlated with movements in the equity markets and high-yield spreads widened out in conjunction with the 1.01% decline in the S&P 500. We continue to hold our investments in investment-grade bonds, which we accumulated over time, as we do not expect much change in this low interest rate environment in the next years.

The Economy

An interim U.S.-China trade deal to delay tariffs will not spare the U.S. economy from a slowdown through the end of the year. Attempts to resolve the trade war and defer the imposition of higher import duties will not eliminate uncertainty which is the key culprit behind the slump in business sentiment that has curbed hiring momentum and prompted a pullback in capital expenditures. Real GDP growth is poised to decelerate to 1.8% in 2H versus 2.6% in 1H. The chance of a recession in the U.S. within the next 12 months is however a low 25% which is a warning sign, but not a panic signal.

Federal Reserve Policy

The Fed followed through on market expectations for a 25 bps rate cut and lowered the interest paid on excess reserves in order to help contain the effective rate within its target range between 1.75% and 2%. The summary of economic projections are primarily showing a modest upward adjustment to the 2019 GDP forecast to 2.2% versus 2.1%, core inflation to remain unchanged and the unemployment rate was revised up slightly to 3.7% from 3.6%. The Fed is, therefore, not inclined to aggressively pursue additional monetary stimulus unless GDP growth is slowing more than expected, the pace of hiring is decelerating, geopolitical risk is rising and trade tensions are worsening. Given such a scenario, a 25 bps rate cut in both October and December is likely.

Earnings

Q3 earnings season has just begun. Analysts expect low single digit earnings growth followed by high single digit earnings growth in Q1 and Q2 of 2020. Energy and materials are expected to show the weakest earnings growth of all 11 sectors. The utility and real estate sectors are expected to lead with the highest year-over-year earnings growth (4%).

Outlook

Despite mounting evidence of a more severe economic slowdown, U.S. stocks continuously bounce back. Falling bond yields make equities more attractive (leaving aside the questions of how far earnings estimates will have to reset, and whether dividend payments will shrink). On a yield comparison, dividends are once again offering over 40 bps more than 10 year Treasuries.

Here are three sectors where we find value. The U.S. industrial sector, in particular industrial distributors which serve cyclical end-markets are interesting, as the group has mitigated tariff costs with price increases, cost-saving initiatives, and supplier optimization actions. We are confident that industrial distributors will continue generating healthy free cash flows, even if global growth continues to slow and trade tensions increase.

Technology stocks recovered in early 2019 with some optimism that the U.S. and China could reach trade agreements and avoid a full-blown trade war. Such concerns mounted again in the second quarter, triggered by the U.S. ban on selling Huawei. Market sentiment improved again in the third quarter, as Huawei did not prove to be a tremendous headwind. We continue to believe that a highly interwoven tech supply chain will still be quite difficult for the U.S. and China to unwind. Buying opportunities in the technology sector are

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mainly presented in the software and online media. In efforts to reduce the high fixed costs associated with running on-premises IT hardware and software, more workloads are being shifted to infrastructure-as-a-service (IaaS), vendors, such as Amazon's Web Services, Microsoft Azure, and Google will benefit.

Real estate was among the best performing sectors in the third quarter, as growing economic concerns have led to declines in interest rates, which have made the defensive nature of long-term leases with tenants and the high dividend payouts of REITs more attractive to investors. To receive tax-free status, REITs are required to pay out most of their net income as dividends to shareholders. These companies are frequently included in portfolios of income-oriented investors.

We continue to prefer a high quality aggregate of diversified investments. Our outlook on the market in general continues to be positive, although the economy is weakening due to the trade war, but remains relatively stronger when compared to global economies. The strong U.S. dollar and interest rate differential remain attractive to foreign investors, and will lend support to our markets. We expect the trade tensions with China to remain during the Trump administration. The Federal Reserve Bank has some flexibility in their monetary policy left to support the economy through a weaker phase, which we believe will be temporary.

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