Insights & Strategies

PRIVATE CLIENT SOLUTIONS

December 7, 2018

Inside this Issue

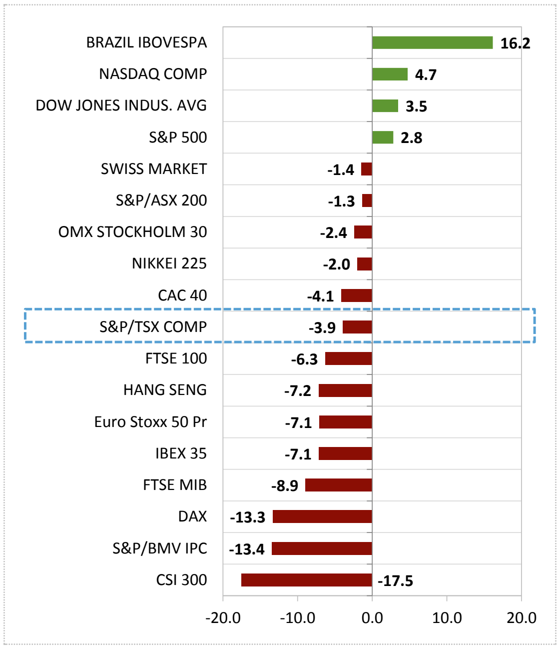
2018 - The Year That Was

From a market perspective, the return of equity market volatility was the biggest newsmaker of the year despite the US economy and corporate earnings firing on all cylinders. Volatility crept back into the market after taking an extended break; 55 times during the year the S&P 500 index closed up or down by greater than 1%. For all of 2017, that only happened eight times! So far this year, the CBOE Volatility index has jumped as high as 37.3 and averaged 15.9, which is a level that is more consistent with "normal" markets.

For much of the year, US markets were buoyed by the Republican tax reform bill that took effect in January. Lower personal and corporate tax rates and the repatriation of foreign cash provided a strong growth tailwind for the US economy and corporate earnings. The fiscal stimulus powered the current bull market to a significant milestone in August, officially becoming the longest uninterrupted bull market in US history. The corporate tax cut not only benefited the bottom line, but also fuelled corporate America's voracious appetite for merger and acquisitions (M&A) and share buybacks. M&A activity is currently running US$2.4 tln, up 16% from a year earlier and, based on the last three quarters of share buybacks, S&P 500 companies are on pace to repurchase a record $750 bln in stock this year. As we approach year-end, S&P 500 earnings are anticipated to grow 22.0% year-over-year (yoy) in 2018.

The US was largely an island unto itself for much of 2018 as global equities struggled under the weight of increased trade uncertainty, a general slowdown in global economic activity, and tighter monetary policy. Trade protectionism was a constant headline throughout 2018; the most damaging being the ongoing trade battle between the US and China, which placed tariffs on hundreds of billions worth of goods. The tit-for-tat tariff war was an additional external factor that contributed to the slowdown of the world's second largest economy, China. Tighter monetary conditions, particularly in the US, also played a role in slowing global growth.

2018 YTD Performance



Source: Bloomberg, Raymond James Ltd. As at December 5, 2018

Please read domestic and foreign disclosure/risk information beginning on page 7.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

The new Federal Reserve head, Jerome Powell, remains on the path to normalizing the Fed's balance sheet and removing monetary stimulus, and central banks around the world are following the lead. The Fed began reducing its holdings by US$10 bln per month last October with the run-off stepping up by a gradual and predictable manner, eventually reaching US$50 bln per month. In addition, the Fed raised interest rates three times while signalling additional tightening (although the Fed's tone has softened in recent days). As monetary conditions tighten in the US and aggregate central bank policy (ECB and BoJ) became more restrictive, asset prices experienced an increase in volatility, which is a typical response to changes in monetary policy.

As global growth slowed and trade uncertainties weighed on investor sentiment, the Shanghai Composite index entered bear market territory in Q2 and continued to slide for the remainder of the year. Emerging markets also struggled under the strain of the growth outlook and a strong US dollar, which created headwinds for countries that have dollar-denominated debt. Over US$200 bln of USD-denominated bonds and loans issued by emerging market governments and companies come due this year and about US$500 bln is due in 2019. The stronger dollar makes it harder to service the debt and puts additional strain on government finances.

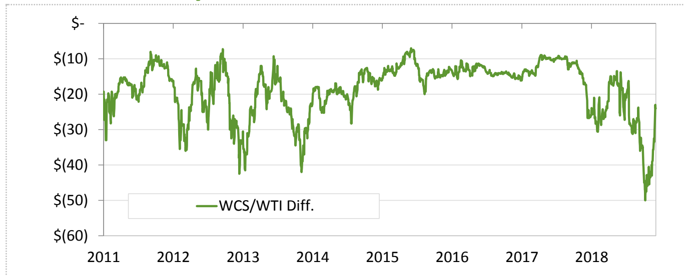
Meanwhile across the pond, European markets struggled under Brexit risks and, more recently, as Italy, euro zone's third-largest economy, entered yet another bout of political uncertainty. The latest round of uncertainty raised questions about Italy's future within the European Union, as the newly formed Italian government disagreed with Brussels over the size of the government's proposed budget deficit.

From a Canadian perspective, many of these external factors influenced our market, but there were also some country specific storylines that played out through the year. Just over 4 months ago, the S&P/TSX printed a fresh new all-time high as strength within the commodity complex provided the tailwind and our domestic economy surprisingly showed resiliency amid trade uncertainties. However, the picture for Canadian equities quickly turned south as external factors and some of our major news stories weighed on valuation.

Energy

Canadian oil price differentials were a major headline-grabber in the latter half of 2018, for all the wrong reasons. A series of unrelated incidents in Q2/Q3 2018, including record high US refinery maintenance, pipeline disruptions and the ramp-up of production from new/restarted oil sands projects, led to a perfect storm where crude oil supply from Western Canada greatly outstripped export capacity. This imbalance caused the most heavily traded Canadian crude oil benchmark, Western Canadian Select (WCS), to drop near record lows vs. the North American benchmark, West Texas Intermediate (WTI), at a time when it was making new, multi-year highs.

Canadian Heavy Crude Crashes in 2018



Source: Bloomberg, Raymond James Ltd.

As the situation progressed, WCS heavy crude, competing for limited pipeline space, began to push out medium and light grades which caused huge price discounts for higher quality crudes that rarely trade far from WTI. Blowouts in WCS spreads happen from time to time but high-double-digit discounts for Canadian light oil are practically unheard of and the net effect caused a massive contraction of equity prices for Canadian oil and gas producers across the board. In early December, the Alberta government announced that it planned to implement a 350,000 bbls/d temporary production cut from provincial producers with the goal of eliminating the current inventory supply overhang, but it could take until H2/19 to achieve this goal.

The differential issue added a second black eye to the Canadian energy sector, which started the year reeling when the US pipeline giant Kinder Morgan threw in the towel on trying to build the 590,000 bbls/d Trans Mountain Expansion Project (TMX) to the BC coast, and put the asset up for sale. With little private sector enthusiasm for an approved infrastructure project that was being challenged at various levels of provincial and regional government, the Trudeau government stepped in and purchased the existing Trans Mountain pipeline and the TMX project for $4.5 billion. However, the drama continued as, on the same week that the sale closed, a federal appeals judge ordered a halt to the construction of the TMX, citing insufficient consultations with local First Nations groups. The feds chose not to fight the decision and provided an additional six months of consultation with the goal of restarting work in early Q2/19.

In the midst of pipeline squabbles and massive revenue and tax losses from crude differentials, there was some good news in 2018. The biggest was Shell Canada's approval of the $40 billion LNG Canada project in Kitimat, BC. Although the mega-project will not come into operation until 2023, the positive final investment decision gave the industry a well-needed vote of confidence from the international private sector, and it will be one of the largest single private investments in Canadian history. This win will be added to the scheduled completion of Enbridge Inc.’s $8.5 bln Line 3 Replacement program in Q4/19 and (pending state approval) TransCanada Corporation’s $9.5 bln 500,000 bbls/d Keystone XL project in 2021/22.

Trade Uncertainties

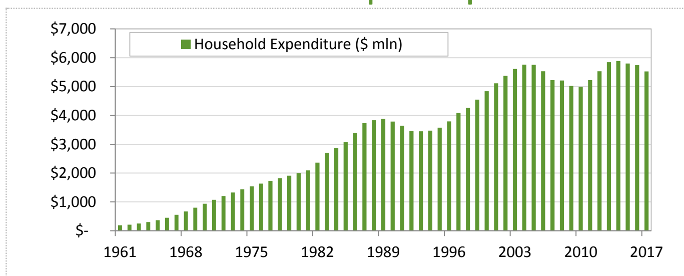
US trade protectionism measures have been far reaching; impacting Europe and Asia as well as its closest neighbours, Canada and Mexico. Following months of negotiations, the US, Mexico and Canada reached an agreement to rejig NAFTA, now called USMCA. The renegotiated trade deal made minor changes to the existing NAFTA agreement, the most significant being alterations to auto content rules, opening up the Canadian dairy market and a non-market clause, which may restrict Canada and Mexico from entering trade agreements with countries deemed to be a non-market economy. The finalized deal must still be approved by US Congress in 2019, so there remains some uncertainty surrounding the agreement. Nonetheless, finding a compromise ends months of back and forth negotiations, allowing Canada to move forward under the new rules of engagement.

Cannabis Legalization

The move to legalize cannabis has been years in the making and, in 2018, Canada officially became the first developed nation to end the decades-long prohibition. In this century, 2001 marked the first step towards legalization when the Liberal government allowed for the use of medical cannabis through the Marijuana for Medical Purposes Regulations. Under the act, cannabis could be consumed for medical purposes only. In 2003 and 2004, the Liberal government attempted to decriminalize possession for personal use of small amounts, but both attempts failed to become law. In 2008, the Conservative government attempted to increase penalties for production and distribution, but that bill also failed to become law. As attitudes toward the drug softened, on April 13, 2017, the Liberal majority government introduced a bill to legalize cannabis by July 1, 2018. The bill passed and officially ended prohibition on October 17, 2018. The government anticipates cannabis will initially generate revenues of $600 million per year, but may eventually exceed $1 bln annually.

Canada’s move to legalize has given it first mover advantage in a world that is becoming increasingly open to cannabis usage. The number of US states that has either legalized recreational consumption or approved medical use continues to grow. Following the US mid-term elections, there are now 10 states and Washington, DC that have legalized marijuana for recreational use for adults and 33 states have legalized medical marijuana, although cannabis remains illegal at the federal level.

Canadian Household Consumption Expenditure

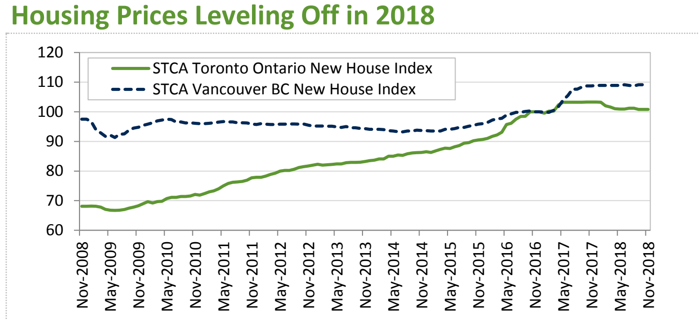


Source: Stats Canada, Raymond James Ltd.

Soft Landing

The Canadian housing market softened in 2018, as tighter mortgage rules and a series of interest rate hikes cooled the red-hot market. The slowdown was more pronounced in major urban areas where valuation levels had become particularly stretched. Looking at common valuation metrics, such as housing prices-to-income, would suggest our housing market is overvalued from a historical perspective. The median household income in Canada is approximately $70k, while the national house price average is $497,000. This leads to a price-to-income multiple around 7.1x versus the standard 3.0x rule of thumb. However, if we exclude Ontario and BC (Toronto and Vancouver, in particular), the national average falls to 5.4x. Given the importance of housing to the Canadian economy, engineering a soft-landing through tighter mortgage standards, in our view, is one of the more important stories of the year.

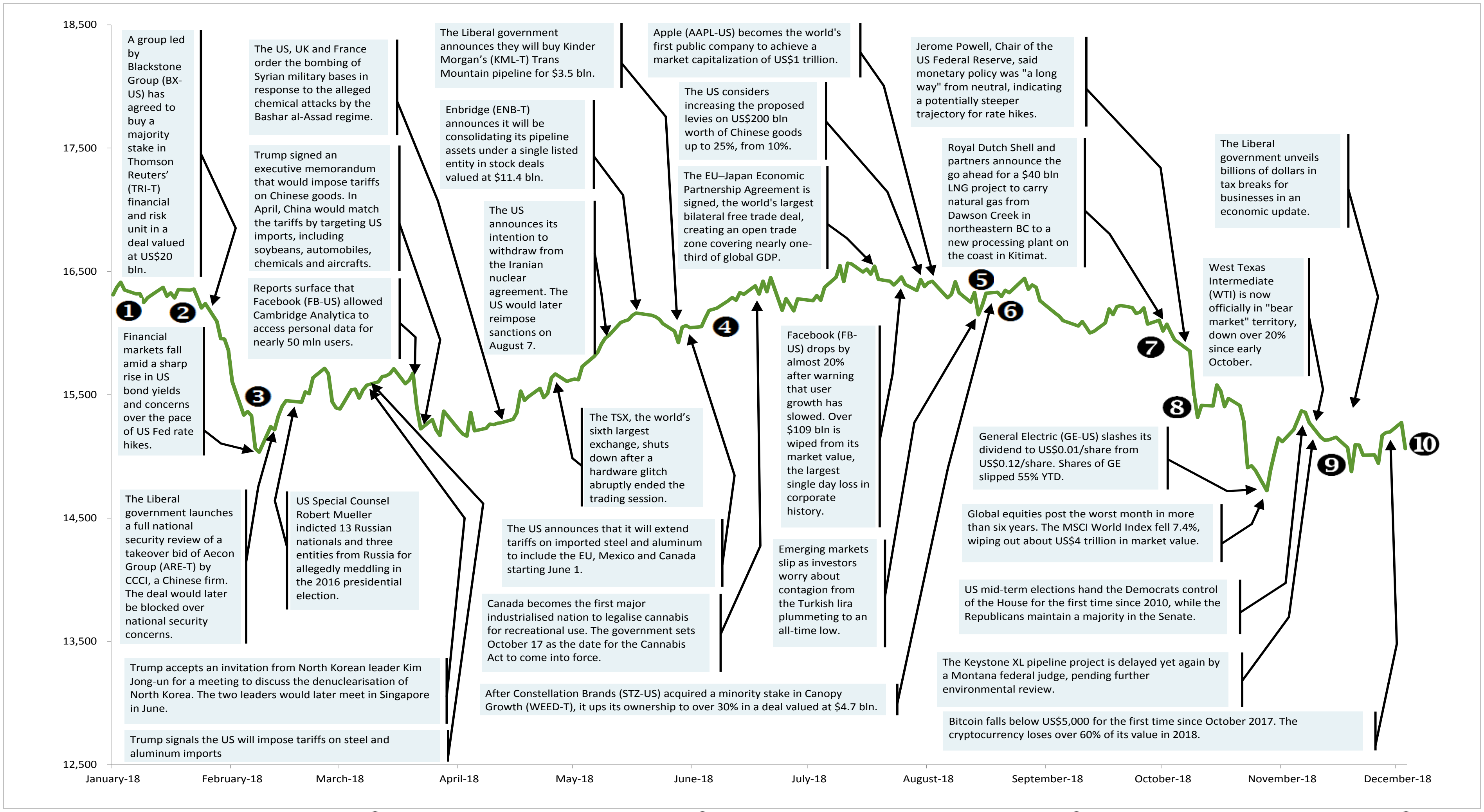
Housing Prices Leveling Off in 2018



Source: Stats Canada, Raymond James Ltd.

Jason Castelli, CFA & Robert Mark, CFA

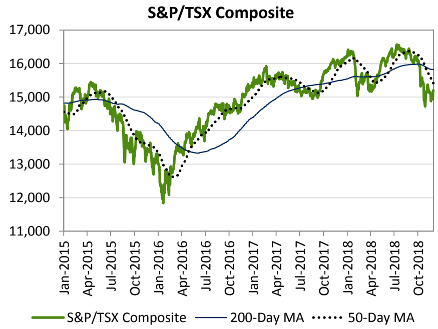
S&P/TSX: The Year That Was

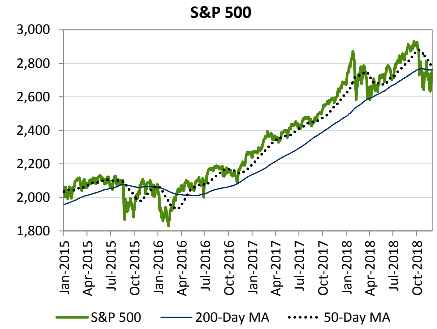


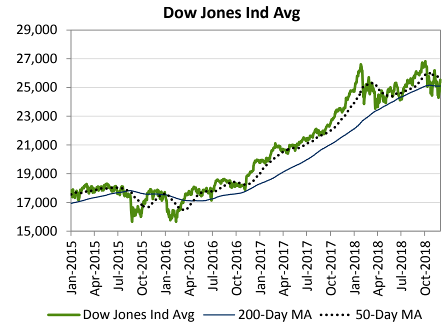
❶ Canadian Govt. 10 year yield hits low of 2.047%; ❷ Gold closes at year high of US$1,365.40/oz; ❸ Natural gas closes at year low of US$2.53/mmbtu; ❹ Copper closes at year high of US$331.55/lb; ❺ Copper closes at year low of US$255.20/lb; ❻ Gold closes at year low of US$1,161.40/oz; ❼ US WTI crude closes at year high of US$76.90/bbl; ❽ Canadian Govt. 10 year yield hits high of 2.611%; ❾ Natural gas closes at year high of US$4.92/mmbtu; ❿ US WTI crude closes at year low of US$49.41/bbl.

Charts of Interest

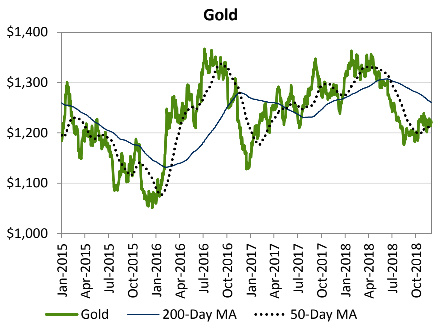
Markets

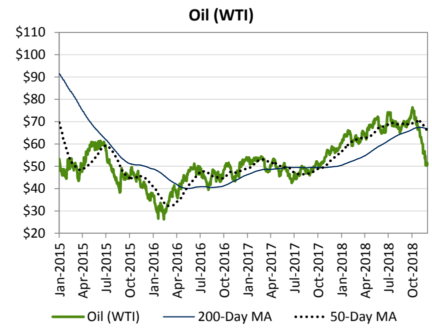


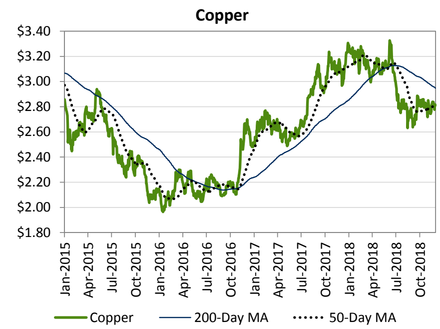




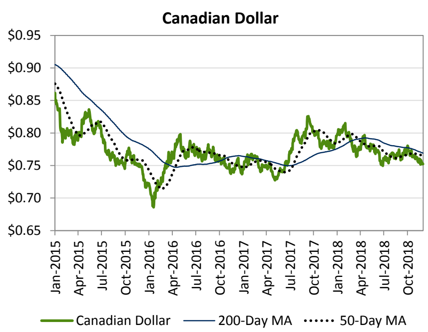
Commodities

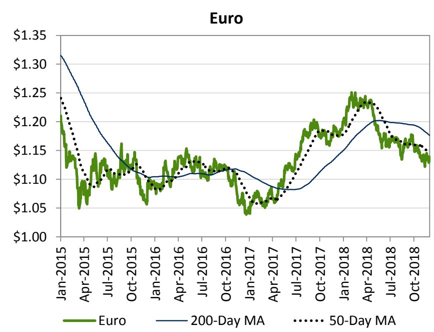


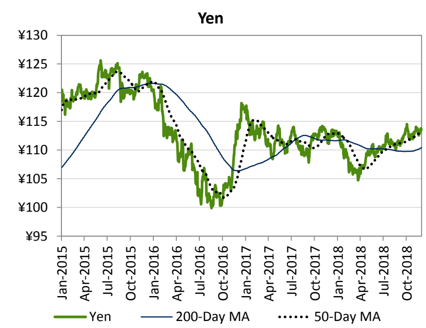




Currencies





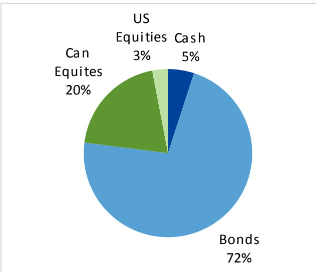


Source: Bloomberg, Raymond James Ltd. Performance as at November 30, 2018.

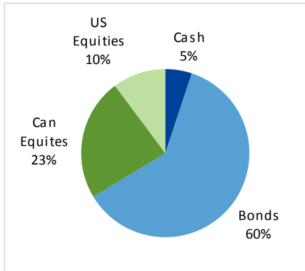
Investor Profiles and Asset Class Weightings

Recommended Asset Allocation

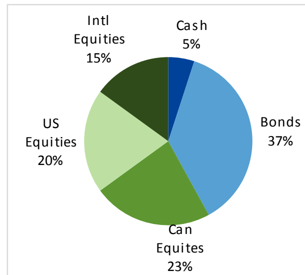
Capital Preservation



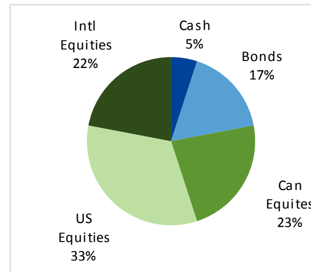
Conservative



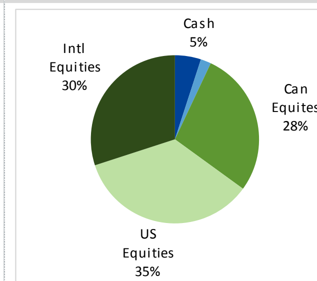
Moderate



Growth



Aggressive Growth



Recommended Asset Allocation	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	5%	5%	5%	5%	5%
Bonds	72%	62%	37%	17%	2%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100

Description

Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Important Investor Disclosures

Complete disclosures for companies covered by Raymond James can be viewed at: https://www.rjcapitalmarkets.com/Disclosures/Index

This newsletter is prepared by the Private Client Services team (PCS) of Raymond James Ltd. (RJL) for distribution to RJL's retail clients. It is not a product of the Research Department of RJL.

All opinions and recommendations reflect the judgement of the author at this date and are subject to change. The author's recommendations may be based on technical analysis and may or may not take into account information contained in fundamental research reports published by RJL or its affiliates. Information is from sources believed to be reliable but accuracy cannot be guaranteed. It is for informational purposes only. It is not meant to provide legal or tax advice; as each situation is different, individuals should seek advice based on their circumstances. Nor is it an offer to sell or the solicitation of an offer to buy any securities. It is intended for distribution only in those jurisdictions where RJL is registered. RJL, its officers, directors, agents, employees and families may from time to time hold long or short positions in the securities mentioned herein and may engage in transactions contrary to the conclusions in this newsletter. RJL may perform investment banking or other services for, or solicit investment banking business from, any company mentioned in this newsletter. Securities offered through Raymond James Ltd., Member-Canadian Investor Protection Fund. Financial planning and insurance offered through Raymond James Financial Planning Ltd., not a Member-Canadian Investor Protection Fund.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual funds. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The results presented should not and cannot be viewed as an indicator of future performance. Individual results will vary and transaction costs relating to investing in these stocks will affect overall performance.

Some of the securities mentioned in this report may entail higher risk. Clients should contact their Financial Advisor to determine if the securities are compatible with their risk tolerance and investment objectives.

Information regarding High, Medium, and Low risk securities is available from your Financial Advisor.