When the secular and the cyclical align

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Key Takeaways

- Secular projections see muted returns for equities, particularly in Canada
- The cyclical outlook for Canada's economy remains tenuous
- We continue to overweight foreign assets in our funds

Our asset allocation research team in Boston recently completed their annual update of *Capital Market Assumptions* (CMA's), which are 20-year projections of real returns across a wide array of asset classes. While the long-term nature of these projections means they are most appropriate for evaluating the underlying structure of our multi-asset class funds, we do also keep them in mind when formulating our shorter-term active asset allocation decisions in the funds. This is because of the inherent difficulty in timing precisely when a given asset class will revert to a return stream that is more consistent with its long-term fundamentals.

As we've written previously, we believe that the shorter-term outlook for returns outside of Canada is favourable compared to those on Canadian assets, based largely on the Canadian economy's severe imbalances and the threat they pose to the economic outlook over the medium-term. Using an independent process, the updated CMA's yield the same preference for foreign assets, and thus at the margin contribute to our active positioning in that direction.

A brief background on the CMA process is appropriate. The secular return projection process begins with a forecast of GDP growth for a wide array of countries, based on expected developments in the deep fundamentals of productivity growth and demographics. From these projections, expected real returns for equities, bonds and cash for each market are built up reflecting the specific attributes of each country's capital markets, such as the return on equity and sustainable level of valuations that are appropriate to a given country's equity market composition.

While we keep proprietary the precise numerical results of the CMA exercise, we can share a number of results germane to our asset allocation process in Canada.

First, around the world, we generally expect lower real returns on all asset classes over the next 20 years than investors have enjoyed over the past 20 (and, frankly, the 20 before that). This should not be surprising, given relatively high starting asset valuations and deteriorating demographics in most markets. As we've said before, investor expectations going forward need to be more realistic about what capital markets can provide than a simple extrapolation of past returns would imply.

Second, the projected secular real returns on Canadian equities specifically are particularly muted, expected generally to be half or less of those projected for equities in the US, other developed markets or emerging markets. This gap results primarily from the composition of the Canadian equity market, which is biased towards sectors such as financials, energy and materials to which lower longer-term valuations should attach based on generally inferior and more volatile returns.

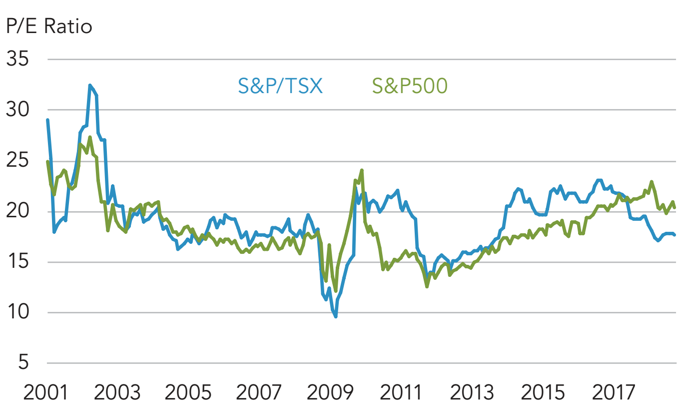
This analysis to some degree represents a rebuttal to the widespread argument that Canadian equities are now 'cheap' because they now trade at a discount to the US market (see Exhibit 1). Following on the above, in our view Canadian equities *should* tend to trade at a discount to the US, given the Canadian markets' poorer mix of businesses. The fact that they haven't generally done so in the past may owe to the particularly elevated degree of home bias among Canadian investors, which now seems to be in the process of ebbing. Regardless, relative Canada-US valuations are a case where we do not expect a sustained reversion to the historical mean.

As mentioned above, the inferior returns projected for Canadian equities over the secular horizon play a relatively minor role in the active allocation process we employ in our Canadian multi-asset class funds, which is driven more by the cyclical outlook. That shorter-term outlook remains a source of concern.

The overreliance of the Canadian economy on debt-fueled household spending is clearly starting to unwind. Housing prices and sales have come off their peaks. Real retail sales are growing at their slowest pace since 2009; real household credit is growing at its slowest pace since 2001 (see Exhibit 2). These trends do not suggest collapse, but do indicate that the sole effective engine of Canadian economic growth in recent years is now sputtering.

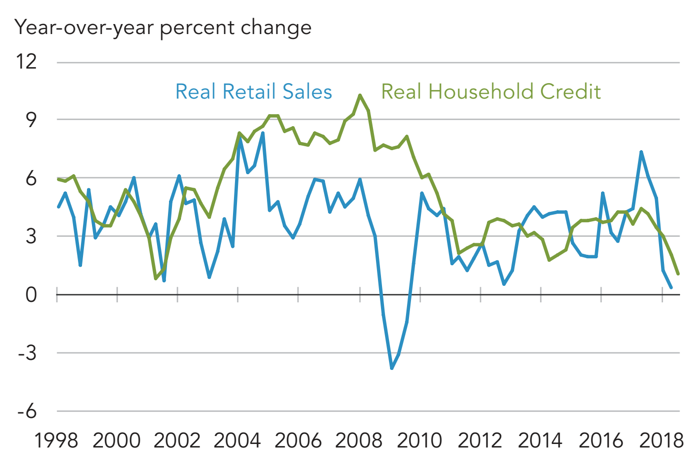
EXHIBIT 1: Canada now trading at a more appropriate discount

Percent Share



Sources: Bloomberg, FMR Co.

EXHIBIT 2: It's happening



Sources: Statistics Canada, Haver Analytics, FMR Co.

Recent Bank of Canada noises regarding a significant extension of the tightening may stall it entirely.

And we remain doubtful that other elements of the economy can pick up the slack where the consumer leaves off. While NAFTA uncertainty has been removed, the competitiveness challenges that have resulted in a decade of disappointing export and business investment performance have not gone away. As a result, we see 2019 as a challenging year for investors and policy-makers alike in Canada, with potential pressure points including domestically-oriented elements of the Canadian equity market (such as the banks) as well as the Canadian dollar. With these challenges front-and-center on the cyclical horizon, against a backdrop of muted projections of Canadian equity returns on the secular horizon, we continue to actively overweight foreign assets in our Canadian multi-asset class funds.

Finally, we should note that this doesn't mean our positioning is static – we made the tactical move to buy back into Canada in the late summer given the resiliency of the Canadian data and the expectation of a positive resolution of trade uncertainty. But it does mean we expect to restore a more significant overweight to foreign assets when the opportunity arises.

David Wolf and David Tulk, November 9, 2018

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