MATCO FINANCIAL

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QUARTERLY MACRO OVERVIEW

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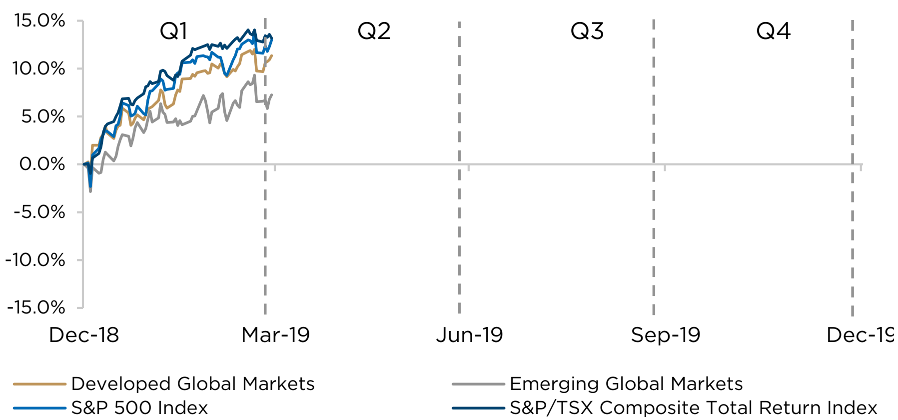
The transition from calendar 2018 to 2019, from a capital markets perspective, has been an eventful one. The theme of heightened market volatility experienced over the last eighteen months remained prevalent as the baton was passed from one year to the next. More specifically, the month of December was one of the worst performing months for North American equity markets in over 30 years. However, this volatility paved the way for a market bounce in January. This magnitude of market turbulence could be characterized as late cycle behaviour. With that in mind, let's take a closer look at some of the recent economic and market developments.

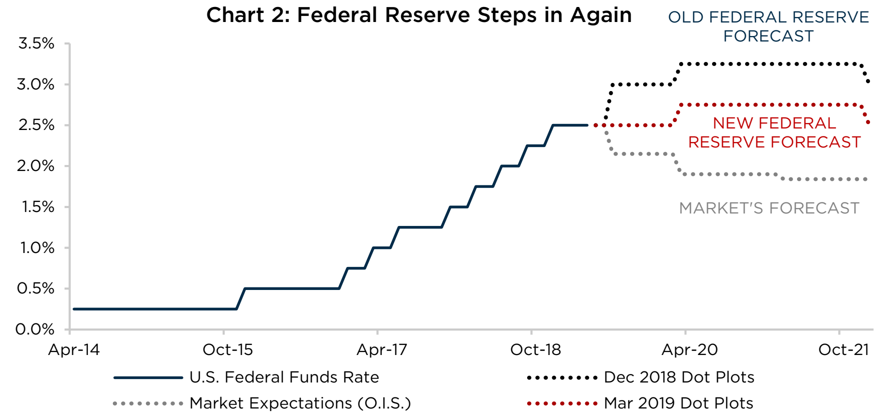
As mentioned, global equity markets experienced welcome respite in January, after a torrid end to 2018. Both developed market equities had a strong first quarter, gaining over 10% (Chart 1) in total return terms. The primary drivers for the valuation bounce in equity markets was the U.S. Federal Reserve, who articulated that they may exhibit more patience in their approach to increasing interest rates. This was further reinforced by a similar shift in tone at both the Bank of Canada and the European Central Bank. This shift in global monetary policy rhetoric has been driven by two predominant factors. First and foremost, the International Monetary Fund has recently warned that a slowing in global growth may come to fruition in 2019; economic data released throughout the first quarter has reinforced this notion. Secondly, it seems that the market turbulence experienced in the month of December also had a material impact. Although the mandate of central banks around the world is to utilize interest to target stable inflation and a healthy labour market, they have now shown that their policies are not immune to the changing health and stability of capital markets (Chart 2).

Chart 1: Global Equity Markets - 2019



Source: Bloomberg

Chart 2: Federal Reserve Steps in Again

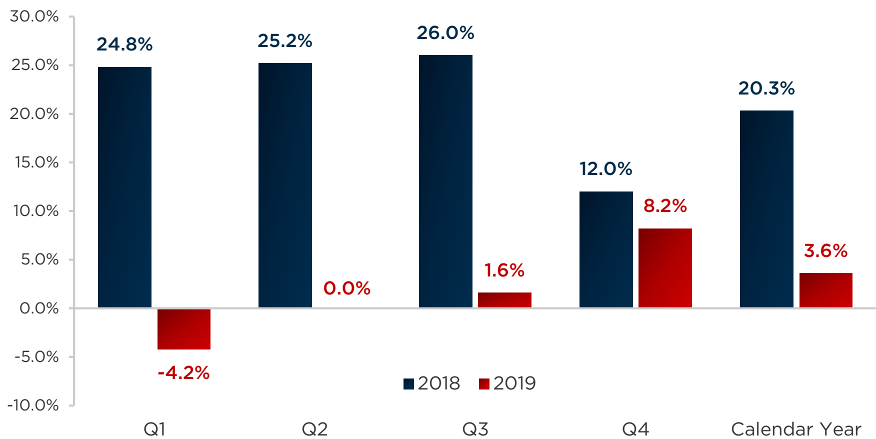


Source: Bloomberg

Economically speaking, the U.S. continues to be one of the strongest contributors to global growth, as fundamentals remain robust. Notably, the U.S. unemployment rate at a 40-year low, GDP growth is hovering around a healthy level of 2% and corporate earnings remain in positive territory. However, this strength in economic fundamentals and corporate earnings becomes increasingly difficult to sustain. In fact, looking out to the first quarter earnings season of 2019, analysts are anticipating the first year-over-year decline in U.S. corporate earnings (Chart 3). History would suggest that the transition from late expansion to soft economic landing has proven to be a challenging period to navigate. Central banks recognize this challenge and appear to be willing to adjust their policy to promote a soft landing. Whether this will be a successful endeavor is likely a story for late 2019 and early 2020.

Looking outside U.S. borders, concerns over a slowdown in China have not dissipated. Fourth quarter real GDP in China was announced at 6.4% year-over-year, the lowest level of growth since the Financial Crisis of 2009. The slowing pace of economic growth is partly a domestic story; however, the uncertainty surrounding U.S. and China trade negotiations has also contributed. As a result, the People's Bank of China announced that it would cut their Reserve Requirement Ratio, a mechanism aimed at stimulating the domestic economy. Further stimulus measures are expected as we progress through 2019. When speaking to the economic landscape outside of North America, we would be remiss not to mention the developments in Europe. The European Union and the U.K. continue to approach extended Brexit deadlines, without any signs of an agreed upon deal or resolution. Whether this will result in a hard Brexit or a second referendum is difficult to ascertain, however these developments have contributed to uncertainty and hampered economic growth.

Chart 3: S&P 500 Earnings Tide: Comparing 2018 to 2019



Source: FactSet, Goldman Sachs Global Investment Research

In order to determine our investment outlook, there are three predominant factors that must be considered: The current state of the economy, the trend of economic data and what influence global monetary policy may have on the future direction of the economy.

As previously mentioned, the global economy remains healthy, foundationally supported by a strong U.S. economy. With the unemployment rate and initial jobless claims both at 40 year lows and wage growth gradually trending higher, the labor market is undoubtably on solid footing. The U.S. housing market, another pillar of the domestic economy, has been trending in a positive direction since the great financial crisis and as previously mentioned, GDP growth continues to hover around a solid level of 2%. So in terms of the economy's current state, the vitals would indicate a clean bill of health. However, the trend of economic data can be equally as important as the strength and health of the current economy. In a sense, this notion is what made the Canadian legend Wayne Gretzky one of the greatest hockey players of all time. His father, Walter Gretzky, instilled in his mind the understanding that it is critical to "skate to where the puck is going, not to where it has been". In other words, understanding how things will progress is more important than the current state. This is equally as critical in the investment world. The chart to the right highlights two sets of data that are inextricably related. The dark blue line is the ISM Manufacturing PMI. This data set indicates the long term structural trend of global economic data. The light grey dotted data set represents the Citi Group Economic Surprise index, which indicates whether current economic data is above or below expectations; it tends to move more swiftly, or cyclically. In examining the earnings series in Chart 3 as well as the PMI and economic surprise series below in Chart 4, the trend of slowing economic data becomes increasingly apparent. Lastly, monetary policy and the influence it may have on the trend of economic data going forward must be considered. North American central banks have pivoted from their course of tightening financial conditions, to stepping onto the sidelines. This could be highlighted by Jerome Powell's comments that the Federal Reserve will be "patient amid global economic developments and muted inflation pressures." The Bank of Canada has also shifted their tone in similar fashion. Beyond North America, it would appear the Bank of England, European Central Bank and the Public Bank of China also favor easing financial conditions. The shift in central bank sentiment is, in large part, due to the slowing economic data we have addressed. Central banks have recognized this slowing, and appear to be willing to adjust their policy in order to help mitigate some of the downward pressure.

As for our concluding thoughts, the bottom line is that the global economy remains healthy, while the structural economic factors indicate we are late in the cycle. However, the puck appears to be moving more to the neutral zone and either the shift in central bank monetary policy will allow markets to re-enter the zone of attack or investors will need to begin defending their own net. This is a question to be answered as we progress through 2019 and into 2020. Our economic assessment and philosophy of risk management currently favours prudence over greed.

Chart 4: Economic Growth Showing Signs of Slowing

Source: Bloomberg