Green Shoots Mark Modest Improvement for 2020

glc asset management

2020 Capital Market Outlook

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Data as of Nov. 30, 2019 unless otherwise stated.

All data as of Nov. 30, 2019 unless otherwise stated.

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The World at Large:
Green Shoots Mark Modest Improvement for 2020

The current economic slowdown should come to an end in 2020. **The global economy is showing signs (the so-called ‘green shoots’) that growth in 2020 should pick-up modestly, aided by a détente in global trade frictions and stimulative central bank policies.** We see an economic environment where corporate earnings growth will be sufficient to support equity market gains. We expect that bond yields will remain low but have a modest upward trend, commodity prices will improve, and the U.S. dollar will weaken.

> *“My sun sets to rise again.”*
>
> *– Robert Browning, English poet and playwright, 1812-1889.*

Global equity markets have moved sideways for 22 months (January 2018 through to October 2019) and are now breaking out to the upside. Equities are moving up in anticipation of improvement in the macro-economic environment into 2020. In contrast to 2019, where many indictors were slowing, these same metrics are starting to turn the corner, pointing to growth in 2020 (see **Green Shoot #1 – Embattled Global Manufacturing Sector Looking Toward Improvement**). The growth won't be robust, but it will at least be moving from a downward trend to a stable or upward trend. **In short, what were headwinds in 2019 will turn benign or become tailwinds in 2020.**

The new normal

As the global economy exits its third slowdown since 2009, we don’t believe equity gains will match those from the previous two recoveries (~50% and ~25%), nor will bond yields climb back to the heights of either recovery (U.S. 10-year bond yields peaked at 3% in 2014 and 3.25% in 2018). In the times since, debt levels have steadily increased, stimulative monetary policy efforts now face diminishing marginal returns and growth is running-up against the constraints of tight labour markets, while trade frictions restrain business investment. Even if trade frictions ebb, we don’t see a complete return to normalcy. The uncertainty unleashed thus far is already disrupting global supply chains, levelling additional costs on the global economy. Add in the increased costs of adopting business processes that move toward a more environmentally sustainable world and **the conclusion leads to a reflation scenario that’ll likely deliver less oomph**.

Longer term, epochal shifts are taking place at the expense of global multinational corporations. A retreat from globalization, greater environmental stewardship and shifting global supremacies are realities that will eat into the profit margins of the companies whose shares make up the bulk of the global investing universe. These developed world multinational companies have benefitted most from a half-century of expanding globalization and trade, low-cost use of the environment and protection under the United States' security umbrella.

To gauge equity expectations, we look to earnings growth and valuations.

- **Earnings estimates for 2020 remain elevated**, but under the right set of conditions (such as easing trade concerns, accommodating central banks, a weakening U.S. dollar and less onerous year-over-year comparisons), earnings in the mid to high single-digit range are achievable.
- **Elevated equity valuations will be supported by a low-inflation, low-yield environment** (rising, but still very low). Central banks have put rate hikes on hold and are providing ample liquidity, along with the increasing confidence that earnings will show growth. **Canadian, international and emerging market equities, being more cyclically oriented and sporting cheaper valuations, are poised to outperform more expensive U.S. equities.**

All in, we forecast 2020 equity returns in the 6% to 13% range, depending on the market in question.

As always, hurdles remain. Of the four contributors to economic growth (consumers, businesses, governments and trade), the strength of the global consumer has held the current slowdown in check.

- **The consumer can't be expected to do all the heavy lifting** indefinitely; success in moving forward requires the other cylinders to begin firing. Policymakers need to provide an environment that lifts the extreme uncertainty brought on by trade frictions and Brexit and paves the way for the return of 'animal spirits' which is the natural, steady-state for both households and businesses.
- We believe **businesses will return to expansion mode** as they receive sufficient reprieve from geopolitical uncertainty. Indeed, the pressure on businesses is building – the ability to meet demand from bloated inventories appears to be coming to an end (see **Green Shoot #2 – U.S. Inventory Cycle Starting to Turn**). Increased business spending will result from demand that holds steady, or slightly improves.

- **Government spending, while not a net detractor in 2019, has room and incentive to expand throughout 2020.** We do not foresee any global fiscal contraction. Japan is launching a stimulus package, recognizing that monetary policy is not enough. Japan's experiment with negative interest rates (resulting in governments being paid to borrow) is alluring and ostensibly makes government spending appear to be an easier choice. Europe faces a similar choice but has yet to commit to any sweeping fiscal boost, despite demands from a variety of voices and ample capacity in the region's main (and faltering) economy, Germany, to do so. In North America, governments on both sides of the border should increase expenditures. The 2020 U.S. election will encourage a liberal sprinkling of program spending and make shutdowns and debt ceiling limitations politically unpalatable. Canada's Liberal minority government will likely spend more in an attempt to conciliate and hold power.
- Despite trade frictions and swirling uncertainty, **global trade volumes are already showing signs of improvement** as the world adapts and continues to figure out a way forward. While September's trade reading was weak, world trade volumes for July and August were the first back-to-back months of increase in 12 months and the three-month trend has turned positive (see **Green Shoot #3 – Flatline for Global Trade Volumes Reaching Exhaustion**). Economies and stock markets that are hypersensitive to trade (such as Germany, South Korea, Taiwan and Japan) are showing nascent signs of improvement, as are most commodities and the semi-conductor space. **We expect global trade to turn from a drag to a slight benefit during 2020.**

While we are constructive on the macro-economic outlook, trade frictions and Brexit uncertainty will have to clear meaningfully to pave the way for this scenario to come to fruition. While the developments of mid-December are encouraging, and some interim resolutions are preferable to descending further into chaos, it's important to note that the U.S./China trade truce is simply a truce – not an end to the war. Additionally, the Conservative win in the U.K. ends the debate over whether or not they are leaving but that may end up looking like the easy part. Next year brings the challenge of negotiating a comprehensive trade deal between the U.K. and the eurozone, and likely the U.K and others, notably the U.S. The bottom line is risks remain and we believe it is prudent to **factor these risks into our asset mix stance; thereby tempering our enthusiasm for risk assets and improving our appetite for safe havens**.

Equity markets have already moved to price in a rosy scenario for trade, supportive global central banks and the expectation that the earnings recession will come to an end in 2020. While our full-year return scenarios leave room for further growth, equities likely require more time to consolidate recent gains (a 5 to 7% correction in equities would pique our interest) and greater evidence (versus just hope) that the clouds are indeed going to part in 2020.

Conversely, **bond yields appear to reflect a degree of pessimism inconsistent with our base-case scenario of modest improvement**. While yields have been in an uptrend since their 2019 lows back in August (making higher highs and higher lows), their attraction is more muted than if yields were currently moving toward the upper-end of their trading range (a 35 to 40 basis point move higher from November 30 levels for Canadian sovereign bond yields would whet our appetite for more fixed income).

Year-to-date returns for most asset classes appear eye-popping despite most being merely a by-product of a recovery from the steep declines of Q4 2018. This is not the case for fixed income. Strong YTD returns for fixed income (8.2%) reflect a structural shift to lower bond yields due to the abrupt about-face on monetary policy early in 2019 by global central banks. That shift knocked yields down by about 0.5% early in the year and is responsible for roughly half of the YTD returns in 2019. The environment now is one where bond and money markets continue to expect further central bank easing. Yet, if the environment improves, that easing is not likely to be necessary or forthcoming. We don't believe bond yields need a significant adjustment higher because central banks are currently on hold with a bias toward easing (versus tightening). It is noteworthy that if yields move higher by 0.25 to 0.50% (in an improving macro-economic scenario), that still represents a historically low yield environment. **Importantly, despite a slight move up, we see a yield environment that remains accommodative: one where businesses and households can access and afford credit and one that doesn't require a downward adjustment to equity market valuations.**

Fixed income's risk-mitigating qualities remain a significant attraction: bond yields are high enough to provide ample room for yields to fall should a risk-off scenario unfold. As a result, investment-grade fixed income continues to be capable of providing risk mitigation within portfolio construction.

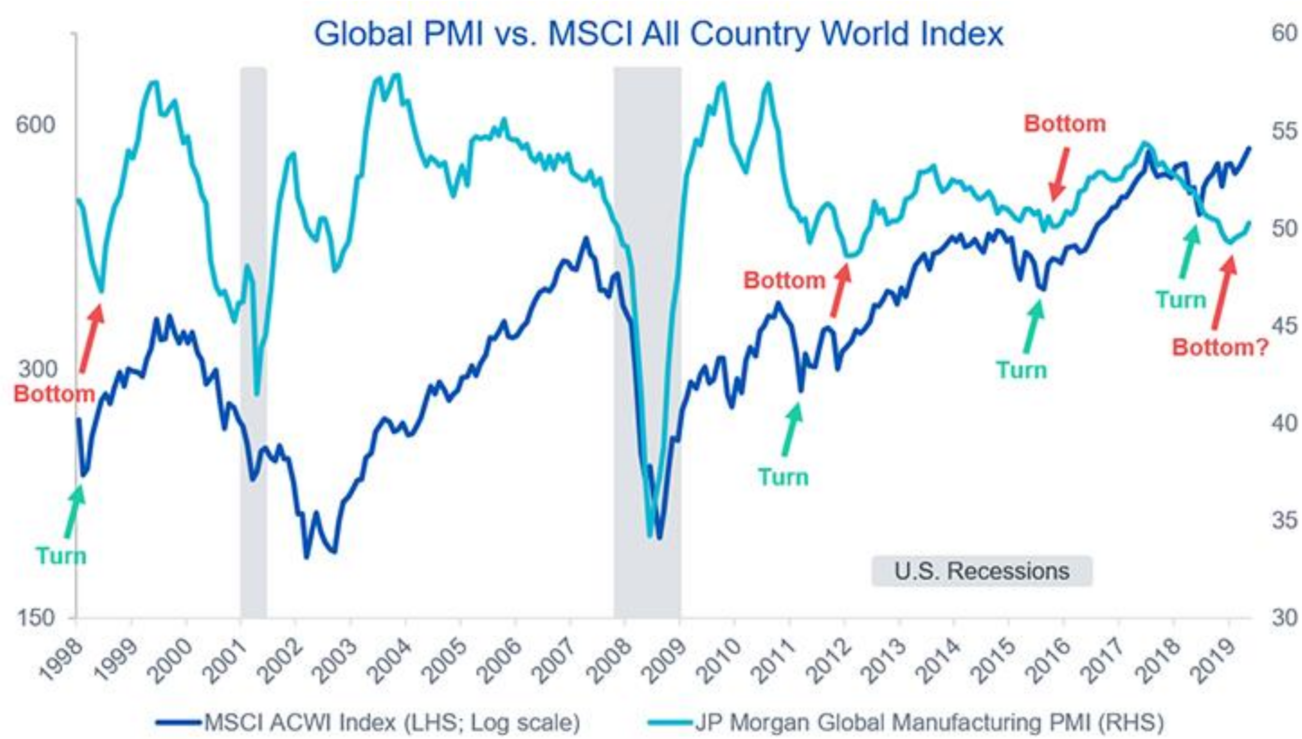
Bottom line: Our current tilt to the defensive side of neutral (i.e., slight underweight in equities and slight overweight to fixed income) continues to offer exposure to participate in equity market growth without overreaching for risk.

- Our 2020 Capital Market Outlook calls for high single-digit equity price gains, with select markets (Canada and Emerging Markets) capable of going slightly higher. Trade-, political- and geopolitical-related volatility is to be expected, with uncertain outcomes requiring a meaningful allocation to fixed income as a safe-haven investment.
- Within equities, we recommend broad, diversified geographic and sector allocations. We recommend neutral exposure to Canadian, U.S. and International (EAFE) equities and an underweight to Emerging Markets.
- For fixed-income investors, we recommend a neutral weight to sovereign bonds, offset by an overweight to investment-grade corporate bonds and underweight in high-yield bonds. Overall, we forecast a 1.5% total Canadian fixed-income return for the next twelve months. Importantly, fixed income remains positioned to deliver on its role as a risk-mitigation tool during bouts of risk-off sentiment or an outright deteriorating macro-economic environment.

Green Shoot #1

Embattled Global Manufacturing Sector Looking Toward Improvement

Responses to manufacturer outlook surveys are beginning to come in “less-bad”, the first step toward outright expansion. This cycle is showing signs of turning; a headwind will shift to a tailwind.



Source: Bloomberg, Nov. 30, 2019.

Green Shoot #2

U.S. Inventory Cycle Starting to Turn

The natural U.S. inventory cycle has been a large part of the slowing U.S. economy. This cycle is showing signs of turning; a headwind will shift to a tailwind.

Source: Bloomberg, Nov. 30, 2019.

Green Shoot #3

Flatline for Global Trade Reaching Exhaustion

Trade matters! When global trade falters, so do global equities. A trade truce and a reprieve from the uncertainty of trade tensions and Brexit (however slight) is poised to help pent-up trade begin to flow again. Equities are already moving in anticipation.

Source: Bloomberg, Nov. 30, 2019.

U.S. Equity

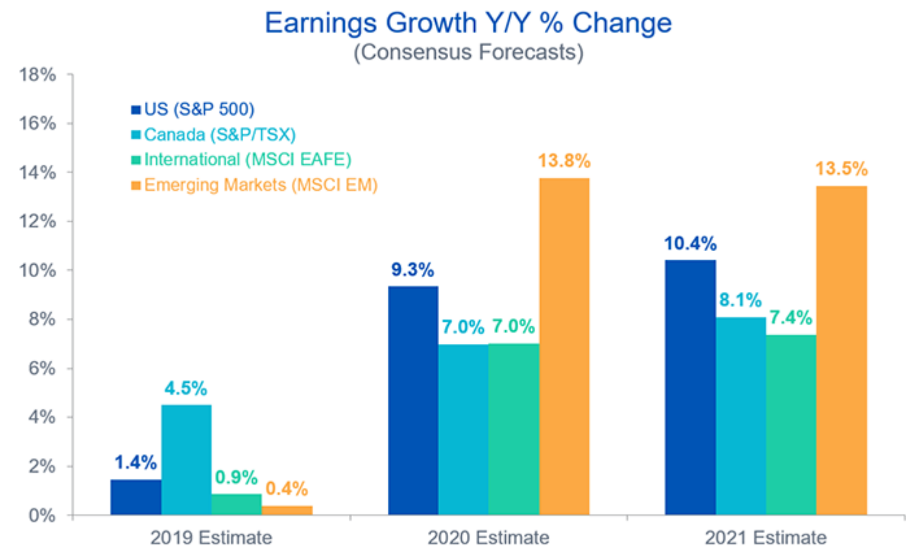
We hold a constructive view on U.S. equities. We believe a year of muted earnings growth in 2019 (against a backdrop of uncertainty and sluggish economic growth) paves the way for earnings growth to recover into the mid-high single-digit range. Consensus 2020 earnings growth estimates for the S&P 500 have fallen from an 11% high earlier in 2019 to just above 9% currently and are showing signs of stabilization (see **Exhibit 2.1 – Global Earnings Growth Expectations**). Earnings growth in the mid-high single digits is reasonable against a backdrop of an improving global growth scenario and waning strength for the U.S. dollar.

Did You Know?

The S&P 500 has historically posted double-digit gains (on average) following each of these occurrences that are all happening now:

- U.S. yield curve inverts, then re-steepens
- U.S. Federal Reserve cuts interest rates during periods of expansion (insurance rate cuts)
- U.S. Presidential election years

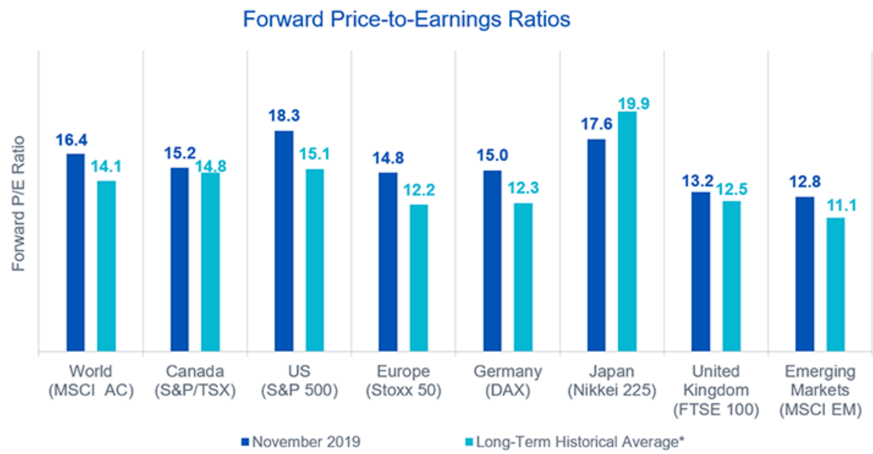
2.1 | Global Earnings Growth Expectations



Source: Bloomberg, JP Morgan, TD Securities; Nov. 30, 2019.

The S&P 500 remains the most diversified equity market in our universe and contains some of the best secular growth opportunities. However, it's also the most expensive market on our list (see **Exhibit 2.2 – Global Equity Market Valuations**). While everyone would prefer the opportunity to buy equities at cheaper valuations, we must deal with what is and not what we would like. The reality is the current backdrop should see equity valuations higher than otherwise. The U.S. Federal Reserve guiding markets toward no further rate hikes and demonstrating they are prepared to provide ample liquidity is an environment supportive of valuations. Additionally, the prospect of low inflation and contained bond yields also inflates valuations, as does any improvement to sentiment, economic conditions or earnings estimates. Given this backdrop, we're prepared to assign an elevated earnings multiple to U.S. equities, but the way forward remains fraught with uncertainty. **While we see a path toward improvement in the economy, trade and earnings growth, U.S. equity markets have already moved a significant way toward the optimistic side, leaving little room for disappointment.**

2.2 | Global Equity Valuations



*Historical Averages: S&P 500,S&P/TSX, Nikkei 225, MSCI AC 15 years; EuroStoxx 50, DAX, FTSE 100 & MSCI EM since 2005.
Source: Bloomberg, Nov. 30, 2019.

Markets are currently buoyed by the notion that global economic activity is bottoming out and set to improve (as is our base case). However, at the bottoms of prior mid-cycle slowdowns that bear a resemblance to the current episode (1995, 1998, 2012 and 2016), equity markets faced a better fundamental starting point than does the current market. On average, GDP growth troughed at higher-than-current levels, earnings growth only averaged ~8% (versus expectations for more than 9% at the current time) and forward price-to-earnings multiples averaged 16.3X (versus 18.3X). One caveat that stands in contrast to this divergence, and is a positive for equities, is that the overall backdrop for yields (outside of the 2016 episode) started at a much higher-than-current level.

In spite of our overall constructive outlook for U.S. equities in 2020, we do have some near-term concerns that temper any desire to overweight the region.

1. Specifically, our concerns stem from the rapid and sharp advance U.S. equities have made in the last several weeks of November. The complete set of S&P 500, Dow Jones Industrials, Nasdaq and Russell 2000 Indices registered over-bought conditions late in the month. **Prior instances with similar run-up in equity prices have more often than not led to periods of consolidation, marked by single-digit check backs. Our experience gives us the confidence to trust these tactical indicators and avoid the temptation to chase recent gains.** U.S. equities are currently pricing-in the better-than-feared global economic scenario we hold as our base case for 2020. Furthermore, U.S. equities are also pricing-in a trade détente. Rumours and green shoots surround both outcomes, but **equities likely require recent gains to be consolidated** and further tangible evidence the clouds are indeed going to part in 2020.

2. Aside from the near-term run-up in stock prices, other issues facing the U.S. market give us reason to pause. Share buybacks have been an important metric that have helped shore up S&P 500 earnings per share. They've also been a source of demand for equities (S&P 500 share buybacks of USD $806 billion set a record in 2018). Share buybacks trended downward from that record-setting pace in 2019 and the trend is likely to continue. **Buybacks are still providing a lift to U.S. equities, but the impetus is waning.**

3. A third U.S. equity concern stems from the S&P 500's sector breakdown. While the index is better diversified than most, it currently exhibits some characteristics that bear watching. **Four sectors have contributed 65% of the S&P 500's last two-year return**: Information Technology, Health Care, Consumer Discretionary and Communication Services (the revamped home to former tech companies like Google, Netflix and Facebook). Of the four, **Information Technology stands out with a 48% cumulative total return since November of 2017** and accounts for 37% of the S&P 500's 2-year return, despite being just 21% of the market weight. Aside from Health Care**, the other three sectors currently display very extreme valuation metrics**, with many measures above two-standard deviations from the last 10-year norm. Granted, these sectors are home to many strong growth opportunities, and all but communications services have delivered very steady and rising earnings growth that investors crave and have been willing to pay handsomely to own.

However, these same sectors are also home to the kinds of businesses that have a high propensity for disruption over time and are **currently a target for regulatory reform** – increased scrutiny that's likely to crimp their ability to continue to succeed at the same pace going forward. **For the Health Care sector**, politicians on all sides are taking aim at controlling drug costs, health care spending and efficiency in general. The spectre of increased regulation looms over sentiment in this sector, and any actual implementation would most likely be a negative for shareholders. **For the Information Technology and Communications Services** sectors (and also Consumer Discretionary since Amazon is included in there), two issues lurk: privacy and anti-trust. Consumer protection relating to technology is at the forefront of the privacy debate and the prospect of greater competition (leading to lower prices), are areas ripe for politicians to exploit. Privacy regulation may hinder the data and targeted advertising business models of these organizations. Their growing size and market dominance are also fueling concerns that some of the larger players may need to be broken up in order to restore competition (Alphabet/Google, Amazon and Facebook in particular). **Increased government regulation and anti-trust investigations would be unwelcome events for shareholders in these businesses.**

Bottom line: **We recommend a neutral position in U.S. equities.**

The S&P 500 remains the most diversified equity market in our universe and contains some of the best secular growth opportunities. However, U.S. equities remain expensive compared to their global counterparts on most valuation measures. Accommodative monetary policy and the low bond yield backdrop support higher valuations than otherwise would be the case. A less pessimistic outlook on economic growth, earnings growth and trade tensions can also justify these higher valuations. However, the current level (3141 on Nov. 30, 2019) reflects a high degree of optimism that a global reflation, trade détente scenario comes to fruition and leaves little room for disappointment.

2.3 | S&P 500 Return Scenarios

2020 EPS Growth @ 9.3% = **$177**

Current trailing P/E multiple = 19.1 X
Estimated 2020 dividend yield = 2%

	Implied Trailing Multiple	S&P 500	% change from Nov. 30 level of 3,141
	17.5 X	3,094	- 1%
base case →	18.5 X	3,271	4%
	19.5 X	3,448	10%

Source: Bloomberg, Nov. 30, 2019; price only return.

Our base-case scenario for the S&P 500 calls for the forward P/E multiple to hold steady around 18X and the trailing multiple to contract slightly from 21X to 18.5X. Earnings growth in the mid-high single digits (against these valuation metrics) drives a 4% price-only return for 2020 (see **Exhibit 2.3 – S&P 500 Return Scenarios**). When coupled with the estimated 2% annual dividend yield in 2020, **we expect a total return of 6% in U.S. dollars for the year ahead**.

Canadian Equity

We hold a neutral view on Canadian equity. At the index level, Canadian equities look relatively cheap and sport reasonable earnings growth expectations (see **Exhibit 2.1 – Global Earnings Growth Expectations** and **Exhibit 2.2 – Global Equity Market Valuations**). The 12-month forward P/E ratio is at its 10-year average, with price-to-cash flow and price-to-book slightly below the 10-year average. Return on equity is rising and sits one standard deviation above the 10-year average. However, Canadian equities suffer under the surface from sector segmentation, with the overall index picture being made up of three groups of sectors: those that are expensive, those that are heavily discounted and a few that come with a mix of fundamentals.

Roughly one-quarter of the S&P/TSX Index (23%) sits at the expensive end of the range in the Utilities, Real Estate, Communication Services, Consumer Staples and Information Technology sectors. Of these, Communication Services and Consumer Staples are stable businesses with solid earnings growth and stability that generally command elevated valuations (and have done so for quite some time). The Information Technology sector is a story of a handful of companies whose fortunes are linked to their unique competitive advantages. Utilities and Real Estate have been beneficiaries of a declining yield environment and the popularity of investors seeking a defensive stance. We are concerned these two sectors will suffer when the appetite for defense wanes, as would be the case under our improving 2020 scenario. Thankfully these two sectors represent a mere 9% of the market.

In the 'mixed fundamentals' category sits the Materials, Industrials and Consumer Discretionary sectors, another quarter of the benchmark (26%). Materials is a two-sided story: gold companies have done well and have benefitted from the declining yield environment and defensive trade (similar to Real Estate and Utilities). We're concerned that gold miners will suffer once the defensive trade goes out of favour. Outside of gold, Materials are home to forest products and base metals, both of which would respond positively to our improving 2020 base-case scenario. Industrials are cheap on a price-to-cash flow basis yet expensive on earnings metrics. However, the sector sports accelerating earnings growth that ameliorates these concerns. Consumer Discretionary (at just 4% of the index) is a mixed bag of reasonable to slightly expensive valuations with sluggish return on equity, but earnings growth is above average and re-accelerating – not an overly concerning sector.

The good news is the Financials, Energy and Health Care sectors have attractive valuations with the first two (making up 49% of the index) being poised to benefit from our improving 2020 scenario.

Financials

The Financial sector continues to suffer from recession fears and concerns over Canadian household and corporate indebtedness. An improving 2020 scenario staves off any recession or 'day of reckoning' for these concerns and they should continue to be buoyed by a Canadian employment market that's pumping out considerable jobs and wage growth. Add-in robust population growth that continues to sustain the Canadian bank's domestic lending franchises. The banks (and insurers) will benefit from a steeper yield curve and modestly higher bond yields. The 33% index weight of the Canadian Financials sector doesn't need to perform any Herculean feats: an estimated 2020 dividend yield of 4.5% and a further 5 to 7% price appreciation is all that's needed to nudge total return into the low double-digits. That kind of price appreciation is a low bar given the starting point of below-average valuations.

Energy

The Energy sector is extremely cheap, raising the question of whether or not it's a classic value trap. Can the Energy sector re-rate back anywhere close to its average valuation of the past? Global investor sentiment is weighing on the sector and considerable uncertainty remains around whether the sector has passed the point of no return regarding environmental concerns and/or alternative fuel technological pressures. It feels like 'Big Oil' is becoming like 'Big Tobacco' of the 1980s. What we know is thirty years later, tobacco companies are still around. If everyone quit smoking tomorrow, the companies would be gone and the world (as we know it) wouldn't change. The same cannot be said about energy – the world continues to need fossil fuels (the recent CN rail strike reminded many Canadians of this fact). So, the question is whether Energy sector share prices (that are at very low levels given where the commodity price sits) respond the way they have traditionally done to a pro-growth scenario? While the Energy sector isn't trading at the rock-bottom lows associated with sub-$30 oil prices (nor are oil prices sub-$30, they are nearly twice that level), it's trading well below much higher price levels witnessed just in the last four years. In that time, the sector has mounted three charges higher with returns ranging between 20% and 50% in periods of multiple months, not quarters. We think the risk-reward here is compelling to warrant exposure.

Health Care

The trials and tribulations of the cannabis industry has this sector now relegated to a 1% weight (it was never more than 3%). We continue to see the risks and uncertainty of this sector outweighing the opportunities as we know them, but for a deep-dive on the subject, read GLC Insights: The Green Rush - Exploring Canada's Cannabis Industry.

3.1 | S&P/TSX Composite Return Scenarios

2020 EPS Growth @ 7% = **$1,138**

Current trailing P/E multiple = 16.7 X
Current dividend yield = 3%

	Implied trailing multiple	S&P/TSX Composite	% change from Nov. 30 level of 17,040
	15.5 X	18,212	7%
base case	16.5 X	18,781	10%
	17.5 X	19,351	14%

Source: Bloomberg, TD Securities; Nov. 30, 2019; price only return.

Bottom line: Canadian equities continue to trade at a wide valuation discount to their U.S. counterparts. The index has a sector composition favourable to a scenario of modestly improving global growth and waning trade uncertainty, including the prospect of a ratified USMCA. The swing factor for outperformance does rest heavily on the Energy sector, where uncertainty and volatility bring a risk profile that warrants some caution. **Weighing the various factors we maintain our neutral recommendation with a base-case scenario for the S&P/TSX Composite of a 7% price return; when coupled with an estimated annual dividend yield of 3%, we expect a total return of 10% for 2020.**

International Equity (EAFE)

We hold a neutral view on non-North American, developed market equities, commonly benchmarked against the MSCI Europe, Australasia and the Far East Index (MSCI EAFE Index). In aggregate, we don't expect EAFE equities to outperform Canadian and emerging market (EM) equities. However, two geopolitical hot topics affect our outlook on international equities in 2020.

1. **Any détente in trade frictions benefits EAFE equities** (not just with U.S./China, but the U.S. versus everybody). We believe the U.S. has a desire to change its trading relationship with most of the world, and certainly with China and Europe, who sport the largest trade imbalances with the U.S. However, with 2020 being an election year and U.S. businesses and the public already suffering from trade war fatigue, we believe the clock has run out for the current U.S. administration to escalate trade frictions until after November 2020.

2. **A resolution of Brexit concerns should help release pent-up business investment.** As much as this likely leads to an appreciation of European currencies (a negative for corporate Europe, which lowers earnings due to foreign exchange translation and dampens export competitiveness), holders of euro- and Sterling-denominated assets stand to benefit from the currency appreciation.

While EAFE equities are heavily influenced by global factors, there are domestic factors as well. The most notable is the Financials sector where we see the potential for this embattled sector to see some relief (the sector remains an 18.5% weight in the EAFE Index and shares of European banks remain more than 40% below levels that prevailed in 2015, when they had just recovered from Europe's homegrown banking crisis). European economic growth is already showing signs of bottoming, but it is the negative interest rate environments in Europe and Japan that have been especially painful for lenders. While central banks in Europe and Japan (ECB and BoJ) have extended their forward guidance into 2020 to keep rates below zero, they're increasingly becoming concerned with the negative consequences of these policies on their banking sectors. In fact, the ECB has already taken steps to provide some relief to the banking system by adopting a tiered interest rate structure. More broadly, expectations of firmer economic growth conditions are seeing global bond yields retreating from their depths of mid-2019, which in turn is leading to steepening yield curves in many parts of the world – a further welcomed development for the Financials sector.

[1]***Note:*** *The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Market countries around the world, excluding the U.S. and Canada. Developed Markets countries in the MSCI EAFE Index include: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.*

3.2 | WTI Oil USD $55 to $65

We forecast a 2020 average price for WTI of US$60/bbl

Source: Bloomberg, Nov. 30, 2019.

Our base-case scenario of improving economic growth into 2020 implies reasonable demand growth for oil. **We also see supply being constrained by OPEC and partners, along with a cresting in U.S. shale output keeping Brent crude prices in the USD $60 to USD $70/barrel range and WTI to range between USD $55 and USD $65/barrel.**

Bottom line: We hold a neutral view toward EAFE equities. Weighed against Europe and Japan's longer-term structural issues, heavily export-oriented EAFE corporations have an opportunity to benefit from a pick-up in growth and a trade détente. The group offers reasonable valuations and decent earnings growth potential, along with a high dividend yield.

Emerging Markets

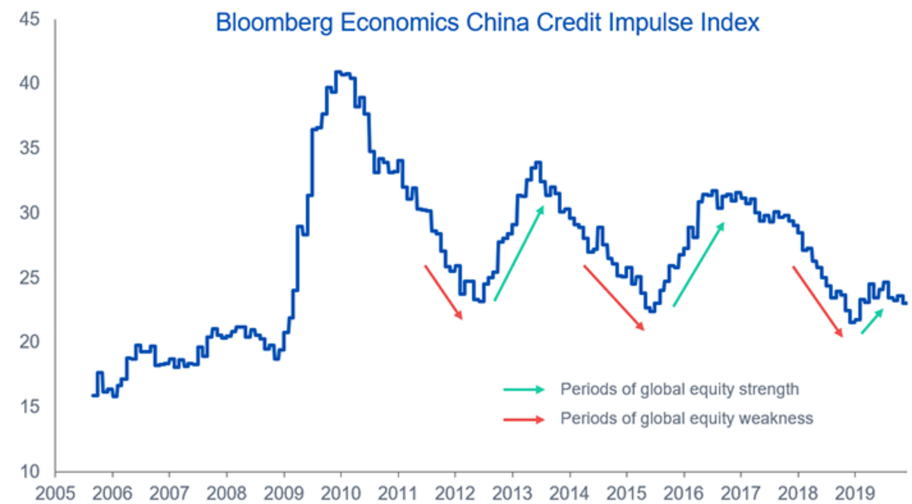
We maintain a slight underweight recommendation for emerging market equities (EM).

EM equities are most sensitive to trade uncertainty and global economic growth concerns, but also to bespoke concerns about growth in China. As such, the risk/reward tradeoff here is stark. **Even with a fair bit of upside potential, the risk profile leads us to recommend a slight underweight position.**

Under our base-case scenario of a trade détente and a pickup in global economic growth, we believe EM equities can post reasonable gains in 2020 despite exhibiting a somewhat tepid response thus far to the ‘green shoots’ that have propelled developed markets. Our forecast is based upon overall portfolio weights being moderately defensive, with a nod to spending our risk budget wisely. We’re comfortable the assets we look to for safety will deliver, if needed, and take risks where the upside is the greatest and risk is cheaper.

Global financial conditions are important metrics for emerging markets. Two factors in particular are foremost considerations: Chinese stimulus through financial conditions and government investment (largely fixed-asset infrastructure investment); and, the strength of the U.S. dollar. We see both of these as tailwinds for emerging market equities in 2020.

4.1 | China’s Credit Impulse Weaker Than Expected



Source: Bloomberg, Nov. 30, 2019.

Emerging markets have been less enthusiastic in embracing the global reflation scenario because of concerns that China’s economic growth may have not yet bottomed. We believe the U.S./China trade confrontation is being assigned too much blame for the slowdown in global trade, manufacturing and China’s economic growth (as well as the broader emerging market’s). Tightening financial conditions in China started as far back as mid-2016, while trade frictions only started to pile on in 2019. We had expected financial conditions in China to turn stimulative by now; however, Chinese officials have been tolerating slowing growth more than anticipated. Although Chinese financial conditions have turned accommodative, the current stimulus is weaker than the prior episodes in 2012 and 2015 (see **Exhibit 4.1 – China’s Credit Impulse Weaker Than Expected**).

Fortunately for investors, we see the eventuality of two higher-probability scenarios driving positive outcomes – albeit with volatility (nothing new for emerging markets).

1. Even without a further acceleration in stimulus, our first scenario expects a resilient Chinese economy where the impact from the limited stimulus already injected is aided by a détente in the trade war.

2. The second scenario is one where the Chinese economy fails to stabilize (a breakdown in trade talks would exacerbate the situation), prompting Chinese authorities to accelerate financial/fiscal stimulus. The trade disruption will likely cause a drop in both emerging and developed market equities in the short-term, until the stimulus pumps them back up. Importantly, we believe that China has ample room to stimulate its economy further – they're not facing a scenario where they've expended their stimulus and aren't seeing results; rather they've deliberately held back. China's reticence is rooted in a prudent desire to wean off the credit boom-bust cycle, not inability or a lack of resources. If this scenario features a breakdown in trade negotiations, an ancillary benefit is that roiling equity markets have been the best motivator to bring all parties back to the table.

Recent U.S. dollar strength has hurt emerging markets. However, with the U.S. Federal Reserve now on pause we believe we're nearing the peak for the U.S. dollar and expect it to weaken, helping EM equities to rebound.

Earnings and valuations – Emerging markets offer the strongest 2020 earnings estimates of any major market (see **Exhibit 2.1 – Global Earnings Growth Expectations**). On a valuation basis, EM equities are not cheap relative to their own history (see **Exhibit 2.2 – Global Equity Market Valuations**), but they're inexpensive relative to developed markets. The gap between forward P/E multiples for emerging and developed markets is well above the historical average.

EM equities remain a riskier, high-beta asset class appropriate for investors with a higher risk tolerance and longer time horizon. EM equities could suffer greatly should a trade détente fail to materialize and/or global growth fails to stabilize. Furthermore, China is dealing with a self-styled economic slowdown that's being exacerbated by trade frictions. Should the Chinese economy remain sluggish and/or Chinese monetary and fiscal stimulus fail to arrive (or work as planned), all equities are at risk, but especially those in emerging markets.

Bottom line: Emerging markets come with an elevated risk profile. The risks and swing factors are many, but when we weigh these factors against the ability for EM equities to outperform developed market equities under a 'less bad than expected' or improving scenario, this leads us to **maintain our recommended weighting at low-neutral**.

Fixed Income

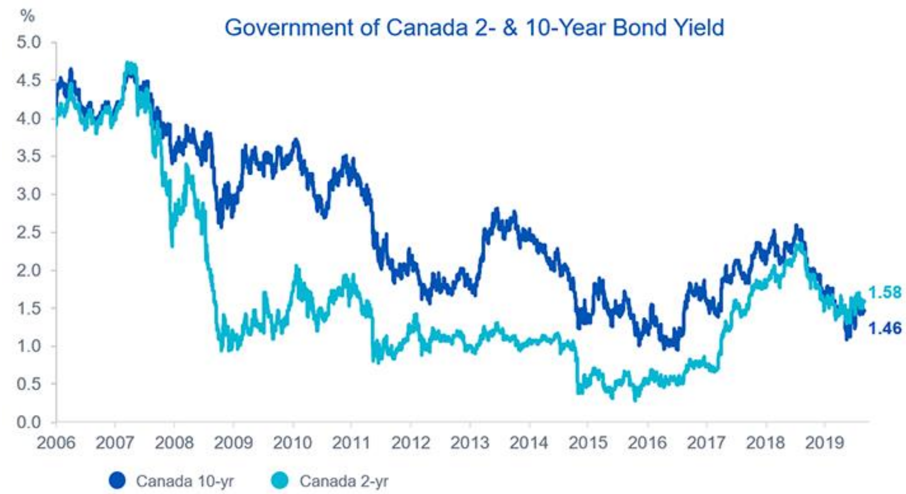
The outlook for fixed-income returns remains modest. Bonds won't offer much upside over the medium term unless a slowdown or recession scenario unfolds. Overall, we forecast a 1.5% total fixed-income return for 2020.

Fixed-income markets have made a tentative move toward a "less bad" 2020 macro-economic scenario. Yields have been on an uptrend since the August lows. However, we currently don't see fixed income being appropriately priced for the mild reflation we hold as our base case (see **Exhibit 5.1 – Government of Canada Bond Yields**). Year-to-date moves of most asset classes may appear eye-popping and while most are a byproduct of the recovery from the deep declines of Q4 2018, this is not the case for fixed income. The strong 8.2% YTD return for fixed income (see **Exhibit 5.2 – FTSE Canada Universe Bond Index Returns**) reflects a structural shift to lower bond yields due to the abrupt early 2019 about-face on monetary policy by global central banks. That shift knocked yields down by about 0.5% and drove approximately half the YTD returns in 2019.

We've been left with a Canadian bond yield trading range between 1.25% and 1.75% (for 10-year yields) that ebbs and flows primarily on trade news and central bank expectations, with macro-economic data having a periodic impact. Bond yields toward the mid-to-lower end of that range (where they sit currently) are pricing in a combination of trade disappointment, further central bank easing and no improvement in growth or inflation. We hold a constructive view on these issues and believe yields should be closer to the upper end of this range.

5.1 | Government of Canada Bond Yields

2020 year-end targets: 10-year = 1.75% | 2-year = 1.75%



Source: Bloomberg, Nov. 30, 2019.

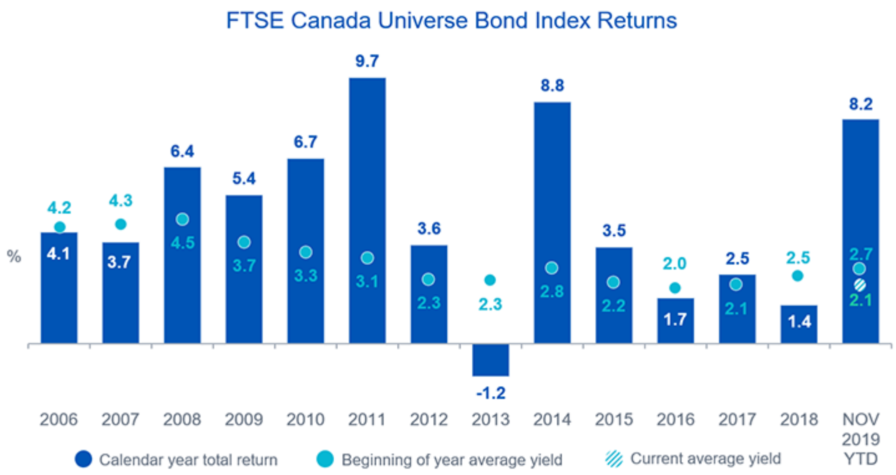
Our view is bolstered by our belief that:

1. Trade frictions will not escalate – while a phase one deal likely holds some disappointment, further escalation is too politically risky for the Trump administration in an election year.

2. With trade no worse and economies showing signs of stabilization-to-improvement, central banks will not be required to cut rates.

3. We see inflation ebbing in Canada by mid-2020 (**see Bank of Canada section below for more**) but expect the bank to hold the line on rate cuts through 2020.

5.2 | FTSE Canada Universe Bond Index Returns



Source: Bloomberg, FTSE Canada; Nov. 30, 2019.

If central banks remain on hold with a dovish bias for at least the first half of the year, we expect to see 2-year yields creep up toward the Bank of Canada overnight rate of 1.75%. A stabilizing global economy relieves some of the downward pressure on longer-term bond yields to allow the 10-year yield to rise to roughly the same level. The result will bring the Canadian 10s/2s yield curve out of inversion. These moves represent an increase of roughly 0.25%, which is a very small headwind that allows the broader investment-grade bond market to deliver a 12-month total return of 1.5%. Despite investing a good deal of time trying to figure out the Bank of Canada's next move, the reality is if the Bank cuts, it would only nudge our fixed income return forecasts higher by a smidge.

Our end of 2020 Canadian 10- and 2-year bond yield forecast is 1.75% for both (versus a 10-year yield of 1.46% and 2-year yield of 1.57% as at Nov. 30, 2019).

Bottom line: Our base-case scenario calls for a 2020 total bond market return of 1.5%. Fixed income's risk-mitigating qualities remain a significant attraction. Canadian bond yields continue to offer enough income that they will deliver a small positive return given the small yield increases we forecast. The majority of our fixed-income return scenarios continue to deliver a positive total return outcome for 2020. If yields move up by more than we expect (i.e., more than a 50-basis point parallel shift in the yield curve), then 2020 could deliver slightly negative returns. By contrast, a risk-off environment (a parallel shift down by 50 basis points) in turn could deliver returns in the 7% range.

Sector insights

a) **Government bonds** – **Attractive for their superior risk-mitigation qualities**, sovereign bond yields have re-rated lower on the 180-degree pivot by central banks from a tightening to an easing bias. Their attraction lies in their ability to deliver the highest level of upside in the event of a risk-off scenario. **We maintain our government bond recommendation at neutral.**

b) **Investment-grade corporate bonds** – **We continue to see these as most attractive given their mix of yield pick-up and modest safety.** Investment-grade corporate bond spreads remain narrow (see **Exhibit 5.3 – Investment Grade Corporate Bond Spreads**) and we see little on offer in terms of further appreciation. The overall low yield environment continues to keep demand for the incremental yield of corporate bonds high (both investment grade and high yield). We prefer the risk-reward tradeoff of investment-grade corporate bonds over high yield bonds, given the greater degree of safety we generally desire from our fixed-income positions. We have a bias toward shorter-duration corporate bonds given the tight spread environment and our expectation for modestly higher yields. We continue to favour the higher credit-quality spectrum at the expense of the lowest BBB tranche. **We maintain our investment-grade corporate bond recommendation at the highest overweight.**

5.3 | Investment Grade Corporate Bond Spreads

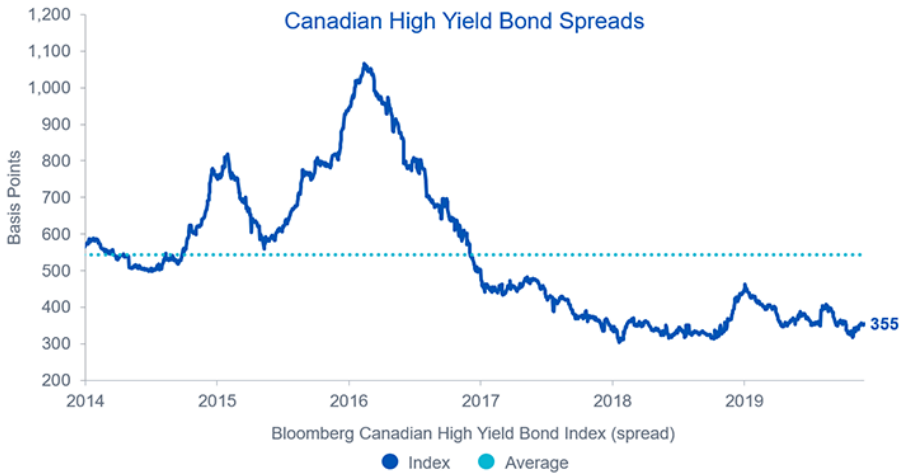
Most attractive given their mix of yield pick-up and modest safety; BBB potential spot for future trouble

Source: BMO Capital Markets, Nov. 30, 2019.

c) **High-yield bonds** – **Given the narrow-spread levels in high-yield bonds in aggregate** (see **Exhibit 5.4 – Canadian High Yield Bond Spreads**), **and their lack of risk-mitigation characteristics as an asset class** (see **Exhibit 5.5 – What's Inside Your Bond Funds?**), **we see their risk/reward tradeoff as unattractive.** High-yield bonds should not be relied upon for risk-mitigation because they generally experience negative returns in 'risk-off' environments. Their main benefit lies in the higher yield and greater potential for capital appreciation they provide as spreads decline. At the asset class level, neither of these metrics (yield offered nor capital-appreciation potential) appear very attractive to us at present. High-yield bond issuers are not a homogeneous group and our active fixed-income managers continue to uncover select unique opportunities through individual security selection where the risk/return tradeoffs are appealing.
We maintain our high-yield bond recommendation at underweight.

5.4 | Investment Grade Corporate Bond Spreads

Very narrow spread levels and lack of risk-mitigation characteristics makes high yield unattractive



Source: Bloomberg, Nov. 30, 2019.

5.5 | What's Inside Your Bond Funds?

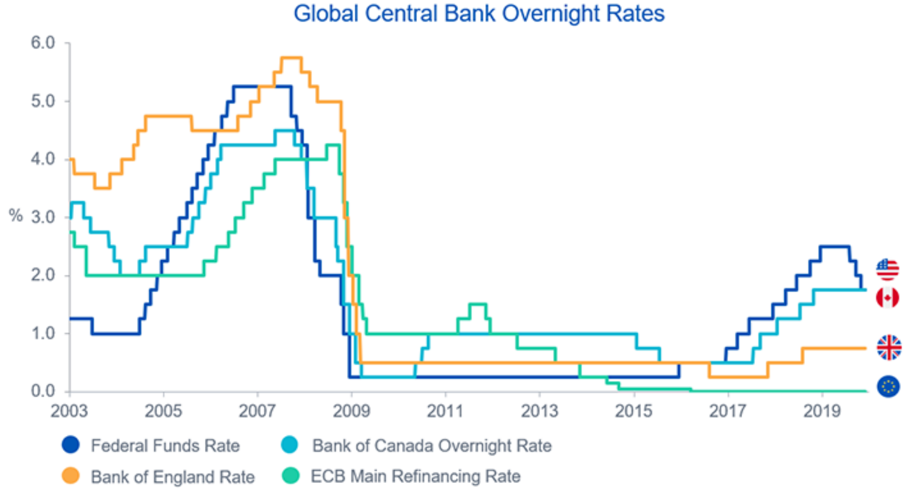
High quality bonds, not high yield bonds, should form the core component of a fixed income portfolio

Steep Decline Periods For Canadian equity	S&P/TSX Composite Index TR	FTSE Canada Universe Bond Index TR	FTSE Canada Corporate Bond Index TR	FTSE Canada High Yield Bond Index TR
Sep 1, 2000 – Dec 21, 2000	-24.2%	3.1%	2.5%	1.9%
Jan 30, 2001 – Apr 4, 2001	-20.4%	1.3%	1.5%	2.0%
May 22, 2001 – Sep 21, 2001	-22.0%	5.0%	4.7%	4.2%
Mar 7, 2002 – Jul 23, 2002	-22.1%	4.5%	3.4%	3.9%
Jun 18, 2008 – Mar 9, 2009	-48.5%	4.7%	0.3%	-16.3%
Apr 5, 2011 – Oct 4, 2011	-20.6%	8.3%	6.5%	-7.8%
Apr 15, 2015 – Jan 20, 2016	-21.5%	0.1%	-0.3%	-6.6%
Sep 21, 2018 – Dec 24, 2018	-14.4%	1.9%	1.0%	-1.7%

Source: Bloomberg, FTSE Canada.

Bank of Canada

5.6 | Central banks providing ample liquidity and easy money



Source: Bloomberg, Nov. 30, 2019.

5.7 | Canadian to U.S. dollar exchange rates

Range between US 74¢ - 78¢

Source: Bloomberg, Nov. 30, 2019.

Governor 'Goldilocks' – The Canadian Conundrum

The Bank of Canada likes things just the way they are; the problem is economic conditions aren't likely to stay unchanged. The bank is doing everything it can to prolong the current not-too-high, not-too-low environment for Canadian yields, inflation and the loonie. The decision to not cut rates keeps yields high enough to arrest the precipitous drop in mortgage rates that can incite borrowing and stoke the housing market. However, keeping rate cut expectations in play (through their 'jawboning' tactics) keeps the loonie lower and helps exporters. Similar to the Goldilocks story, "just right" is a nice place to be: mortgage rates firm, but the loonie weak. The problem is it can be tough to sustain – jawboning can only take you so far.

Reasons why the Bank of Canada would cut rates:

- **Soft Canadian economic growth** – Canadian GDP growth is currently at 1.3% y/y and has averaged just 1.4% y/y in the first eight months of 2019, below the bank's annual GDP growth forecast between 1.8% and 1.9%.
- **Soft consumer spending** – Canadian retail sales are running at just 1.1% y/y growth, well below the 5-year average of 4.1% y/y.
- **Flagging exports** – Export growth has fallen from averaging 3% y/y in H1 2019 to averaging -1.4% y/y in Q3 2019.
- **U.S./Canadian dollar exchange rate** – Should the loonie appreciate too much (above USD 79¢), it'll weigh on the already weak export sector.
- **Trade uncertainty** – USMCA is yet to be ratified; ongoing global trade tension (U.S./China, U.S./G7 and Brexit).
- **Inflation likely to soften by Q2 2020** – While current inflation is running close to the bank's 2% target, inclusive of a very strong increase between January 2019 and May 2019 (racked up 5.9% annualized CPI), this base effect will put downward pressure on Canadian inflation in Q1/Q2 of 2020.

Reasons why the Bank of Canada would not cut rates:

- **Household and corporate debt levels remain elevated** – Lower rates risk reigniting a troubling trend.
- **Mortgage credit growth, housing activity and housing prices are turning higher** – Lower bond yields fed directly into the mortgage market, with the expected stimulative response in mortgage credit growth and housing. The bank is loath to undo the past work that arrested the dangerous upward trajectory of the housing market and credit growth.
- **The Canadian dollar is currently not too strong** – We don't see the bank having any concerns as long as the loonie remains within 2 to 3¢ of its 5-year average of USD 77¢.
- **Inflation remains close to target and wages are rising briskly** – Even with the prospect of milder inflation in 2020, Canadian inflation is still likely to run close to the bank's target and sit amongst the highest in the developed world. Wage growth also remains robust (4.4% y/y), near the highest levels of the past 20 years.
- **Fiscal stimulus is expected** – While the bank claims they don't react to policy changes until they are enacted, their job is to be forward-looking because their tools largely only work with a lag. Increased government spending (especially at a healthy point in the business cycle) typically tilts central banks toward tighter monetary policy.

In the end, we don't see the Bank of Canada cutting rates – but it's a close call. The Bank of Canada would cut if the U.S. Federal Reserve also cuts – a scenario we don't foresee.

GLC Outlook Summary

[1] From June 2019.

Change in view[1] | Under | Neutral | Over

Fixed income

Bond yields have begun to rise, but we do not see bond yield increases being sufficient to negate a positive total return in 2020. Fixed income remains attractive as a risk-mitigation tool. We recommend a high-neutral weight. Our base-case scenario calls for a total bond market return of 1.5% over the next twelve months.

Government bonds

Government bonds are attractive for their superior risk-mitigation qualities. Yields have shifted to a lower trading range. We will opportunistically take advantage of relative-duration opportunities depending on where yields are within this new range.

Investment grade corporate bonds

We see investment-grade corporate bonds as most attractive given their mix of yield pickup and modest safety. On an absolute basis, investment-grade corporate bond spreads remain narrow, moderating any significant price appreciation.

High-yield corporate bonds

High-yield spreads remain low and narrow. When coupled with a lack of risk-mitigation characteristics, we see the risk/reward trade-off in high-yield bonds as unattractive. Our active fixed-income managers continue to uncover selected unique opportunities through individual security selection where the risk/return trade-offs are appealing.

Equity

We believe the global economy is showing signs that global growth should pick up in 2020, aided by a détente in global trade frictions and stimulative central bank policies. Corporate earnings growth supports equities, keeping our outlook constructive. However, valuations are elevated and risks remain so we see a low-neutral stance as appropriate.

Canada

Canadian equities continue to look attractive. Sentiment has improved and valuations remain attractive against earnings growth of 7%. The sector composition (favouring cyclicals and value) is poised to outperform in a scenario of modestly improving global growth and waning trade uncertainty. With a 3% dividend yield, we see a total return of 10% in 2020.

U.S.

U.S. equities are home to some of the best secular growth opportunities and are capable of delivering decent earnings growth. However, current elevated valuations drive muted return prospects. With a modest dividend yield of 2%, we forecast a 6% total return for 2020, leading to our neutral recommendation.

International

We hold a neutral view toward EAFE equities. Weighed against Europe and Japan's longer-term structural issues, heavily export-oriented EAFE corporations have an opportunity to benefit from a pick-up in growth and a trade détente. The group offers reasonable valuations and decent earnings growth potential, along with a high dividend yield.

Emerging markets

EM equities are the most sensitive to trade and policy uncertainty, making their risk/reward trade-off stark. EM equities remain a riskier, high-beta asset class most appropriate for those with higher risk tolerance and longer time horizons.

Disclaimer

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