SIM

STODGELL INVESTMENT MANAGEMENT LIMITED

REVIEW AND COMMENTARY- 2018

The fourth quarter of 2018 was difficult to say the least. While we cautioned about a correction in 2018 the severity and pace of it in the fourth quarter was unexpected. One thing we had discussed in prior Commentaries was that recent corrections tend to be more dramatic in depth and timing than preceding decades where corrections could take years to complete.

For 2018 we made the following predictions;

1) **Market volatility will increase in 2018.**
2) **Long bonds will provide negative returns in 2018.**
3) **Equities will continue to outperform fixed income.**

Of our three predictions above we were wrong on the last, mixed on the second and correct on the first. To say that market volatility would increase in 2018 was an understatement.

December 2018 was an exceptional month for market volatility. The SP 500 (in US dollars) posted the worst month of December since 1931. There was a stretch of just over a week where the index posted daily declines of 350 points or more 6 times. More impactful to investor's confidence was that the index was up or down more than 1% more than nine times in the month of December and 64 times during the year. This compares to 8 times in 2017. The 1,000+ point gain on the Dow Jones on December 26th was a first. And there were five 1000 point daily swings in the Dow Jones during 2018. There have only been 8 such swings since the index was established in 1896. Understandably, such swings will become more common with an index that is presently valued north of 23,000 points but it does little for the confidence of investors when looked at in terms of points rather than a more practical perspective of percentage changes.

When discussing market volatility a year ago, we mentioned that sometime during 2018 we would expect the equity markets to undergo a correction in excess of 10%. These pullbacks occur quickly and are impossible to predict consistently. We felt that sometime in 2018, whether from existing levels in January or sometime during the year, a pullback would materialize. In the last quarter of 2018 the Canadian SP/TSX Total Return equity index posted a loss of 10.1%. Up to that point the index had been positive. One of the more important barometers of the Canadian economy, at least from a Canadian perspective, is the price of oil. During the last quarter 2018 WTI Crude dropped from the mid $70's to the mid $40 range which, in turn, negatively pressured our Canadian equity, currency and bond markets. Even after OPEC+ (as well as the Province of Alberta) decided to curtail production, oil prices continued downward only to finally consolidate in the low 40's and have since shown signs of improving.

Long bonds in Canada did not produce negative returns but did in the US. The 30 year Government of Canada bond posted a gain of 4.1% for 2018. For the first nine months of the year, it had a negative

...../2

return. In the last quarter of 2018 long bonds gained 5.7%. Despite a similar strong performance in the US long bond, its return in 2018, in US dollars, was a loss of 2.6%. During the latter half of the year, with a background of rising interest rates by the US Federal Reserve, investor concerns mounted that the Fed had become less data centric and more focused on 'normalizing' rates (meaning that they would increase rates regardless of inflationary indicators or economic strength). This spooked many institutional investors would had become accustomed to low interest rates to fuel their asset purchases. The relatively new Federal Reserve Chairman Powell learned a valuable lesson in market skittishness when he realized that every word of his post Fed decision address would be dissected mercilessly. The market reaction to his comments and those of threatening dissent by the President of the United States appear to have moderated his approach and his anticipated future interest rates moves. His future as Chairman appears more certain which has calmed markets though corporate earnings will take front stage in the upcoming quarter.

Equities outperformance relative to fixed income was not an accurate prediction for North America equities in 2018. The SP 500 Total Return (US Dollars) posted a loss of 4.4% in 2018, the Canadian SP/TSX Total Return index lost 8.9%. Both indices were positive for the first three quarters of the 2018 but that is little solace to investors considering where the markets ended the year. Corporate tax cuts in the US contributed significantly to the rise of US equities relative to most other major developed countries' indices. Canada lagged for this reason and the pending new NAFTA deal was not considered as favourable to Canada as it will be to the US. One of the more influential sectors in the SP TSX index, the Canadian energy sector, fell over 18% in 2018. Almost 95% of the sector's loss was incurred in the fourth quarter. While there were a number of concerns that contributed to the market weakness, general corporate health on both sides of the border, save energy companies, was strong.

While performance of the capital markets in the last quarter was not typical, increased volatility, especially in the US, should be expected going forward,. With the conclusion of the Mueller Report expected sometime in 2019 and an outspoken new Attorney General in state of New York, indictments surrounding the US Administration will should dominate headlines and, in turn, capital markets. As well, the outcome of the threatened tariff trade wars between the US and various allies, most notably China, will add to volatility. Intentions from both sides will become clearer within the first quarter of 2019 and whatever is resolved will significantly influence the direction of equites. Recent data shows the Chinese economy contracting. Given the present US government impasse on the border wall and subsequent shutdown, clouds on the horizon regarding the behaviour of many past and existing members of the US administration, the effect of trade tensions on corporate earnings (Apple's guidance may be the first of many) and the newly elected Democratic majority in the US Congress, Trump may be looking to provide a boost to the US economy by agreeing to favourable terms regarding trade with China. This would boost the equity markets and provide a needed positive distraction for President Trump. World markets must still deal with on-going concerns surrounding the Middle East, the UK Brexit and US relations with Russia and North Korea.

However, here are our predictions for 2019;

1) **President Trump will not be impeached**
2) **Oil prices will trend higher in 2019**
3) **Canadian equities will outperform fixed income**
4) **Equity markets in the US will bottom in the first quarter of 2019.**

Thank you for your past and continued support.

Happy New Year.