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Turning uncertainty into opportunity

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What seemed like a Teflon coat protecting U.S. stocks last year is showing signs of wear and tear as the trend of outsized daily market moves that began in early February persisted into mid-April. Last year, investors were focused on U.S. tax cuts and the accompanying narrative that the tax cuts would pay for themselves through a virtuous cycle of prosperity begetting more prosperity. This was enough to deflect investors' attention from much of the bad news, including two major hurricanes that devastated parts of the U.S. and the Caribbean Islands, several key departures from the U.S. government, three interest rate hikes by the U.S. Federal Reserve, a highly controversial travel ban, and threats of a nuclear attack by the North Korean government. This year, investors have switched to being on high alert, focusing initially on rising interest rates and now primarily on escalating trade tensions.

Attempting to explain past market behaviour, particularly over short time horizons, is often a subjective endeavor. At certain times, prices may rise for the same reasons that they may fall at other times. Given the complexities of constantly changing financial markets, their endless number of variables, ongoing shifts in investor sentiment, and unpredictable events, it is impossible to use past data to reliably forecast performance in the near term. As the time horizon extends further, the forecasts become more reliable but still include sufficient uncertainty to cause high levels of volatility and potentially significant declines. In an uncertain world, having too much confidence in forecasts can be destructive. Instead, an investor can benefit from having a reliable and robust risk management process that can be implemented with confidence.

Investors often make the mistake of treating risk as if it were symmetrical. However, history shows that equities tend to be steadier when rising and more volatile when falling. It is also common for investors to view risk management through a symmetrical lens. For example, by increasing cash weights when feeling bearish, an investor can reduce downside volatility but will also forgo an equal amount of upside volatility. To ensure investors remain on track to achieving their objectives, let alone adding value, they must rely on precise timing along a single dimension by increasing or decreasing market exposure – a highly difficult and usually unreliable feat. To progress from a symmetrical distribution of outcomes to an asymmetrical one, risk management should be applied across multiple dimensions, using multiple asset classes with allocations that are determined based on a sound, repeatable process. Option strategies can further improve the odds of delivering asymmetric outcomes.

Global markets have taken a much different tone in recent months and there are changes occurring at the margin to accompany this shift: corporate credit spreads have crept higher, a flattening yield curve has been challenging traditional banking models, and following the sharp correction in February, investors may no longer have blind faith that stocks will rise indefinitely. However, the world has not fundamentally changed from a year ago. Many developed nations, particularly the U.S., remain saddled with record levels of debt, a product of the all-too-familiar fiscal policy of cutting taxes but failing to cut spending and relying on developed nation status to borrow cheaply to fund the scheme. Wage growth in the U.S. remains depressed despite strong corporate profits, underscoring a widening of the wealth gap. Over the long term, we continue to remain skeptical of the U.S. government's ability to emerge unscathed from its debt problems.

Though many of the driving forces of asset performance over the past three and half decades have largely been spent, one important force that remains is human ingenuity and the desire for people to keep progressing. With open minds and a view through our multi-asset lens, we continue to see many opportunities across the investable universe that have attractive valuations and fundamentals. Using our active risk management process, we are committed to turning uncertainty and volatility into asymmetric outcomes that skew the odds favourably to our investors.

Combined top 15 equity holdings as of March 31, 2018 of a representative balanced Private Client Managed Portfolio with alpha-style equity exposure*

1. Atco	6. Galp Energia	11. Canadian Natural Resources
2. SNC-Lavalin	7. Loblaw Companies	12. E-L Financial
3. Suncor Energy	8. Sinopharm Group	13. CIBC
4. ICICI Bank	9. HeidelbergCement	14. Mullen Group
5. AltaGas	10. Power Financial	15. Assicurazioni Generali

Combined top 15 equity holdings as of March 31, 2018 of a representative balanced Private Client Managed Portfolio with value-style equity exposure*

1. Toronto-Dominion Bank	6. Magna International	11. CCL Industries
2. Royal Bank of Canada	7. Suncor Energy	12. KLA-Tencor
3. Bank of Nova Scotia	8. XI Group	13. TMX Group
4. Alphabet Class C	9. CI Financial	14. Manulife Financial
5. UnitedHealth Group	10. Alimentation Couche-Tard	15. Canadian Natural Resources

Combined top 15 equity holdings as of March 31, 2018 of a representative balanced Private Client Managed Portfolio with growth-style equity exposure*

1. Walgreens Boots Alliance	6. George Weston	11. Gilead Sciences
2. Franco-Nevada	7. Restaurant Brands International	12. Praxair
3. Tourmaline Oil	8. CSX	13. Intact Financial
4. Canadian Pacific Railway	9. Keyera	14. Nutrien
5. Symantec	10. Canadian Natural Resources	15. Hydro One

*Approximately 33% fixed-income, 10% enhanced income, 49% equities, and 7% global real estate.

To see the top 15 holdings of the individual pools or the equity alpha mandates, please contact your Stonegate advisor.