



## Market update

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From 2009-2017, the S&P 500 averaged returns of +15.7% annually, representing an extended period in which optimism reigned and volatility was muted. Equity markets saw broad increases backed by the tailwinds of accommodative monetary and fiscal policy, which not only drove earnings growth but also valuations, first back to long term averages and then slightly beyond as 2017 ended.

Fast forward to today, when many winds of potential change are on the minds of investors: good but likely slowing economic growth, the impact of trade tensions, the consequences of higher interest rates and questions about how these factors might affect the future return of equities.

The interpretation of economic signals is nuanced, with good growth but slowing momentum. On one hand, the tentative United States-Mexico-Canada Agreement (USMCA) has reduced a significant protectionist risk. As well, U.S. economic numbers remain strong. Data released on October 26 showed the U.S. economy is expanding at a fast clip, inflation came in lower than expectations and consumer spending continued to be strong. On the other hand, global growth, while still better than the post-financial crisis norm, has slowed over the past year, with some further deceleration likely into 2019.

Rising interest rates have been a key spark for recent stock market concerns. Higher yields simultaneously create a headwind for economic and earnings growth while, for the first time in many years, presenting a tempting substitute for investors. These are non-trivial concerns. Fortunately, we believe a large fraction of the rising rate experience may be priced into the market. Furthermore, central bankers always have the option of deferring future policy rate increases, should markets and the economy prove unreceptive.

In the short-term, expected earnings growth rates are susceptible to change, and small movements in revenue can be magnified by shifting profit margins. However, the longer-term outlook for earnings is far less volatile than the daily gyrations of the stock market would suggest. Over time, companies are able to respond to an evolving environment, with management teams repositioning their businesses with new revenue sources and/or a focus on efficiencies.

Against a longer term outlook, when the market declines, the future return potential increases. For example, taking consensus 2019 EPS estimates (\$172) and applying a normal earnings growth rate (7%) with an average multiple (15x) and a reasonable dividend yield (2%) would suggest a solid mid-to-high single digit total return for the S&P 500 in the next 10 years. This would represent a departure from the above-average double-digit returns we've seen in recent years, but still provide healthy gains for long-term investors. Even in a scenario where earnings growth slowed and valuations contracted, the long-term return potential for stocks remains relatively more attractive than cash or fixed income.

Part of our process is approaching markets with a mindset that's open to a number of different outcomes. And we also accept the reality that the path to achieving investment objectives over time is not likely be linear in nature. In any 10-year time frame, there will be periods of strong expansion and periods of sluggishness. Importantly, the scenario above outlining the return potential for the stock market going forward is consistent with the long-term performance of equities in the past. And it's worth noting that these returns have been achieved over time despite a variety of positive and negative economic backdrops.

When volatility increases, it is natural to believe that it might continue and something should be done. Today, balancing a moderating economic backdrop and an ageing business cycle with improved long term return potential is no easy feat, but doing so in the context of a financial plan with measured investment objectives and a defined risk tolerance greatly improves the odds of investment success. Forecasting short-term movements is undeniably difficult, but the ability of the market to deliver results to investors over time remains in place.

### In Summary

- Investors today are concerned with slowing growth, the impact of trade tensions, the consequences of higher interest rates and the potential impact on equities in the near-term.
- The interpretation of economic signals is nuanced; global growth, while better than the post-financial crisis norm, has slowed over the past year, with some further deceleration likely into 2019.
- Central bankers have the option of deferring future policy rate increases, if necessary.
- The longer-term outlook for earnings remains far less volatile than the daily gyrations of the stock market.
- While forecasting short-term movements is undeniably difficult, the ability of the market to deliver results to investors over time remains in place.

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Total return in USD.

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