# REFLECTIONS ON GROWING ECONOMIES AND FADING STIMULUS

2018 Global Investment Outlook

## CANADIAN EQUITIES: OPPORTUNITIES IN 2018

Dec 1, 2017


**Garey Aitken, MBA, CFA**

Chief Investment Officer

Developed Markets Equity – Franklin Local Asset Management

Franklin Bissett Investment Management


**2018 OUTLOOK:** *"Financials and energy are two sectors we think will provide interesting investment opportunities in 2018."*

Over the past year, the Canadian equity market has reflected both the state of divergent economic growth rates among the regions of the world and select "made in Canada" developments. For a number of reasons, we believe 2018 will see a similar pattern.

**Rising Rates at a Snail's Pace**

In 2017, improved economic growth was the catalyst for interest rate increases in both the United States and Canada, but we may see the two countries diverge in 2018. While the US economy is forecast to chug along in the mature stage of its economic cycle, consensus estimates are projecting slower Canadian growth. No one yet knows how a slowdown would affect the pace of monetary tightening by the Bank of Canada (BOC), although like the United States, we expect Canada to remain in a rising rate environment.

Typically, higher rates have a negative impact on the valuation of individual stocks although, depending on what is priced into the stock, the market price may compensate the investor for taking on that risk. As bottom-up investors, we don't try to forecast changes in interest rates. However, such changes do affect the valuation of a business.

*Duration* measures the sensitivity of a security to interest rate movements. Until quite recently, the extended period of low interest rates favoured businesses with long duration, and many of those securities became overvalued. In recent years, our bottom-up portfolio work has generally led to trimming or completely selling out of longer-duration businesses.

**Wishes for a Weaker Loonie**

Another consequence of last year's rate hikes was a surge in the value of the Canadian dollar, which has fortunately receded somewhat as the year draws to a close. A weaker Canadian dollar benefits many Canadian businesses, including companies with revenues priced in a foreign currency (non-Canadian dollar revenues), but domestic operations (Canadian-dollar expenses). Many materials and energy companies fall into this category, as their commodities are often priced in US dollars while domestic extraction costs may remain in Canadian dollars. Companies with US and/or other foreign operations that repatriate revenues back into Canadian dollars on more favourable terms—such as Canadian commercial banks and life insurance companies—also thrive in a lower Canadian-dollar environment.

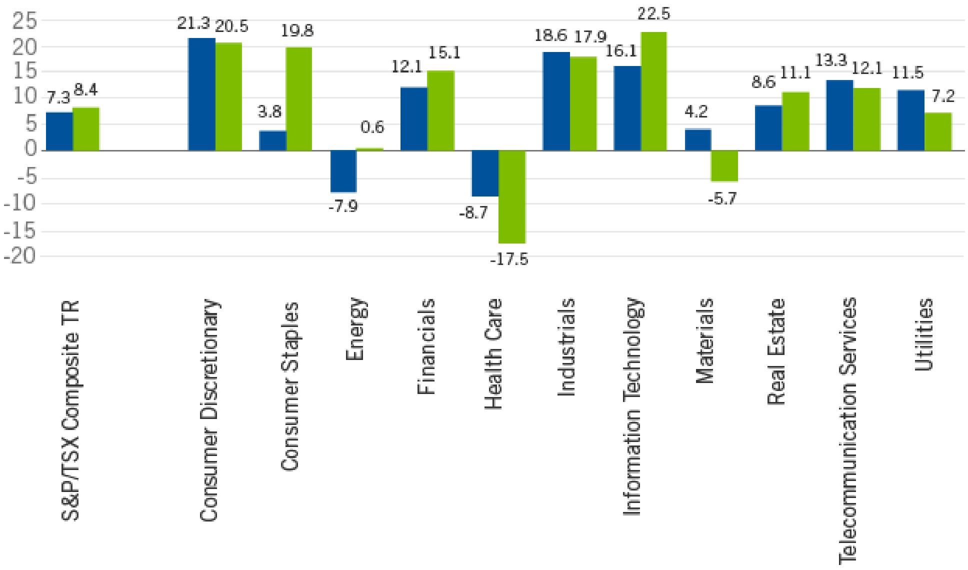
**Financials and Energy: Sectors to Watch in 2018**

Financials and energy are two sectors we think will provide interesting investment opportunities in 2018. Financials should benefit from any further increases in interest rates, especially the banks, which tend to see higher profits as loan costs typically increase faster than interest payouts to investors and depositors. Given their role as mortgage lenders, recent concerns about the frothy state of the housing market have tended to depress stock prices, allowing investors an opportunity to buy into quality businesses at great prices.

In the energy sector, share price declines have made for compelling valuations. Despite persistent commodity price volatility, a recovery in the sector appears to be gradually taking shape. Production cuts led by the Organization of Petroleum Exporting Countries (OPEC) have finally begun to drain global oil inventories, although the market remains fixated on US onshore production trends. The overall supply-demand equation is looking more positive, with global economic growth generally supportive of strong consumption trends and improving prices. As longtime believers that the commodity-centric nature of the Canadian equity market creates inefficiencies that benefit our truly active and disciplined approach, we look forward to capturing the emerging investment opportunities in the year ahead.

## Certain Sectors still have Room to Run

S&P/TSX Composite Total Return Index Returns by Sector
Year-to-date and five-year returns as of October 31, 2017




YTD

5-Year*

*Annualized

Source: ©2017 Morningstar Research Inc. All returns in Canadian dollars.

**WHAT ARE THE RISKS?**

**All investments involve risks, including possible loss of principal.** Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline.

**IMPORTANT LEGAL INFORMATION**

The information provided is not a complete analysis of every material fact regarding any country, market, industry, security or strategy. Because market and economic conditions are subject to change, comments, opinions and analyses are rendered as of the date of this posting and may change without notice. A portfolio manager's assessment of a particular security, investment or strategy is not intended as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy.

For more information on any of our funds, contact your financial advisor or download a free prospectus (/en-ca/public/downloads/legal-financial-documents/simplified-prospectus). Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. The prospectus contains this and other information. Please read the prospectus carefully before investing or sending money.

You need Adobe Acrobat Reader to view and print PDF documents. Download a free version from Adobe's website (https://get.adobe.com/reader/).

**Franklin Templeton Distributors, Inc.**