Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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Year of the Pig: Better Fortunes to Come?

China is yet again at the forefront of investors' concerns amid a slowdown in the country's economy. In 2015-2016, the Middle Kingdom experienced a slowdown, which caused ripple effects across global equity markets. The US and Canadian markets swung 15% and 25%, respectively, peak to trough, as investors worried about the potentially negative impact a slower Chinese growth rate would have on global GDP. Decelerating growth is nothing new for the world's second largest contributor to the global economy, as its annual grow rate peaked last decade and has steadily decelerated since then. However, the growth scare in 2015 led economists to question the targeted growth rate of 7% amid worrying signs of a greater deceleration in economic activity. As the government acted to prevent a hard landing and markets adjusted to the new reality of a slower annual growth rate, the markets found a firmer footing.

Fast forward to late 2018, and many of the elements that were present in 2015 are evident again. The government has pumped monetary and fiscal stimulus into the system as there are signs growth may take another step down. As in 2015, the current slowdown has rippled across global markets, negatively affecting growth estimates. Late last year, the International Monetary Fund cut its 2019 global growth estimate citing China and, again in January, offered another downward revision to account for weakness in Germany (China is Germany's third largest export market). China's slowdown is also evident in corporate earnings as a number of companies cited China as a reason for revising guidance. In a letter to shareholders, Apple's (AAPL-US) CEO Tim Cook wrote:

> *"While we anticipated some challenges in key emerging markets, we did not foresee the magnitude of the economic deceleration, particularly in Greater China. In fact, most of our revenue shortfall to our guidance, and over 100% of our year-over-year worldwide revenue decline, occurred in Greater China across iPhone, Mac and iPad."*

Video-game chipmaker Nvidia (NVDA-US) cited deteriorating macro conditions, particularly in China, which represents ~22% of total revenue:

> *"The reduction in that inventory and its impact on the business have proceeded largely inline with management's expectations. However, deteriorating macroeconomic conditions, particularly in China, impacted consumer demand for NVIDIA gaming GPUs."*

As the all-important Chinese Lunar holiday begins in the first week of February, analysts and economists will be watching consumption trends closely. With any luck, the year of the Pig can reverse the negative momentum experienced in retail and vehicle sales that have slumped in recent months.

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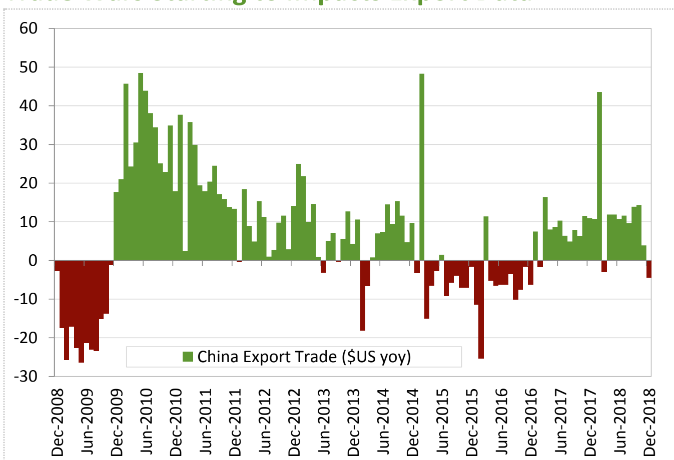
One distinction between 2015 and today is that the US and China were not embroiled in a trade war. A resolution to the trade spat between the US and China may be seen as the panacea for the market, but a trade deal does not solve the fact that growth in the world's second largest economy is decelerating. The slowdown in China has far more to do with internal factors rather than external pressures, such as trade. Looking at Chinese export data, we can see that the impact of trade tariffs has been minimal on China's export growth in 2018. China posted double-digit growth in all but three months of the year. The export resiliency can likely be explained by exports/imports front-running more punitive tariffs imposed in late September and ahead of the potential jump in the tariff rate on $200 billion of Chinese goods this year. Such front loading may gradually fade to some extent and the negative impacts may begin to appear in 2019. If so, this could put further downward pressure on the Chinese economy.

Trade Wars Starting to Impacts Export Data

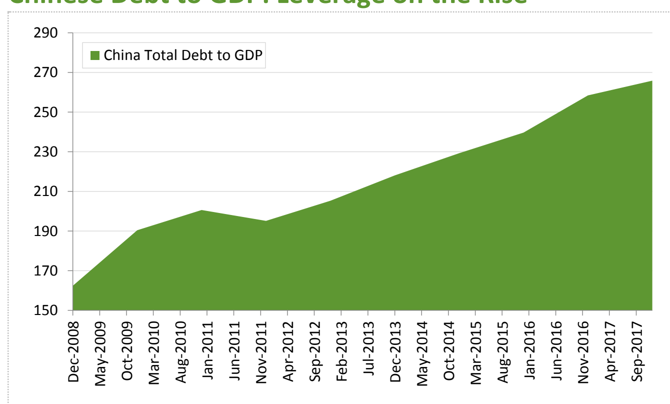


Source: Bloomberg, Raymond James Ltd.

Command and Control

The government has taken steps to address the current slowdown by lining up additional monetary and fiscal stimulus, but it remains to be seen if these measures can reverse the trend. Predicting economic outcomes for China is challenging given the government's control over its economy. In a market-driven economy, like the US, market excesses are purged from the system, and from the ashes, new strong companies arise. In a command-economy, many of the excesses that typically would have been removed in a market-driven economy are allowed to persist. Warning signs such as excess capacity in multiple industries, excessive corporate leverage, increased bank lending to shaky corporations, limited progress on labour productivity and an uncertain housing market have been present for over a decade. The government has taken steps to address these issues, and has implemented structural economic reforms to transform their economy to compete with the world's most developed markets. However, these reforms have at times negatively contributed to economic growth, forcing the government to backtrack in a bid to support the economy. The primary tool to address temporary slowdowns has been through credit creation, which has increased overall leverage by a staggering amount. Total debt to GDP has now surpassed 250%, up from 140% in 2008, according to the Bank of International Settlements. The sheer amount of debt within the Chinese economy is worrisome and may eventually limit the government's ability to respond to a more severe slowdown and/or social unrest. However, this is a big maybe given the extent of control the government exerts over the country.

Chinese Debt to GDP: Leverage on the Rise



Source: Bloomberg, Raymond James Ltd.

Social Credit System

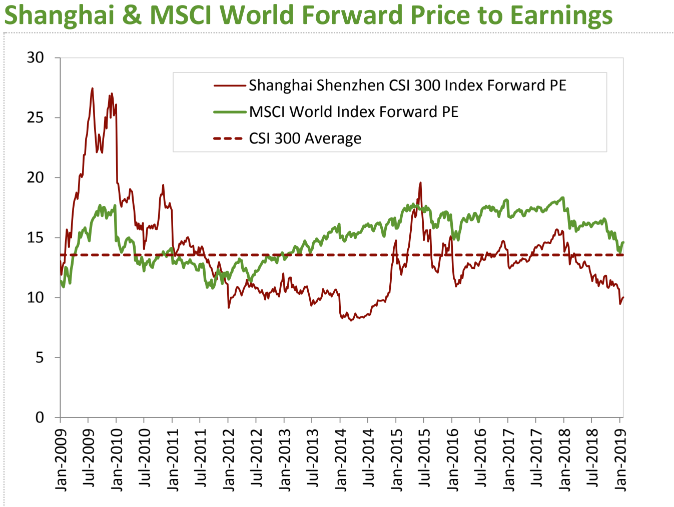
Besides the economic intervention, China has embarked on another massive social experiment. If George Orwell were alive today, China's Social Credit System (SCS) would put his dystopian novel *1984* to shame. Over the past few years the government has rolled out a monitoring and scoring system, which rates individuals based on their behaviors, personal interactions and the actions of their friends and relatives. The government tracks individuals' every move through a web of CCTV cameras, monitors web traffic and other personal data such as eating and drinking habits all with the intent to assign a score. Those with high SCS scores gain benefits such as VIP treatment at hotels and airports, cheap loans and a fast track to the best universities and jobs, while those with low SCS scores are blacklisted and locked out of society. A national roll-out of the system is scheduled for 2020.

The government's ability to control and coerce more than a billion people, along with its grip over banks, corporations and capital flows, makes predicting economic outcomes in China an elusive task. Risks that would normally have been flushed out in a market-driven economy remain and it is anyone's guess whether the negative consequences will eventually be realized.

Technical: Absolute and Relative

The Shanghai market is off 33% from its 2018 highs, putting the country's benchmark index in bear market territory. To understand the overwhelming direction on the market, we can look at moving averages, which smooth the day-to-day market moves. Judging by the negative slope of the 200-day moving average, we can say the market trend remains decidedly bearish; however, if we compare the Shanghai market relative to the MSCI Total World Index, we can see that the relative performance of Chinese has improved since October. While the technical picture remains mixed, valuation is attractive relative to historical levels. The Shanghai market trades at 10.1x price-to-earnings (P/E) compared to its 10-year average of 13.5x. Comparing the Shanghai market to the MSCI World index, Chinese shares trade at a 30% P/E discount.

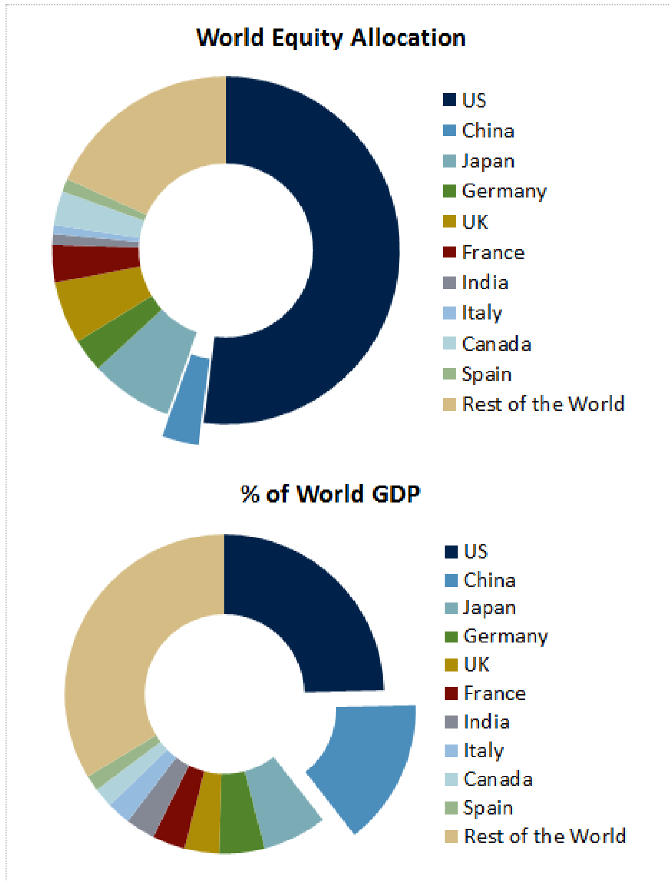
Shanghai & MSCI World Forward Price to Earnings



Source: Bloomberg, Raymond James Ltd.

Another positive for Chinese equities is their broader inclusion within the MSCI Emerging Markets (EM) index. At present, China represents 28% allocation in the MSCI EM index; however, by 2030 this will grow to over 40%. While China represents ~15% of world GDP, it remains severely underrepresented in total world equity allocation. The world's largest economy, the US, contributes 25% of world GDP and represents over 50% allocation in world equities. By contrast, China only represents 3.4% of total world equity allocation. Greater inclusion will be a natural long-term tailwind for Chinese equities.

China Economic Size & Inclusion in MSCI



Source: Bloomberg, Raymond James Ltd.

Conclusion

China is clearly experiencing an economic slowdown, the severity of which is yet unknown. However, the Chinese government has taken steps to support the economy and, given the extent of their authority, the probability of a more severe contraction is limited, in our view.

From a technical and valuation perspective, we are receiving a mixed signal that suggests a certain amount of caution in the near term. However, investors with a long-term time horizon appear set to benefit from China's increased allocation within broad market indices and a currently attractive valuation level, allowing entry at a reasonable price.

Jason Castelli, CFA
VP Head of Investment Strategy

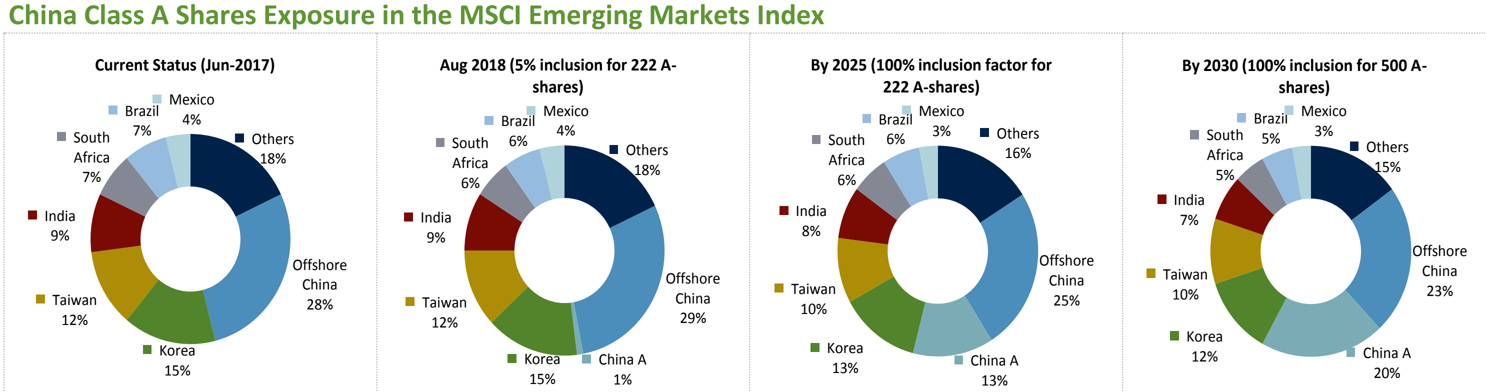
There's a New S&P 500 Juggernaut in Town.

China has been a significant outperformer in the global equities markets over the past 15 years. However, up until recently, it has been difficult for Canadian investors to gain access to Chinese markets, particularly the mainland "A-shares" market place. Although there have been products available for some time that have exposure to Chinese companies, they were typically only able to hold stocks listed in either Hong Kong or in the US through ADRs. Effectively, you had access to only a sliver of the total marketplace. That has changed recently due to a technology platform called Stock Connect. Stock Connect is based in Hong Kong and facilitates trading between mainland China and the rest of the world's capital markets. As a result of this new technology, investors now have access to essentially all publicly traded Chinese companies. This new access also translates into some major structural changes to global indices where China A-shares were previously excluded due to liquidity and tradability. For example, China A-shares will be added to the MSCI Emerging Markets Index (EM), All Country World Index (ACWI), and China Index. The chart below highlights how significant China will become in the MSCI EM index. Strictly based on passive rebalancing flows for index funds (EM and ACWI), approximately $19 billion USD will flow into 234 companies in the short term.

Since the launch of Stock Connect, there have been several new and notable product launches in the space. From an index perspective, we will start with the **Wisdomtree ICBCCS S&P China 500 (CHNA.B)**. This product provides a holistic approach to Chinese equities, and is comprised of the largest and most liquid Chinese companies covering all eligible share classes including A-shares, H-shares, and US ADRs. There is a dizzying number of different share types, but the table below provides an overview of the share type structure of the Chinese marketplace. On the other hand, if you are interested in pure-play index exposure to mainland China, consider the **Mackenzie China A-shares CSI 300 Index ETF - QCH**. Mackenzie has partnered with one of the largest financial asset managers in China, China AM, to bring both this index ETF as well as an actively managed fund – the Mackenzie All China Equity fund -- to market in Canada.

China is a marketplace that we feel is ripe to benefit from the touch of an active manager, given multiple reporting standards, and the influence of the government on state-owned enterprises. In addition, while day trading by the average retail investor is now possible essentially anywhere in the world, the Chinese marketplace is particularly influenced by major swings based on sentiment. While an investment vehicle might benefit from an active touch, managing money in the Chinese market can be exceptionally difficult if you're not integrated within the market yourself. For example, companies may report in Mandarin, Cantonese or English. In this respect, we feel that Mackenzie has the right approach by partnering with an existing asset manager, China AM, which has "boots on the ground" and extensive experience to manage the **Mackenzie All China Equity Fund**. China AM is one of the largest asset managers in China with 200 investment professionals covering the Chinese marketplace. This large number of analysts allows them to conduct over 3,000 on-site visits annually, which again we feel is relatively more important than in other major markets in the world. The fund takes a blended approach of detailed bottom-up analysis, complemented by macro and sector overlays. They are looking for cash generating, competitively positioned businesses that have effective management and trading at a discount to intrinsic value.

China Class A Shares Exposure in the MSCI Emerging Markets Index



Source: Mackenzie Investments

In terms of portfolio construction, we have always been proponents of diversifying both geographically and by sector. With that in mind, having exposure in your portfolio to one of the largest and fastest growing economies in the world seems to make sense in the long term. Moreover, while China's projected GPD growth rate may be slowing, it is important to remind ourselves that slow growth in China is north of 5%. How this may fit into your portfolio is a function of your risk tolerance and investment time horizon. For those with a long-term investment horizon and higher risk tolerance, we feel this makes an excellent complement to, or replacement for your Emerging Markets sleeve. In terms of the allocation to a particular manager or mandate, we would reiterate our view that this market favours active management. With that said, those wanting low cost beta exposure will be well suited in either **CHNA.B** (S&P 500 China ETF) for broad-based exposure or **QCH** (Mackenzie China A-shares CSI 300 index ETF) for a pure China play.

Spencer Barnes, MSC, CIM
AVP, Mutual Funds & ETF Strategy

China Share Class Exposure

Exchange Location	Share Class	Description	Trading Currency	Largest Sector	Companies	S&P China 500 Index	MSCI China Index	FTSE China 50 Index
Mainland China	A-Shares	Chinese securities incorporated in mainland China, listed on the Shanghai or Shenzhen Stock Exchange and traded in yuan (CNY)	CNY	Financials	Kweichow Moutai, Ping An Insurance, China Merchants Bank	●	●	
	B-Shares	Chinese securities incorporated in mainland China, listed on the Shanghai Stock Exchange (USD) and the Shenzhen Stock Exchange (HKD)	USD / HKD	Industrials	Shanghai Lujiazui Fin & Trade Dev, Inner Mongolia Yitai Coal, Chongqing Changan Automobile	●	●	
International	H-Shares	Chinese securities incorporated in mainland China, listed on the Hong Kong Stock Exchange (HKD)	HKD	Financials	China Construction Bank, ICBC, Ping An Insurance	●	●	●
	Red-Chips	Chinese securities of state-owned companies incorporated outside mainland China, listed on the Hong Kong Stock Exchange (HKD)	HKD	Telecom. Services	China Mobile, CNOOC, BOC Hong Kong	●	●	●
	P-Chips	Chinese securities of non-government-owned companies incorporated outside mainland China, listed on the Hong Kong Stock Exchange (HKD)	HKD	Consumer Discretionary	Tencent, Geely Automobile, China Evergrande	●	●	●
	N-Shares	Chinese securities (including ADRs) incorporated outside Greater China (mainland China, Hong Kong, Macao and Taiwan), listed on the NYSE Euronext-New York, NASDAQ, NYSE AMEX (N-Shares), traded in USD, and Singapore Exchanges (S-Shares), traded in Singapore dollars (SGD)	USD	Information Technology	Alibaba, Baidu, JD.com	●	●	
	S-Shares		SGD	Industrials	Yangzijiang Shipbuilding Holdings, Yanlord Land Group, SIIC Environmental	●	●	

Source: WisdomTree, S&P, MSCI, FTSE, as of 6/30/18

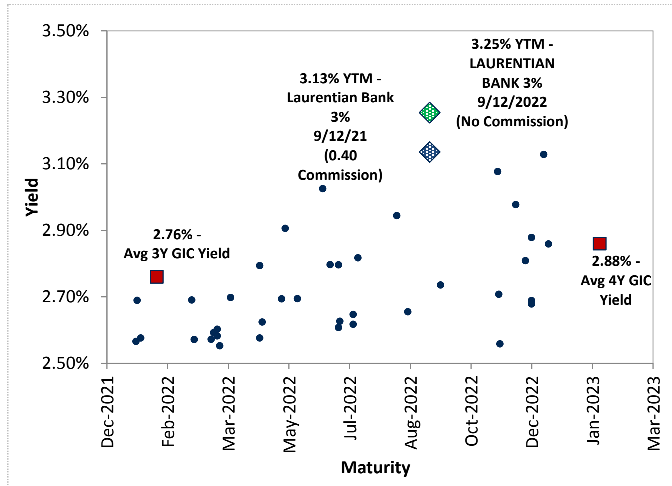
The Bond Shift

The disconnect in global equity and credit market movements from economic data has begun to reverse. In this late stage of the debt cycle, where central banks are normalizing monetary policy, we are seeing some cracks in economic data. While manufacturing and employment trends remain solid, housing data, inflation and output trends have been softening. Both in the US and Canada, central banks have changed their tone from decisive rate hikes, to the more data dependent approach seen in Yellen's days. This has provided some relief to the credit markets, which saw spreads widen significantly in December. Yields on the 2-10 year terms have crept down 5-7 bps while the 30 year is up 2-3bps in both Canada and the US, dampening the flattening trend of 2018. Kicking off 2019 there is fresh optimism over U.S-China trade relations, though China's domestic economy is clearly showing signs of slowing, which will weigh on global business sentiment. Indeed, economists are calling for a global growth slowdown of 0.1-0.3% from the 3.7% print in 2018.

Over the last 30 days, Canadian GIC yields have moved down by an average of 15 bps on the 1-4 year terms and 25 bps on the 5-year term. We have seen flow shift away from GIC's towards investment grade corporate bonds as yields become increasingly attractive. Our top three favourite investment grade bond issuers for 1-3 year terms are **Laurentian Bank**, **Nissan Canada** and **Canadian Western Bank**.

The Laurentian Bank 3.0% September 12, 2022 bond is one of our top trade ideas, offering 3.14% Semi-annual / 3.15 % annualized equivalent yield for going roughly 3.5 years out (chart for comparison below). For one year and shorter terms, we still recommend GIC's if liquidity isn't an issue or BA's if clients want the option to sell the position early.

Laurentian Bank 3% Sept 12, 2022 Vs. Comparable Bonds & GIC's



Source: Bloomberg, Raymond James Ltd.

In the table below, we illustrate how we would construct a portfolio for a moderate investor. Currently the portfolio yields roughly 3% and has a modified duration of 5.46 years. The portfolio shown below contains a mix of government, provincial and corporate bonds with a weighted average rating of single A high.

Ahmed Husain
Fixed Income

Overall Portfolio Analysis

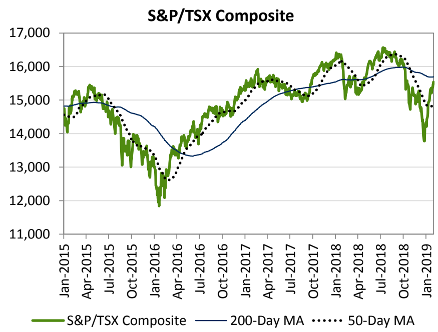
Pricing Date		Portfolio Parameters							Portfolio Value *(rounded values)*		
ISSUE PRICES AS OF:	30-Jan-19	*Weighted Rating	Total Maturity Value	Total Premium (Discount)	Weighted Yield to Maturity	Weighted Annual Equiv.	Weighted Term (years)	Weighted Duration (Mod.)	Total Accrued Interest	Total Principal Cost	Total Portfolio Investment
BOND SETTLEMENT:	Standard Conventions										
		A high	$118,000	0.38%	3.01%	3.03%	6.11	5.46	$783	$118,452	$119,235

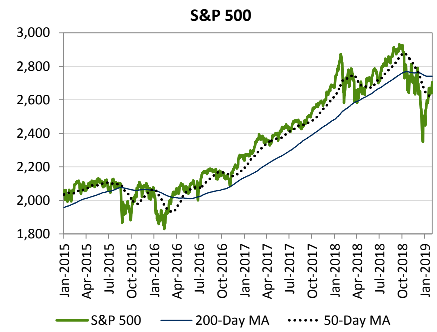
Individual Issue Analysis

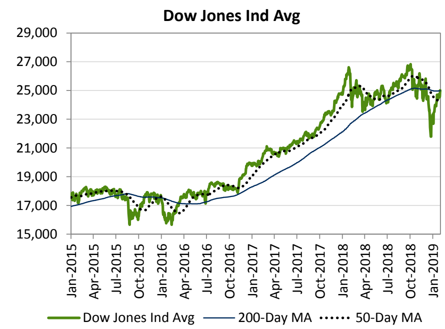
Issuer	Coupon Rate	Maturity Date	Debt Rating	Maturity (Par) Value	Offering Price	Yield to Maturity	Annual Equiv.	Term (years)	Duration (Mod.)	Accrued Interest	Principal Cost	Total Cost
Bank of Nova Scotia	1.900%	2-Dec-21	AA	$10,000	$98.100	2.60%	2.62%	2.84	2.73	$32	$9,810	$9,842
Fairfax Financial Holdings	5.840%	14-Oct-22	BBB high	$10,000	$108.950	3.25%	3.28%	3.70	3.29	$176	$10,895	$11,071
HSBC Bank Canada	2.542%	31-Jan-23	A high	$10,000	$98.750	2.88%	2.90%	4.00	3.77	$1	$9,875	$9,876
Telus Corp	3.350%	1-Apr-24	BBB high	$10,000	$101.000	3.14%	3.16%	5.17	4.66	$113	$10,100	$10,213
George Weston Ltd	4.115%	17-Jun-24	BBB	$10,000	$103.200	3.46%	3.49%	5.38	4.78	$52	$10,320	$10,372
Wells Fargo & Co	3.874%	21-May-25	A high	$10,000	$101.600	3.59%	3.62%	6.30	5.52	$76	$10,160	$10,236
Province of Ontario	2.600%	2-Jun-25	AA low	$13,000	$100.400	2.53%	2.55%	6.34	5.78	$56	$13,052	$13,108
Bell Canada	2.900%	12-Aug-26	BBB high	$11,000	$96.750	3.39%	3.42%	7.53	6.60	$151	$10,643	$10,794
Enbridge	3.200%	8-Jun-27	BBB high	$12,000	$97.100	3.60%	3.64%	8.35	7.21	$58	$11,652	$11,710
Canada Housing Trust	2.350%	15-Jun-27	AAA	$22,000	$99.750	2.38%	2.40%	8.37	7.53	$68	$21,945	$22,013

Charts of Interest

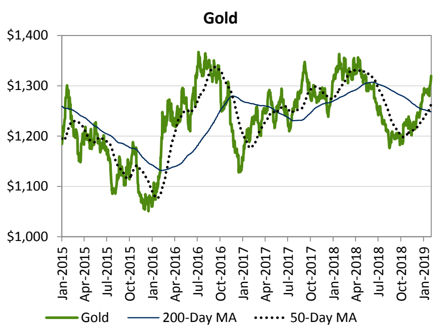
Markets

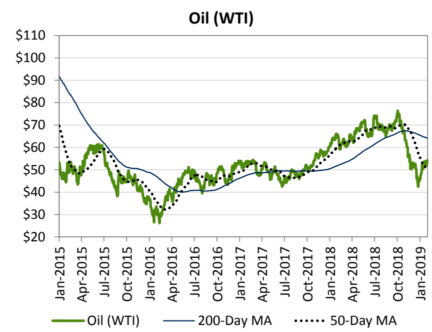


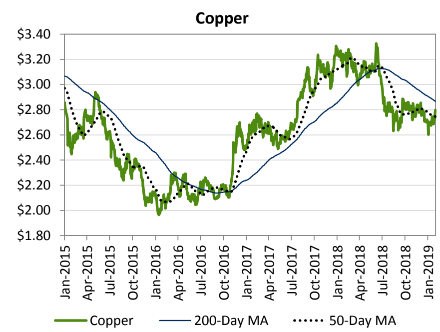




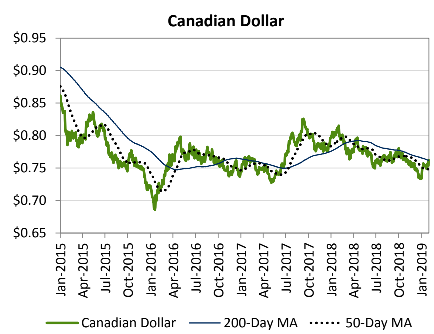
Commodities

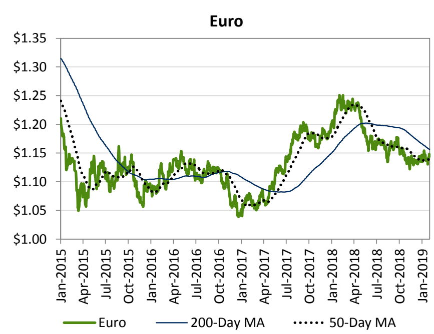


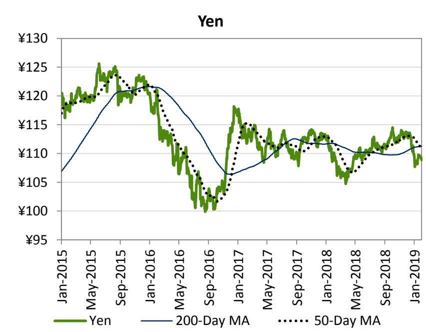




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at January 31, 2019.

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