

WisdomTree Canada 2019 ETF Industry & Market Outlook

The Canadian exchange-traded fund (ETF) industry reached a new peak in 2018, with more than \$15.9 billion in inflows and approximately \$162 billion in assets under management (AUM) as of November 30, 2018¹—an increase of about 10% from 2017. While the increase in AUM was less than the 30% flow increase witnessed from 2016 to 2017, ETFs continue to gain traction and market share in Canada. Flows into equity ETFs were strong at \$9.7 billion,² while fixed income ETFs saw sizable inflows of more than \$5 billion.³

WisdomTree believes Canadian fund industry assets will continue to shift from mutual funds to ETFs, and within ETFs, product innovation is likely to persist. WisdomTree has also observed an erosion of market share among major ETF providers, allowing a group of smaller players to gain assets and offer investors differentiated and diverse investment products. From a markets perspective, WisdomTree expects the Bank of Canada (BOC) will continue on its path of policy normalization and will likely continue to raise rates in 2019. WisdomTree also anticipates emerging markets will outperform relative to Canadian stocks in the year ahead.

Overview—2018 Canadian and Global Trends

ETF INDUSTRY GROWTH

Despite some experienced volatility in the market, the ETF industry as a whole still witnessed another year of AUM increases. In addition, turbulent markets did not appear to upset the ongoing shift from mutual funds to ETFs.

The Canadian ETF industry continued to attract new entrants, with a recent count of 33 firms managing \$157 billion in October, up from 27 firms with \$147 billion at the end of last year. For perspective, there were only 18 companies in the business managing \$113.6 billion when WisdomTree Canada entered the Canadian market in 2016.⁴

Another promising development for the industry has been the steady erosion of the oligopolistic power among the major providers. As recently as 2014, many of today's participants had not yet entered the market with TSX-listed ETFs. That made the choices narrow, with the Canadian ETF Association (CETFA) identifying nearly \$9 of every \$10 invested as being housed with just three providers at that time.

Fortunately, recent years have witnessed a virtual doubling in the proportion of assets managed by other players in addition to the top three providers. The next 10 largest providers (including WisdomTree) increased their market share to 20.1% of industry-wide AUM in Q3 2018, up from 17.4% at the close of 2017 and 14.1% the year before.

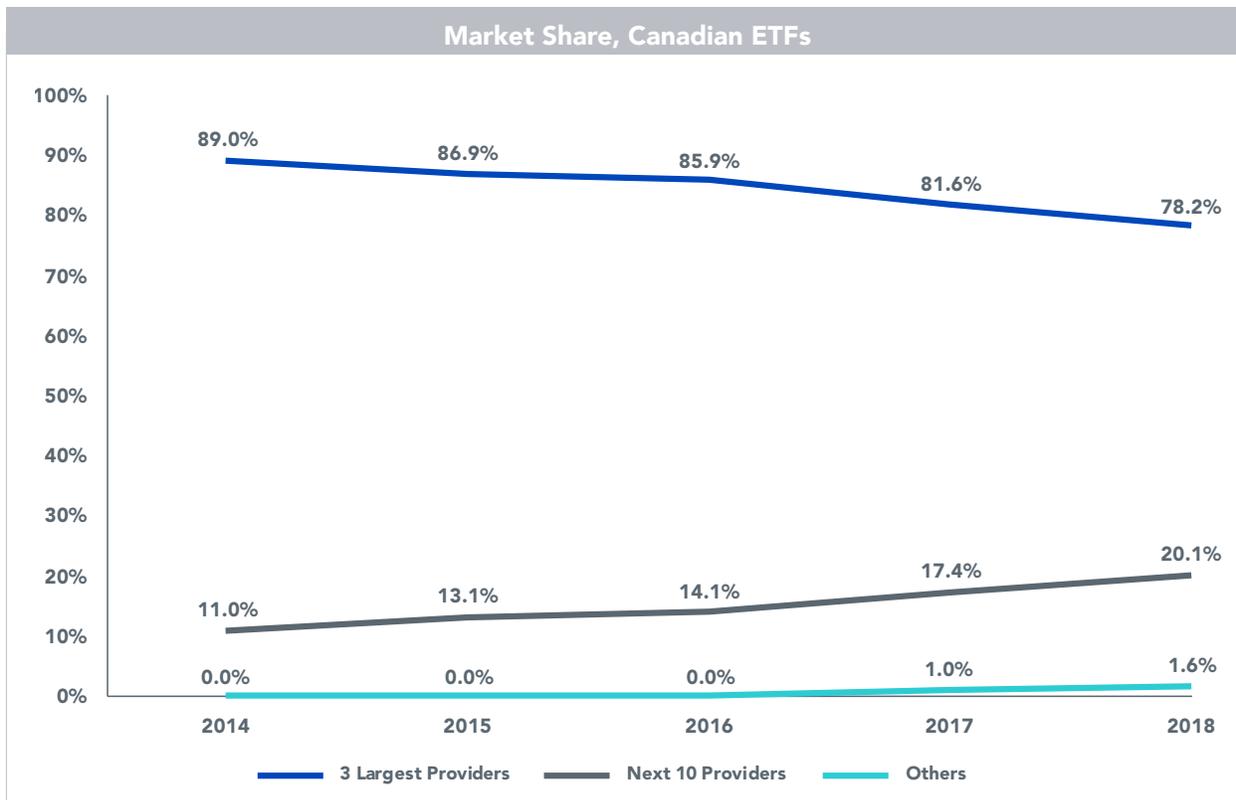
Note: All figures in Canadian dollars unless otherwise noted.

¹ Source: Bloomberg, as of 11/30/18.

² Source: Bloomberg, as of 11/30/18.

³ Source: Bloomberg, as of 11/30/18.

⁴ Source: Canadian ETF Association (CETFA)



Source: WisdomTree, using CETFA data. Data for 2018 as of 9/30/18.

Additionally, another group of smaller players has recently entered the market, rapidly collecting almost 2% market share, a difficult feat in any industry characterized by such intense competition. Although these smaller providers are competitors, we welcome their entry, as they are also in the marketplace communicating the benefits of the ETF structure.

EQUITIES IN 2018

2018 was a year that equity investors would rather forget, with the S&P/TSX Composite posting a cumulative year-to-date loss of 3.7% through November. The stock market was rudely reminded in October that growth metrics alone are not the sole determining factor for equity performance. However, the dismal year-to-date market performance is not unique to Canada, as markets in the U.S., Europe and the rest of the world witnessed sharp corrections. This is especially noteworthy given that global GDP growth remains healthy.

In the U.S., the degree of stock market losses surprised many investors, and that is just the sort of turbulence that sometimes triggers the kind of multiyear regime change that brings forth new market leadership. Such leadership change could lead to a period in which value stocks outperform growth stocks. Growth stocks in the U.S. have outperformed value stocks by a cumulative 145% over the last 12 years, a development that begins to rival only the days when Nortel and dot-com stocks ruled the market a generation ago.⁵

We are intrigued by the recent rotation in market leadership. WisdomTree’s use of dividend-weighting methodologies in our Canadian ETF strategies would benefit if the market reappreciates the long-term benefit of paying cash to shareholders.

⁵ Source: Bloomberg. S&P 500 Growth and S&P 500 Value Indexes, 7/31/06–11/30/18, in CAD. Annualized returns are 12.04% and 8.10%, respectively, or a gap of 394 basis points per year.

FIXED INCOME IN 2018

As expected, we saw sizable flows into fixed income ETFs in 2018, with about \$5 billion coming into TSX-listed products as of November 30, 2018. However, 2018 fixed income flows are on pace to come in below 2017 totals, likely a result of this year's multiple rate increases. In broader terms, developed market fixed income yields have been on an ascending trajectory, with Canada as no exception. Needless to say, this landscape has proven difficult for investors, which helps explain the reduced flows compared to 2017.

It's no surprise then that investors have been searching for solutions to help mitigate rate risk. Prior to 2018, the theme seemed to be tilted more toward income needs, but this sentiment appears to be shifting to rate protection strategies for 2019.

Looking Ahead: 2019 Industry & Market Trends

ETF INDUSTRY GROWTH TO CONTINUE IN 2019

Despite an end to 2018 characterized by market volatility, ETFs were able to grow assets at a double-digit annual pace due to what we believe to be a continuation of the fund industry's preference of ETFs over mutual funds. However, the amount of capital invested in TSX-listed ETFs is still only a fraction of the quantity that has built up in legacy mutual funds over generations. For context, the Investment Funds Institute of Canada (IFIC) still counts \$1.52 trillion invested in general mutual funds as of Q3 2018.

WisdomTree has long hypothesized that the benefits of ETFs, ranging from intraday liquidity to cost and tax advantages, should create a natural draw from mutual funds. While it's clear that ETF assets will continue to chip away at mutual fund market share, a scenario such as a bear market or a correction is likely to serve as a catalyst for more assets moving in this direction in an effort to minimize capital gains.

Against this backdrop of heightened competition, product innovation is likely to continue into 2019 as investors increasingly demand solutions that provide low-cost alpha. While WisdomTree is focused on taking a Modern Alpha™ approach to investing—combining the outperformance potential of active management with the benefits of the ETF structure—some firms have focused on thematic ETFs. For example, a few competitors made a splash with cannabis-related ETFs in 2018, and we anticipate that the exchange-traded structure will be the vehicle of choice for product innovation of this variety for the foreseeable future.

FIXED INCOME AND INTEREST RATES IN 2019

On the fixed income front, WisdomTree believes the tailwinds from what are still extraordinarily accommodative developed world monetary policies will likely recede in 2019. The overarching theme seems to be geared more toward normalization, with the exact form and scope of this process varying among central banks.

The Bank of Canada is expected to be a continued participant in policy normalization, a process that began in 2017. The BOC has already raised rates three times this year, with additional hikes expected for 2019. The message of further rate hikes has been an integral part of its forward guidance.

The expectation of potentially higher rates in 2019 will most likely keep bond investors defensive. As a result, "rising rate" solutions could be at the forefront of the portfolio decision-making process, with short duration strategies playing an integral role. We believe the WisdomTree Yield Enhanced Canada Short-Term Aggregate Bond Index ETF (CAGS) offers investors such a solution.

Another time-tested rising rates strategy is to utilize the barbell approach, combining a short duration instrument for rate protection with a longer duration vehicle for income needs. While the aforementioned CAGS can fill short duration, the WisdomTree Yield Enhanced Canada Aggregate Bond Index ETF (CAGG) completes the other “weight” of the barbell. For bond investors, rate risk and income needs are traditional investment goals, and 2019 looks to be another year that the barbell strategy will present itself as an opportunity.

AVOIDING THE PINCH

With the Street believing the Bank of Canada’s policy rate will be 2.50% at this time next year, up 75 basis points from the current rate, investors may want to immunize against firms that tend to get pinched if financing costs affect Canadian housing. With Canadian mortgages rising sharply since mid-2017, it is possible that softness in Vancouver and Toronto housing could hang like a cloud over the Big Five banks. Together they make up a shocking 28.1% of the MSCI Canada Index.

To avoid the pinch that could hit the consumer should BOC Governor Stephen Poloz approach 2019 with a more aggressive tack, de-emphasizing Canadian banks could prove fortuitous.

In contrast to the headwind facing the banks, the broader Canadian market could catch relief from the beleaguered energy sector. The series of events that could drive this would be a realization by the Trump administration that Western Canada Select Crude oil at \$33 is a giveaway price.⁶ Such a development would be a performance obstacle for our flagship ETF, DGRC, which tracks the WisdomTree Canada Quality Dividend Growth Index, due to its current energy under-weight. However, we believe that our concerns with respect to Vancouver and Greater Toronto Area housing and our related scepticism toward Canadian financials could offset this.

CURRENCY DYNAMICS

The Canadian dollar (CAD) has fallen from US\$0.796 to US\$0.758 in 2018. Our purchasing power parity metrics have been largely neutral on the currency pair for several years. However, we would not be surprised to see the Bank of Canada flap its wings as one of the more “hawkish” central banks in North America in 2019, perhaps bringing its 1.75% policy rate above median Bay Street forecasts. While we are sympathetic to that base case, the room for surprise appears to be a number closer to 2.75% than 2%. We anticipate gentle CAD strength relative to the USD over the next year.

Additionally, the possibility of considerable appreciation for CAD relative to the euro (EUR) should be entertained given rising banking risks in Europe. At a minimum, continued uncertainties stemming from the Italian budget saga should keep the European Central Bank on a very gradual policy normalization path, with the timing of any potential rate hikes perhaps coming later rather than sooner.

As for the Japanese yen (JPY), we have little in the way of a strong view one way or another relative to CAD, although we remain philosophically of the belief that Canadians should treat Japanese equities from a base case unhedged-currency posture. This is due to JPY’s historic role as being CAD’s alter ego in the G10 currency “risk on/risk off” pecking order. It is possible that Japanese equities owned with additional yen currency exposure present lower risk dynamics than even domestic stocks.

⁶ As of 12/3/18.

EMERGING MARKETS: A MARGIN TOO WIDE TO IGNORE

We believe 2019 will be the year that emerging market equities shine relative to Canadian stocks. For example, EMV.B, which tracks the WisdomTree Emerging Markets Dividend Index CAD, is changing hands at a forward P/E ratio of just 9.1, with a dividend yield just short of 5%. As a matter of comparison, the S&P/TSX Composite Index is on offer for 14.3 times earnings with a dividend just north of 3.2%.⁷ Canadian equity metrics are satisfactory but nowhere near the depressed valuations in the emerging world.

For context, WisdomTree's emerging markets valuation metrics are at levels rivalling what was observed amid the fallout from the Lehman crisis. The aforementioned WisdomTree emerging markets ETF has a price/sales ratio that is at 2009 levels. A similar situation exists for its price/book ratio, which at 1.24 is one of the lowest we've seen in the last decade. The record was touched in September 2015 amid fears of a Chinese slowdown. That and the current figure are lower than the 1.25 price/book ratio registered in Q1 2009, in the teeth of the global financial crisis.

⁷ Sources: Bloomberg, WisdomTree, as of 12/3/18.

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