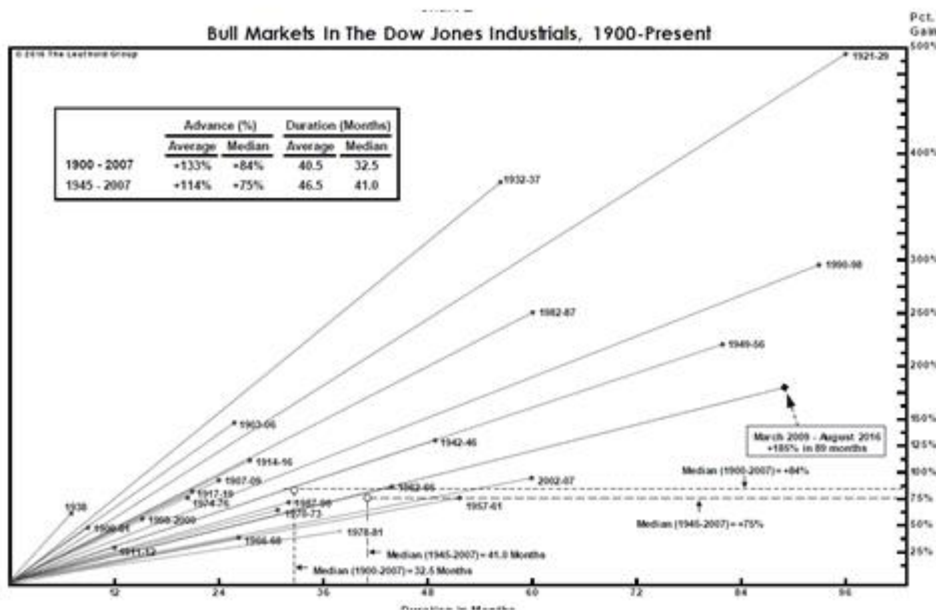
**2016 Third Quarter Summary**

The purpose of this summary is to provide you with a brief overview of the markets globally as well as highlight activities within our portfolios during the third quarter of 2016. The summary is ended with something I think everyone will find of personal interest.

**Extended Bull Market**

Currently we are in bull market that began after the 2008 financial crisis. Since 1900 the average bull market has lasted on average slightly under four years and has produced an average total return of approximately 123%. This current bull market has run for almost double the average bull market duration – 89 months so far. The total return has been 185%, which is significantly more than the long term average. The only bull markets that have lasted longer preceded the 1929 stock market crash and the 2000 technology bubble. If this current bull lasts just six more months, it will be the longest running bull market since 1900.




The purpose of the chart is to illustrate that this bull market, in terms of duration, is extended well beyond the historical average. This is not to say that it cannot continue for many more months or years, but the length of this bull is unusually long. To use a baseball expression, this bull may be in the late innings of the game.

**Global Stock Market Summary**

Global Stock Market Performance as of September 30, 2016 and in local currencies.

| Stock Market | 2016 | Last 12 Months |
|---|---|---|
| Toronto | 13.2% | 10.4% |
| London | 10.5% | 11.2% |
| India | 8.1% | 1.4% |
| USA (S&P 500) | 5.1% | 11.1% |
| Germany | -2.2% | 10.0% |
| Japan | -12.8% | -6.4% |
| China (Shanghai) | -15.1% | -1.6% |

Source: BMO Capital Markets

Despite this aging bull market, a number of stock markets worldwide have enjoyed robust results 2016. Specifically, commodity focused countries such as Canada, Brazil and Russia have enjoyed double digit returns with both Russia and Brazil providing returns exceeding 30% year to date.  The London and Indian markets have also provided modestly positive returns. Interestingly, both Japan and the China have been active buyers of equities in their own domestic markets. Despite their ongoing version of “quantitative easing”, both markets have produced negative returns year to date.

## Corporate Earnings

Corporate Earnings as of September 30, 2016

| Market | 2016 | Last 12 Months |
|---|---|---|
| Canada (TSX) | -6.2% | -11.0% |
| USA (S&P 500) | -4.6% | -8.8% |

Source: BMO Capital Markets

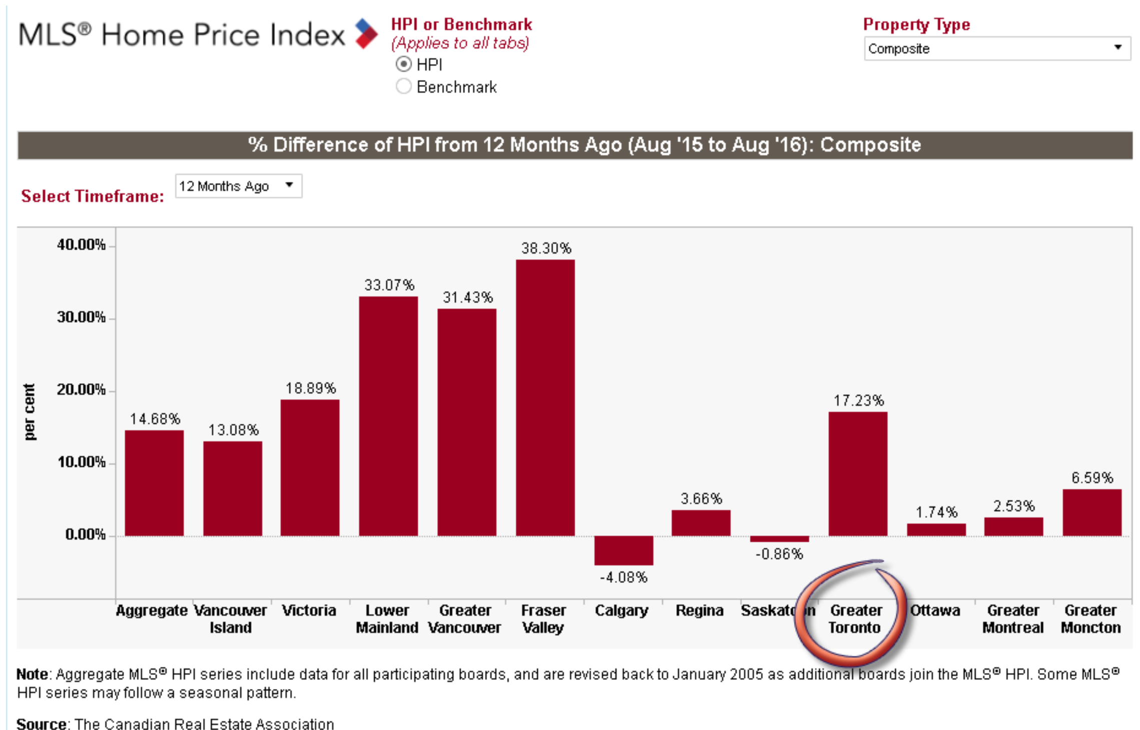
It is interesting that both the S&P/TSX and S&P 500 have rallied as earnings for each market continue to decline.

In Canada, the recovery in oil has had a material impact on Canadian oil and gas producers, which garners almost a quarter of the S&P/TSX weighting. In the U.S the weighting is significantly lower. The recovery in oil prices has also impacted the Canadian dollar, which has advanced 5.4 cents against the U.S. dollar.

We are often asked why the Canadian and U.S stock markets are advancing despite declining reported corporate earnings. One possible explanation is that the stock markets are excellent discounting tools. In other words, the markets are anticipating higher corporate earnings in the future and investors are willing to pay higher multiples for higher anticipated profits. The other possible explanation is interest rates. The following chart is the ten year Bank of Canada Government Bond yield.

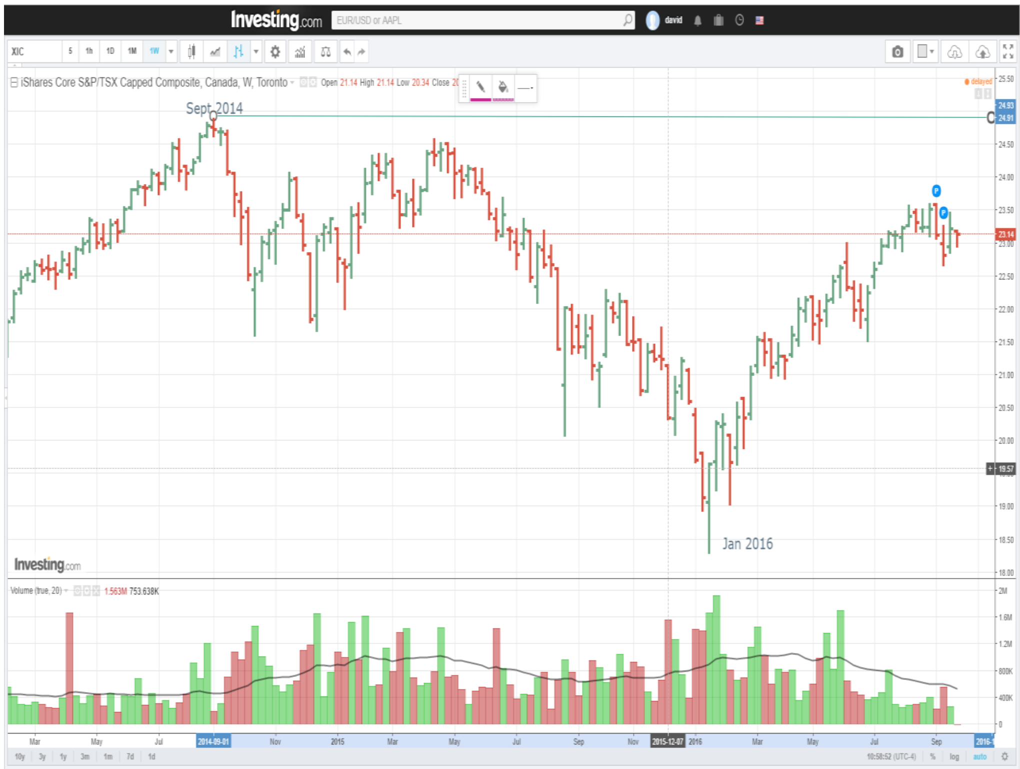
Since the financial crisis ended in 2009, interest rates globally have been lowered in a co-ordinated effort by central banks to stimulate global economic growth. Specifically in Canada, the yield for a 10 year Government of Canada bond is now less than 1%, while other countries continue to have "negative" interest rates. Investors who typically invested in the safety of bonds have found their current income approaching zero. As a result, investors, large and small, are investing in asset classes (i.e. high dividend paying stocks) that they anticipate will offer a potential return higher than the current risk free returns on government bonds. This has been the key reason why stock prices in North America have advanced despite lower corporate earnings and sluggish GDP (Gross Domestic Product).

Perhaps the best illustration of investors anticipating higher returns is real estate.




With record low interest rates globally, demand by domestic and international real estate investors has fueled extraordinary price gains in specific markets including the Greater Vancouver and Greater Toronto areas. Prices have risen so quickly to prompt municipal governments to implement taxation changes and the Federal government to change mortgage requirements to try to limit the level of speculation in this asset class.

While year to date and trailing 12 month returns have been decent for the S&P/TSX, the index has yet to recover to the old highs achieved in 2014.




Unlike Canada, the S&P 500 has broken out of its 18 month trading range, yet the market is virtually unchanged since May of 2015.

## Portfolio Activities

Traditional investors implement a “buy and hold” approach, primarily focused on stocks and bonds. This approach is appropriate for investors who are willing to accept temporary, but significant losses due to inevitable bear markets. Historically, bear markets arrive roughly every four years and have produced peak to trough declines of 30%, while the last two bear markets delivered losses of 50%.

Our portfolio approach is to allocate your investments to those assets exhibiting the greatest demand. Investments with strong demand generally increase in price, while weak demand generally leads to lower prices. We also invest in a variety of asset classes including Canadian, U.S and International stocks, commodities, real estate, currencies, bonds, preferred shares, and most importantly, cash. Our goal is to capture most of the markets upside potential, while limiting large drawdowns during bear markets.

Bonds have been the leading asset class for many years, and as a result, have garnered the greatest allocation in our portfolios. This is a result of the ongoing co-ordinated effort to keep interest rates low. While bonds continue to rank highest in our rankings, equities in Canada and the U.S are making inroads. If this continues, we expect to increase our exposure to equities in the future.

Perhaps the most significant change in the portfolios this year was our decision to reduce our exposure to bonds and increase our exposure to preferred shares. In the last quarter we sold 9% of our bonds in favour of five preferred shares. Doing so increased the yield to maturity on this position from 1.65% to approximately 4.9%, and reduced the management expense incurred by owning bond Exchange Traded Funds (ETFs). We anticipate further reducing our bond exposure in favour of preferred shares depending on the availability of investment grade preferred shares.

You may have noticed an increase in the number of purchase and sales in the stock portfolios we manage. This occurs when there is a lack of leadership within the markets, or when there is a leadership change from one sector to another. This is akin to shifting gears in a car, which can cause a temporary pause in the momentum of a portfolio. This has been especially true in our Canadian stock portfolio during the third quarter. Earlier in the year demand was focused in a number of mining and gold stocks. However, by mid-summer, demand had quickly shifted towards oil and energy stocks.

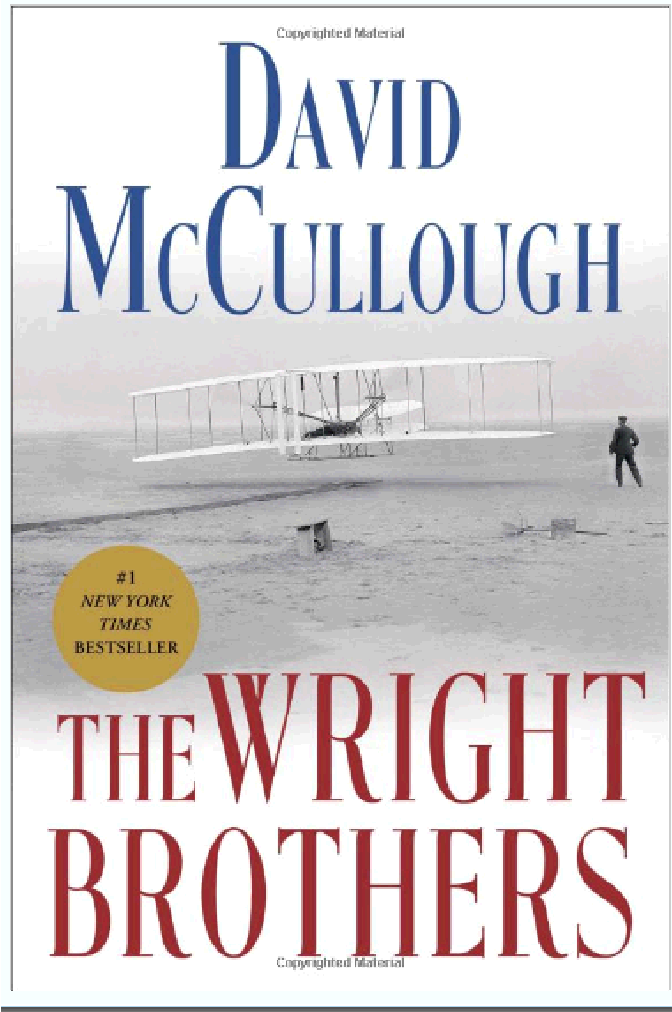
## Forecast

Predicting the future is difficult at best, so we refrain from making forecasts. The markets will do what they will do, and we will continue to execute our investment process as market conditions change. What we can be fairly certain of is that the

U.S. elections in November will cause some short term gyrations. If history is a guide, the election results have little long term impact on the markets.

**A Personal Suggestion**

I was recently stopped by a client at the gym and was told how much she enjoyed a previous book recommendation. With this in mind, I would highly recommend the biography of the Wright Brothers. It is a fantastic read.



As always, if you have any questions regarding this summary, or your investment portfolio, please call us.

Sincerely,

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