2017 First 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 first quarter of this year.

Equity Strategy

We have been bullish on equities for a number of years, and we continue to see stocks as the asset class of choice. However, with the global and European political landscape becoming increasingly uncertain and many indices at record highs, we continue to maintain minimal exposure to European equities.

European politics

Fundamentals, and especially economic momentum, trump politics when it comes to market performance. However, at this juncture, we have a number of major elements of uncertainty which could shake the very foundations of the European Union and a single currency. First, Brexit negotiations have not even begun but British Prime Minister, Theresa May, has secured Parliamentary approval to begin the process. It is hard to handicap the outcome, but Britain does not appear to have a strong hand at this point, and discussions could become contentious and lead to trade disruptions and other repercussions down the road. There is also burgeoning talk of another Scottish independence referendum, the Greek crisis simmering in the background, and important Dutch and French elections with Nationalist, anti-Euro parties leading in the polls.

To say that financial markets have set aside the many political uncertainties would be misleading. Equity markets have nonetheless been very resilient in the face of this new political reality.

Silver linings: Important Eurozone macro indicators continue to improve and stocks are relatively cheap

European economic momentum continues to move higher and has actually reached a multi-year high. The continued strong data lowers the risk of a big pullback in the near future.

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American Politics

The surprise election win last fall by Donald Trump propelled the US market upwards, and this has continued during the first quarter. High expectations in his potential tax reform and pro-business attitude provided investors with the confidence to continue to invest in US equities. This confidence is also reflected in retail sales, which have experienced a robust year over year increase of more than 5%.

Interest Rates and Central Banks

While rising inflation is one of the main drivers for higher interest rates, another factor supporting higher rates is the strong global economic data seen recently, including a surprisingly robust Canadian economy. These factors contributed to the major central banks shifting their views, starting with the U.S. Federal Reserve (the Fed) which raised rates at its March meeting.

Factors supporting an earlier policy decision are inflation trending towards the Fed's objective of 2%, and a tight labour market that is considered close to maximum employment (amid an unemployment rate below 5%). However, one thing that still seems to be missing for the Fed to be confident in raising rates is strong real growth. Despite positive economic data, it appears that U.S. growth will come in below the initial forecast of 2% to 2.5% in the first quarter (BMO Economics is at 2.2%). With limited positive impact expected from fiscal policies, it is difficult to foresee a more rapid re-normalisation path for interest rates.

Furthermore, after experiencing surprising political events like Brexit and the U.S. election, the Fed seems less concerned about geo-political risk at a time when the political agenda in Europe is about to get busier, with the Dutch and French elections. News headlines have exposed the potential rise of populist votes which contributed to German 2-year yields making a new record low of -0.95% in February.

In the past, the Fed would have delayed tightening amid concerns of slowing growth, geo-political risks, and even a strengthening of the U.S. dollar. This time, not even the fact that rising inflation seems to be led by more temporary factors is enough for the Fed to delay further. This helps explain why the longer end of the U.S. yield curve has been stuck in a tight trading range so far this year, after rates rose by more than 100 basis points in the second half of 2016.

While the Fed may be shifting gears, the U.S. yield curve does not seem to be overly concerned by the rise in inflation; not only did the curve flatten lately, but the U.S. treasury 30-year bond is one of the best performing sectors so far this year, despite consumer price growth reaching the highest level since 2012. This is a sign that investors continue to expect costs to be held in check and expansionary fiscal policies could be too late to have any significant impact on economic growth this year.

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It is not the same story in Canada, where the strong fourth quarter of 2016 is carrying over into 2017, as the economy benefits from the positive windfall from commodity prices and driven by a strong labour market. The Bank of Canada (BoC) has now shifted to a neutral policy, practically eliminating the likelihood of further easing and contributing to expectation that the BoC will begin tightening at the end of 2017 (instead of in mid-2018). As the BoC continues to see persistent economic slack despite recent progress, it lowers the probability it would follow the Fed on its current tightening path, at least not yet.

The combination of better global economic growth, glimpses of inflationary pressures, low geo-political risk, and central bank's decreased appetite for easier monetary policies has contributed to rising interest rates since last summer, a bias that is likely to persist this year. This calls for greater prudence in fixed income investments. *

Portfolio Changes

The most significant change in the portfolio during the first quarter was a further reduction to bonds in favour of preferred shares. We began reducing the bond exposure in September of 2016 in favour of a number of individual preferred shares. These changes would reduce our risk to rising interest rates, increase the yield on the fixed income portion of the portfolio, and provide potentially provide more favourable tax treatment. In February, we made further reductions and purchased units of the Dynamic iShares Active Preferred Shares Exchange Traded Fund (symbol - DXP). This ETF is actively managed, broadly diversified, and provides reasonable dividend income.

Our portfolios are currently composed of a variety of asset classes including Canadian and US individual stocks, bonds, preferred shares and a "rotation" component comprised of Canadian, U.S. and International ETFs (illustrated here). The Canadian and "rotation" components performed poorly during the first quarter, while the U.S. stock component performed exceptionally well. While all components utilize the same process based on the universal law of supply and demand, the variability in returns illustrate that the process can be impacted by sector rotation in one country and not another, or by macro shifts in supply and demand globally.

Looking Forward

The rally in the U.S. as a result of the Trump election has been strong and broad based. As a result the odds of a significant correction in the near term are relatively low. However, the bull market that began in 2009 is now the longest bull market since 1900, and valuations in a number of markets globally are no longer inexpensive. As always, if we see a significant shift in risk in the markets, we will adjust our portfolios accordingly.

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If you have any specific questions regarding this summary or your portfolio, please call us.

Sincerely

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