The Cosgrove-Brock Group

Newsletter #1 **_Summer 2013_**

Rates Changing Gears?

The COSGROVE-BROCK Group

BMO Nesbitt Burns®

Making money make sense®

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Philip's Comments

We have seen all kinds of markets in the last half-year. Notably, the month of June offered up a 3.8% decline in equities in Canada and a 1.3% decline in the US.[i] Market movements in July have done much to make up for June's losses, and as this comment is being written (mid-July) equity markets in the US are hitting all-time highs, with the S&P500 approaching the 1700 point level. The tamer Canadian markets are advancing as well, though lagging behind our neighbours to the south, and near the 12,700 point level, still far off their June 2008 highs.

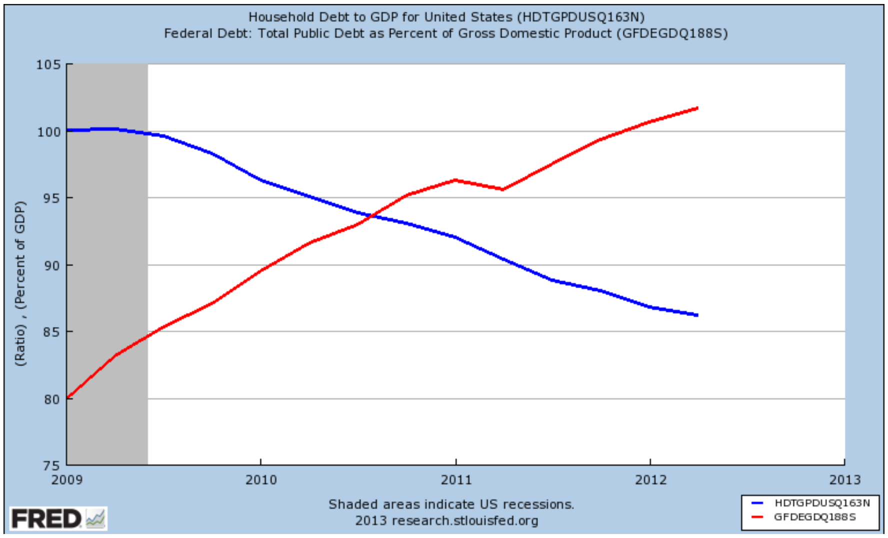
Earnings season is underway and corporate profitability seems to continue to be strong. As of now about a fifth of the S&P500 has reported earnings, and about 3 out of every 4 companies that have reported have beat analysts' expectations – with an emphasis on stronger revenues, a very encouraging sign.[ii]

Still, for those who would be tempted to say that "good times are here again", it is important to remember that we are not operating under "normal" conditions. The global economic landscape is still a debt-laden, artificially-stimulated place. We will explore the risks and opportunities that influence our thinking and how we feel investors should position themselves at this time.

Still in the Red

It has been 5 years now since the financial meltdown of 2008, but its origins are still very fresh in our memory. The US consumer, having taken on far too much debt, faced a collapsing real estate market, followed by a collapsing job market. Much has happened since then, and notably US consumers have turned the corner and begun to pay down their credit card bills. But it cost the US government dearly to supply the stimulus needed to push the US economy forward. The result is not less debt, but a shift of the debt burden from the consumer to the US government (see chart 1).

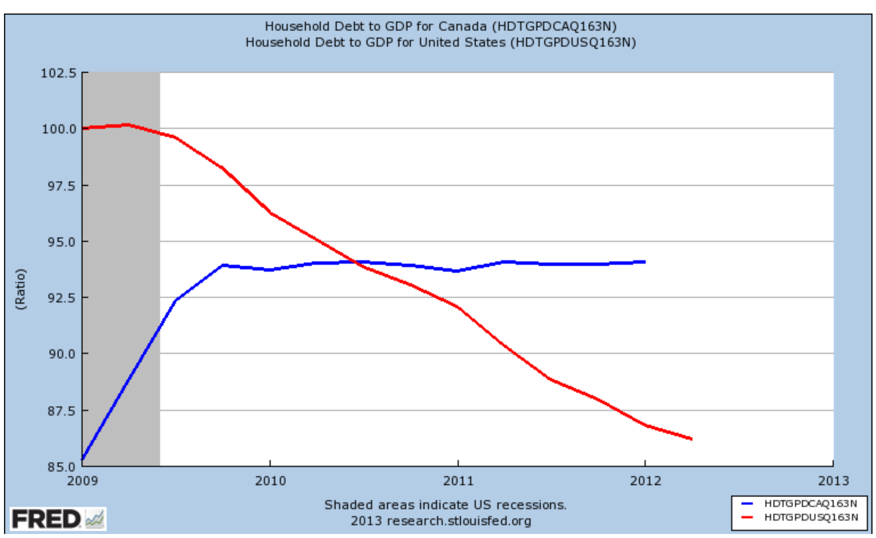
Chart 1: Shifting debt burden from consumer to government[iii]



We do not view this as purely negative. The US government, supplier of the world's reserve currency, capable of borrowing at some of the lowest interest rates in the world, is much better suited to bear this debt than a US consumer facing near record-high unemployment.

As the financial crisis began, Canadian consumers were not as deeply indebted as our American counterparts. However, one of the consequences of not feeling the full brunt of the economic crisis is that we have not had to improve our households' balance sheets like in the US (see chart 2). We now find ourselves just as levered as ever, and this will likely mean slower economic growth in Canada compared to the United States for some time to come. This forecast, combined with a strong Canadian-dollar, should point Canadian investors to broaden their portfolios.

Chart 2: Canadians haven't been paying off their debts[iv]



The process of the normalisation of debt levels amongst consumers and governments is called de-leveraging, and it is likely going to take a long time. The unwinding of so much debt will result in modest economic growth, higher savings rates, government austerity, and tightening mortgage and lending standards amongst the developed world.

The Risk of Safety

In our introduction we mentioned how the global market is a debt-laden, artificially-stimulated place. We've addressed debt so far, but what do we mean by artificially-stimulated?

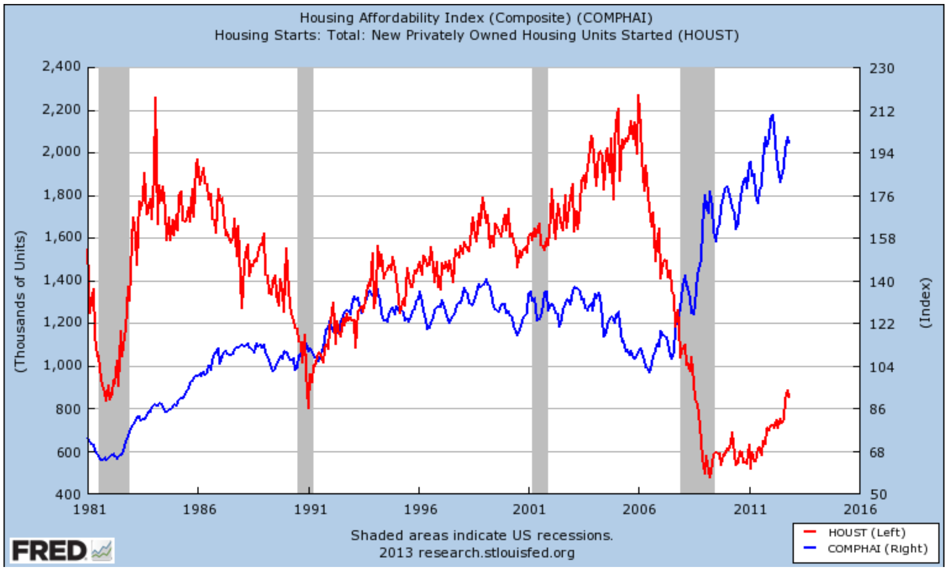
The government reaction to the financial crisis was to institute stimulus packages to spur economic activity: to use fiscal policy as a stimulant. We saw this in Canada (the "Economic Action Plan"), in the USA as well as in China. This is one of the causes of larger debt loads in developed countries. But government did not act alone – central banks also did their part through the use of monetary policy. Interest rates fell to record levels to encourage borrowing and to stimulate economic activity. The goal of an interest rate decrease, the traditional kind of stimulus at the disposal of a central bank, is to push liquidity into the marketplace. But how do you do that when interest rates are already near 0%?

Ben Bernanke, the Chairman of the US Federal Reserve, instituted "Quantitative easing (QE)", a form of central-bank driven liquidity creation that involves purchasing financial products directly from financial institutions, in order to bolster their reserves and increase the likelihood that they will lend more to the public. As this comment is written, we are on our third round of Quantitative Easing, with about $40 billion US per month being exchanged against mortgage-backed securities held by US financial institutions.

One other tactic being employed by the US Federal Reserve is to communicate clearly the timeframe of its various actions, most notably, the announcement made in September 2012 to maintain a low interest rate policy until mid-2015.

With all these measures in place, we've seen interest rates fall to historically low levels. This has helped push home affordability higher in the United States, and we're beginning to see housing recover (see chart 3).

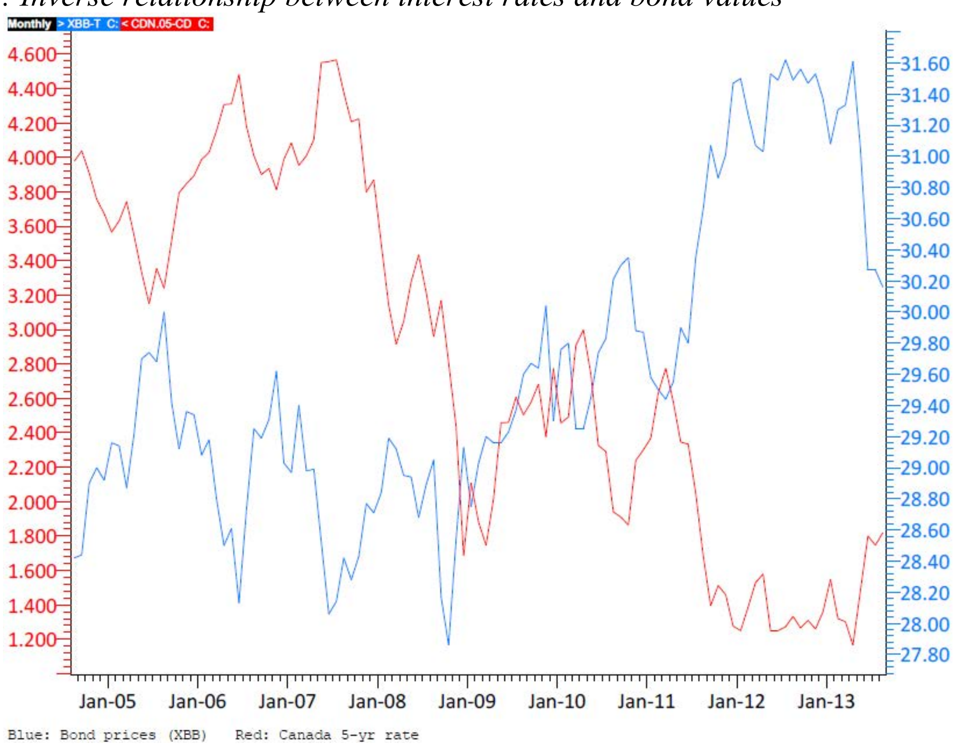
Chart 3: US housing is healing[v]



As the US housing market, the source of the 2008 financial crisis, heals, we are seeing a positive impact on economic growth in the US, as well as the stock market.

One other consequence of very low interest rates has been a very strong bond market: we have seen bond markets rise to historic heights as rates have fallen (see chart 4).

Chart 4: Inverse relationship between interest rates and bond values[vi]



This inverse relationship between interest rates and bond values is at the core of our greatest concern. It tells us that as interest rates rise, interest-sensitive financial assets will suffer. These assets are not limited to bond markets. Certain equities are sensitive to rising interest rates – notably debt-laden sectors like utilities and real estate investment trusts (REITs).

These are the very sectors that conservative investors have seen as sources of stability of late, and given the understandable flight to safety that has transpired since the financial crisis, these sectors have seen historically high prices.

But now this is starting to change. On May 22nd, in a statement before the US Congress, Ben Bernanke spoke of the possibility that "very low interest rates, if maintained for too long, could undermine financial stability". He also added that if sustained labour market improvements were evident, the US Federal Reserve could "take a step down in our pace of purchases".[vii] This refers to the eventual end of the Quantitative Easing program mentioned above. It didn't take too long for the market to interpret the potential "tapering" of the emergency stimulus measures as akin to an interest rate increase. In Canada, during the month of June, the DEX Universe Bond Index, a measure of bond prices, fell by 2%. Over the same period, interest-sensitive equities such as utilities and REITs lost 4.7% and 6.6% respectively.[viii]

The very sectors that were seen as safest – bonds, real estate, utilities – are subject to a new threat: rising interest rates.

We do not know if the events of June mark the beginning of the inevitable long-term climb of interest rates. And, as mentioned in our first section, given the debt levels of consumers and governments alike, it is likely that rates will stay low for an extended period of time. However, we feel it is not too early to begin to prepare our clients for this next big change, and we have begun to reduce exposure to interest-sensitive sectors. The high price of bonds and their sensitivity to rising interest rates is at the core of our preference for equities over bonds for the marginal dollar within the investment portfolio, and for less-interest-sensitive short-term bonds or GICs for the fixed income portion of our clients' portfolios. Furthermore, we like the idea of moderating portfolio exposure to the most interest-sensitive equity sectors as well as increasing allocation in client portfolios to a sector that does well in rising interest rate environments: life insurance companies. Life insurers need higher long-term rates to meet their obligations to policy-holders, and their stock prices generally do well when long-term interest rates rise. Increasing exposure to life insurance providers could help hedge the risk of holding interest-sensitive sectors like utilities and REITs.

Conclusion

The market that faces us is far from being free of risk or volatility. The painful process of deleveraging is sure to take its toll on growth rates for some time to come, and rising interest rates bring with them a whole set of new challenges. However, we remain convinced that equities should offer investors better outcomes going forward.

- Equities are attractively valued relative to bonds, given how richly-priced bonds have become after years of record-low interest rates. Equity P/E multiples are reasonable based on historic levels at about 15x forward earnings.[ix]

- Corporate balance sheets are generally strong, having had the opportunity to refinance debt at very low rates, and with historically high cash balances on-hand.

- For Canadian investors, a strong US market offers good relative value and the opportunity to diversify investment portfolios beyond the traditionally interest-sensitive sectors.

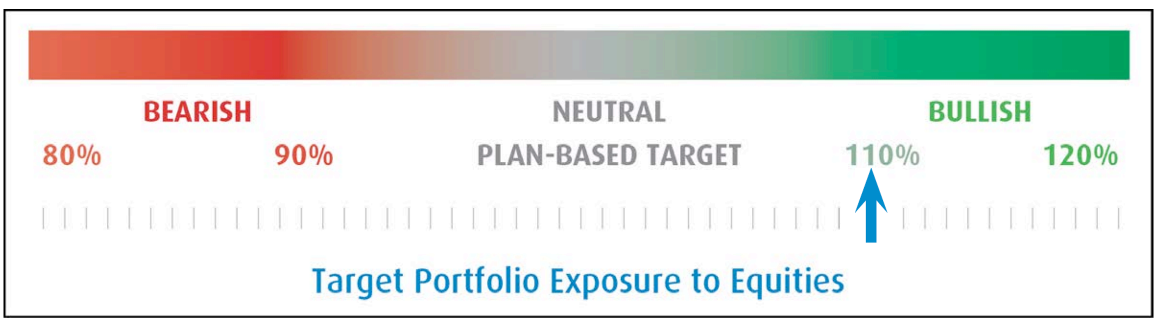
- Investors should be wary of pockets of over-valuation, especially in interest-sensitive sectors such as utilities or real estate.

- Life insurance companies can be used within the portfolio to help offset some of the risk of rising interest rates.

Asset Allocation

Every investor's asset allocation target should be determined through a financial planning process. The portfolio's equity allocation should be in line with this target when our view on the markets is "neutral". At times, financial markets will present us with possibilities for greater growth or greater risks. Modifying the asset allocation of the portfolio to account for these factors is appropriate, so long as the investor's actual asset allocation doesn't deviate too severely from their plan and remains within their investor profile and risk tolerance boundaries.

At this time, our view is that portfolios should be tilted as follows (deviations are a percentage of equity exposure, not a percentage of the total portfolio):



For example, a portfolio with a long term strategic target of 60% equity should currently be targeting a 66% equity weight, which represents 110% of the long term equity target.

Model Portfolio Metrics

	Model Portfolio	MSCI World Index
Yield*	3.75%	2.65%
Portfolio Beta*	0.90	1.00
Number of Holdings	28	1604

Sector Allocation (Core Portfolio)

Financial Services	30.0%	20.8%
Telecom. Services	7.5%	3.7%
Utilities	7.5%	3.3%
Consumer Staples	10.0%	10.7%
Consumer Discretionary	10.0%	11.7%
Healthcare	5.0%	11.2%
Information Tech.	5.0%	11.8%
Industrials	10.0%	11.0%
Energy	10.0%	9.8%
Materials	5.0%	7.0%

*As at 2013-07-31; source: Thomson ONE

Meet Our Team

Elizabeth I. Cosgrove, CFP

Vice-President, Senior Investment Advisor and Financial Planner

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Elizabeth became an Investment Advisor in 1983 after spending her first 8 years in the business working as an assistant. She received her securities license in 1980 by successfully completing the Canadian Securities Course and the Canadian Options Course. Elizabeth achieved her Vice President status in 2004. She has been practicing financial planning as a CFP® certificant since 1998 after successfully completing all six courses offered by the Financial Planners Standards Council. Elizabeth is fluently bilingual and offers her services in either French or English.

Elizabeth was born and raised in Ottawa in a family of eight. She currently resides in Manotick with her husband David. They enjoy golfing, gardening, bird watching and playing music.

Philip Brock, CFA, CFP, B.Com

Investment Advisor and Financial Planner

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Since his entry in the financial industry in 2004, Philip has advised many families on retirement planning, personal credit, and investment management. He holds a Bachelor's degree in Commerce from the University of Ottawa and holds the Chartered Financial Analyst (CFA) designation. In addition, he has been practicing financial planning as a CFP® certificant since 2007. Philip is happy to offer his services in French, English or Spanish.

Born in Montreal, Philip has lived in the National Capital Region since 1987. He currently calls Orléans home along with his wife Kathleen and their young son, David. When he's not providing financial advice to his clients, he can usually be found on the curling rink or off in the woods on a canoe trip.

Patricia Butler, B.A.

Associate Investment Advisor

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Patricia has been in the financial services industry since 1985. She received a B.A. from Concordia University in 1987 and has completed the Canadian Securities Course and the Professional Financial Planning Course. She joined BMO Nesbitt Burns in March 2004. As Associate Investment Advisor, she engages with our clients around issues of financial planning and portfolio maintenance among others. Patricia is fluently bilingual and is happy to assist you in either French or English.

Patricia enjoys reading, playing soccer and golf and spending time with her husband and two children.

Debbie Kelly

Administrative Assistant

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Debbie joined BMO Nesbitt Burns in 1999 after a career in banking. Debbie takes care of all the administrative needs of the team. She will be happy to assist you with any inquiries you may have regarding your accounts. It is also her role to reach out to our clients to coordinate the scheduling of periodic review meetings.

Debbie grew up in a large family in the Pontiac and currently makes Orléans her home. She enjoys spending time with her three granddaughters.

[i] Asset Manager (July 2013) – Bloomberg, PC Bond

[ii] Global Equity Weekly (July 19, 2013), BMO Captial Markets

[iii] Economic Research, Federal Reserve Bank of St. Louis

[iv] Economic Research, Federal Reserve Bank of St. Louis

[v] Economic Research, Federal Reserve Bank of St. Louis

[vi] Thomson ONE

[vii] Testimony Before the Joint Economic Committee, US Congress, Chairman Ben S. Bernanke (May 22 2013)

[viii] Asset Manager (July 2013)

[ix] Asset Manager (July 2013)

[x] Profiles for GE, JCI, NA, TD, BNS, TRP, VET, BCE, IFC, MFC and TGT replicated from June 2013 Canadian Equities Guided Portfolio and US Equities Guided Portfolio, BMO Nesbitt Burns Portfolio, Action and Research Team.

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