The Cosgrove-Brock Group

Newsletter #3 | *Summer 2014*

"Are we there yet?"

The COSGROVE-BROCK Group

BMO Nesbitt Burns®

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Philip's Comments

As the father of a four-year-old, if there is one phrase that can summarise the summer road-trip season, it would have to be "***Are we there yet?***"

From our clients' perspective, if there is one phrase that can summarise investor sentiment right now, "***We must be due for a correction***" is probably it.

Since the publication of last winter's newsletter, titled "*Holding Course*", we have done just that, and investors have been rewarded through the continued strong performance of their equity assets. Over this time period markets have continued their ascent to new highs with the S&P 500 hitting almost 1,990 points and the S&P/TSX Composite moving to almost 15,400 points by mid to late July – both record closes and representing 11% and 12% increases respectively since the end of January.[i]

As this newsletter is being written (late July), corporate earnings are being released for the second quarter of 2014. Prior indications were for a strong earnings season and so far this has been the case. Once again corporate profitability seems to have come in very strong, with positive surprises in the technology and financial sectors. The engine of our global economy – the corporate sector – seems well-oiled and finely tuned at the moment.

So what about this long-awaited correction?

Global geo-political events seem to have delivered enough instability to have us spin our wheels for a time. On the measurement date of this newsletter – July 31st – markets gave us a taste of turbulence. In recent months we have witnessed great upheaval in Iraq, Eastern Europe, and most recently renewed violence between Israël and Hamas militants in Gaza. These events can be massive in their societal implications and markets certainly do not ignore them but we ought to remember that there is not a single calendar year in which we cannot point to at least three or four major news items as reasons to fear equity markets. Major world events like the Japanese Tsunami or the Arab Spring may have a huge human and historical impact but at times the market impact can be muted. Over the long run corporate profitability, financial stability, and economic growth will determine the trajectory of markets far more than global strife and instability.

Much of this newsletter will be devoted to the argument that, barring the short-term effects of such "page 1" news items, the long-feared correction may not come just yet – or if it does then it will likely be modest and one of only a few corrections in the current market cycle. Our view remains generally positive despite the sense of vertigo that we are all starting to get when we look at equity markets. In the rest of this text we will present to you the reasoning behind our positive outlook.

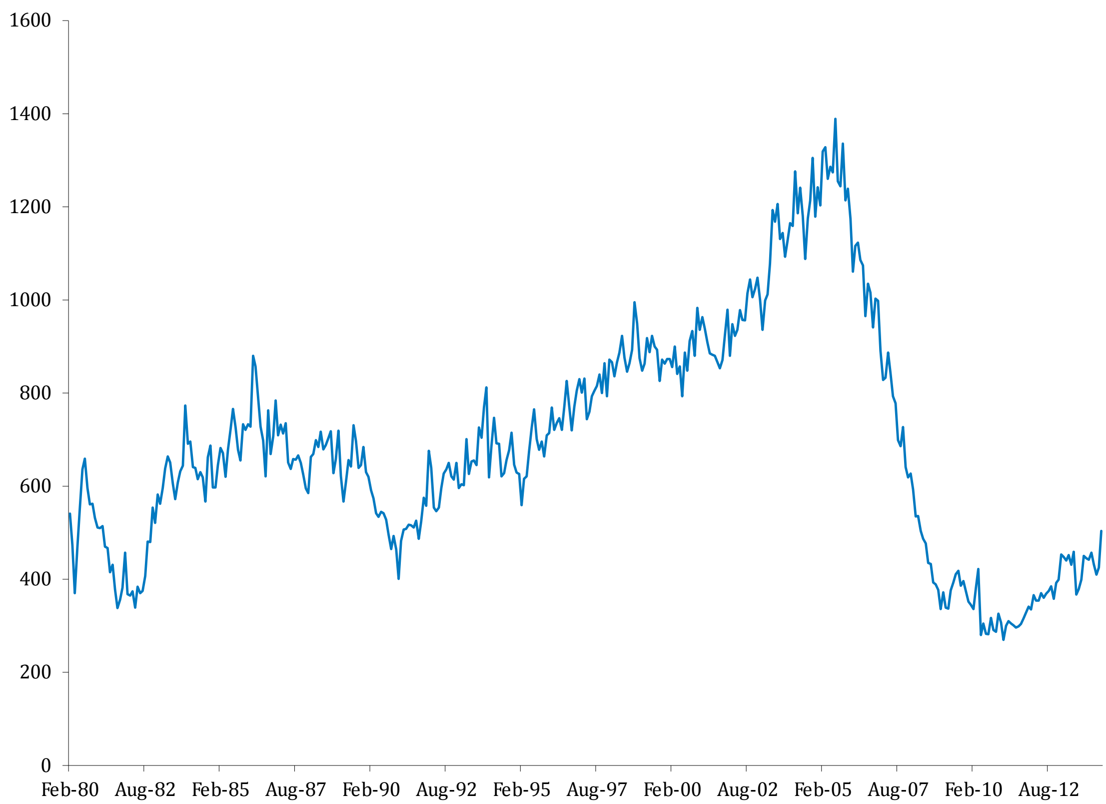
Fuel in the tank

The single strongest argument for the resilience of the stock market is the continued recovery, and indeed renaissance, of the US economy.

The effect of the 2008 financial crisis was truly traumatic to the US consumer who was beset by a simultaneous massive increase in unemployment and a vast reduction in net worth due to shrinking financial assets and real assets. It will not be news to our clients that the US economy is actively recovering from the effects of the crisis. In fact it can be argued that strong US equity returns have been a consequence of this recovery, which has been ongoing for years.

What may be more surprising is the argument that there is still likely quite a bit of gas in the tank.

Figure 1: US New Home Sales Since 1980 (thousands of units)



Source: Private Client Research, Bloomberg

Figure 1 shows that US new home sales have certainly been on the road to recovery but are still very far from the levels of the mid 2000's. Further, Figure 2 shows us that US house prices are nowhere near Canadian levels (though our gravity-defying housing sector may not be a great benchmark).

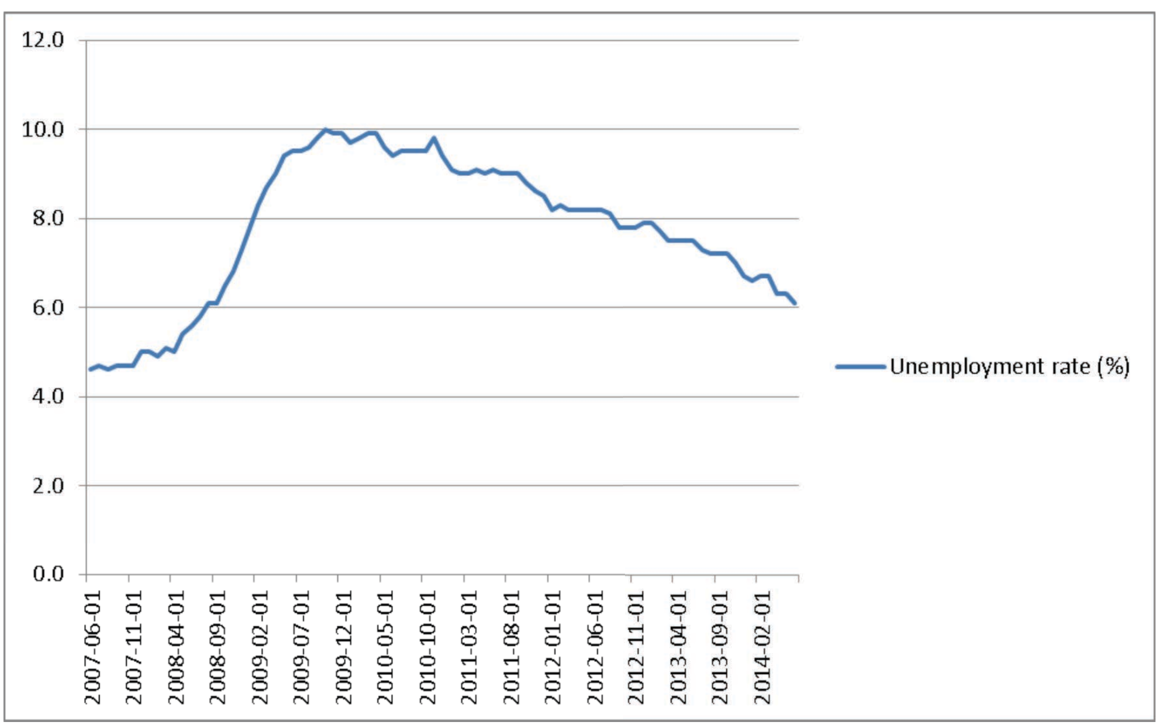
Figure 2: US Home Prices vs. Canadian Home Prices (local currency, thousands of dollars)

Source: Private Client Research, BMO Capital Markets Economics

The complete recovery of this sector could have momentous consequences to the US financial, construction, and manufacturing sectors. Not to mention the direct effect on the consumer's balance sheet of growing housing prices – a "Wealth Effect" that can easily translate to increased consumer confidence and spending.

While we will later make the argument that interest rates are bound to rise – which would be a clear headwind to continued recovery of the US housing market – most commentators would point to interest rates staying relatively low for a long time. Further, we have seen a drastic improvement in terms of US employment levels (see Figure 3).

Figure 3: US Civilian Unemployment Rate (%, monthly, seasonally adjusted)



Source: Economic Research Division, Federal Reserve Bank of St. Louis

Take one part low interest rates, one part increasing levels of employment, and one part low housing costs, and the reasons for our belief in the sustainability of a continued US housing recovery become quite clear. The effect of such a recovery on the broader US economy cannot be overstated: it is a key reason why our model portfolio boasts a strong US component – a component primarily focused on US consumer and business spending: sectors such as consumer staples, consumer discretionary, industrials and technology are dominated by US equities in our model.

Lessons from the past

Our sense of optimism should not be confused for recklessness. We are clear-eyed about the fact that risk remains present whenever we invest. However, there are historical precedents for extended periods of positive growth and low volatility in markets.

One of our sources of market analysis, François Trahan of Cornerstone Macro, points to the 1990's as a good proxy for the state of markets today[ii]. Though economic conditions varied (as they would over any decade) much of the 1990's was marked by strong economic growth, a strong US dollar, and moderate inflation.

Trahan highlights an interesting fact: between the 20% market drop that began in July of 1990 (precipitated by the Gulf War and ensuing concerns about the price of oil) and the 18% drop that began in July of 1998 during the Russian financial crisis, the S&P 500 advanced for 8 years without succumbing to a 10% correction. He further highlights that what corrections took place in the 1990's were rather short – the longest lasting only 91 days. That is enough time to get three investment statements: not a very pleasant quarter, but still very short in terms of the lifecycle of an investment portfolio!

We mention this anecdote not at as suggestion that the past is bound to repeat itself nor as a suggestion that a hand-picked time period can teach us any clear lessons about the present. However the lesson we *do* learn is that markets have the capacity, under the right conditions, to advance significantly with few interruptions for lengthy periods of time.

The key question is 'are the conditions we currently face conducive enough to growth for this kind of lengthy advance to occur.'

Those conditions: modest inflation, stimulative interest rates, strong corporate balance sheets, strong corporate earnings, improving public and private finances, and an improving employment picture can all be witnessed right now in our neighbours to the south. We are not making a claim that markets have nowhere to go but up but we do think that up is the likeliest place for them to go.

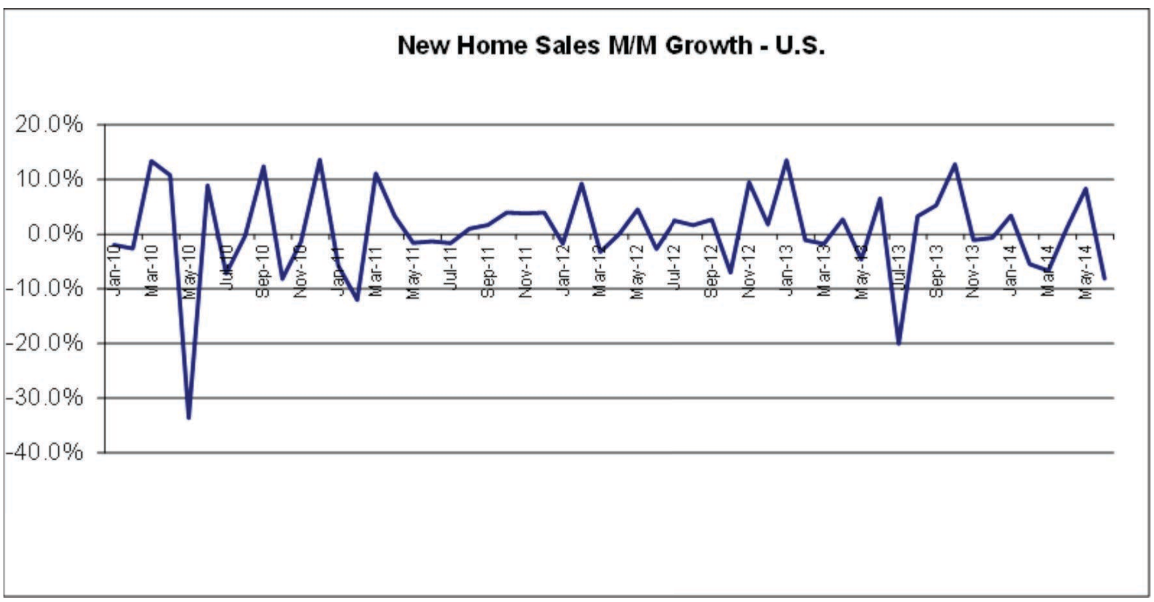
Speed limits

While we have strong conviction that the picture for equities is positive and is likely to remain so for some time, it is important to take a moment to discuss those factors that have the capacity to slow such an advance – or even to reverse it.

By its very nature economic data is unstable. Externalities such as weather, political realities and (as discussed) geo-politics all have the capacity to throw a wrench in our gears.

As an example of this, Figure 4 speaks to the month/month growth in new housing sales in the US – effectively our main argument for strong markets in this newsletter. As this is being written we've been delivered a very underwhelming June result: housing demand was 8% lower than the prior year.[iii] Should this rattle our investment thesis? Certainly if this datapoint were to become a trend we would be forced to rethink things. However, as Figure 4 so clearly shows, data of this kind is very volatile. So long as the ingredients for growth and recovery are there we can expect a positive chemical reaction to take place.

Figure 4: US Month-Over-Month New Home Sales Growth (%)

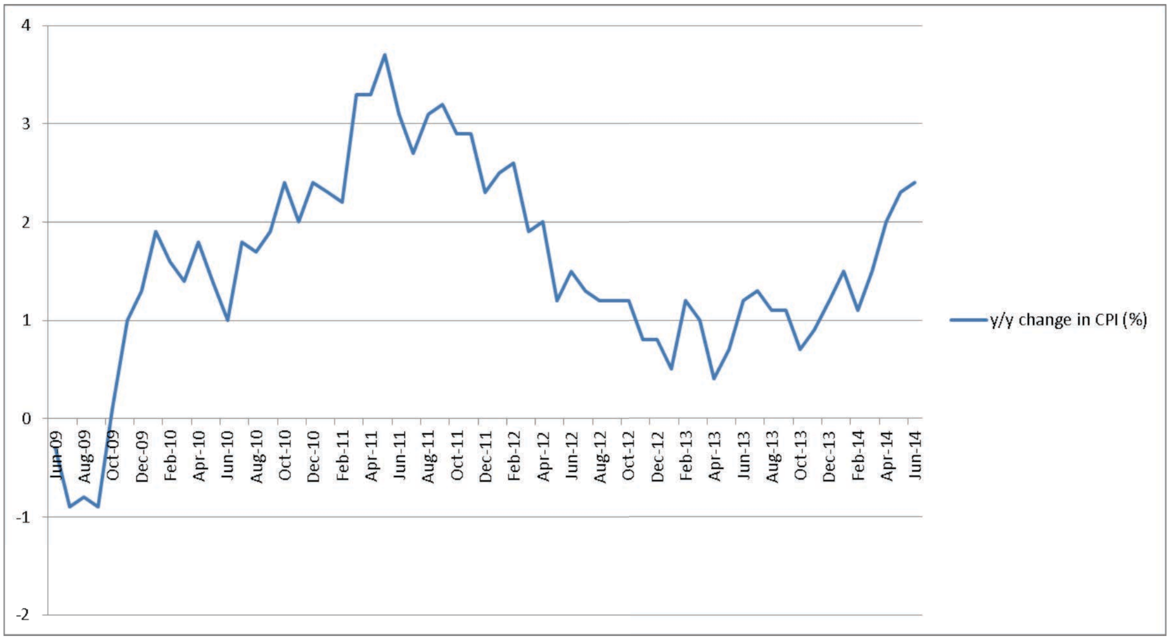


Source: BMO Private Client Strategy, Bloomberg

It would also be important to refer back to the core message of our two previous newsletters: "*Rates shifting gears?*" and "*Holding Course*". The concern we raised in those two texts was the seemingly inevitable ascent of interest rates. It is still our belief that the single biggest challenge money managers will face in the next phase of the market is asset management in a time of consistently rising interest rates. We have been working to make our clients' portfolios ready for this new reality by limiting exposure to very rate-sensitive sectors like utilities and real estate investment trusts (REITs) and increasing exposure to life insurance companies. We are also beginning to add floating-rate preferred shares to non-registered fixed income portfolios as a way to shorten the duration, and therefore the rate-sensitivity, of those portfolios.

So what would be the catalyst for central banks to begin to adjust their current course and raise short-term rates? Inflation would be the chief suspect – as central banks see it as their main enemy, and increases to interest rates their main ammunition. Finally, in the context we described above of lower unemployment, strong and healthy global corporations, and stronger public and private finances, we may be starting to see inflation return – albeit modestly – after a notable absence (see Figure 5).

Figure 5: Canadian Consumer Price Index (12-month % change)



Source: Statistics Canada

As long as this return to an inflationary environment is tempered by gradually increasing interest rates and measured action by global central bankers we have reason to continue to be positive about the direction of equity markets. The US Federal Reserve is continually reducing the "Quantitative Easing" stimulus program and we find ourselves perhaps within a year of the 2015 timeframe[iv] that the former chair of the Fed, Ben Bernanke, had suggested for rates to begin to rise again.

It has been a smooth ride of late and we have lots of freshly paved road ahead: but as we continue to administer our clients' portfolios we have both hands firmly on the wheel – attentive to what we will find around the next bend.

Conclusion

We are not advising a major deviation from our strategy for the moment. The growth prospects of the US market still compare favourably to most other markets. While investors must act in accordance to their personalised asset allocation target, which takes into account risk tolerance, we feel that equities provide investors with a better risk/reward trade-off than fixed income securities.

- Though many current geo-political events threaten to undermine investor confidence it is our belief that the underpinnings of the current economy – lower unemployment, low interest rates, controlled inflation, strong corporate profitability, and strengthening public and private finances – should provide the right conditions to shorten and shallow any market corrections.

- These same conditions are providing a strong backdrop for a continued recovery in the US housing sector. While this recovery has been and will continue to be volatile it has the potential to strengthen consumer confidence and spur a "Wealth Effect" that pushes consumer spending higher.

- Historically, periods of market calm like the one we have recently lived through can occur and be prolonged if the right conditions are in place. Volatility, corrections, and even bear markets will always be with us – as we have seen in the dying days of July. Generally though we see current conditions as favourable to growing markets.

- The possibility of rising interest rates – the chief concern we highlighted in our Summer 2013 and Winter 2014 newsletters – continues to be top-of-mind. Recent economic data points to a re-emergence of inflationary pressures which could foreshadow central bank action to increase short-term rates. We continue to advise lower exposures to utilities and real estate investment trusts (REITs) and higher exposures to life insurance companies. When appropriate, we may also advise the inclusion of floating-rate preferred shares as a portion of non-registered fixed income portfolios.

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 does not 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.

Please note that our Model Portfolio is meant to be a guide as to the equity portion of our clients' portfolios – not their entire portfolio. Clients who have *Balanced* or *Income* investor profiles will require significant assets in fixed income securities in addition to the equities they hold.

Model Portfolio Metrics

	Model Portfolio	MSCI World Index
Yield*	3.31%	2.43%
Portfolio Beta*	0.88	1.00
Number of Holdings	28	1611

Sector Allocation (Core Portfolio)

Financial Services	30.0%	20.6%
Telecom. Services	7.5%	3.5%
Utilities	7.5%	3.4%
Consumer Staples	10.0%	9.7%
Consumer Discretionary	10.0%	11.9%
Healthcare	5.0%	11.7%
Information Tech.	5.0%	12.3%
Industrials	10.0%	11.2%
Energy	10.0%	10.1%
Materials	5.0%	5.7%

*As at 2014-07-31; 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 sons, David and Jonathan. 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.

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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] ECM Canada Daily Market Commentary – July 23 2014

[ii] Cornerstone Macro, Portfolio Strategy – June 30 2014

[iii] BMO CM Economics Newsflash: U.S. New Home Sales (June) – July 24 2014

[iv] Zero Interest Rates Will Continue Until At Least Mid-2015, Bernanke Promises, Robert Lenzner, Forbes.com – December 20 2013

[v] Profiles for GE, ECA, ITW, JCI, NA, TD, BNS, TRP, VET, BCE, IFC, MFC and MCD replicated from the June 2014 Canadian Equities Guided Portfolio and US Equities Guided Portfolio, BMO Nesbitt Burns Portfolio, Action and Research Team – June 2014

MSCI World Index, MSCI Inc, www.msci.com

U.S. Housing Sector Recovery Revisited, Investment Themes, Portfolio, Action & Research Team, BMO Nesbitt Burns – June 2014

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