A Familiar **Feeling**

BMO Wealth Management
BMO Nesbitt Burns

The COSGROVE-BROCK Group

Table of Contents

Philip’s Comments

What year is this? And why does it feel like we have been here before?

Here are a few headlines that we are being subjected to this summer:

- *Greek referendum call prolongs political uncertainty and raises capital fears (The Guardian, June 2015)*

- *Emerging markets had biggest outflow since 2009: JP Morgan (Economic Times, July 2015)*

- *Saskatchewan wildfires could burn until fall (The Canadian Press, July 2015)*

- *Federal election is a toss-up: poll (News 1130, July 2015)*

Sound familiar? These very same headlines could have been drawn straight off the front page of any newspaper in 2011.   The parallels are uncanny – a real walk down memory lane:

- *Greek cabinet back’s PM’s call for bailout referendum (Associated Press, Nov 2011)*

- *Analysis: Emerging markets face capital exodus again (Reuters, Sep 2011)*

- *No way out: Smoke hampers evacuation of northern Saskatchewan fly-in community (Globe and Mail, June 2011)*

- *Federal Election: the real issues in this campaign (Toronto Star, March 2011)*

Equity returns in 2011 were lacklustre to be sure: in Canada the S&P/TSX Composite Index generated a total return of -8.71% and on the American side the S&P500 provided a total return of 2.11%[1]. How could we expect otherwise with the full-blown existential crisis in the European Union that took place over the summer of 2011?

“Lacklustre” would also be a word that we could apply to 2015 so far: the S&P/TSX Composite Index produced a year-to-date total return of 0.59% (to July 31st) and the S&P500 index generated a total return of 3.35% over the same time period[2]. The price of oil and the value of the Canadian dollar as compared to its US counterpart are both at similar levels now to where they were when we published our last newsletter, “*A Crudely Built Economy*”, in January. As in 2011, this summer has also brought what some are calling an existential crisis for the Eurozone. As we explain below, we generally feel that these fears are overblown, but the uncertainty that the Greek situation has caused will be no help to markets this year.

With any luck, the parallels to 2011 will continue in the next few years: equity market returns in both Canada and the United States were very positive in each of the three years following 2011.

Whether this will transpire or not is impossible to know ahead of time but we feel that there is a strong case for positive equity returns in the medium term – especially as it relates to US equities and those Canadian equities that benefit directly from US economic growth.

As this newsletter is being written corporate earnings for the second quarter of 2015 are being released. Of the US companies that have reported, roughly 75% of them have reported earnings that are above analyst's expectations, and over 50% of them have exceeded expectations on their revenue number[3]. This is evidence of continued stability in corporate America, despite volatility caused by the broader economic and political issues we describe in this issue of our newsletter.

The Greek tragedy

The story that has dominated headlines so far this summer is the continuing "Greek tragedy" – and the situation has provided for plenty of theatrics. Unable to meet its financial obligations, Greece needs emergency funding as well as a longer-term "bailout" from its European neighbours.

Act one was the initial negotiation with the "Troika": the International Monetary Fund (IMF), the European Commission (EC) and the European Central Bank (ECB), and the adversarial approach taken by Greek finance minister Yanis Varoufakis, who recently compared the terms of the latest agreement to "fiscal waterboarding".

Act two was the surprise referendum called by Greek Prime Minister Alexis Tsipras, the victory of the "No" vote, rejecting the initial proposal by Greece's creditors, and the subsequent resignation of minister Varoufakis, widely seen as a step to appease the country's creditors.

Act three was the subsequent round of negotiations, highlighted by the firm stance taken by German Chancellor Angela Merkel, and finally an agreement that would allow Greece to enter into negotiations on the details of an 86 billion Euro bailout over the next three years. In order for these final negotiations to begin Greece has to implement massive legislative changes. At the time this commentary is being written, Tsipras has successfully passed two legislative packages trough Greece's parliament, relying on opposition support to do so[4].

On August 20th Greece must make a 3.2 billion Euro payment to the European Central Bank[5]. This is the next in a seemingly constant stream of "deadlines" for Greece. The obtaining of the bailout funding seems likely at this point, given the legislative changes that have been achieved at the request of Greece's creditors. But we can be sure that there is a fourth act ahead of us – and probably a fifth, and a sixth, and a seventh…

How much attention does the Canadian investor need to pay to what is transpiring in Greece at the moment? The financial crisis of 2008 taught us that that the interconnectedness of international finance can cause a problem in one part of the world (in 2008 it was the US housing market) to be very consequential globally. However, it is important to view the Greek problem with the proper perspective[6]:

- Greece's share of European gross domestic product (GDP) is a very modest 1.8% (see figure 1).

- Greece accounts for approximately one two-thousanth (0.05%) of both Canadian and US exports.

- Greek debt is held primarily by the European public sector rather than private bondholders. This is a marked difference from the situation the world faced during the financial crisis of 2008, when the questionable debt securities were held predominantly in private hands, which lead to concerns over "counterparty risk" – the risk that the financial institution on the other side of your transaction is unable make good on its commitments due to the health of its balance sheet.

Figure 1: Euro Members – Share of Euro Area GDP

Euro Members

Share of Euro Area GDP [1]

Country	Share	Country	Share
Germany	28.7	Portugal	1.7
France	21.1	Slovakia	0.7
Italy	16.0	Luxembourg	0.5
Spain	10.5	Slovenia	0.4
Netherlands	6.6	Lithuania	0.4
Belgium	4.0	Latvia	0.2
Austria	3.3	Estonia	0.2
Finland	2.0	Cyprus	0.2
Ireland	1.8	Malta	0.1
Greece	**1.8**		

[1] latest four quarters of available data (to 2014:Q3); sum of countries does not equal 100 due to rounding

Source: D. Porter, BMO Capital Markets Economic Research, July 2015

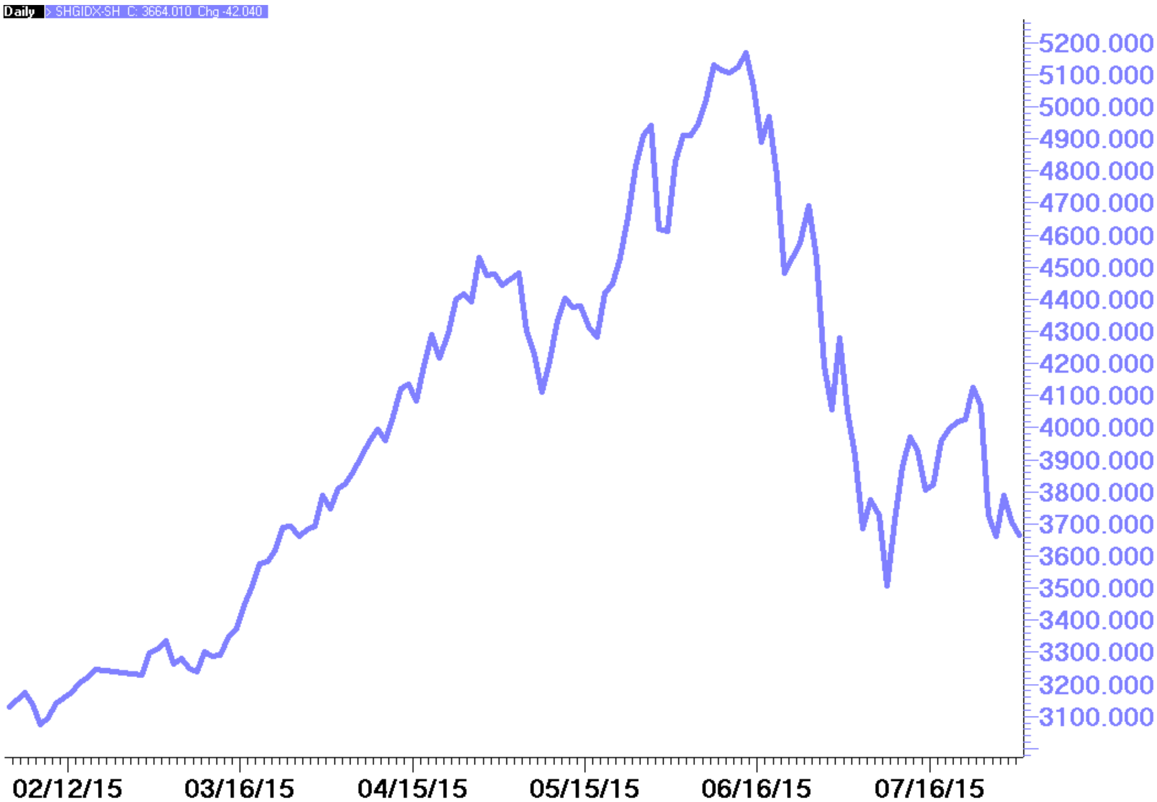
The play is not over yet and it likely will lead to more pain for Greece. Markets will keep a close watch on the evolution of this story and it will continue to be a source of uncertainty and volatility. However, given the size of the Greek economy and the lengthy lead-time European institutions have had to prepare this situation, our belief is that the actual consequences to the global economy – and the North American economy in particular – of a Greek exit from the Eurozone are limited.

Closer to home

To discuss the state of markets in Canada we must look just about as far away from Canada as possible – to the Middle-East and Asia.

Much noise was made this summer of a ferocious stock market correction in China. The Shanghai Composite Index fell 29% in a six week period from mid-June to the end of July (see Figure 2)[7]. The Chinese government imposed an unprecedented "freeze-up" – suspending securities from trading in an effort to calm the market. Just as debt has been the cause of Greece's public finance problem, margin debt (or loans by investors) is one of the central causes of the recent instability in the Chinese market.

Figure 2: Rise and fall of the Shanghai Composite Index



Source: Thomson One

Despite this, China's economy is still growing at an annual rate of 7%[8]. The concern for Canada is that the nature of this growth has veered away from industrial-based and infrastructure-based growth to growth driven by domestic spending by the Chinese consumer. The result of this: lower demand for commodities and energy and therefore lower prices for the natural resources that Canada sells to the world.

Meanwhile, after months of negotiations an agreement has been reached with the Iranian government over the development of nuclear energy in Iran. This could eventually lead to a lifting of sanctions and an increase in oil production by Iran. On the whole this would lead to a greater supply of oil and lower prices which would be no help to our Canadian energy producers. However, as Earl Sweet, Senior Economist with BMO Capital Markets, mentions in a recent publication[9]:

> *Although Iran has about 30-to-40 million barrels in floating inventories that could be delivered relatively quickly, that is unlikely to have a major impact on a global market where annual demand is in the vicinity of 34 billion barrels. It would likely take about a year for Iran to increase exports by about 500,000 barrels/day. Over this period, the [International Energy Agency] projects that global demand will increase by around 1.4 million barrels per day.*

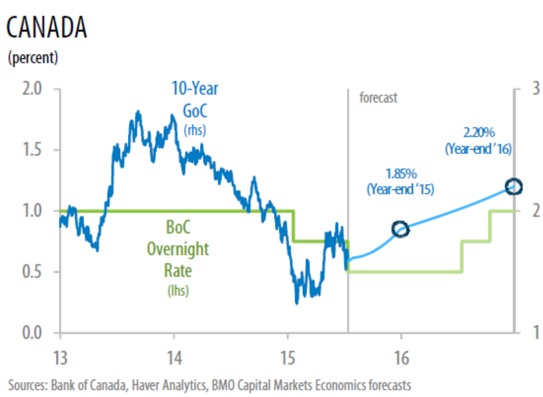
It is likely that investors have over-estimated the downward pressure that this agreement will apply to the price of oil.

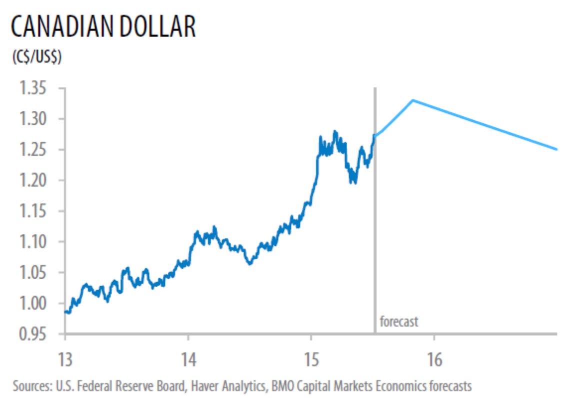
These situations abroad have a very clear impact on our domestic economy: lower resource prices. The Canadian economy (and the Canadian stock market) is dominated by energy and natural resource companies who suffer when the prices of the commodities they produce are depressed.

The Bank of Canada has seen the danger that low commodity prices pose to our economy and, just like in January, on July 15th Governor Poloz decided to cut the Bank's key lending rate by another 0.25% to 0.50%. In contrast, on the very same day, US Federal Reserve Chair Janet Yellen reiterated her intention to begin to increase interest rates in the United States later this year during testimony she gave to the US Congress[10].

Many factors affect the USD / CAD exchange rate, but none more than the two countries' comparative interest rates. When US rates rise as Canadian rates fall, we can expect the Loonie to drop, and indeed it did in July. On July 1st, one Canadian dollar was worth 0.80 US dollars. On July 24th, the Canadian dollar had fallen by approximately 3.5 US cents to 0.766 US dollars - a significant drop[11]. Given that Canada is heading into a fall federal election with a very uncertain outcome, BMO Capital Markets forecasts a 75 cent dollar by October. This summer's volatility has brought us most of the way there (see figures 3 and 4)[12].

Figure 3 and 4: Path and forecast of Canadian interest rates and the Canadian dollar





Source: Rates Scenario, BMO Capital Markets Economic Research, July 2015

Conditions for global growth

After a difficult 2011, markets drove higher in the ensuing three years. This occurred because conditions were favourable for economic growth. It also occurred because during this period the US Federal Reserve was stimulating the economy through quantitative easing – the bond purchase system that aggressively pushed liquidity into financial markets.

The Fed ended quantitative easing (QE) last October, but many other factors are at play that are providing stimulus to the economy. It is the combination of these factors that we feel will drive equity markets higher in the medium term, as was the case post-2011.

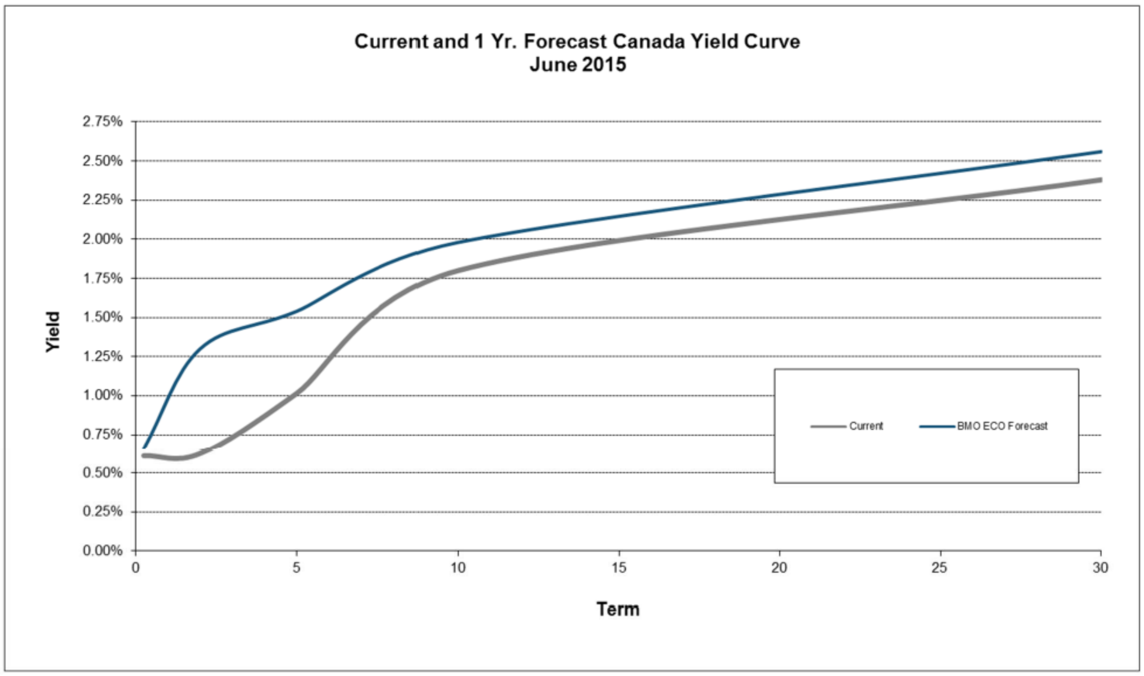
Interest rates

- Interest rates are low around the world and they continue to fall: 83 governments around the world have cut interest rates in the last year.[13]

- Quantitative easing is ongoing in Europe and Japan, providing liquidity in those markets much like the QE program in the US did while it was in effect.[14]

- Not only are rates low, but the yield curve is positively slanted and is steepening (see figure 5). The yield curve is the structure of interest rates in the market. It is also one of the best predictors of markets available: a steepening yield curve is generally followed within an 18 to 24 month timeframe by strong markets, and a negative yield curve (when long term rates are lower than short term rates) is often followed (18 to 24 months later) by negative markets.[15]

Figure 5: Current and 1yr forecast Canada yield curve



Source: Bloomberg, BMO Nesbitt Burns Private Client Research, BMO Capital Markets Economic Research, June 2015

- Low interest rates are a key element to housing affordability, which in turn should help fuel a recovery of the US housing sector, as we discussed in depth in last summer's newsletter, entitled "*Are we there yet?*"

Commodity prices

- For Canada, low commodity prices are an economic headwind, but it is not so for larger economies such as Europe, Japan and in particular the United States.

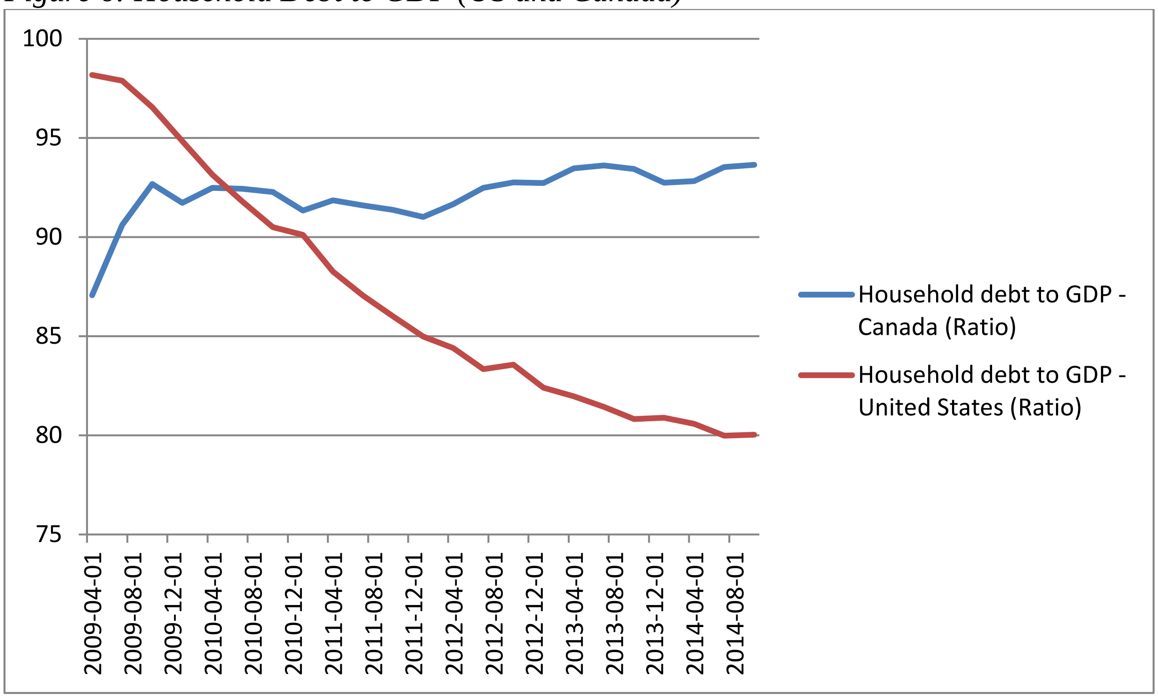
- Decreasing energy prices provide a stimulant to the global economy by increasing disposable income for the consumer (less money paid at the pump allows for spending on other goods and services) and decreasing the costs of production for industry.

Debt

- As mentioned above the commonality between the Greek situation and the Chinese situation is indebtedness – government debt in the case of Greece and investor debt in the case of China.

- Just as debt is working against these economies, lower debt levels are positioning the US consumer as a source of economic growth in the coming years. Unlike in Canada, US consumers have decreased their debt load substantially since the financial crisis (see figure 6).[16]

Figure 6: Household Debt to GDP (US and Canada)



Source: St. Louis Federal Reserve

- This helps insulate the US consumer from economic volatility, and sets up an important component to economic growth: consumer spending.

In sum, despite worries and headline news regarding situations beyond our shores, we feel that the backdrop is in place for the continued growth of the equity portion of our clients' portfolios. Low interest rates and a steepening yield curve, accommodative central bank policies such as quantitative easing, low commodity prices and lesser consumer debt levels in the United States should all contribute to providing the global economy with enough momentum to see itself through this familiar moment in time.

Conclusion

In the last six months equity markets have been weighed down by concerns over commodity prices, political stability in Europe and slowing Chinese growth. We continue to believe that the model portfolio – with its significant exposure to the US dollar and its modest volatility – is well suited for the current environment and for continued growth as equity markets normalise.

- A major source of market volatility this summer has been the situation in Greece. While news from Greece will likely continue to affect markets in the short term, in the long term we do not feel that the Greek economy is a large enough piece of the larger European economy or of North American exports to derail economic growth.

- Low commodity prices, low interest rates, accommodative monetary policy in Europe and Japan (quantitative easing) and a financially healthy US consumer have provided enormous stimulus to the global economy. We believe that in the medium term the positive impact of this stimulus will overshadow the short-term volatility markets have been subjected to this summer.

- Energy prices remain low due to a problem of over-supply, slowing growth in China and the fear of increased production due to the possible lifting of economic sanctions in Iran. This will be a headwind for the Canadian economy, but is real stimulus for most of the world, in particular the United States. We have been pleased our model portfolio's allocation to Energy stocks has been far smaller than the weight of the Energy sector in the Canadian stock market. To account for the decrease in value of energy-related companies we are decreasing our target weight for Energy from 10% to 5%, in favour of Consumer Staples (+1%), Consumer Discretionary (+1%), Industrials (+1%), Information Technology (+1%), and Healthcare (+1%).

- By focusing on shorter-term maturities we are maintaining our defensive posture in the fixed income side of our clients' portfolios. This will best prepare us for a rising interest rate environment.

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[17]
Yield*	3.51%	2.46%
Portfolio Beta*	0.88	1.00
Number of Holdings	28	1645

Sector Allocation (Core Portfolio)

Financial Services	30.0%	21.0%
Telecom. Services	7.5%	3.3%
Utilities	7.5%	3.0%
Consumer Staples	11.0%	9.7%
Consumer Discretionary	11.0%	13.2%
Healthcare	6.0%	13.5%
Information Tech.	6.0%	13.3%
Industrials	11.0%	10.7%
Energy	5.0%	7.3%
Materials	5.0%	5.1%

*As at 2015-07-31; source: Thomson ONE

Meet Our Team

Elizabeth I. Cosgrove, CFP

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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

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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.

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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

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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.

[1, 2] S&P Dow Jones Indices, McGraw Hill Financial, *S&P 500* and *S&P/TSX Composite (CAD)*, July 31 2015

[3] BMO Capital Markets, Economic Research, *Global Equity Weekly*, Robert Kavcic – Senior Economist, July 24 2015

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[5] CNN Money, *Greece: Next steps before in can get bailout*, Ivana Kottasova, July 21 2015

[6] BMO Capital Markets, Economic Research, *10 Reasons Investors Shouldn't Fear Greece… Much*, Douglas Porter, CFA, Chief Economist, July 3, 2015

[7, 11] Thomson One

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[9] BMO Capital Markets, Economic Research, *Focus – Iran Deal: Impact on Oil and Canada*, Earl Sweet, Senior Economist, July 17, 2015

[10] USA Today, *Fed's Yellen reiterates she expects rate hike this year*, Paul Davidson, July 15 2015

[12] BMO Capital Markets, Economic Research, *Rates Scenario*, Michael Gregory, CFA, Deputy Chief Economist, Benjamin Reitzes, Senior Economist, July 16, 2015

[13, 14] Cornerstone Macro, *What's Driving the Business Cycle? (A Past and Present Look)*, François Trahan, Michael Kantrowitz, Emily Needell, CFA, July 13 2015

[15] BMO Nesbitt Burns Portfolio, Action & Research Team, *Asset Manager – July 2015 Equity Strategy: Steeper Yield Curve Bullish for Stocks and We Went Back to 1927 to Prove It*, Stéphane Rochon, July 2015

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

[17] MSCI World Index, MSCI Inc, www.msci.com

[18] Profiles for BNS, BCE, GE, GIS, GWO, ITW, IFC, JCI, JNJ, MFC, NA, TD, and TRP replicated from the June 2015 Canadian Equities Guided Portfolio and US Equities Guided Portfolio, BMO Nesbitt Burns Portfolio, Action and Research Team, June 2015

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