Two Uncertain **Votes**

BMO Gestion de patrimoine
BMO Nesbitt Burns

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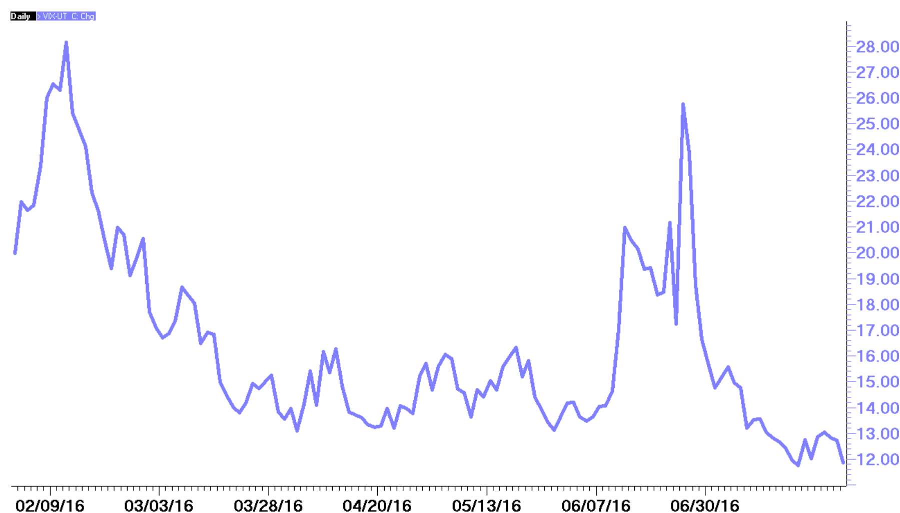
Philip's Comments

The S&P/TSX Composite Index is up 15%[1] since the publication of our last newsletter at the beginning of February and the S&P500 is up 12%[2] over the same time period. This speaks to how well markets have done, but also how quickly the volatility in January abated.

In fact, the period from February 1st to July 31st 2016 saw gradually reducing market volatility[3] (see Figure 1), with the exception of a spike in the month of June, caused by the market's surprise about the outcome of British referendum on participation in the European Union.

Figure 1: Chicago Board of Exchange Volatility Index (VIX) – February 1 – July 31 2016



Source: Thomson One

Over the same time period, we have seen the Canadian dollar strengthen against its US counterpart, gaining 5 cents (or 7%) to close at the end of July at 0.7669 cents US[4]. This is in no small part due to the recovery in the price of oil, which increased by almost $10 / barrel over the same 6-month time period. This represents an increase of almost 32%[5].

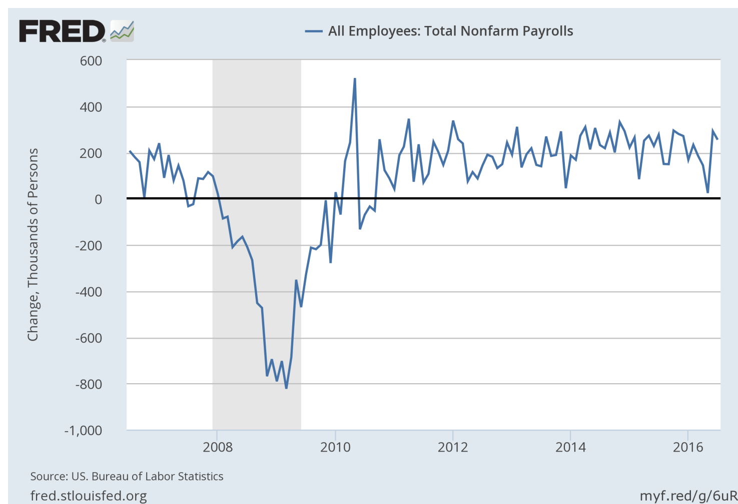
At the time of the writing of this newsletter, we find ourselves part-way through the release of 2nd quarter corporate earnings. So far, we are seeing approximately 80% of reporting companies topping analysts' expectations[6]. If we take a longer term perspective, the financial services sector, commodities, and the energy sector have all seen earnings decline on an annualized basis since the first quarter of 2007. This is understandable, given what has occurred to the prices of oil and base metals, and considering lingering the impact of the 2008 financial crisis on the financial sector. The seven other industrial sectors have all seen positive growth in earnings over the same time horizon[7]. This tells us that despite bouts of market volatility and uncertainty, over the longer term growth in corporate earnings has been progressing at an encouraging pace.

The State of the ~~Union~~ Market

We remain generally upbeat about markets, as many economic indicators seem pointed in the right direction (US jobs, US housing, and business spending, for example).

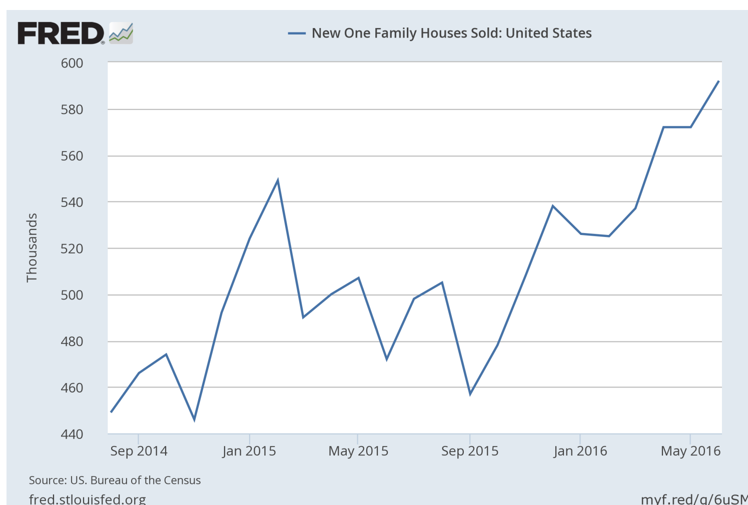
On the US jobs front, we have seen good consistency (with a few surprises along the way) in job creation (see Figure 2). While jobs are not necessarily considered a leading indicator, they are a convincing sign of economic health. On average, over the last 6 months, 189,000 jobs have been created every month[8].

Figure 2: Monthly change, US Nonfarm Payrolls – trailing last 10 years



It should not be surprising that as the employment picture improves, so does the US housing market. In our Summer 2014 newsletter, titled *"Are we there yet?"*, we made the case for the recovery of the US housing market providing fuel for a broader economic recovery[9]. Since then, we have seen a continued improvement in US housing starts, and also sales of new homes[10] (see Figure 3).

Figure 3: U.S. New Home Sales



To quote ourselves from our newsletter two years ago, and express a sentiment in which we still have conviction:

> *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.*

If jobs and housing are the domain of the consumer, it is good to see that the business sector is also on the right track. The US ISM New Orders index, which looks at new orders by a sampling of purchasing executives, is widely considered to be a leading economic indicator. It is firmly in positive territory, currently sitting well above the neutral score of 50[11] (see Figure 4).

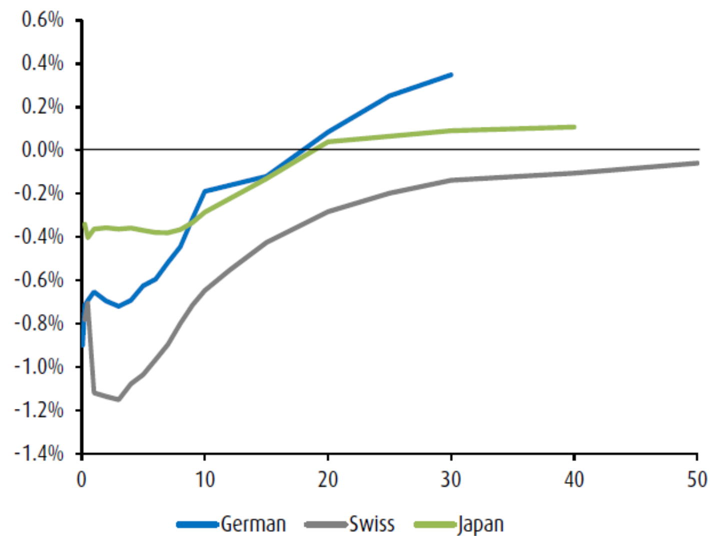
Figure 4: S&P 500 Index Monthly Y/Y Return and ISM New Orders

Source: BMO Nesbitt Burns, Bloomberg

Part of the explanation for these positive macroeconomic indicators may be the significant financial stimulus currently at play – very low interest rates, accommodative policies from central banks, and low oil prices are all providing fuel for markets.

Central banks around the world have kept rates very low and kept their monetary policy accommodative – which is to say that they are trying to stimulate economic growth. In some areas, rates have been pushed so far down that they have entered negative territory[12] (see Figure 5). In Europe and Japan there are currently over $10 trillion US in negative-yielding securities[13].

Figure 5: German, Swiss and Japanese Bond Yield Curves (horizontal axis in years)



Despite this real evidence that financial markets are on firmer footing, just as real are the sources of uncertainty that we have had to contend with recently – and that we will need to contend with in the near future. Uncertainty can come in many forms, and the prevalence of negative interest rates and their impact on the future health of the bond market, is adding to this uncertainty. However, in our view the likeliest source of concern for markets going forward stems from two votes, an ocean apart.

The Twin Tribunes

"Democracy is the worst form of government, except for all the others."

— Winston S. Churchill

As we referred to in Figure 1, the largest spike in market volatility that transpired in the last 6 months took place on account of the "Brexit" referendum vote in Great Britain, meant to decide on whether or not the U.K. would continue to exist as a member of the European Union. In advance of the vote, public opinion polls showed a very tight race, and yet it was still a surprise, and an affront to over 40 years of gradual European integration and broader globalization, that on June 23rd citizens of the United Kingdom voted fifty-two percent in favour of leaving the EU. The British Prime Minister, David Cameron – whose election promise of a referendum set the U.K. on course for the vote – committed to resign after the defeat of his favoured "remain" side.

Predictably, these events resulted in a negative reaction by financial markets. The S&P500 fell by over 5% over the ensuing two trading sessions[14]. Over the ensuing two weeks, the British Pound fell more than 13%[15]. Since then the Pound has remained weak, but after their initial decline, equity markets have strengthened over the course of July, apparently appreciating the quick selection of Prime Minister Theresa May as a

replacement to David Cameron, and also underlining that the U.K. economy, while significant in the context of Europe, is but a small part of a much larger global picture.

While markets seem to have taken the immediate aftermath of the U.K. vote in stride, the deeper concern is over the longer term disruptions and uncertainties caused by "Brexit". Significant uncertainty remains around the timing and the process of the U.K.'s departure. Some even continue to question whether or not it will take place, though the consensus seems to be that it will, and that it will slow economic growth in Britain and in the EU, and decrease the trade of goods and services between the two neighbours. Uncertainty also exists around the desire among other EU member nations to hold their own referendums, as well as Scotland – which strongly favoured remaining a part of the European Union – possibly holding a second referendum on its own independence. As Prime Minister May has committed to not formally initiating the withdrawal of the U.K. from the EU until next year[16], the uncertainty surrounding "Brexit" will be with us for some time.

"No government is perfect. One of the chief virtues of a democracy, however, is that its defects are always visible and under democratic processes can be pointed out and corrected."

— Harry S. Truman

The UK referendum is not the only vote that is making headlines, as we are also in the midst of a historic US presidential election. Hillary Clinton's candidacy is historic because for the first time a woman is the nominee of one of the two major American political parties. The story though of this electoral campaign so far has been the candidacy of the Republican nominee, Donald Trump, and his unconventional approach to campaigning.

Markets respond poorly to uncertainty. The nature of the Republican nominee's campaign for the presidency is such that were he to win or to appear to be in a position to win come the fall, markets would have to contend with the unknown.

These comments do not constitute a comparative analysis of the Democratic and Republican platforms, in terms of which policies would be more market-friendly. Conventional wisdom states that Republican presidents are more pro-market, though an analysis of historical rates of return would indicate that markets tend to do better during Democratic administrations[17].

Some opinion polls have shown the race to be close, and some polls have shown Clinton with a solid lead. Whatever the polls say, it is important to remember that the American president is not elected by popular vote, but rather by proportion of vote in the Electoral College, which is distributed on a state-by-state basis. If recent polls are looked at from this perspective, Hillary Clinton's lead over Trump grows wider[18]. As of right now, the electoral math does not seem to favour Donald Trump, and it may be because of this that markets have taken his ascendance to the Republican nomination with relative calm. There are many days left between now and November, and this election has to potential to contribute to significant uncertainty for markets which would increase overall market volatility.

Conclusion

The first half of 2016 has seen an abatement of the volatility we witnessed in the first few weeks of the year. We feel that this more positive stance for markets is well-justified by a broadly accommodative monetary policy as well as some key macro-economic indicators.

- Indicators such as employment, housing, and business spending all seem to point to a healthy economic environment for stocks. We would expect that as long as these indicators remain positive, markets should be well supported.

- The prevalence of negative interest rates in some parts of the world – the side effect of extremely accommodative monetary policy, does add some uncertainty to the macroeconomic picture, in particular as it relates to the future health of the bond market.

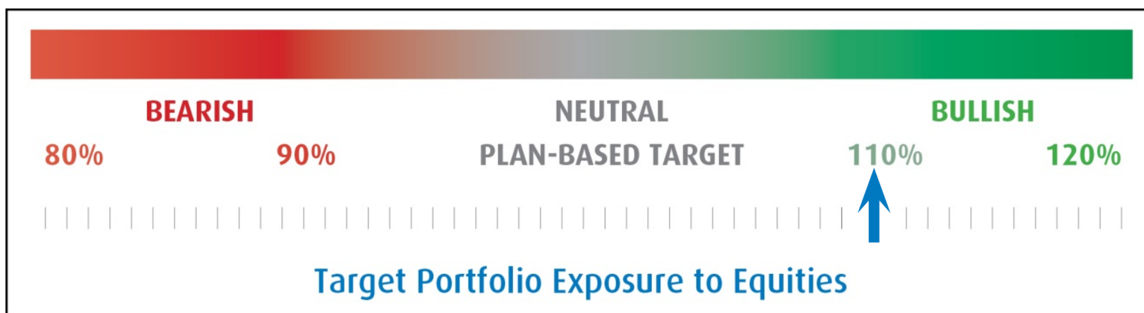
- The "Brexit" vote has added an element of uncertainty to the European economic picture, but markets have adjusted very well after initial shock around the outcome of the vote. The longer term process of exiting the European Union will be a real test for future European and British economic growth.

- The US Election in November will be an added source of uncertainty this year. Current opinion polls seem to favour a Democratic victory. This is likely the market's preferred outcome given that a Donald Trump's approach to public policy has yet to be clearly articulated, and Clinton's track record is well known.

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[19]
Yield*	3.13%	2.66%
Portfolio Beta*	0.91	1.00
Number of Holdings	28	1645

Sector Allocation (Core Portfolio)

	Model Portfolio	MSCI World Index
Financial Services	30.0%	19.0%
Telecom. Services	7.5%	3.7%
Utilities	7.5%	3.7%
Consumer Staples	11.0%	11.3%
Consumer Discretionary	11.0%	12.4%
Healthcare	6.0%	13.3%
Information Tech.	6.0%	14.0%
Industrials	11.0%	10.9%
Energy	5.0%	7.0%
Materials	5.0%	4.7%

*As at 2016-07-29; 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, F.Pl., 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, and has held the *Institut Québécois de planification financière*'s F.Pl. designation since 2015. 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, Jonathan and Nicolas. 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

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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.

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