# One Border, **Two Stories**

BMO Wealth Management
BMO Nesbitt Burns

The COSGROVE-BROCK Group

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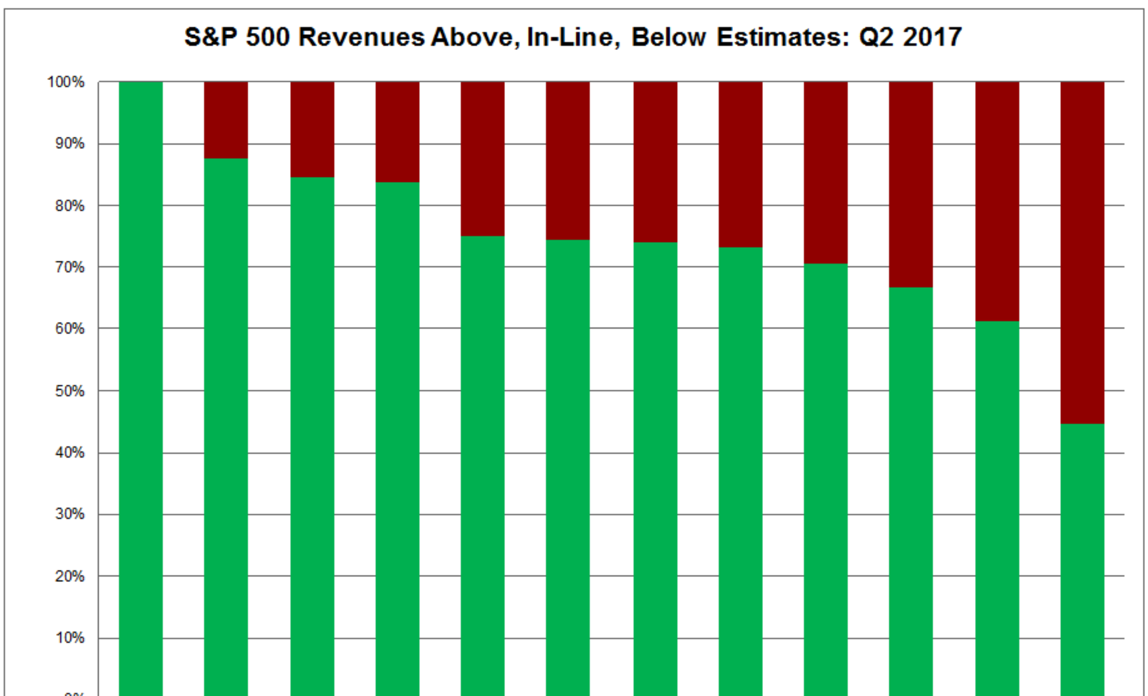
# Philip's Comments

So far, 2017 has seen markets on both sides of the border take opposite paths, with US markets pushing significantly higher – up approximately 8.0% since February 1st, and Canadian markets softening slightly – down approximately 1.5% over the same time period[1].

In Canada, the real star in this period has been the advancement of our Loonie, which has seen an increase in part due to actions by our central bank. USD/CAD opened at 76.73 cents on February 1st, and currently is trading just above 80 cents – up a solid 4% over the last 6 months[2]. For Canadian investors with US holdings, this has unfortunately moderated portfolio returns, though the silver lining is that we are now more comfortable adding new USD positions to investment portfolios.

Second quarter corporate earnings are currently in the process of being released, and up to now the trend of accelerating earnings and revenue growth is holding true. On the sales revenue side to July 31st, 73% of S&P 500 companies that have reported have posted numbers above estimates (see Figure 1), a number that is amongst the highest in this category in the last 10 years. In terms of actual earnings, a similar number of companies that have reported - 73% - have reported profits above expectations[3].

*Figure 1: S&P 500 Revenues Above, In-Line, Below Estimates: Q2 2017*




| | Telecom Services | Energy | Materials | Info. Technology | Consumer Staples | Health Care | Financials | S&P 500 | Industrials | Real Estate | Consumer Disc. | Utilities |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Below | 0% | 13% | 15% | 16% | 25% | 26% | 26% | 27% | 29% | 33% | 39% | 56% |
| In-Line | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Above | 100% | 88% | 85% | 84% | 75% | 74% | 74% | 73% | 71% | 67% | 61% | 44% |

Source: FactSet

Source: FactSet, S&P 500 Q2 Earnings Season Update: July 28

In our winter 2017 newsletter "*POTUS: Precarious Potential"* we spent some time "looking past the tweets", in an attempt to underline the fact that markets are more richly inspired by fundamental economic data than they are by political winds. The last six months have proven that with good enough economic data, even a political tornado can be overcome.

In this, our Summer/Fall 2017 newsletter titled "One Border, Two Stories", we compare and contrast the recent performance of US and Canadian equity markets, and make the case that it is truly economic, sector, and corporate fundamentals that dictate the direction of markets, rather than the dizzying political news cycle.

## The US Picture: Political Noise and Market Clarity

The last six months have challenged even the most voracious consumers of news media with a steady tide of unprecedented headlines from Washington. Following the trials and tribulations of the administration of Donald Trump has not been for the weak of heart. Since his inauguration, we have seen:

- Numerous high-level White House staff resignations and firings, including Chief of Staff, Communications Director, Chief Strategist, and Press Secretary.

- Failed or curtailed policy initiatives, including legal challenges to travel restrictions, and an inability to repeal and replace the Affordable Care Act (a.k.a. "Obamacare").

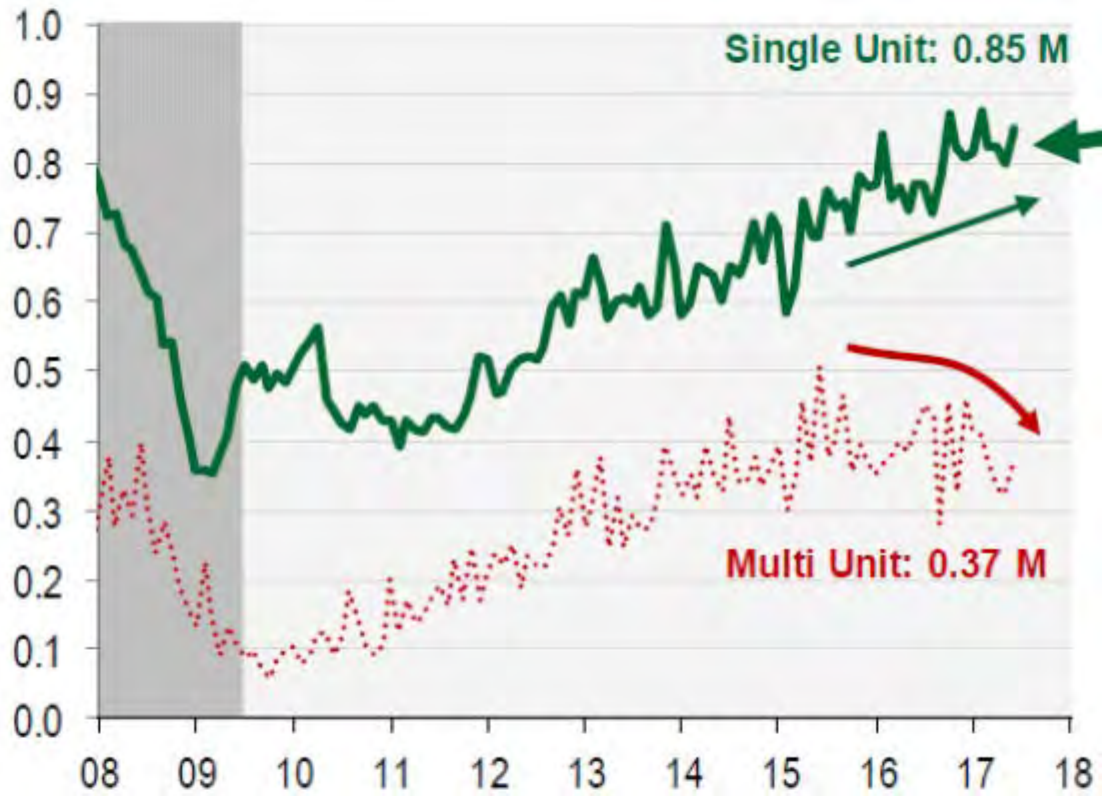
- A presidential firing of the head of the FBI, and an all-out Justice Department investigation into Russian interference in the 2016 presidential election.

If equity markets were necessarily tethered to the politically-charged news cycle, we would have expected the last six months to have been disastrous. However, since the opening bell on the morning of February 1st, the S&P 500 index has gained a total of 186 points to close at 2472 points at the end of the day on July 28th. This represents a solid pace of growth: 8% higher over a 6 month period[4].

In our view, much of this growth can be explained by some very positive economic news: with positive housing start numbers (see Figure 2)[5], strong levels of consumer confidence[6], corporate earnings growth[7], and modest inflation[8]. Interest rates remain low and continue to provide economic stimulus, and private and corporate balance sheets remain strong.

While evolving political dynamics in the White House and Congress may lead to short term shocks that could result in market adjustments, our belief is that the underlying strength of the US economy will continue to provide a positive environment for growth. In most cases, markets will care more about earnings data and economic data, than matters of public policy.

*Figure 2: US Housing Starts – Single Unit vs. Multi Unit*




Source: Cornerstone Macro, Portfolio Advisory Team, Afternoon Update – August 1 2017

What will likely have an impact on markets is the apparent intention of the US Federal Reserve to start "balance sheet normalisation" this fall[9] – in other words curtail some of the extra stimulus for which it has been responsible. The mere fact that the Fed feels comfortable moving in this direction is a confirmation of a strengthening economic position south of the border.

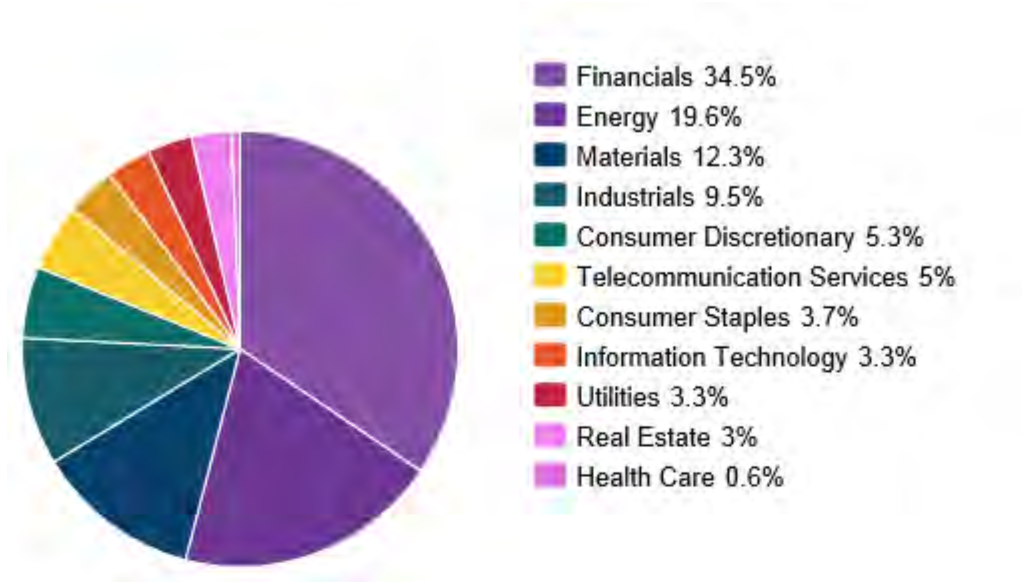
## The Canadian Picture: Economic Growth and a Lagging Market

Meanwhile, the picture in Canada since the beginning of the year has been one of a surprisingly strong currency, an engaged central bank (with the Bank of Canada's first interest rate increase in seven years), and a housing market pushing ever-higher – up 5% nation-wide in June, despite the implementation of a 15% "non-resident buyers" tax in parts of British Columbia and Ontario[10].

These factors contributed to Canadian GDP numbers in May showing 4.6% growth – the highest growth rate in 17 years[11].

Despite this good economic news, the Canadian stock market has been soft over this time period, and the sector concentration of our stock market is partly to blame. A look at the S&P TSX Composite Index (see Figure 3) reveals that Financial Services – of which Banks are the largest portion, represent 34.5% of the index, and Energy represents 20% of the index[12].

*Figure 3: Sector Weights in the S&P/TSX Composite Index*




Source: S&P Dow Jones Indices, S&P/TSX Composite Index

This is relevant as a way to explain the disconnect between Canadian economic data and market performance. Since the publication of our last newsletter, Canadian chartered banks have been hit with reports of questionable sales practices, contributing to steep declines in March. Energy stocks, for their part, have been directly impacted by very weak oil prices. In can be said that part of the weakness in Canadian stocks is a side effect of the small scale of our market, and its over-concentration is some economic sectors. Broadly speaking, the economic picture is bright.

This strong economic position is not without its risks though – our consumers are highly levered, our real estate market, in the opinion of some, is over-valued (though this is not clear-cut fact), and the first round of the renegotiation of the North American Free-Trade Agreement (NAFTA) will have begun by the time this newsletter is printed. It remains to be seen how difficult these negotiations will be for Canada, given that the press release from the US government that identified its negotiation objectives focused on the US trade imbalance with Mexico – not Canada[13].

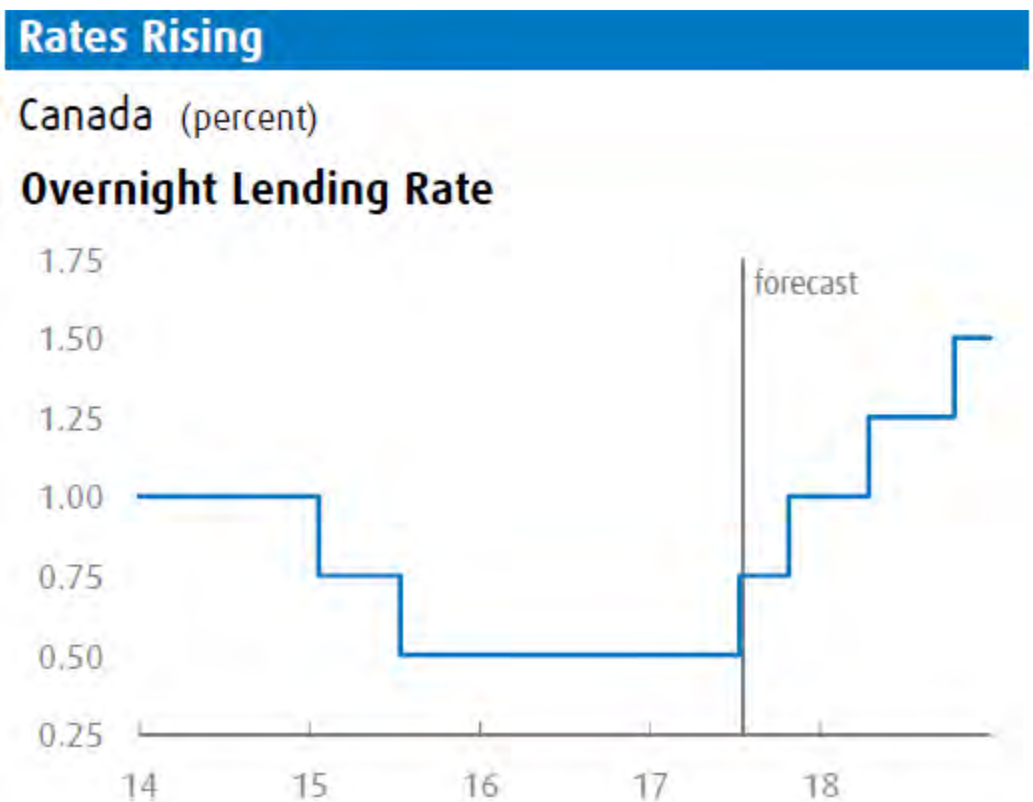
## Balancing Risk and Reward

With the publication of our last newsletter, we reiterated our belief that our clients' asset allocations should be at their long-term planning-based target. Rebalancing portfolios that have seen their equity allocation grow beyond their targeted weight is best done when the news is generally good, and markets strong and stable.

Our cautious instinct in this regard should not be confused for imminent concern over the current level of equity markets. We have seen equity valuations in the US, as measured by the Price-to-Earnings (PE) ratio, be relatively stable, despite seeing markets at all-time highs. This is because in general the earnings of the companies that comprise the market have also been growing, helping justify their current valuations[14].

When balancing an investment portfolio, we must also assess different asset classes in relation to each other. While equity valuations may seem rich to some, it is important to remember that in the last 6 months, the Bank of Canada seems to have has started on a path of increasing interest rates, with the July increase in the overnight rate (see Figure 4), and the Federal Reserve in the US is apparently on a similar path, with increases in the Fed Funds rate in March and June. During periods of rising interest rates, we can expect the bond market to underperform. As rates increase, the value of existing bond issues generally decreases, which leaves us with lowered performance expectations from fixed-income securities.

*Figure 4: Canada Overnight Lending Rate*




Source: BMO Economics, Haver Analytics, Focus, July 21 2017

In comparison, dividend-paying equities can provide a source of recurring tax-efficient income while providing investors with greater leverage to relatively strong economic realities on both sides of the border.

While each investor’s tolerance for risk must the guiding factor in the determination of an appropriate asset allocation strategy, the current context of rising interest rates and healthy economic fundamentals reinforces our belief that equities will play a central role in any well-diversified portfolio.

## Conclusion

Canadian and US markets over the last six months have taken two different paths. Meanwhile, our Loonie's rise over the same time period has prevented most Canadian investors from fully benefiting from the increase in US stocks.

- While there is serious question as to the ability of the new Trump administration to deliver on its pro-business agenda, US equity markets seem to have focused more closely on the positive elements of the American economic backdrop.

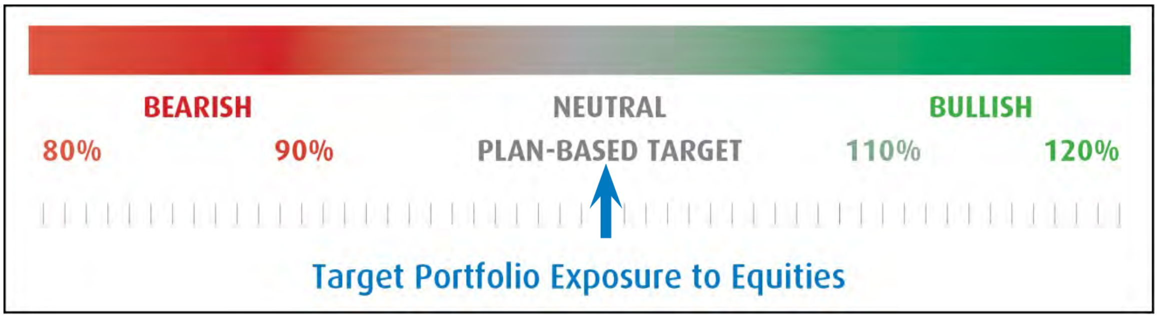
- The Canadian context is showing even more dynamic economic growth, but the rather narrow sector allocation of our stock market, and certain sector-specific challenges have caused underperformance in Canadian stocks so far this year.

- With interest rates now rising on both sides of the border, we can expect only modest returns from bond markets. Given the strong economic backdrop that is evident in Canada and the United States, we believe that dividend-paying equities will retain their place at the centre of a well-built investment portfolio.

## 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 60% equity weight, which represents 100% 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[15] |
|---|---|---|
| **Yield*** | 3.06% | 2.42% |
| **Portfolio Beta*** | 0.92 | 1.00 |
| **Number of Holdings** | 28 | 1656 |

## Sector Allocation (Core Portfolio)

| | | |
|---|---|---|
| **Financial Services** | 30.0% | 21.1% |
| **Telecom. Services** | 7.5% | 3.0% |
| **Utilities** | 7.5% | 3.2% |
| **Consumer Staples** | 11.0% | 9.7% |
| **Consumer Discretionary** | 11.0% | 12.3% |
| **Healthcare** | 6.0% | 12.6% |
| **Information Tech.** | 6.0% | 15.7% |
| **Industrials** | 11.0% | 11.5% |
| **Energy** | 5.0% | 6.0% |
| **Materials** | 5.0% | 4.9% |

*As at 2017-07-31; 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, F.Pl., B.Com

Portfolio Manager 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, 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 ski hill, 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.

[1, 2] Thomson One

[3] Butters, John, Record Number of S&P 500 Companies Beating Sales Estimates for Q2, https://insight.factset.com/earningsinsight_07.31.17, July 31 2017

[4] Thomson One

[5] Handelman, Jessica, *U.S. Housing*, Portfolio Advisory Team, Afternoon Update, August 1 2017

[6] Sheetz, Michael, *Consumer confidence strengthens in July, beating expectations for a drop*, CNBC, https://www.cnbc.com/2017/07/25/july-us-consumer-confidence.html

[7, 14] Jones, Chuck, *S&P 500's Revenue And Earnings Growth On A Solid But Underwhelming Upturn*, Forbes, July 22 2017

[8] Portfolio Advisory Team, *Portfolio Strategy*, Fixed Income Strategy, August 2017

[9] Oyedele, Akin, *Fed says unwind of its $4.5 trillion balance sheet will start 'relatively soon',* Business Insider, http://www.businessinsider.com/fed-statement-balance-sheet-interest-rates-july-meeting-2017-7, July 26 2017

[10] Handelman, Jessica, *Canadian Housing*, Portfolio Advisory Team, Afternoon Update, July 26 2017

[11] CBC News, *Canada's GDP expanded by 4.6% in the year up to May, strongest pace in 17 years*, July 18 2017

[12] S&P Dow Jones Indices, *S&P/TSX Composite (CAD)*, August 31 2017

[13] Gregory, Michael, *NAFTA Talks Set to Start*, Focus, BMO Capital Markets Economics, July 28 2017

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

[16] Profiles for BNS, BCE, CSH.UN, EMR, WN, HD, JNJ, MFC, SU, TD, and TRP replicated from the June 2017 Canadian Equities Guided Portfolio and US Equities Guided Portfolio, BMO Nesbitt Burns Portfolio Advisory Team, June 2017



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