Diverging **Paths**

BMO Wealth Management
BMO Nesbitt Burns

The COSGROVE-BROCK Group

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Philip's Comments

In late June, my wife and I took our three boys camping at Bon Echo Provincial Park, on the shores of Mazinaw Lake near Cloyne, Ontario. Despite the occasional thunderstorm, the clouds of mosquitos, and one tornado warning (welcome to Eastern Ontario in 2019), we had a lovely time. I had not been to Bon Echo since my grandparents – keen supporters of the Ontario Provincial Park system – brought me there for a day trip when I was ten or eleven years old, and I found myself reminded of the hikes I would take with my grandparents during our visits to various parks. We would often find ourselves facing a fork in the road - *Diverging Paths*. Of course, we had a trail map to help us decide what direction to take.

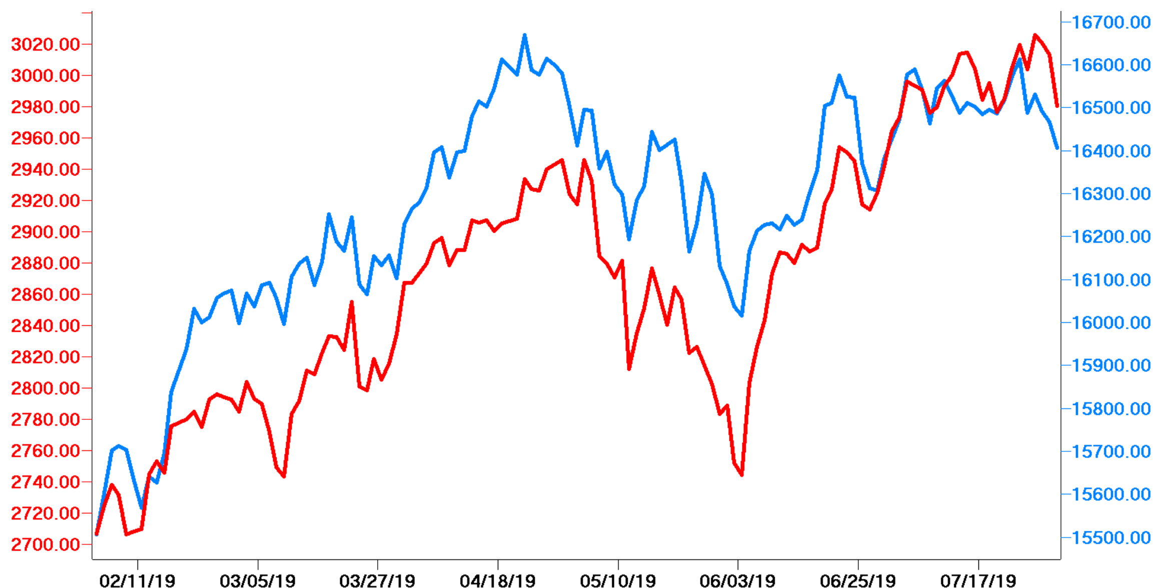
We do not get to decide what direction the global economy takes, but in the time that has elapsed since the publication of our Winter 2019 Newsletter: *Overtime for the Business Cycle*, we have clearly seen equity markets and economic data take divergent paths. Stock markets around the world took one path, continuing their advance, rebounding strongly from a difficult end to 2018.

Meanwhile, economic data has taken a rockier path, painting the picture of a slowing global economy, and a global effort by central banks around the world to prolong this decade-long economic expansion by using the monetary policy means at their disposal.

Since February 1st, the S&P500 has led the way – up 10.3%, an increase that came on the heels of January's remarkable one-month rally of 9.2%.[1]

In Canada, the S&P/TSX Composite Index climbed 5.4% over the last six months[2] – a less remarkable advance, but a strong one nonetheless (see Figure 1). The Canadian Dollar's performance was unremarkable over this time period – closing on July 31st just slightly lower than its January 31st value.[3]

Figure 1: Performance of ***S&P500*** *&* ***S&P/TSX Composite Index*** *(February 1 2019 – July 31 2019)*



Source: Thomson ONE

The evolution of markets over the last six months has reinforced our conviction that investors should be cautious in their approach to asset allocation and security selection. Rather than steering away from equities entirely, in our view caution means adopting a slightly reduced equity weight, and selecting securities from industries that demonstrate conservative characteristics, and/or that benefit from growth trajectories that are linked to structural changes in consumer behavior, rather than cyclical economic trends.

In this edition of our newsletter, we will walk down the obstacle-filled path followed by the world economy, describing the twists and turns that may await us on the road ahead. It may be possible for economic forces to proceed safely onwards – there are elements that continue to provide positive momentum as we advance. But it is the potential pitfalls that inform our more cautious approach, and so it is here that we will start.

Twists and Turns

Like it or not, the economic path before us is not clear and straight, but seems to be presenting its fair share of twists and turns. This is something of a change: it seems like just yesterday (and indeed it was not more than a few quarters ago) that the road ahead at the Federal Reserve was straight and clear, and the main monetary policy question at play was not whether rates should be cut, but rather how many rate increases would be implemented in 2019. The motivation to "normalize" rates – to reverse the emergency measures put in place after the financial crisis of 2008 – was the driving force behind monetary policy decisions in 2018. It was said that through interest-rate increases, the Fed would be re-establishing the ammunition it would eventually need should the economy truly begin to slow.

Consensus has now significantly changed, with the Fed cutting rates by 25 basis points at the July 31 meeting of the FOMC – the first interest rate *cut* in the United States since 2008 – and the futures market fully expecting *at least* one more rate cut by November of this year.[4]

Furthermore, central banks around the world are adopting similar approaches – Australia and India have cut interest rates, while other entities such as the European Central Bank as well as the Bank of England have issued dovish (more likely to cut rates) commentary: none clearer than Europe's Mario Draghi, who proclaimed that "*If the economic outlook doesn't improve and inflation doesn't strengthen, additional stimulus will be required.*"[5]

On the home front, the Bank of Canada is less likely to follow this global trend towards more accommodative monetary policy. Interest rates in Canada are already lower than in the United States, and there is concern that lower interest rates here would send our already rocketing housing market right into orbit. Could we see, with this possible divergence of central bank policy in Canada and the US, a period of firmness for the Canadian dollar? It is reasonable to expect this, as interest-rate differentials between the two countries are an important variable in the evolution of our exchange rate. BMO Capital Markets is forecasting a slightly stronger dollar – 0.7680 USD/CAD by the end of 2020 – up slightly from current levels.[6]

But what are these twists and turns in the road that are causing central banks (with the exception of ours) to reevaluate their positions and turn to more economic stimulus?

Twists: Weak manufacturing data

Over the course of the last 12 months, the Institute for Supply Management (ISM) Manufacturing Index, an indicator of commercial activity among 300 surveyed manufacturing firms, has been steadily declining (see Figure 2).

Figure 2: Evolution of the ISM manufacturing index (July 2016 – July 2019)

Source: Institute for Supply Management, via FRED (St. Louis Federal Reserve)

A score of over 50 signifies strong sentiment among manufacturing firms and is seen as a proxy for economic health. A year ago, the ISM Index sat at 58.4 for the United States, 55.1 for the Eurozone, and 53.8 for the United Kingdom. Today, these indices sit at 51.2 in the US – still indicating growth, but at a declined rate from prior levels – while the Eurozone and UK sit at 46.5 and 48.0 respectively[7] – a sign of economic contraction (see Figure 3).

Figure 3: United States – ISM Manufacturing Index (percent reporting)

	Jul	Jun	May	19Q2	19Q1	Jul 18
Manufacturing ISM	51.2	51.7	52.1	52.2	55.4	58.4
New Orders	50.8	50.0	52.7	51.5	57.0	60.8
Production	50.8	54.1	51.3	52.6	57.0	59.1
Supplier Delivery Delays	53.3	50.7	52.0	52.4	55.1	62.1
Inventories	49.5	49.1	50.9	51.0	52.7	53.3
Employment	51.7	54.5	53.7	53.5	55.1	56.8
Prices Paid	45.1	47.9	53.2	50.4	51.1	73.2
Exports	48.1	50.5	51.0	50.3	52.1	55.3
Imports	47.0	50.0	49.4	49.7	53.4	54.7
Eurozone PMI	46.5	47.6	47.7	47.7	49.1	55.1
United Kingdom PMI	48.0	48.0	49.4	50.2	53.3	53.8

Source: BMO Economics, Haver Analytics

In fact, the global Purchasing Managers Index (PMI), a similar indicator, has been declining for the last 14 consecutive months. Today, 68% of the global economy is weighed down by a negative PMI.[8]

The ISM Manufacturing Index is considered a leading indicator of US economic growth. It is reasonable to project, based on the moderation of the score over the last year, US GDP growth being challenged in the coming quarters.

Turns: Continued concerns about trade

One potential cause for the less-than-stellar PMI numbers discussed above is growing concern about the stability of the global supply chain. We live in a world that for many years believed that the economy was borderless. Companies established varied operations in different locales based on the availability of affordable manufacturing capacity (unskilled labour) and talent (skilled labour). This resulted in many large corporations moving goods across borders to maintain their operations and produce and distribute their wares. And why not? Free trade was contagious, with round after round of trade barriers falling to the might of NAFTA, the European Common Market, and the World Trade Organization. Globalization was the new world order.

Many of us continue to believe that liberalized trade, while imperfect, is a strong force for economic growth, and broad advancement in human prosperity – a tide that would raise all ships. However, even proponents of free trade will admit that liberalized trade policy had the effect of disrupting the status quo, and in many cases transported entire industrial sectors (like manufacturing) across borders, leaving certain regions and populations disadvantaged. Recent years have seen populist political actors take advantage of this phenomenon, advancing a narrative that turned the victims of this "creative destruction" into a strong political force.

We have seen this contagion spread all over the world, but nowhere more stridently than in the United States and in the United Kingdom.

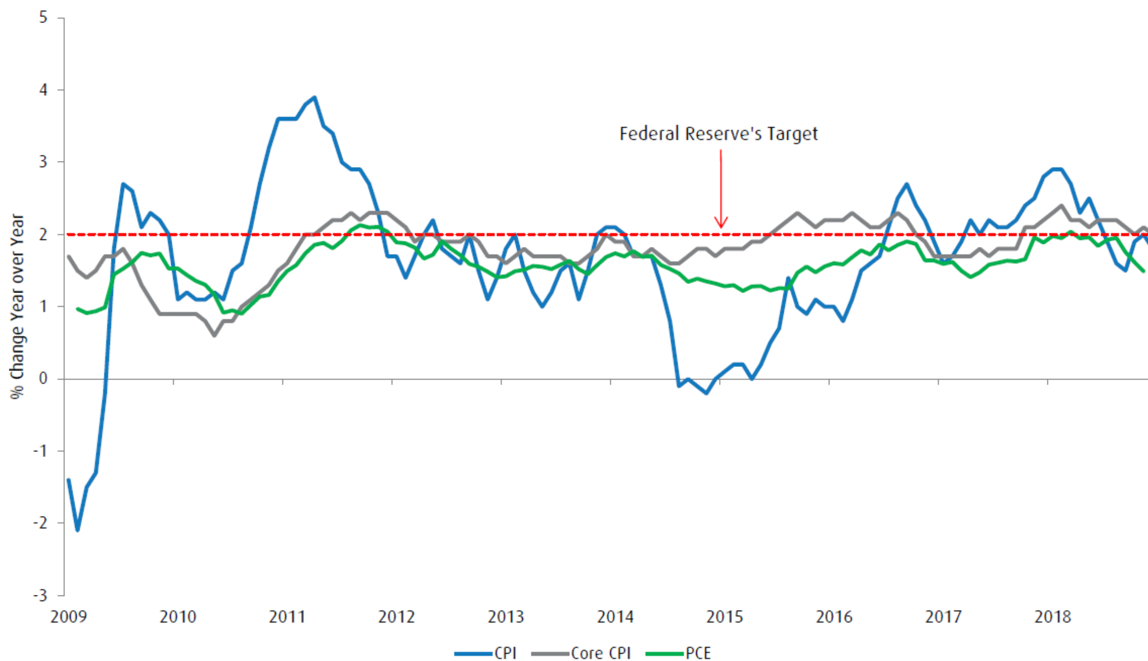
South of the border, this populism was personified in two individuals on opposite ends of the political spectrum: now-president Donald Trump, and now-presidential-candidate Bernie Sanders. Since his election, President Trump has withdrawn the US from the Trans-Pacific Partnership, forced the renegotiation of the North-American Free Trade Agreement, and imposed layer-upon-layer of new trade tariffs on friends and foes alike.

The most consequential of these measures to financial markets is the now hot trade war between China and the United States. Since March of 2018, both countries have lobbed new tariffs on hundreds of billions of dollars of imported goods back and forth across the Pacific. Not-totally-invalid accusations of unfair trade practices, currency manipulation, and intellectual property theft have permeated the discussion. The tone seemed to reach a fever pitch with the arrest in Canada of Meng Wanzhou, CFO of Huawei, and her impending extradition hearing to the United States on charges that she was part of a conspiracy to circumvent US trade sanctions on Iran, as well as bank fraud and wire fraud.[9]

Rounds of trade negotiations have – so far – not led to an agreement. A moment of respite came after the countries' leaders seemingly called a truce at the June 2019 Osaka meeting of G20 leaders.[10] Unfortunately, this was a short-lived lull in hostilities, with the US announcing on August 1st the imposition of a new tariff on $300 billion of Chinese

goods.[11] A significant concern is that this latest round of tariffs would be applied on goods that have a direct bearing on the American consumer. The resulting pass-through to the consumer may result in inflationary pressures. While inflation has remained stubbornly low over the last decade (the Federal Reserve has been under its 2% inflation target 75% of the time since the financial crisis)[12] (see Figure 4), a jump in inflation caused by trade taxes, accompanied by a broader slowdown in economic growth (see Twist #1), could see us have to dust off an economic curse-word: "stagflation" – the simultaneous combination of economic stagnation and climbing inflation.

Figure 4: Various Measures of Inflation vs. Federal Reserve's Target (2009 – 2018)



Source: Bloomberg, BMO Wealth Management Portfolio Advisory Team

This scenario is partly mitigated by technological advancement – some believe that the productivity gains brought about by accelerating technological change have been chiefly responsible in keeping inflation low for so long.[13] Given the current context, we hope this is the case!

In the United Kingdom, this phenomenon has taken the shape of a renewed isolationism, and a desire to break ties with the European Union. After the "Brexit" referendum was won by the "leave" side, a process of tough negotiations between Britain and the European Union began. The agreement reached by then-Prime Minister Theresa May failed to be ratified by the British Parliament, eventually leading to her resignation on May 24th. Former Mayor of London Boris Johnson (indeed, both the US and the UK are now led by men with very identifiable hair) became Prime Minister on July 24th, and it is now his responsibility to find some kind of arrangement with Europe before the final deadline for the UK to leave the union – October 31st 2019. Failure to achieve an agreement – what is commonly known as a "no deal" Brexit – remains a significant source of uncertainty for the economic future of the UK, and Europe in general.[14]

For all the uncertainty before us, it is comforting to know that there are elements that continue to help us along the path; the US, for instance, is operating a full employment[15], and wage growth is picking up[16] while overall levels of inflation remain controlled. As

described above, central banks are taking action to help us walk forward. However, despite these positive elements, which may help to ensure that the current growth cycle maintains itself for some time, we believe caution is the best policy.

Keeping our Footing

Any good hiker knows that the keys to keeping one's footing along a challenging trail are preparation and proceeding carefully. Given the twists and turns described above, there are two steps that we feel all investors should take in order to safely navigate the path ahead.

#1 – Walk Slowly: Keep allocation to equities under your target

- The single biggest determinant of the risk taken in one's investment portfolio is the asset allocation decision. In particular, equities (as opposed to cash and fixed income) constitute both the biggest source of risk, and the best potential for portfolio growth.

- Your target asset allocation, especially your exposure to equities, should be established in a way that takes into consideration both your *ability* to take on portfolio risk based on your financial situation, and your *willingness* to take on risk based on your innate comfort level with uncertainty.

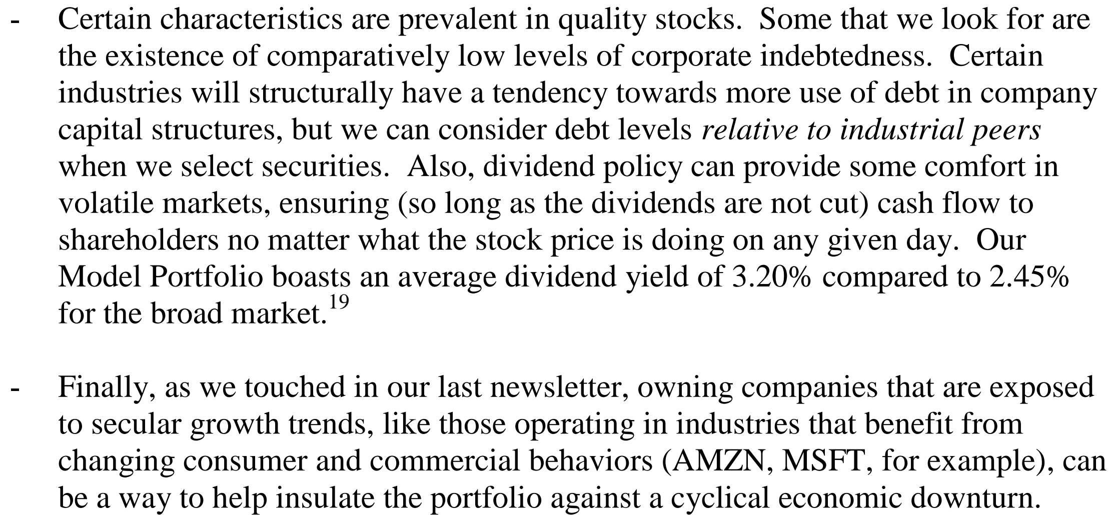
- In general, we should not let news flow or short term market volatility impact our target asset allocation. It is our view that maintaining ones exposure to equities yields great benefits over the long run. However, we do feel that in certain circumstances, we can make tactical shifts in asset allocation – always keeping our target equity exposure as our magnetic north.

- We believe that this is one of those times – and since early 2018[17] we have recommended that investors set their equity exposure at 90% of their target asset allocation. This means that for an investor with an equity target of 60%, we'd want to see the portfolio sit at around 54% (90% of 60%) of equities currently.

#2 – Use Quality Equipment: Adapt your holdings for a time of increased risks

- A good pair of shoes and well thought-out provisions goes a long way to ensuring a safe and successful hike. In portfolio terms, this means that the individual companies you own should be selected with conservatism in mind.

- One metric to keep in mind is how historically volatile the stocks have been in comparison to the volatility of the broad market. This is defined as a stock's "beta", with a beta of 1 indicating volatility in-line with the market, a beta over 1 indicating a more volatile stock than the average of the broad market, and a beta under 1 indicating a stock that has a history of being more stable than the market as a whole. A portfolio's "beta" can be determined based on its constituents. Our Model Portfolio currently has a "beta" of 0.88, decidedly less aggressive than the market as a whole.[18]



- Certain characteristics are prevalent in quality stocks. Some that we look for are the existence of comparatively low levels of corporate indebtedness. Certain industries will structurally have a tendency towards more use of debt in company capital structures, but we can consider debt levels *relative to industrial peers* when we select securities. Also, dividend policy can provide some comfort in volatile markets, ensuring (so long as the dividends are not cut) cash flow to shareholders no matter what the stock price is doing on any given day. Our Model Portfolio boasts an average dividend yield of 3.20% compared to 2.45% for the broad market.[19]

- Finally, as we touched in our last newsletter, owning companies that are exposed to secular growth trends, like those operating in industries that benefit from changing consumer and commercial behaviors (AMZN, MSFT, for example), can be a way to help insulate the portfolio against a cyclical economic downturn.

Conclusion

The road ahead is fraught with obstacles that the global economy is attempting to surmount. There are elements of the current landscape that we find encouraging (low unemployment, controlled inflation, wage growth), but in our view these are outweighed by a confluence of risks which must lead us to adopt a more cautious approach.

- Central banks are easing monetary policy around the world, in an effort to navigate slowing manufacturing indicators and a quickening trade war between China and the US. Uncertainty in Europe remains with Brexit bearing down on us this fall.

- The first step in our approach to this environment is to use a slightly more conservative asset allocation for client portfolio, taking some of the risk that equity markets present off the table.

- The second step to a more conservative footing is through sound security selection and portfolio construction, focusing on a lower beta approach, and companies with good dividend policies and strong comparative balance sheets.

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 54% equity weight, which represents 90% 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[20]
Yield*	3.20%	2.45%
Portfolio Beta*	0.88	1.00
Number of Holdings	28	1655

Sector Allocation (Core Portfolio)

Financial Services	25.0%	15.8%
Communication Services	7.5%	8.3%
Real Estate	5.0%	3.2%
Utilities	7.5%	3.3%
Consumer Staples	11.0%	8.5%
Consumer Discretionary	11.0%	10.5%
Healthcare	6.0%	12.6%
Information Tech.	6.0%	16.3%
Industrials	11.0%	11.2%
Energy	5.0%	5.7%
Materials	5.0%	4.6%

*As at 2019-07-31; source: Thomson ONE

Meet Our Team

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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 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.

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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.

Clara Augustine
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Clara has over 13 years of experience in Business Administration and Sales Management. She received her BBA from the University of New Brunswick in 2009, subsequently beginning her career in the financial services industry. Clara worked with several BMO Bank of Montreal branches in a management capacity, joining BMO Nesbitt Burns in 2018. She works closely with each member of the Cosgrove-Brock Group to ensure your administrative needs are met seamlessly in the pursuit of your investment goals, and is pleased to offer her assistance in either English or French.

Clara was raised on the East Coast, but now calls Rockland home, where she lives with her husband and their young children. In her spare time, she is passionate about fitness, and enjoys cooking, writing, playing music and travelling with her family.

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