# POTUS: Precarious Potential

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The COSGROVE-BROCK Group

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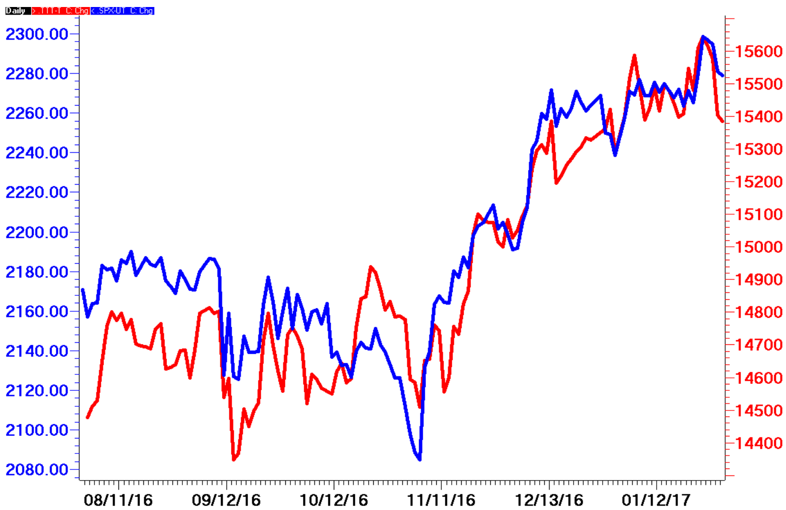
# Philip's Comments

If we left you with a sense of uncertainty following the publication of our Summer 2016 newsletter *"Two Uncertain Votes"* – financial markets have certainly clarified their view of the political dynamics since then. Over the course of the last six months, to January 31st 2017, the S&P/TSX Composite Index posted a very healthy price return of 6.3%, and the S&P500 posted a price return of 5.0% over the same period (see Figure 1)[1].

*Figure 1: **S&P/TSX Composite** and **S&P500** – August 1 2016 – January 31 2017*




Source: Thomson One

Meanwhile, the Canadian Dollar advanced modestly, increasing in value versus its US counterpart by a modest 0.3% and closing at 76.43 cents US on January 31st[2]. As for the price of oil, its progress was more substantial – moving from $40.06 to $52.72 over the same time period, an increase of $12.66 / barrel – or almost 32%[3].

At this time of year companies start releasing their final earnings numbers for the prior calendar year. As things stand at the date of the production of this newsletter, 68% of the S&P500 component companies who have reported so far have topped analysts' estimates[4]. The expectation is for roughly 6% year-over-year earnings growth, which represents an improvement over the results from last quarter[5].

Recent headlines have been dominated by the aftermath of the November 8th election of Donald J. Trump as 45th President of the United States. Neither the electoral result nor the markets' subsequent reaction to this outcome was expected to play out as it has. As you may have surmised by the cover, in this edition of the newsletter we will spend some time discussing whether "The Trump Effect" – the market's positive view of the new presidency – is rooted in reality and specifically we discuss added risks that may come with the new political landscape in the United States. We will also try to look past the tweets at the broader macroeconomic context in which we find ourselves and how current economic trends may impact markets going forward. We have titled this newsletter *"POTUS: Precarious Potential"* due to our view that many of the variables currently at play justify a higher price-level for equity markets, however those variables come paired with a greater degree of uncertainty that investors will need to adapt to.

It should be noted while the focus of this newsletter will be on events happening south of the border, the sheer interconnectedness of the North American economy means that policy decisions taken by our neighbours to the south will have real consequences on the health of the Canadian economy. When it comes to questions of economic growth, our border is quite thin.

## The Policy Landscape

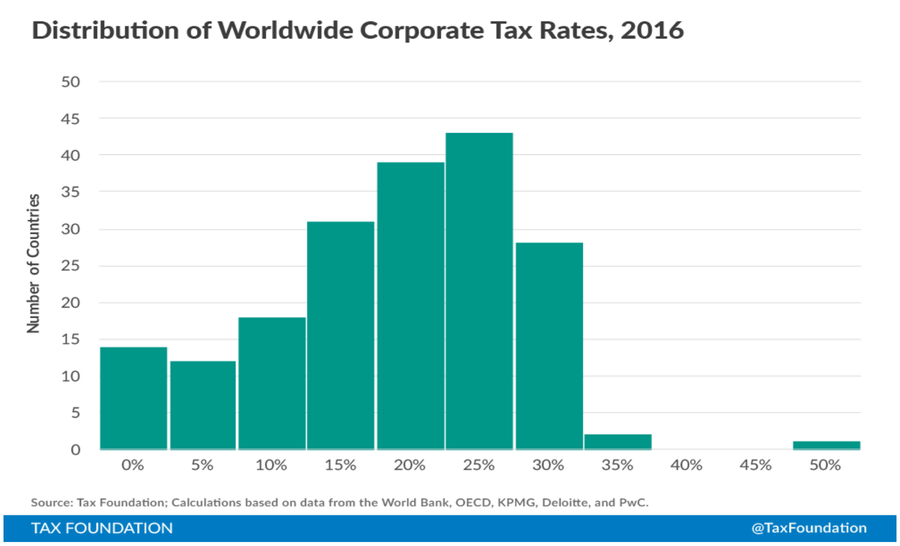
The reaction we are seeing from markets to the new US administration likely has little to do with the personality of the new president, and more to do with the specific policy proposals that he has put forward. Many of President Trump's policies are controversial, and a discussion of the impact of his social, immigration and security policies is outside of the scope of this newsletter.

As it pertains to the fiscal and economic policies of the new administration, we will look at the four major proposals that have been discussed by both Candidate and President Trump. As this newsletter is being written, President Trump has yet to issue a formal tax proposal. However, it is expected that one will be forthcoming.

<u>Corporate taxes: cut and simplify</u>

The current US corporate tax regime boasts some of the highest tax rates for businesses in the world at 35% (see Figure 2)[6]. Tax rates for a corporation in Ontario, by comparison, are around 25.6% (federal and provincial rates combined)[7]. The proposals of the Trump campaign seek to lower the corporate tax rate from 35% to 15%.

*Figure 2: Distribution of Worldwide Corporate Tax Rates, 2016*




Source: Tax Foundation (data from World Bank, OECD, KPMG, Deloitte, and PwC)

In addition, in an attempt to simplify the tax code, most tax breaks that corporations currently benefit from would be repealed.  This may include the ability for corporations to deduct interest expense.  Here we find a potential headwind for some businesses, as corporations with more debt could see a direct impact to their profitability as well as an increased cost of capital which would have the effect of stifling growth.

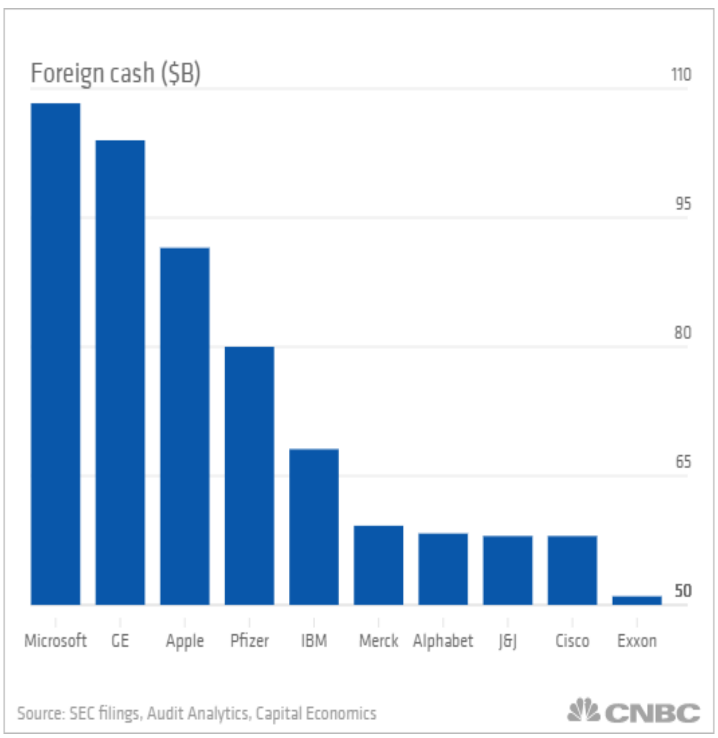
In the aggregate though, this measure is seen as generally pro-business.

<u>Repatriation of US corporate cash held abroad</u>

Some estimates put the amount of cash held outside of the United States by US corporations at $2.5 trillion[8].  This is due to a particularity of the US tax system, as it is today.  Unlike most countries (including Canada), the US does not have a “territorial” tax system.  By and large, countries do not tax their citizens or corporations on income earned abroad – they leave it to the jurisdiction where the income is earned to levy the tax.  However, the US taxes its citizens and corporations on their worldwide income, levying the 35% corporate tax on businesses when the profits are brought back to the United States (repatriated) to be distributed to shareholders.

This system has had the effect of inciting US-based multinationals to keep their foreign-earned profits offshore, as a way to defer (or altogether avoid) taxation in the US.  Some of the companies in our model portfolio, such as Microsoft, General Electric and Johnson & Johnson, have taken advantage of this approach (see Figure 3).

*Figure 3: Foreign Cash Held by Large US Corporations*




Source: CNBC / SEC filings, Audit Analytics, Capital Economics

Other companies have opted to use complex merger strategies to pair themselves up with a non-US corporation and profit from more favourable tax policy. It is this so-called "corporate inversion" strategy that lead to a former model-portfolio holding, Johnson Controls, to strike a deal with Irish firm Tyco in 2016.

From the standpoint of the US government, this presents a major problem. Its own corporations are not bringing their profits home, which means that they are not spending, expanding, or hiring in the US. These cash reserves do nothing to contribute to US economic growth. As a remedy to this, during the election campaign, the Trump team put forward the idea of allowing US corporations to take advantage of a "tax holiday" and bring their profits home, subject to a 10% (as opposed to 35%) tax.

While it is unlikely that every dollar will be repatriated, and it is even more unlikely that every repatriated dollar will be injected into the US economy through expansionist corporate spending, the sheer size of the offshore cash hoard ($2.6 trillion is larger than the first round of the federal reserve's quantitative easing program) has spurred hope that this policy could yield real economic benefits.

Reducing Regulation

A perennial complaint of Republican politicians is the amount of stifling regulation that exists at the federal level in the US. It is hard to argue that regulatory costs can be completely avoided – many regulations are required to ensure public safety, consumer protections, or the stability of the financial system. However, it is also true that regulatory compliance is a direct charge to a corporations' bottom line, and the enforcement of federal regulation is done by federal agencies funded through tax revenues – another drain on corporate profitability. This regulatory cost has been estimated at around $2 trillion / year[9]. Reducing this cost would be beneficial to US firms.

On January 30th President Trump signed an executive order stating that for any new federal regulation that is created by a federal agency, two additional regulations need to be eliminated. Further, the executive order sets a cap on US government spending on new regulations – that cap has been set at $0 for the rest of fiscal 2017.

Where this policy has the greatest potential to affect financial markets is in the regulation of the financial system itself. In 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (known as Dodd-Frank), which imposed sizeable new limitations on the business practices of financial institutions in the US, including the imposition of the Volcker Rule, which limits some speculative trading practices by these institutions.

The Trump administration has expressed its desire to reform Dodd-Frank on the basis that the regulation has gone too far and has made it more difficult for US banks to lend to small businesses. On the other side of the argument, Fed chair Janet Yellen has cited Dodd-Frank as being responsible for setting the US financial system on a much firmer footing than was in place before the financial crisis of 2008[10].

Trade Policy

While the three policy positions mentioned above are seen as being pro-business (to varying extents), the President's populist tendencies towards global trade are not seen in the same light.  On his first full weekday in office, Trump signed an executive order removing the US from the Trans-Pacific Partnership (TPP) – the 12-country agreement that would see broad trade liberalization amongst Pacific-Rim economies.

President Trump has also been an outspoken critic of the North-American Free Trade Agreement (NAFTA).  While most of his attention seems to be focused on US trade with Mexico, there exists a real risk to Canadian economic growth if significant trade barriers are erected between our two countries.  The US/Canada two-way trade relationship stood at approximately US$1.9 billion / day in 2015[11].  It remains to be seen what stance the US administration will take if it opts to renegotiate NAFTA, as it has threatened to do.

It should be noted that as far as Canada and the US are concerned, NAFTA was preceded by the Canada-US Free Trade Agreement of 1989.  To the extent that the US would favour bilateral agreements with individual countries over larger multilateral trade regimes, there may be some precedent for much of the existing trade relationship between Canada and the US to be left in place.

This area will remain one of some concern and risk going forward, as a change in trade policies could have a real impact on economic growth on both sides of the border.

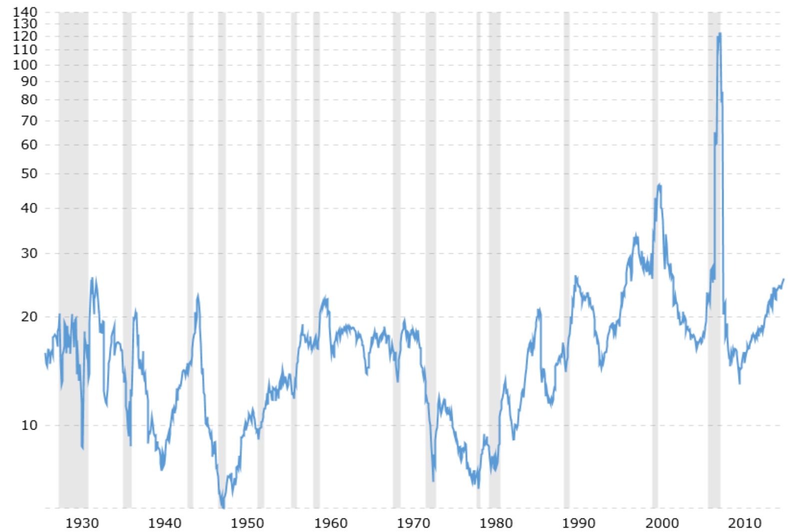
## The Risk Math

Barring drastic changes to US trade policy, successful delivery on these promises should help spur economic growth in the United States.  The market is certainly expecting this – both the S&P500 and TSX hit or neared record highs in January.  So far, the Trump presidency seems to have caused good returns for equities.

Sound financial management must go beyond the generation of returns for investors. There must be as much (if not more) attention paid to the risks that are born in the achievement of investment returns.

One way to assess prevailing risks in the market is through the measurement of valuation – how expensive is an asset relative to the income that it has provided, or will provide in the future.  Currently, we find the main benchmark in the United States, the S&P 500 Index, trading at approximately 26x trailing (last 12-month) corporate earnings (see Figure 4).  This level is not unprecedented, but is substantially higher than the long-run mean of approximately 16x trailing earnings[12].

*Figure 4: S&P500 PE Ratio – 90-year Historical Chart*




Source: Macrotrends.net

It should also be said that the market is currently facing increased unpredictability of policy, pronouncements, controversies, and even the direct engagement of the President over social media.  This uncertainty has the potential to be translated into increased volatility of currency and equity markets.

Policy change may lead to higher investment returns, while equity valuations and the unpredictable nature of this president may yield higher market volatility.  It is against this backdrop of "precarious potential" that we have shifted our target asset allocation down from 110% of equity to 100% of equity (see the Asset Allocation section of the newsletter).  This is the first such change since the publication of our first newsletter in the summer of 2013.  It should be noted that that to-date our tilt towards equities has been beneficial: the annualized rate of return for S&P500 over the period from August 1 2013 (our first newsletter) to January 31st 2017 was 11.4%, as compared to the longer term (since 1871) return for the S&P500 of 9.0%[13].

This change in our stance should not be seen as an endorsement of market timing as a sound investment strategy.  We firmly believe in the importance of staying invested, particularly when our investment portfolio is comprised of high-quality, dividend paying companies that are leaders in their respective fields of operation.  This investment discipline, though, must be paired with an understanding of the importance of tactical shifting and of rebalancing back to your own personalized long-term equity target when market conditions dictate such a shift.

## Looking Past the Tweets

While Donald Trump would likely have no problem taking full credit for the recent performance of markets, there are factors that are at play that either predate or have little to do with his election to the presidency.

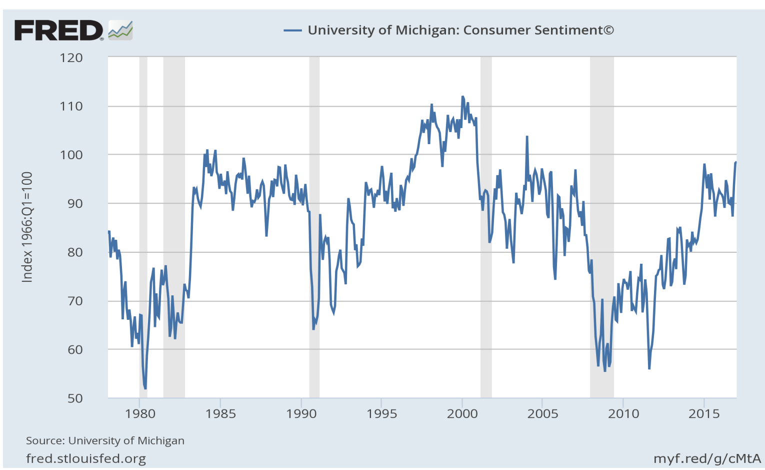
First and foremost, corporate earnings are growing again – having been in decline for much of 2015 (see Figure 5)[14]. As mentioned, recent earnings results have led to estimates of 6% year-over-year growth in corporate profits.

*Figure 5: US Corporate Profits – 2012 – January 31 2017*


Source: www.tradingeconomics.com / US Bureau of Economic Analysis

Beyond earnings, consumer confidence is high and growing, currently reaching levels not seen in over 10 years (see Figure 6)[15].

*Figure 6: Consumer Sentiment - US*




Source: University of Michigan / St. Louis Fed.

Interest rates remain low and stimulative, and even if the Fed raises rates (and most economists think they will do so twice in 2017[16]), they will still be near historic lows. There are factors that are causing some to re-examine this forecast for slow-moving interest rate increases. For example, for the first time in a long time, we are seeing signs of wage growth[17]. Generally a sign of good economic health and an economy operating near full employment, wage growth can be a precursor to higher rates of inflation. Another potential catalyst for higher inflation is increased government spending on infrastructure. Governments around the world have been turning to budgetary policy to help stimulate their economies as the available monetary policy ammunition of central banks has been mostly used up. If inflation were to increase in a meaningful way, we would expect the US Federal Reserve to accelerate the rhythm of interest rate increases.

## Conclusion

Markets seem to have taken the news of the new Trump presidency very positively. The expectation of President Trump's stated economic policies has helped buoy equity markets, but not without increasing the general level of risk in markets as well.

- Most of Donald Trump's main economic policies (corporate tax reform, foreign profit repatriation, de-regulation) have the potential to increase economic growth in the US, but it is too early to be sure if he will be able to successfully implement them all. The Trump approach to global trade continues to present itself as a source of risk amongst his policies.

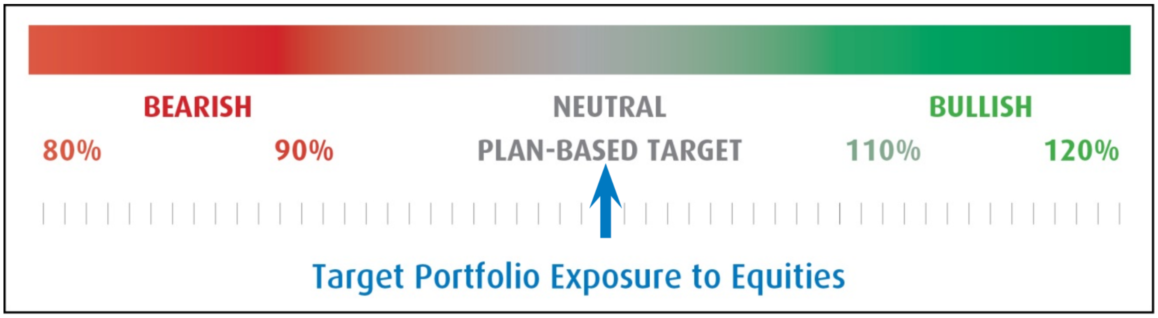
- Given the recent advances in equity markets, and the higher potential for market risk (high equity valuations, unpredictability of policy, of Trump himself), we have moved our recommended allocation of equities from 110% of a person's personalized equity target to 100% of their target. This is the time to rebalance our equity allocations and ensure we are comfortable with the level of risk in our portfolio.

- Despite these enhanced risks, various economic factors point to continued positivity for markets. These factors include low interest rates, growing corporate earnings, and high consumer confidence. While rebalancing may be timely, staying invested remains the centrepiece of our approach.

## 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[18] |
|---|---|---|
| **Yield*** | 2.98% | 2.46% |
| **Portfolio Beta*** | 0.91 | 1.00 |
| **Number of Holdings** | 28 | 1652 |

## Sector Allocation (Core Portfolio)

| | | |
|---|---|---|
| **Financial Services** | 30.0% | 21.1% |
| **Telecom. Services** | 7.5% | 3.3% |
| **Utilities** | 7.5% | 3.1% |
| **Consumer Staples** | 11.0% | 9.7% |
| **Consumer Discretionary** | 11.0% | 12.4% |
| **Healthcare** | 6.0% | 12.0% |
| **Information Tech.** | 6.0% | 14.9% |
| **Industrials** | 11.0% | 11.2% |
| **Energy** | 5.0% | 6.9% |
| **Materials** | 5.0% | 5.2% |

*As at 2017-01-31; 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.

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[11] Government of Canada, *Trade and Investment*, http://can-am.gc.ca/relations/commercial_relations_commerciales.aspx?lang=eng

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