Pushing the limits

BMO Wealth Management
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The COSGROVE-BROCK Group

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Philip's Comments

Dear reader,

It is important to point out that the commentary you will find below was written and completed by January 31st 2018. Since then, some of what we point to in this commentary has come to pass, with markets facing some turmoil in the early part of February. Nevertheless, we feel that the core of this message is still very valid, and we hope you enjoy the read.

As usual, if you have any questions, we would love to hear from you.

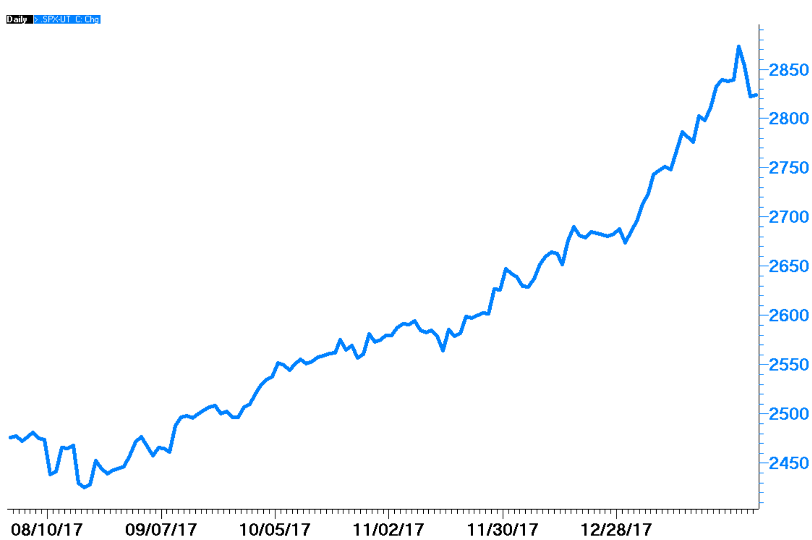
Sincerely,

The Cosgrove-Brock Group

One finds limits by pushing them.
- Herbert Simon

Over the last six months, stocks, especially in the United States, have pushed ever higher as evidenced by the results of the S&P 500 which climbed 14.0% between August and January (see Figure 1)[1]. A 14% return over a six month period is strong, indeed.

Figure 1: S&P 500 – from August 1st 2017 to January 31 2018



Source: Thomson ONE

Consistent with the theme of our last newsletter titled *"One Border, Two Stories"*, what is true for US stocks is not always true for Canadian markets. Over the same time period, markets north of the border were up by 2.6%[2]. The Canadian Dollar also advanced over the last six months, gaining 1.9% to sit at the end of January at $0.8128 USD[3] – not far below BMO Capital Markets' 2018 average forecast for the CAD/USD exchange rate of $0.8180[4].

This is the time of year when companies announce their results from the previous calendar year. As of the time of writing of this commentary, 118 S&P 500 companies have reported earnings, and only 10% of those companies have announced results below analyst estimates, with 78% of reporting companies beating estimates[5].

This is the tenth issue of our semi-annual newsletter. It is interesting to note – and illustrative of the length of the current market cycle – that this is the fourth consecutive newsletter in which we have been able to report rising markets over the previous six month period. Not since January of 2016 have we had to interpret declining markets as part of this commentary. We are almost nostalgic – but not quite.

Our newsletter, entitled "*Pushing the limits*", explores the current state of equity markets, identifies what obstacles, or "bumps" might be in our path, and what we can do in our portfolio to mitigate the risks ahead.

The Wind at our Back

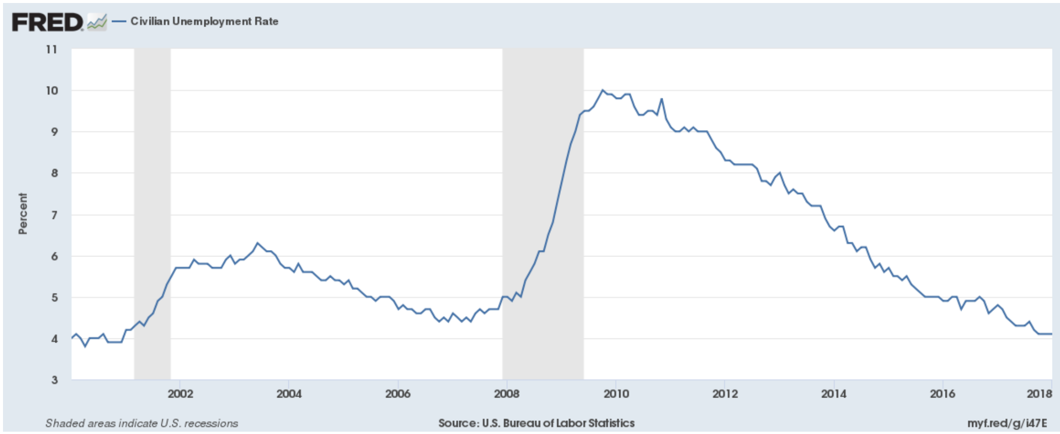
There are many factors that have contributed to the recent impressive rise of equity markets, particularly US equity markets. As we have explained in previous newsletters, economic fundamentals are a major contributor to market success, and just about every economic metric underscores the strength of the current economy. At the time of writing, US Federal Reserve chair Janet Yellen has just presided over her last public reporting meeting (known as the FOMC meeting) on the status of the US economy. When her successor, Jay Powell, takes the reigns on February 3rd, he will do so in the following context[6]:

- The US labour market is as strong as it has been in recent memory, sporting an unemployment rate of 4.1%, which is the lowest rate in 17 years (see Figure 2).

- Inflation in the United States is below 2% and has been stable. Price stability is one of the main functions of the Federal Reserve.

- Economic growth at 2.5% is above "potential" GDP growth – and a sign that the US economy is firing on all cylinders.

Figure 2: US Civilian Unemployment Rate (January 1 2000 – January 1 2018)



Source: St. Louis Federal Reserve

An economy can certainly grow above its potential growth rate for a time, but eventually we would expect to see one of two outcomes. The first outcome is that through the natural ebbs and flows of the economic cycle, GDP growth reverts back to "normal" levels. The second outcome is that the strong growth soaks up any excess labour and leads to inflation by way of rising wages. So far this has not been the case, likely due to the large segment of the American labour market that considers itself "underemployed". Before wages rise significantly, we would expect to see the "underemployment" segment drop.

As if low unemployment, low and stable inflation, and healthy economic growth was not sufficient, US corporations will soon see the benefits of the new tax bill passed by Congress and signed by President Trump in late December.

Conventional economic strategy would be to implement such a strong fiscal stimulus at a time when economic growth was sluggish or negative, as a way to counteract a bad economic landscape. As stated above, the current economic landscape is far from negative, and a possible outcome of jump-starting an already revving economic engine is the emergence of inflation.

Corporate earnings are strong and growing, and will benefit directly from tax reform in the United States. These reforms have also opened the door to US corporations repatriating assets that had been up until now hoarded oversees. On January 17th, Apple announced that it would repatriate $350 billion from overseas operations over the next five years and that it plans significant investment into its US operations[7].

Beyond the US picture, we see signs of economic strength in every corner of the globe. The European, Japanese, and Chinese situations are all improving in tandem. Given all of these positive elements, we can clearly understand why markets have had the wind at their back.

Bumps Ahead

Our view is that, given the clearly positive economic backdrop in which we find ourselves, we expect to see equities continue to perform strongly for some time. However, this market is demonstrating certain characteristics that cause us to be more concerned at this point that a long-overdue market pullback could be approaching.

Bump 1: Inflation

If we had to write a recipe for inflation stew, we would likely start with a low and falling unemployment rate, add a healthy dose of above-potential GDP growth, stir in a low interest-rate environment, and add a pinch of tax-cuts for good measure.

It is fair to say that over the course of the last year, the US Federal Reserve has been confounded by the absence of any real inflationary pressures. Some suggest that while unemployment is low, the "underemployment" rate that we mentioned earlier has to fall further before true wage pressure will surface. Others suggest that the disruptive effects of technological change have kept the costs of goods and services low (think Uber and Amazon, for example).

We are of the view that before long, if the economy stays as robust as it has been, inflation will begin to emerge. Low levels of inflation are normal, and can be managed at the central bank level though traditional monetary policy. However, if inflation were to begin to accelerate, this could be a real impediment to equity returns. The value of any stock is simply the sum of its future cash flows, discounted based on the risk of the underlying business. Inflation represents the decrease in the value of those future cash flows, and therefore has a negative impact on the value of stocks.

Bump 2: Political Uncertainty

Despite the unconventional leadership-style, despite the many firings and resignations that have marked his administration, and despite the tweets, markets have clearly taken a liking to President Trump. He ran on a platform of deregulation and tax reform, and in late 2017 successfully implemented a plan to cut taxes (temporarily) for individuals and (permanently) for businesses.

The Justice Department probe under Special Counsel Robert Mueller is currently investigating matters of collusion between the Trump campaign and Russia during the election, elements of money-laundering in some of the President's business interests, and obstruction of justice by the Trump White House. These are serious matters, and in some circles are being compared to the Watergate affair that led to the resignation of President Nixon in August of 1974.

It is impossible to know when the investigation will wrap up, and what, if any, the consequences of this process will be for the White House. However, until this process has played itself out, these matters remain a potential source of instability for financial markets.

Bump 3: NAFTA

An issue of particular concern to Canadians is the current renegotiation of the North American Free Trade Agreement. During the presidential campaign, Donald Trump routinely threatened the wholesale withdrawal of the United States from NAFTA. As recently as January 18th, he called NAFTA a "bad joke"[8] (in a tweet, of course).

Round 6 of the renegotiation of NAFTA has just concluded in Montreal, with some commentators suggesting that early and slow progress is being made towards an agreement. The next round of talks takes place at the end of February, but time may be short to reach a deal, with Mexican presidential election campaigns slated to begin in March, with a vote in July. It is unlikely that any agreement can be reached during that time period.

In a recent report titled "The Day After NAFTA", Douglas Porter, Chief Economist for BMO Capital Markets, laid out the potential consequences of the abolition of free trade with the United States, and reversion to tariff-levels in-line with WTO norms. Porter concludes[9]:

- The termination of NAFTA would have a definite negative effect on Canadian economic growth, but not a devastating one, with other levers such as monetary policy, currency adjustments, and fiscal policy being available to help offset any NAFTA-related slowdown.

- Total GDP growth, according to these estimates, would be diminished by approximately 1% over a five-year period, and unemployment would be higher by 0.5%.

- According to this report, a short-term decline in the Canadian Dollar of approximately 5% could be expected upon the cancellation of the agreement. From current levels, this would imply a $0.77 USD/CAD exchange rate (we note here that holding USD-denominated stocks in one's investment portfolio may offer a good hedge against this particular risk).

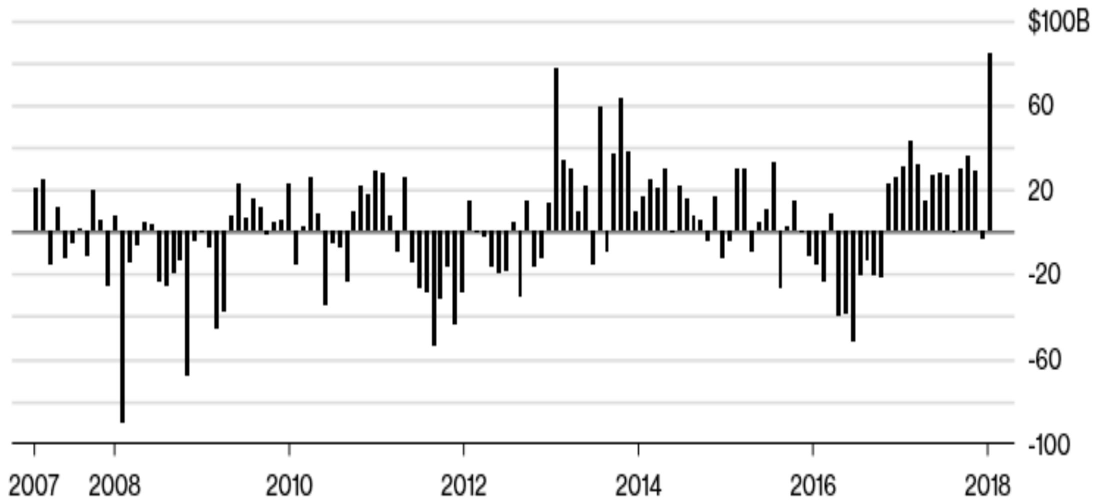
Avoiding Icarus

The three "bumps" we identify above are not certainties, and as mentioned the strong economic position in which Canada and the US find themselves currently is likely to more than make up for the presence of these risks. Markets have been strong and have been rising in spite of (and in full knowledge of) the risks outlined above.

However we are starting to see signs that are typically seen in "late" bull markets. When positive investor sentiment becomes "consensus", we should start to question whether a herd mentality is setting in. "Fear of missing out" is not an investment strategy. For example:

- In January, fund-flows into equity funds was on pace to reach its highest level ever (see Figure 3)[10].

Figure 3: Equity Fund Flows (January 2007 – January 2018)



Source: EPFR Global / Bloomberg

- Based on a Conference Board survey, the amount of people that expect markets to rise is at a record high (see Figure 4)[11].

Figure 4: Consumer Confidence Expectation of Stock Price Increase (Conference Board, 1990 – 2018)

Source: The Conference Board / Bloomberg

- The current Bull Market is within seven months of setting the record for being the longest in history[12].

Just like Icarus who flew too close to the sun, the risk to client portfolios of maintaining current equity levels is growing with every new high that equity markets hit. While we continue to believe that equities provide clients with far better risk-adjusted after-tax returns than any other asset class, and should continue to do so, we are also looking to build a bulwark, a defence, against some of the "bumps" that we identified. We want to continue to participate in these strong equity markets, but we want to do so from a position of strength.

It is in this mind-set that we are recommending at this time our second tactical asset allocation change since the publication of our first newsletter in the summer of 2013.

- When we issued our first newsletter in August 2013, we had set an equity allocation of 110% of a client's long-term equity target, as a guide for clients.

- A year ago, in the winter of 2017, after the presidential election had been decided, we decreased our recommendation to 100% of a client's long-term equity target.

- At this time, we are decreasing our equity target further, and out of caution we are setting it at 90% of a client's long-term equity target.

We would like to suggest that as markets continue to advance, even portfolios with slightly lower equity allocations will continue to progress nicely. Crucially, when a correction or bear market occurs, investors who have taken steps to build cash and short-term fixed income reserves will be in an excellent position to proactively seize opportunities presented by correcting equities. This is not an attempt to time the top of the market, but rather a strategy to ensure that when the market finally corrects, when the market realizes that it has "pushed the limits", our clients will have the ammunition necessary to be able to rebalance their portfolios and acquire stocks at better valuations.

Conclusion

Equity markets – especially in the US – have advanced significantly over the last six months. It is our view that the increases we have seen have been justified by strong economic fundamentals, but that emerging risks should steer us towards caution.

- Markets are operating with a strong economic backdrop. Unemployment is low, inflation remains low, interest rates remain low, corporate earnings are growing, and new tax cuts in the United States should continue to bolster economic activity.

- Despite this, some risks have emerged such as the possible re-emergence of inflation, political uncertainty, and changing trade policies (NAFTA). In addition to this, market sentiment seems to be unabashedly positive. These factors do not guarantee the end of the bull market, but the risk of a pullback has increased.

- In anticipation of this, and to ensure that in the midst of a pullback our clients have adequate levels of cash in their portfolios to be able to seize opportunities, we are recommending that the equity weight of an investor’s portfolio be set at 90% of his or her long-term equity target.

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[13]
Yield*	2.87%	2.33%
Portfolio Beta*	0.86	1.00
Number of Holdings	28	1653

Sector Allocation (Core Portfolio)

Financial Services	30.0%	21.2%
Telecom. Services	7.5%	2.8%
Utilities	7.5%	3.1%
Consumer Staples	11.0%	9.0%
Consumer Discretionary	11.0%	12.2%
Healthcare	6.0%	12.0%
Information Tech.	6.0%	16.9%
Industrials	11.0%	11.5%
Energy	5.0%	6.2%
Materials	5.0%	5.1%

*At 2018-01-31; 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

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.

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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.

[1, 2, 3] Thomson One

[4] Porter, Doug, *Economic Forecast*, Focus, BMO Capital Markets' Economics, January 26 2018

[5] Lahiff, Keris, *Earnings have been 'unambiguously positive,' and it's going to get even better, says JPMorgan*, CNBC, January 28 2018

[6] Gregory, Michael, *Janet's Job Well Done*, Focus, BMO Capital Markets' Economics, January 26 2018

[7] Balakrishnan, Anita, *Apple announces plans to repatriate billions in overseas cash, says it will contribute $350 billion to the US economy over the next 5 years*, CNBC, January 17 2018

[8] Gillespie, Patrick, *NAFTA is close to falling apart with time running out*, CNNMoney, January 22 2018

[9] Porter, Douglas, *The Day After NAFTA – Economic Impact Analysis*, BMO Capital Markets' Economics, November 2017

[10, 11, 12] Popina, Elena, Ponczek, Sarah, and Wang, Lu, *Is the Long Bull Run Nearly Over?*, Bloomberg, January 31 2018

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

[14] Profiles for BNS, BCE, CSH.UN, EMR, HD, JNJ, MFC, MSFT, SU, TD, and TRP replicated from the December 2017 Combined Guided Portfolios, BMO Nesbitt Burns Portfolio Advisory Team, December 2017

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