Overtime for the **Business Cycle**

BMO Wealth Management
BMO Nesbitt Burns

The COSGROVE-BROCK Group

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Philip's Comments

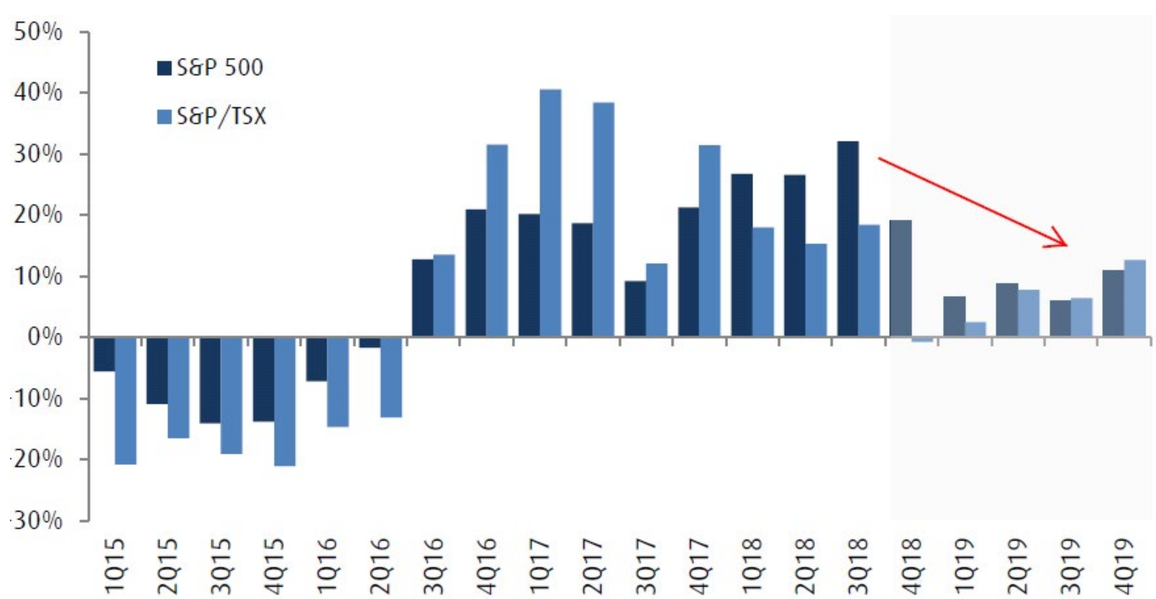
Markets have stumbled since the last time we wrote this commentary, not quite "Clearing the hurdles" that we alluded to in our last note. We saw over the autumn and start of winter a real return of market volatility. In fact, December 2018 now has the dubious distinction of producing the worst US stock market performance since 1931[1] – with the S&P 500 dropping 10.2% in one month. But the New Year brought new vigor for the market, as the S&P 500 posted a 9.2% recovery to start out the year.[2]

All told, since the publication of our last newsletter in August 2018, the Canadian market, represented by the S&P/TSX Composite Index, fell 5.1% – only slightly worse than the 4.1% decline of the US-based S&P 500[3] – validating our more defensive posture adopted in early 2018.

Our dollar was mostly flat over the last six months, drifting approximately 1% lower to close at 76.2 cents / USD on January 31st.[4]

As for the health of the corporate sector, we have seen a deceleration in the growth trajectory of earnings (not to be confused with declining earnings). Economic growth and market performance have been buoyed by strong corporate profitability in the last two years but as earnings growth slows (see Figure 1) and the current economic cycle enters into overtime we will want to maintain our more defensive approach.

Figure 1: S&P 500 & S&P/TSX Year-over-Year Quarterly Earnings-per-Share Growth (actuals & estimates)



Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES, S&P

The Natural Lifecycle of the Economy

We know that economic growth is not constant, but naturally ebbs and flows. This process is called the economic cycle, or business cycle. A typical trip around the economic wheel would look something like this:

- The economy emerges from recession and recovers, driving unemployment down and corporate profits up, bringing wages up and inflation with them.

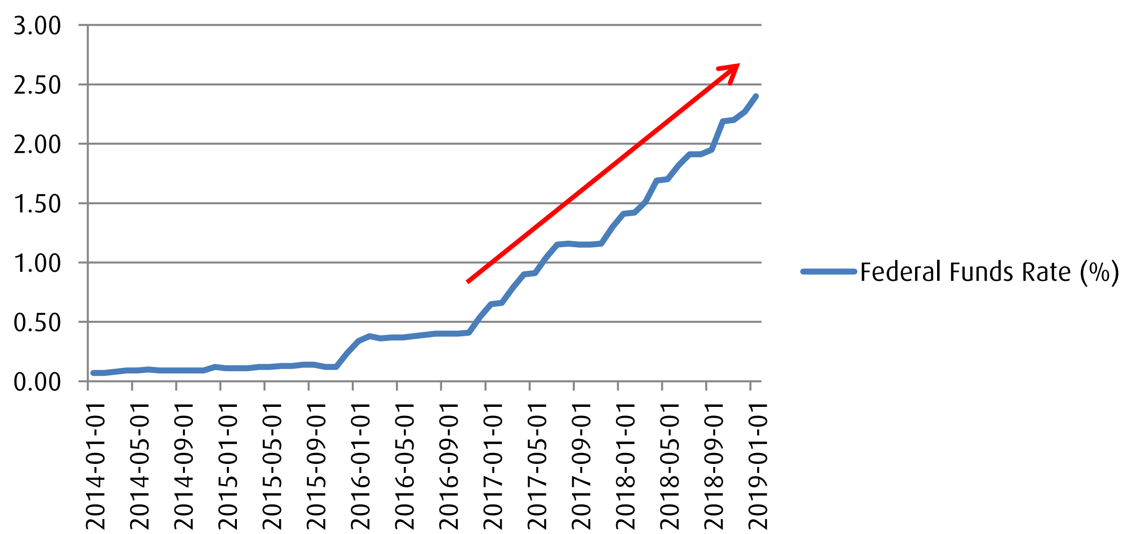
- Central banks react to rising inflation by raising interest rates, slowing consumer spending and impacting corporate profitability.

- The resulting slowing economic growth fuels unemployment and economies contract, sometimes entering into recession (defined as two consecutive quarters of economic contraction).

- Central banks and governments react by providing monetary and fiscal stimulus, which spurs consumer and corporate spending. Recovery ensues, and the cycle begins again.

In our view, we currently find ourselves in the late stages of an economic expansion. There are a number of data points that lead us to this conclusion. As we discussed in our summer 2018 newsletter, central banks around the world have been raising interest rates for some time, as best illustrated by the actions of the US Federal Reserve (see Figure 2).

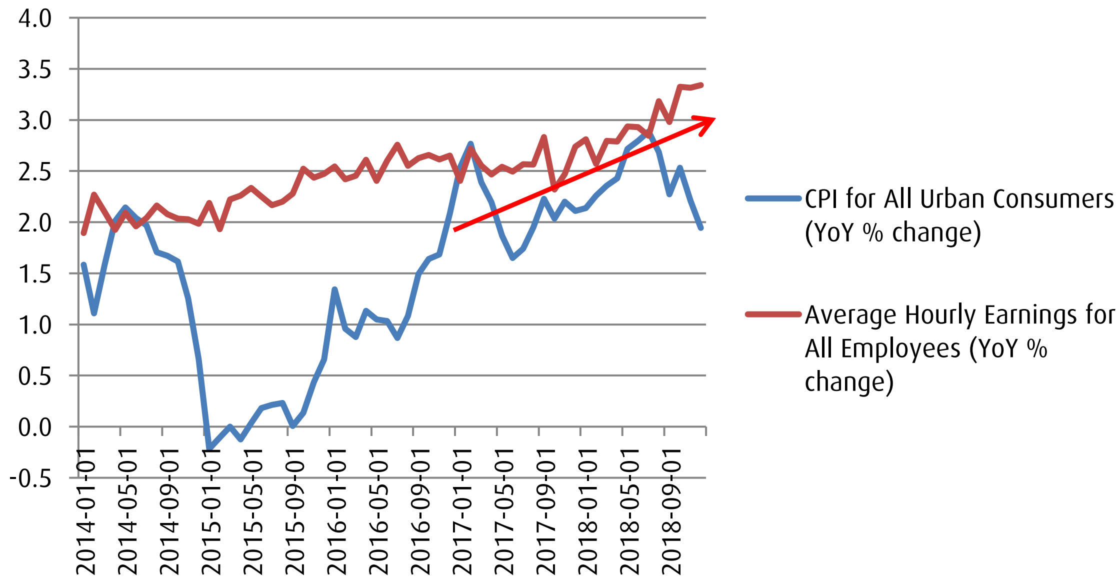
Figure 2: Effective Federal Funds Rate (%)



Source: Board of Governors of the Federal Reserve System (US), fred.stlouisfed.org

Central bankers have justified a pattern of interest rate hikes and other tightening measures as a return to "normal", effectively ending the emergency measures put in place in the midst of the financial crisis over a decade ago. But a more traditional rationale for tightening monetary policy can also be observed, as we have seen both inflation and wage growth increasing over the last few years (see Figure 3). These factors are not yet at levels that should cause concern, but the trend is unmistakable.

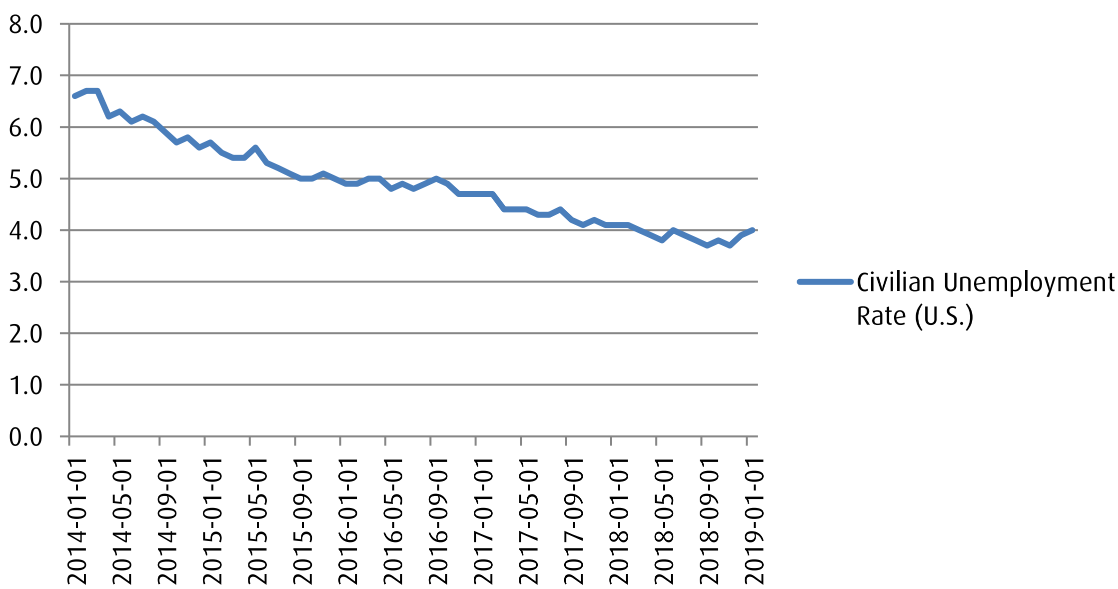
Figure 3: Price Inflation and Wage Inflation (%)



Source: U.S. Bureau of Labor Statistics, fred.stlouisfed.org

Combined with the data points identified above (slowing earnings growth, rising wage and price inflation, and rising interest rates) we make the observation that the U.S. economy is at or near full employment (see Figure 4). The health of the current labor market confirms our view that we are in the late stages of an economic expansion.

Figure 4: Civilian Unemployment Rate – U.S. (%)



Source: U.S. Bureau of Labor Statistics, fred.stlouisfed.org

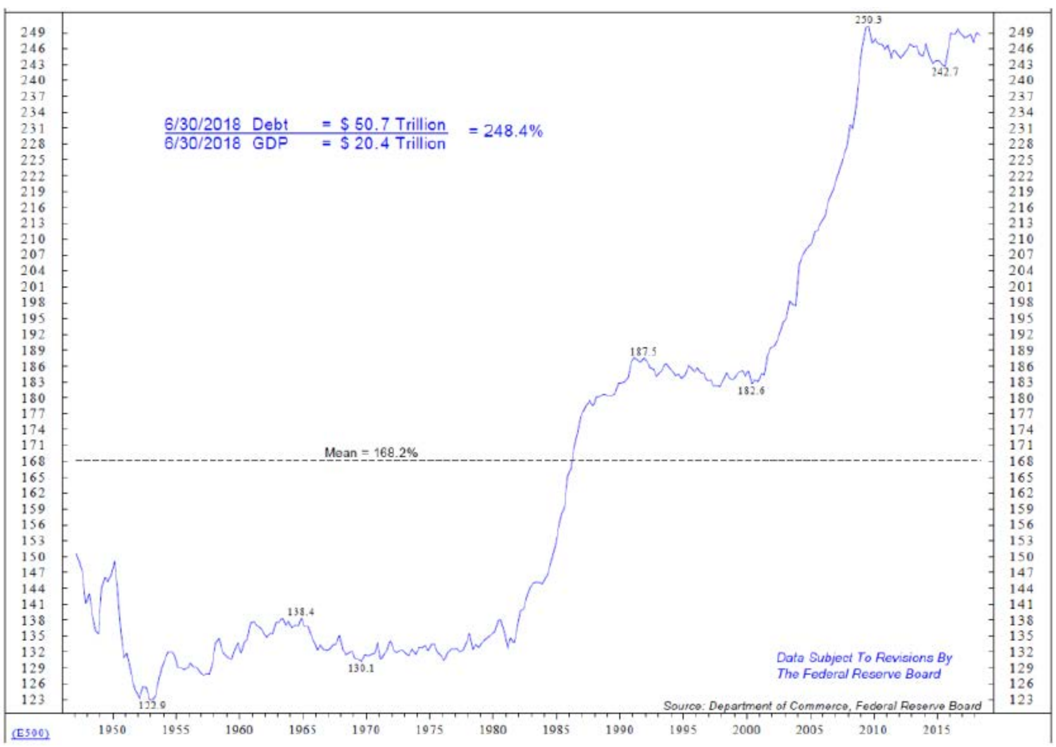
The question is: are we ready for what comes next?

Aggravating Factors

At this point in the economic cycle we would want to see across the board preparedness for an economic downturn, with all economic actors – consumers, the corporate sector, government, and central banks – ready to enact measures to avoid significant economic contraction.

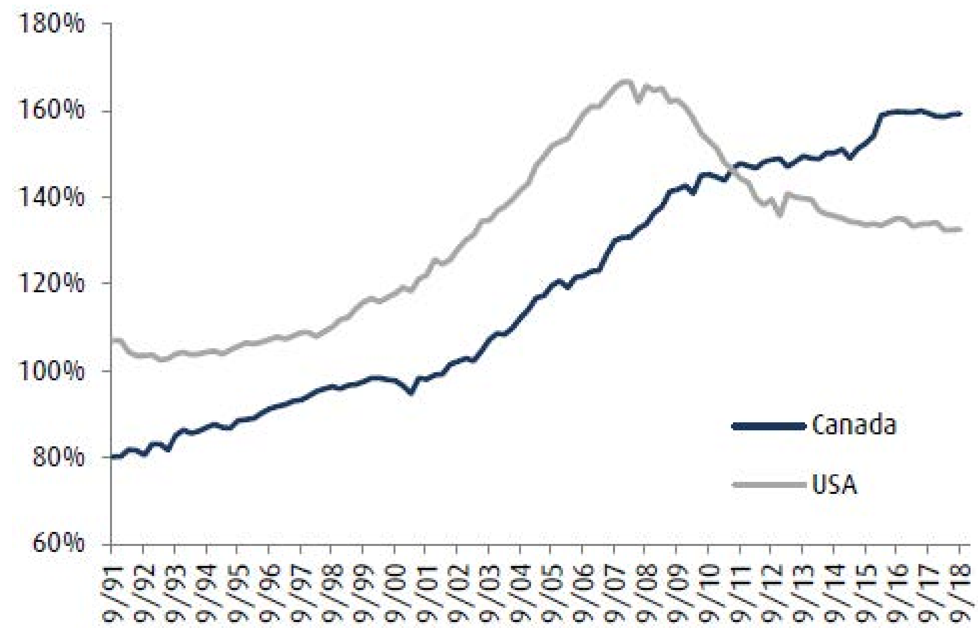
It is far from certain that economic contraction is just over the horizon, but it would be even harder to argue that we are prepared should a recession come to pass. It is true that central banks around the world have been actively decreasing stimulus measures, providing monetary policy ammunition to deal with a slowing economy. However, indebtedness in the corporate and government sectors is at a level that could make it difficult to navigate a period of sustained economic contraction (see Figure 5). Furthermore, the U.S. consumer's balance sheet is in fair shape, but in Canada consumers have been unable to moderate their debt load (see Figure 6).

Figure 5: Total Domestic Non-Financial Debt as a Percentage of GDP



Source: BMO Nesbitt Burns Portfolio Advisory Team, Ned Davis Research

Figure 6: Household Debt to Disposable Income (%)



Source: BMO Investment Strategy Group, Statistics Canada

Beyond these factors, significant uncertainty still remains over the U.S. trade relationship with China. Trade tensions as well as internal economic dynamics have led to a noticeable slowdown in Chinese economic activity, with Chinese GDP growth dropping by approximately 0.5% in the last 18 months to settle at 6.5%[5], well below the rate of economic growth we have been accustomed to seeing in China. Somewhat comforting are the actions taken by the Chinese government to try to bolster economic growth. Various measures were put in place in 2018; including decreasing interest rates, increasing spending on infrastructure projects, and providing encouragement to the Chinese banking sector to make loans more available.[6]

We also should not forget that the United Kingdom's currently rudderless exit from the European Union is set to take place on March 29th unless delayed by policymakers.

Markets may overlook many of these concerns in the coming months, or any one of them may be sufficient to cause further volatility. Our approach to portfolio management must be informed by these risks.

A More Cautious Approach

We have alluded to "overtime" in this commentary so far, but a better analogy for investment management late in the economic cycle would be playing with a lead late in the third period of a hockey game. We must ensure our strategy is sufficiently defensive, but not hesitate to take advantage of opportunities as they present themselves.

- The first part of this strategy is adopting an approach to asset allocation – the portfolio mix between cash, fixed income, and equities – that favours conservative asset classes. Two years ago, in the Winter 2017 edition of this newsletter, we advised clients to move their equity holdings from 110% of their long-term target to a more neutral stance at 100%. Last year, in the Winter 2018 newsletter, we recommended a further reduction in equity exposure, to 90% of an investor's long-term target. We stand by this recommendation, and continue to advise clients to hold a lower percentage of equities in their portfolio than their long-term target would suggest.

- Among the securities that we hold, we should favour stocks that have defensive characteristics. Chief among these are the oligopolies: companies that operate in industries where there are few competitors, where barriers to entry are high enough that they prevent new entrants from beginning operations, allowing existing operators to have pricing power over their customers.[7] Our model portfolio is founded primarily on these types of enterprises: Canadian banks (BNS, TD, NA), utility companies (TRP, INE), telecommunications companies (BCE) and railways (CP) are all examples of oligopolies.

- With a defensive asset allocation and security selection strategy in place, we are well positioned to take advantage of opportunities when they present themselves. It is no accident that the addition of Amazon.com (AMZN) and Alphabet (GOOGL) to our model portfolio in early January followed December's worst-ever-performance for the technology-heavy Nasdaq stock exchange.[8] These companies are also driven by *secular* trends that may override the market's *cyclical* nature. For example, it is estimated that by 2021, spending on cloud-based applications will rise to $300 billion US, double levels seen in 2017.[9] These types of structural economic changes can help sustain a stock price despite the existence of a cyclical downturn. Even when you are playing with the lead, with defensemen on the ice, scoring opportunities can present themselves, and should be taken advantage of.

Conclusion

The current economic expansion may persist for some time, yielding positive returns to investors. However we should recognize where we are in the natural lifecycle of the economy, and conduct ourselves accordingly.

- There is strong evidence to suggest that we are in the latter stages of an economic expansion: with the economy at full employment, price and wage inflation has started to rise, interest rates are on a path higher, and corporate earnings growth has started to decelerate.

- The economic levers that would usually be useful in the mitigation of an economic downturn may not all be available due to the unusually high levels of debt carried by consumers (in Canada more acutely than in the United States), governments and corporations. Central banks will have some ability to act, but they still have not fully unwound the emergency policies set up during the last financial crisis.

- While not ignoring opportunities when they present themselves, a more cautious approach to investment management should be implemented, with an emphasis on conservative asset allocation (owning a lower proportion of one's portfolio in equities) and conservative security selection (favoring oligopolies).

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[10]
Yield*	3.16%	2.76%
Portfolio Beta*	0.89	1.00
Number of Holdings	28	1633

Sector Allocation (Core Portfolio)

Financial Services	25.0%	16.2%
Communication Services	7.5%	8.3%
Real Estate	5.0%	3.2%
Utilities	7.5%	3.5%
Consumer Staples	11.0%	8.7%
Consumer Discretionary	11.0%	10.4%
Healthcare	6.0%	13.4%
Information Tech.	6.0%	14.9%
Industrials	11.0%	10.9%
Energy	5.0%	5.9%
Materials	5.0%	4.6%

*As at 2019-01-31; 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 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.

Clara Augustine
Administrative Assistant
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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.

[1, 8] O'Halloran, Suzanne, *Dow, S&P 500 post worst December since 1931, as Nasdaq has worst on record*, FOXBusiness, December 31 2018

[2, 3, 4] Thomson One

[5, 9] *Outlook – Long-term perspective on markets and economies*, Capital Group, January 2019

[6] Rochon, Stéphane, *Equity Strategy – January 2019: A New Hope*, BMO Nesbitt Burns Portfolio Advisory Team, January 2019

[7] Rochon, Stéphane, *Equity Strategy – December 2018: The Virtue of Oligopolies*, BMO Nesbitt Burns Portfolio Advisory Team, December 2018

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

[11] Profiles for AMZN, BCE, CHE.UN, CP, JNJ, MCD, MSFT, SU, TD, and TRP replicated from the BMO Capital Markets RED Sheet, January 31 2018

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