Ever **Higher?**

BMO Wealth Management
BMO Nesbitt Burns

The COSGROVE-BROCK Group

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Philip's Comments

In November of 2011, I brought my fairly young advisory practice into partnership with a tenured Investment Advisor named Elizabeth Cosgrove. At its inception, our collaboration was based in Elizabeth's wish to secure a viable succession plan for her clientele. At that time her retirement was not imminent, but Elizabeth had enough foresight to know that even with her departure on the distant horizon, the right preparations needed to be made and that would take time. That time has now come. As you likely know, after a 44-year career, Elizabeth retired this past Friday, January 31st.

The unification of our practices led to an eight-year collaboration that resulted in the improvement of both of our approaches to client service and investment management: a real example of the whole being greater than the sum of its parts. This very newsletter, for example, and the inception of our Model Portfolio in the summer of 2013, was born out of a need for us to communicate with our clients in a shared voice.

Those of you who have worked with Elizabeth will know what has driven Elizabeth's investment view over the years: a strong belief that holding high-quality, dividend-paying equities over the long-run, through market cycles, leads to the building of wealth and the ability to use portfolio income to maintain one's quality of life. This way of managing money is elegant in its simplicity, and will remain at the core of our approach. It has successfully built a strong financial foundation for Elizabeth's clients.

Looking ahead, let me say to Elizabeth's clients just how much I look forward to building on this firm foundation that Elizabeth has laid. I've had the chance to meet many of you already, and in some cases to work with you extensively over the years, and our team and I look forward to continuing to be of service to you and your families for years to come.

And to Elizabeth, who I suspect will continue to be an avid reader of this newsletter; I say congratulations on a job well done! May you and Dave enjoy a well-deserved life of pursuing your other passions, with the heartfelt thanks of your colleagues and your clients.

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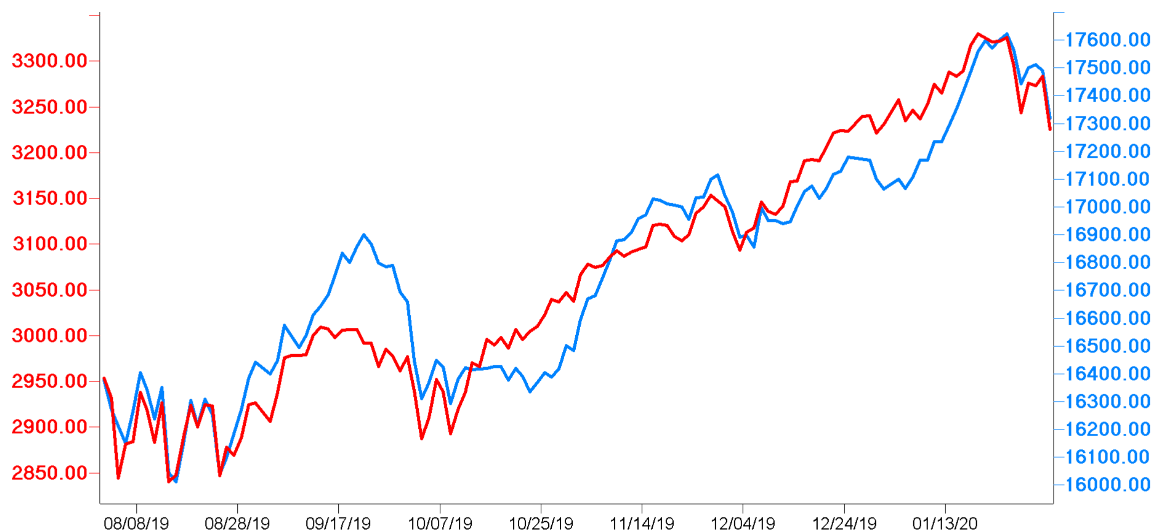
Onwards and upwards! – those have been the marching orders for equity markets since the publication of our last newsletter in the summer of 2019 – *Diverging Paths*. In our commentary at that time, we spoke to the increasing divergence of markets – on a set upward trend – and economic growth, which was facing real hurdles in terms of global manufacturing and trade. Since that time, the paths may have converged somewhat – not because of the equity slowdown that we feared, but rather because some of the economic pitfalls that loomed on the horizon seem to have been avoided, or at least delayed.

Between August 1st 2019 and January 31st 2020, Canadian markets advanced, with the S&P/TSX Composite Index gaining 929 points, or 5.7%[1]. The US market, as represented by the S&P 500 Index, did even better with a gain of 245 points, or 8.2% over the last six months[2] (see Figure 1). This is record territory for both indexes, and these increases come after equally impressive periods in the six months ending July 31st 2019.

*Figure 1: Performance of **S&P500** & **S&P/TSX Composite Index** (August 1 2019 – January 31 2020)*



Source: Thomson One

For its part, the Canadian dollar gained almost two cents on the greenback by the beginning of 2020, but gave up those gains over the course of the month of January, closing at 0.756 CAD/USD[3]. It did so primarily due to its high correlation to the price of oil, where a similar story played out: light crude increased by nearly $10/barrel between August and early January, but gave up all of those gains and then some by the end of January, closing the month at just over $51.56/barrel[4].

The precipitous decline in the price of oil in January can be tied to two major geopolitical events that posed challenges to markets in recent weeks:

- First, tensions increased between the United States and Iran following the US' targeted military strike against Iranian General Quasem Soleimani, which caused oil to increase quickly until it became clear that Iranian retribution for the attack was measured, and that escalation of the conflict into a hot regional war was unlikely[5].

- Then, just as oil was already letting off some steam, global concerns over the Corona Virus spiked, with the Chinese government effectively shuttering an entire large city, Wuhan, in an effort to stem the spread of contagion[6]. The resulting concerns over the impact of the virus on Chinese, and in fact global, economic growth helped the price of oil continue its decline.

These types of unforeseen events (referred to in our industry as "exogenous shocks") represent some of the greatest risks to financial markets, especially given the valuations at which markets currently trade. We will take the opportunity to explore the topic of lofty market valuations, as strong economic conditions have continued to push markets ever higher.

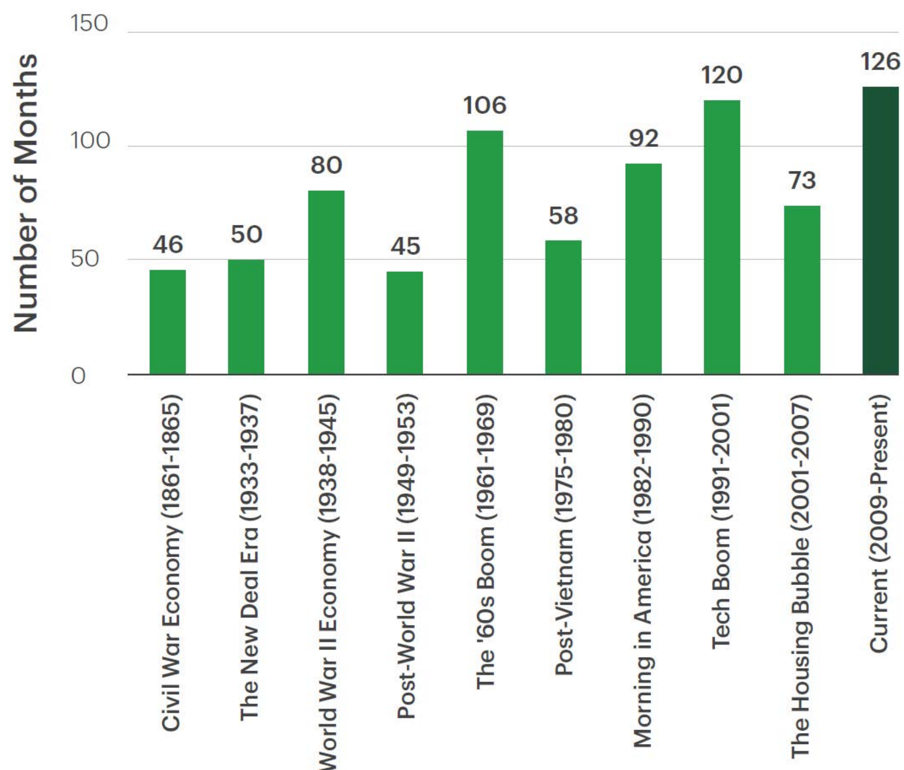
The Marathon Bull

It has already been two years since the Winter 2018 newsletter titled "Pushing the limits", where we recommended that our clients take a more cautious approach to asset allocation, by holding a slightly lower allocation to equities than their long-term equity target. Clearly, the growth of markets since then has made this recommendation look overly cautious. However, our primary focus must be the safety of clients' invested capital, and this recommendation was made with that in mind.

We have been fortunate that the cautionary signs in 2018 did not lead to a sharp economic decline, and we have enjoyed two years of continued growth since then. The cautionary signals are still present, however, and the red flags are waving even harder than before.

Over the course of the last six months we have ended many days with the words "record high", especially as it pertained to the progression of the main US stock index, the S&P 500. With the exception of a brief interruption in late 2018, the US market has pushed consistently higher, fueled by accommodative monetary policy and economic growth. In fact, the economic expansion itself is the longest on record in US history, as defined by the number of consecutive months of positive GDP growth[7] (see Figure 2).

Figure 2: Longest Economic Expansions in US History



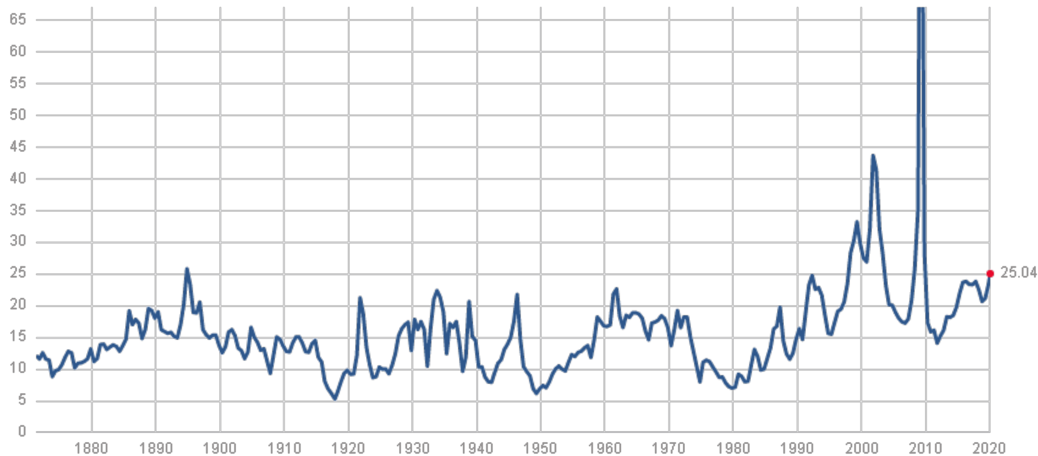
Source: TD Asset Management, Year Ahead 2020, U.S. Business Cycle Expansions and Contractions, The National Bureau of Economic Research http://www.nber.org/cycles.html

On its own, the length of this period of strong markets is not a reason for conditions to suddenly change, but it has caused equity valuations to continue to stretch. Valuation analysis is the evaluation of how much a stock, or an index of stocks, is worth (price)

relative to another measurable financial input (earnings, sales, cash flow, and book value are often used). On its own, valuation is a poor predictor of the timing of market movements, but a very good way to answer the question of "*Am I paying too much for this asset?*"

So where are we, in terms of market valuation, if we look at things from a historical perspective? Let's take a look from the standpoint of the price/earnings ratio (Figure 3), the price/sales ratio (Figure 4), and the price/book ratio (Figure 5).

Figure 3: Historic S&P 500 Price/Earnings Ratio, using 12-month trailing earnings



Source: www.multpl.com/s-p-500-pe-ratio

Clearly from this chart we can find periods where this ratio breaks down (look at the fallout from the financial crisis of 2008 for example, where trailing 12-month earnings were so low that the multiple skyrocketed off the chart), but in general this ratio is a sound gauge for the "expensiveness" of equities. Current trailing P/E stands around 25 times earnings, significantly higher than the median level of just under 15[8].

Can we confirm this finding with other valuation ratios? Observe below the price/sales ratio for the S&P 500, measuring the price of the index over the trailing 12-month sales-per-share of its components (Figure 4), as well as the S&P 500's price/book-value ratio (Figure 5), which compares share price to the book value of the underlying companies. Book value is simply what you're left with if you take the total assets of a company and subtract from them the company's total liabilities.

Figure 4: Historic S&P 500 Price/Sales Ratio, using 12-month sales

Source: www.multpl.com/s-p-500-price-to-sales

Figure 5: Historic S&P 500 Price/Book Value Ratio, using latest S&P 500 Book Value

Source: www.multpl.com/s-p-500-price-to-book

These two metrics – the highest Price/Sales ratio in 20 years for the S&P 500, and a Price/Book-Value ratio only surpassed by the "irrational exuberance" of tech-bubble-era valuations, help confirm what the Price/Earnings ratio indicated. Stocks are, by almost any measure, expensive.

As we mentioned earlier, valuation analysis is a poor predictor of the timing of market movements, and trying to "time the market" is a fool's pursuit and not one that we are interested in attempting. However, the conclusion that equities are trading at lofty valuations should absolutely help us determine how to position the asset allocation of our clients' portfolios. We also need address the reality that it is with equity markets as richly-valued as they are that we are heading into a period which is still fraught with possible pitfalls, or as we referred to earlier in this text, exogenous shocks.

Exogenous shocks = things that can go wrong

There has never been a time in history where a forward-looking view didn't raise the possibility of incoming problems for an economy. To say that we are currently more-exposed-than-normal to the next crisis is the usual territory of fear-mongers and alarmists. On the other hand, there is nothing "usual" about the world's current geo-political footing, and we live in a world where unpredictability Trumps the "usual".

At the time of the writing of this newsletter, the World Health Organization has declared a global health emergency in regards to the Corona Virus, and every indication is that it will rival SARS in terms of its reach and scope. This will almost certainly cause slower economic growth in China, which will have an impact on global growth. In 2003, the SARS outbreak caused economic growth in China to decline by approximately 2%, but that was off of a base of an 11% growth rate. Today's China, the world's second-largest economy, is more domestically-focused, with a prevailing level of growth closer to 6%[9]. In other words, there is a real risk that a "shutdown" of Chinese cities like Wuhan could have a larger impact on Chinese GDP than the SARS epidemic did almost 20 years ago. And let's be clear, Corona is not SARS and comparisons are unlikely to be accurate. Could Corona Virus be capable of providing that "exogenous shock" that sets equity valuations back to reasonable levels? Yes, it is possible.

And what can we say about good old fashioned politics? After all, 2020 is a Presidential election year. Can a newly "vindicated" post-impeachment Donald Trump inject enough raw uncertainty into markets to prompt an equity correction? Or can a very progressive Democratic nominee such as Bernie Sanders or Elizabeth Warren generate enough policy uncertainty to prompt corporations high on Trump-style deregulation to get nervous enough to cause markets to contract? Yes, it is possible.

It is because of the intersection of these potential exogenous shocks and those that we cannot foresee, with the prevailing high valuations of stocks, that our recommendation for your portfolio to sit at 90% of its long-term equity target stands.

This newsletter's focus on continued caution may prompt some readers to ask, "why not issue an even more conservative recommendation?" After-all, the scale in the "Asset Allocation" section of this newsletter allows for positioning of equity portfolios all the way down to 80% of our long-term equity target. However, there is still a strong argument that the currently-high valuations of equities are at least *partially* justified, and as such we don't recommend such an extremely defensive stance at this time.

Margin of safety

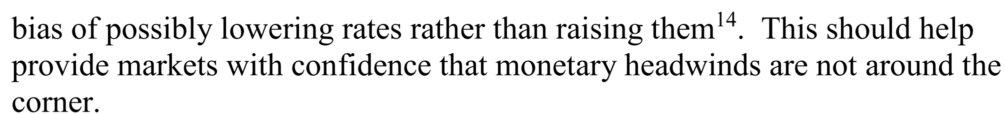
The current economic context remains concerning from a valuation standpoint, but there is also data to suggest that some of the broader risks to global economic growth are abating. Specifically:

- In our last newsletter, we pointed to a global slowdown in manufacturing, as evidenced by lower purchasing managers' indices (PMIs) in the US, the UK, and in Europe. While PMIs are all lower in their most recent survey than the levels that prevailed 6 months ago, they have been on an increasing trend in the last couple of surveys[10]. We may have turned the corner on this particular economic indicator.

- The other major concern that we underlined was concern over the trade relationship between the US and China. While it remains tense, the two countries have de-escalated tensions through the signing of a "Phase 1" trade deal in January[11].

- Last summer, the possibility of a "no-deal" Brexit seemed likely, but of greatest concern was that the UK seemed politically unequipped to deal with such an occurrence, with the governing Conservatives holding a minority in Parliament. Since then, an election has helped confirm Boris Johnson's mandate for Brexit though the election of a large Conservative majority. Brexit has taken place effective January 31st. The world has not ended, but we are still in the period where a final economic agreement between Europe and the UK will be negotiated[12]. This situation still presents potential risk, but at the very least political paralysis does not appear to be a contributing factor.

- Central banks around the world continue to implement an accommodative (stimulus-heavy) monetary policy, with the US Federal Reserve likely "on hold" during the 2020 election year[13], and the Bank of Canada recently pivoting to a



bias of possibly lowering rates rather than raising them[14]. This should help provide markets with confidence that monetary headwinds are not around the corner.

- Perhaps most importantly, the US consumer seems to be in very good health, propped-up by a 50-year low in the unemployment rate in the US[15], modest inflation[16], and a five-month high in consumer confidence[17]. Jobs are plentiful, and consumers *feel* as if times are good, which helps fuel the self-fulfilling prophecy of economic growth.

The bottom line is: as markets continue pushing ever-higher, we can take some comfort in the fact that we are operating against an economic backdrop that is helping to justify these lofty valuations. We remain cautious, but recognize that economic conditions have granted markets a certain margin of safety.

Conclusion

For two years now, we have adopted a cautious approach to asset allocation. We remain cautious, but also recognise that the world's economic landscape has some redeeming qualities that should not be ignored.

- The evolution of markets over the last six months has pushed the current economic expansion to record lengths, and equity valuations to significant historical highs. Equities are expensive at the moment, and this influences our approach to portfolio management, prompting our caution.

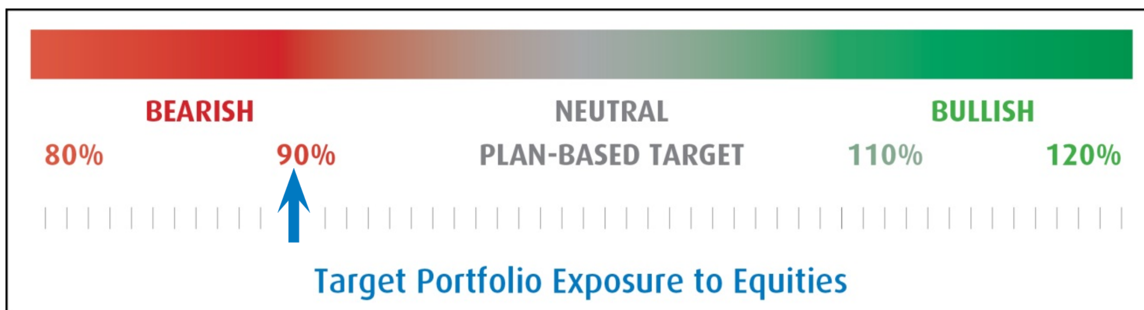
- In addition to these concerns about the expensiveness of stocks, there is the risk of substantial instability stemming from Corona Virus, policy uncertainty generated by the US presidential election, as well as other less obvious "exogenous shocks".

- Despite these concerns, the world economy continues to be supported by a strong, confident, and employed US consumer. Relaxation of certain global trade tensions and accommodative global monetary policy also continue to provide momentum for economic growth.

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[18]
Yield*	3.06%	2.34%
Portfolio Beta*	0.88	1.00
Number of Holdings	28	1644

Sector Allocation (Core Portfolio)

	Model Portfolio	MSCI World Index
Financial Services	25.0%	15.4%
Communication Services	7.5%	8.4%
Real Estate	5.0%	3.3%
Utilities	7.5%	3.6%
Consumer Staples	14.5%	8.3%
Consumer Discretionary	7.5%	10.3%
Healthcare	6.0%	12.9%
Information Tech.	6.0%	18.1%
Industrials	11.0%	11.0%
Energy	5.0%	4.5%
Materials	5.0%	4.2%

*As at 2020-01-31; source: Thomson ONE

Meet Our Team

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Philip made his entry in the financial industry in 2004, and joined BMO Nesbitt Burns as an Investment Advisor in March of 2006. Since then, Philip has advised many families on retirement planning, personal credit, and investment management. In addition to his work with clients, Philip served as Assistant Branch Manager for the Ottawa Dalhousie/Lansdowne branch of BMO Nesbitt Burns between 2014 and 2019.

Philip 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 English, French, 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 and his family can usually be found on the ski hill or off in the woods on a canoe/camping 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, BBA
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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 Gatineau 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, 2, 3, 4] Thomson One

[5] Gaouette, Nicole; Alkhshali, Hamdi; Browne, Ryan; Starr, Barbara; Qiblawi, Tamara, *Trump says "Iran appears to be standing down" following its retaliatory attacks against Iraqi bases housing US troops*, CNN, https://www.cnn.com/2020/01/07/politics/rockets-us-airbase-iraq/index.html, January 8 2020

[6, 9] *China braces for blow to economic growth from coronavirus*, Financial Times, January 27 2020

[7] *Year Ahead 2020*, TD Wealth Asset Allocation Committee, TD Asset Management, Q1 2020

[8] S&P 500 PE Ratio; S&P 500 Price to Sales Ratio; S&P 500 Price to Book Value Ratio, multpl.com

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

[19] Profiles for AMZN, BCE, CP, WN, INE, IFC, MFC, MCD, NA, SU, TRP, and WMT replicated from the BMO Capital Markets RED Sheet, February 8 2020

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