Morin Dupont Lessard
& Associates

Sound advice with outstanding service

Newsletter #51 April 2014

# Does Obama Care?

## (Excerpt)

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& Associates

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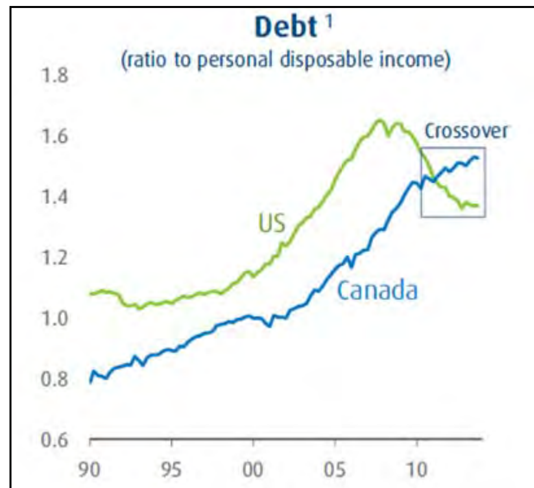
# Pierre's comments

Last January, we issued our annual RRSP /TFSA letter at a time when the market was going through a correction – a correction that sent the market down roughly 8%, rekindling fears of an imminent crash. We attempted to highlight some of the reasons why we should remain confident and describe the evolution of an improving investment environment. Allow me to quote this paragraph from the RRSP / TFSA letter highlighting these improvements.

"*CONFIDENCE is now the key! Confidence can be found in the corporations' financial ability to expand again. Confidence builds when consumers feel new job opportunities, lower cost of debt and knowing that they can keep their homes as real estate prices continue to firm up. Confidence that the government is back on the right track…Confidence starts at the top and works its way down. Confidence is shown when the US government is finally able to get a budget through Congress after 4 years of absence. Confidence is when the debt ceiling causing government shut-downs is no longer an issue and deficits are shrinking significantly. The Fed is sending us a confidence signal when it believes the underground strength of the US economy is strong enough to start tapering. Although the economy is only growing at 2%, industries that were decreasing by double digits a few years ago such as industrial, commercial and residential real estate as well as automobiles are now growing. Japan, whose economy was stagnant at best for the past 20 years, is now expanding. Europe's economy is finally improving as well. Mergers and acquisitions (M&A) activity is picking up and the IPO market was red hot in 2013. None of those conditions existed 5 years ago. We now have an environment to stimulate confidence and it can feed on itself. Consumer confidence leads to job creation and stronger economic growth.*"

Confidence is first expressed by a slow pick up in consumption, then in the form of investment (in stocks and real estate). At the beginning of a cycle, the use of leverage is barely existent, then begins to expand as confidence builds. Excess confidence appears when the use of leverage drives irrational investment behavior and speculation. In this letter we will try to formulate where we stand in the current cycle, both from consumer and corporate standpoints.

**Chart 1**

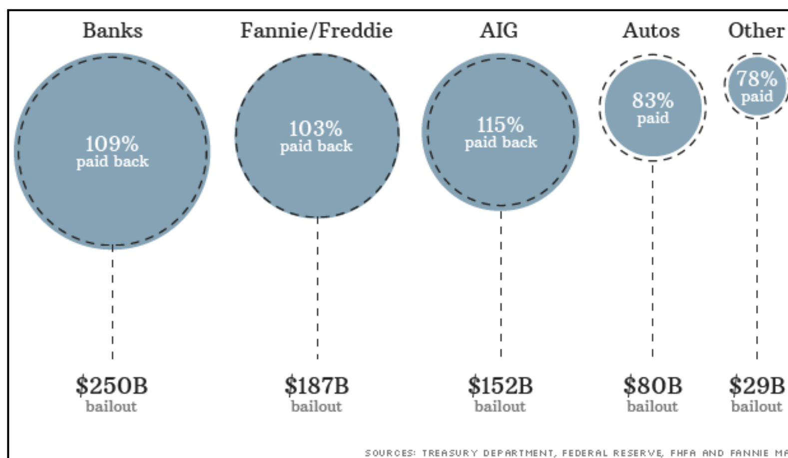



Source: BMO Capital Markets

On the consumer side, chart 1 serves to demonstrate the disciplinary actions taken by American consumers in the aftermath of the 2008-09 financial collapse. Over-leveraged back then (end of cycle), Americans lost a huge amount of wealth with the stock and real estate meltdown of 2008-09. Some Americans lost their jobs; worse, some lost their homes. At the lowest point, it felt like consumption was limited to the bare necessities. We can question – even doubt – the ways and means used by the Federal Reserve Board to revive the economy, but at this point in time, many things seem to be back on track. At a huge cost, true, but at least the plan's working … albeit at a slow pace, for now.

March 9th marked the fifth anniversary of this bull market – the end of the meltdown. The Dow is up more that 128% in that time and continues to reach new all-time highs. And although these new highs can be perceived as scary, there are fundamental justifications to support current valuations, and reasons to believe that evolving consumer behavior could turn this rally into the longest bull market in history. Only three other cycles lasted longer than five years prior to this one. However, this is the only one that has been fuelled by unprecedented central bank interventions.

**Chart 2**




Source: Treasury Department, Federal Reserve, FHFA and Fannie Mae

At the height of the crisis, there were five major bailouts: The banks ($250 billion), Fannie May & Freddie Mack (government-sponsored mortgage agencies - $187 billion), American Insurance Group ($152 billion), the auto industry ($80 billion) and “others” ($29 billion). Taxpayers were not impressed when the government took money from their pockets to bail out greedy financial institutions while they themselves were losing their homes, but today we can confirm that 109% of the bank bailout funds, 103% of the Fannie/Freddie amount and 115% of AIG bailout money have been paid back!

In dollars, that means taxpayers are up about $50 billion for those three groups combined. Meanwhile, 83% of the amount used to bail out the auto industry and 78% of funds used for “other” bailouts have been repaid to taxpayers, leaving them short roughly $13.6 billion and $6.38 billion, respectively. Overall, within five years, taxpayers have recouped more than they put in… Who would have thought?

We have now entered what is referred to as the “tapering’’ period of quantitative monetary policy (we’re still printing money, albeit at a reducing pace). Remember that, at first, this freshly printed paper was intended to provide the necessary liquidity for the banking system to survive, thus avoiding bank runs. Then, it was used to refinance mortgages by repurchasing long bonds, driving down 30-year fixed term mortgage rates – which reached 3.31% at their lowest, in November 2012. This action allowed defaulting homeowners to refinance their mortgages and keep their homes. And thus began a new consumption cycle. These low rates also allowed for a real estate inventory cleanup which, in turn, had an upside impact on home valuations. As home inventories fell, housing starts picked up momentum as well. With consumer balance sheets starting to look better, buying homes and stocks came back into style. And thus began a new investment cycle. In the past two years, U.S. household net worth has increased by $13 trillion. In my mind, this is a huge confidence booster and should positively impact consumer demand going forward. It should be noted that banks tightened their lending standards during the financial crisis. Now, with delinquencies falling, capital increasing and economic expansion continuing at a healthy pace, banks are likely to ease their lending standards at some point, which would further fuel a U.S. housing recovery and, by ricochet, boost consumer confidence.

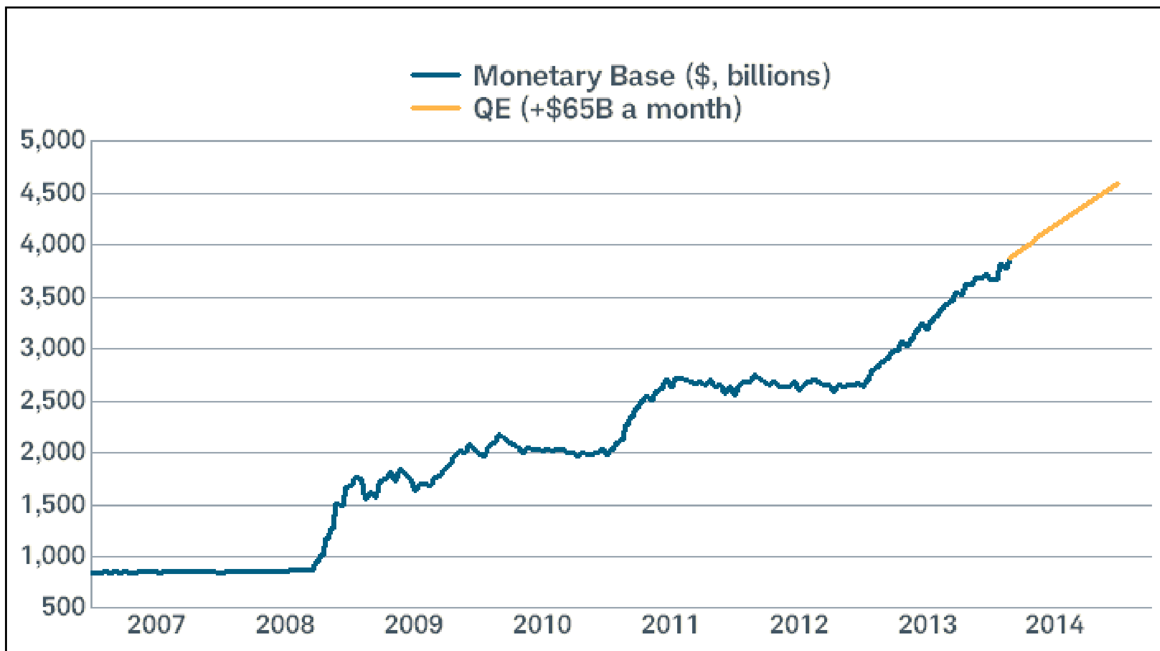
Referring back to Chart 1, U.S. consumers have paid down debt significantly compared to Canadians. Total debt as a percentage of revenues has reached new all-time levels for Canadians. In the U.S., total mortgage debt is down by $1.4 trillion since 2008, leaving Americans with room to re-lever. In due course, as confidence continues to build, this growth spin will feed on itself. As for Canadians, excess leverage doesn’t seem to worry them yet. A falling dollar reflecting a slower economy, weak commodity prices and lack of productivity may result in improving bottom lines, but for the wrong reasons. Enhanced M&A (mergers and acquisitions) activity worldwide may put unproductive Canadian companies at risk of falling into foreign hands, resulting in the loss of jobs and/or head offices. It seems paradoxical that, during the Canadian dollar’s longest stance at or near par with the U.S. dollar, Canadian companies failed to seize the opportunity to significantly invest in systems, equipment, etc. to enhance productivity. As a result, investments are starting to shy away from Canada, and capital is flowing out, further impacting our growth and the value of our currency. The only productivity gain that Canadians can claim comes from a lower loonie… which is nothing to brag about.

Canadian markets, led by the TSX (up 78% from 2009 low), have significantly underperformed their U.S. counterparts over the past few years and at 14,300 points, the TSX still has not reached its all-time high of 15,154 recorded in June 2008. A lower loonie will help some Canadian exporting companies to record better earnings, and perhaps propel the TSX to new all-time highs as well. But as this bull run ages, investors will begin to worry about bubble formation. It is important to understand that by definition, a bubble is when irrational buying using excessive credit occurs, while chart 1 above, shows a reduction in indebtedness on the consumer front. Perhaps the 2008-2009 real estate and stock market collapse is still fresh in peoples' minds.

On the corporate side, debt levels are also very low. Corporate spending has been waiting on the sidelines for consumer demand to pick up in a convincing fashion. Although the Fed has been a huge provider of liquidity to the system, through QE 1, 2, 3…, the money isn't finding its way into the economy, yet. But the money is there!

**Chart 3**

Fed's Balance Sheet Still Rising



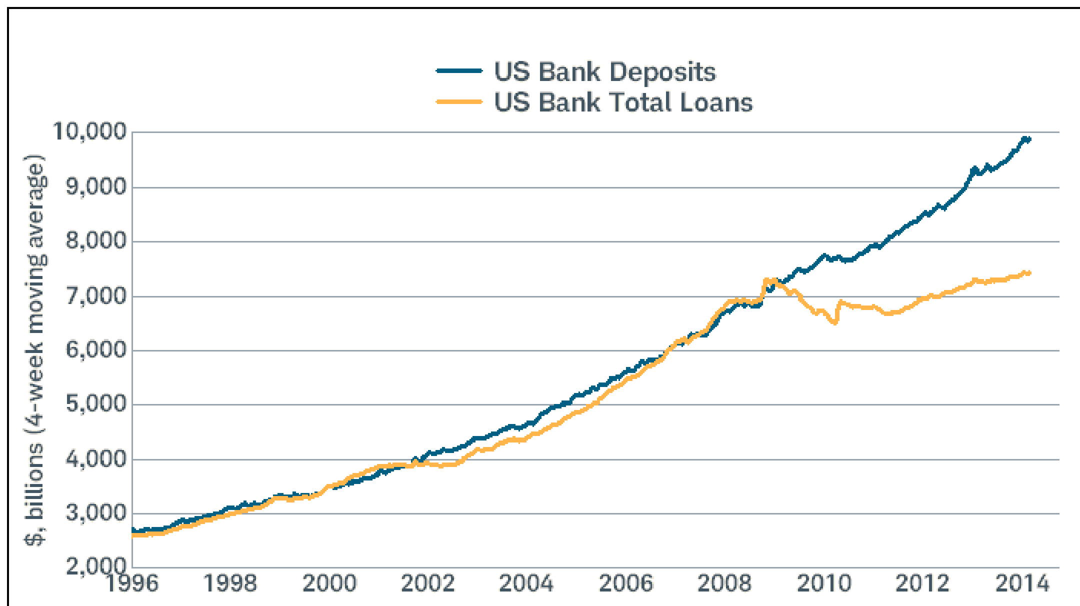

Source: FactSet, Federal Reserve, as of February 21, 2014.

Chart 3 shows the Fed's balance sheet and expansion of its monetary base since the financial crisis. From less than $1 trillion in 2008 to over $4 trillion in 2014 – that's a huge expansion in money supply (also referred to as M1). Back in the 1980's, M1 became the most watched indicator for a sign of inflation relief. Interest rates had risen to over 20% to kill the ever expanding inflation spiral. Wage inflation was in the middle of this mess, and the more wages increased, the higher the price of goods had to go, just so suppliers could pay their workers. Therefore, then Fed Chairman Paul Volker drove interest rates to 20% to encourage saving rather than spending, and this eventually caused a new disinflationary cycle, which allowed for interest rates to begin a downward trend.

At this point in time, we find ourselves at the other end of the spectrum. We came so close to deflation and depression that the Fed's solution was to re-inflate by printing money, and encourage spending and consumption by keeping rates extremely low. We should all be worried when consumer and corporate debt gets out of control, but we are not there yet. In fact, the one positive thing the financial crisis caused was the beginning of a huge de-leveraging process, as shown in Chart 4.

**Chart 4**

Record Gap Between Bank Deposits and Lending




Source: FactSet, Federal Reserve, as of February 21, 2014.

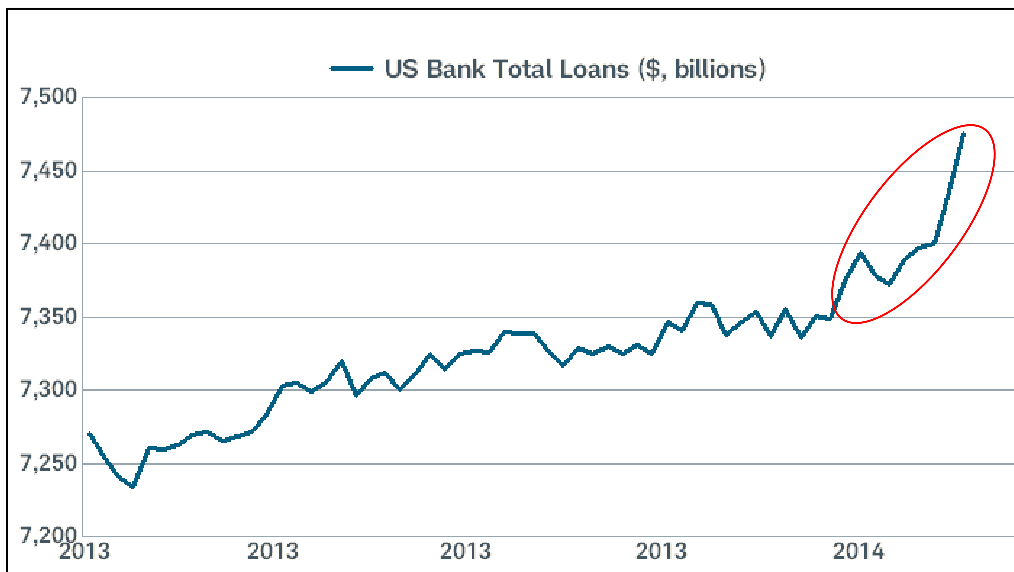
New, more stringent global rules and regulations, such as the Basel III agreement, reduce banks' ability to lend in an extreme manner that would put bank depositors at risk. The gap between U.S. bank deposits and total loans might be greater in the future than in the past, but we believe it should narrow from here.

Loan growth has been almost at a standstill since the beginning crisis. Also referred to as the "velocity of money" or the "money multiplier", loan growth is also an indicator of corporate optimism. A 2% growth in GDP is not too exciting for corporate leaders who have to decide whether to expand the business or not. In that sense, a rise in corporate indebtedness indicates increasing confidence on the part of corporate leaders. It is the absence of such leadership that worries investors and holds back the consumer. So the best use of cash for consumers is to pay down debt and, for corporations whose debts are negligible, it is to pay higher dividends and buy back stock, pushing the stock markets higher. Then stocks are fully priced based on the current capacity of generating earnings without sales growth. Investors will focus more and more on sales growth given that margin expansion from a cost management point of view has achieved most of its potential. At one point, volume growth becomes essential for continued profitability expansion.

There is no bubble in the U.S. or Canadian markets, given the financial strength of corporations, the U.S. consumers financial discipline and the relative price-to-earnings ratio sitting slightly above historical averages at nearly 17 times. Perhaps the good news lies in Charts 5 and 6.

**Chart 5**

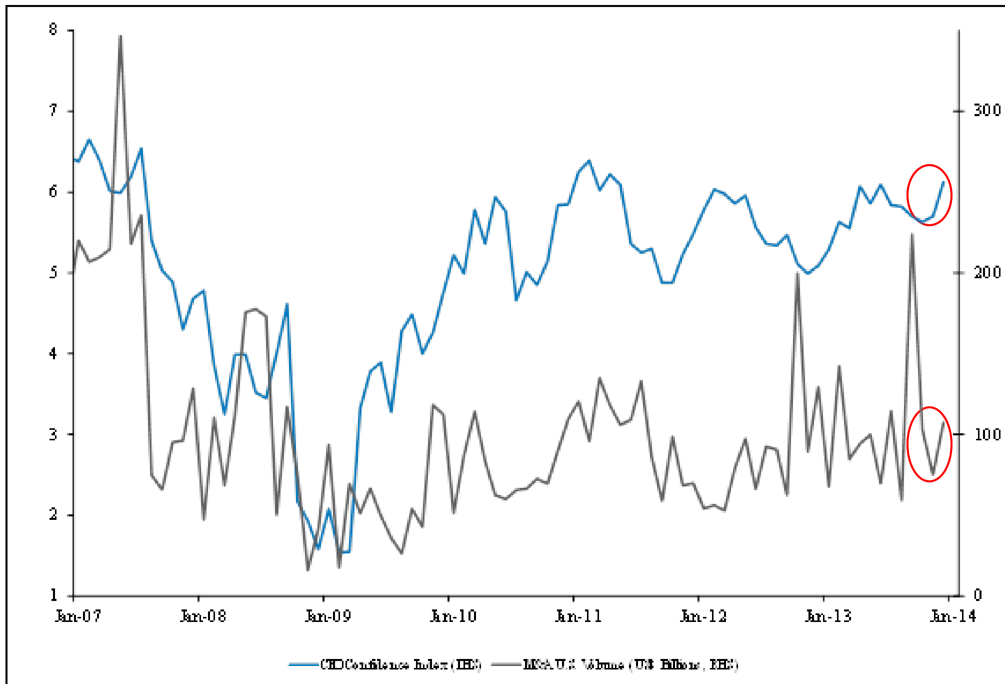
Bank Lending Now Surging




Source: FactSet, Federal Reserve, as of February 21, 2014.

**Chart 6**

M&A Volume vs. U.S. CEO Confidence Index




Source: BMO Private Client Strategy, Bloomberg

Zooming in on loan growth for 2013-14, we can see on chart 5 significant momentum building, especially in the most recent quarter. Chart 6 reflects this increasing corporate confidence, as well as M&A activity, probably the result of stronger than expected top line (sales) growth in the last quarter, suggesting continued expansion of earnings.

<u>Government interventions</u>

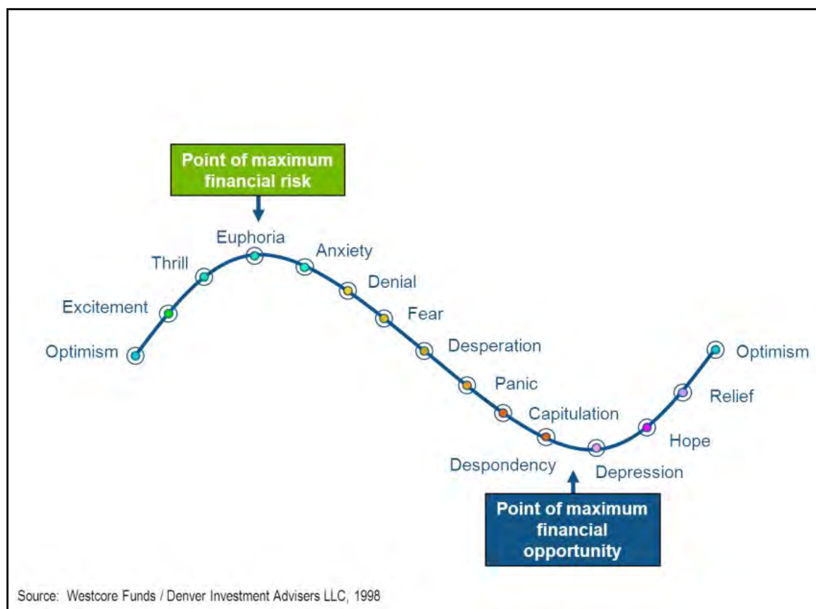
The Federal Reserve Board has done what it could to revive the economy, but we are still waiting for the U.S. government to do its part. Some baby steps were achieved recently, but much more is expected. If history is right, then the last two years of a term are usually favorable to equity markets. Mr. Obama, the first black President, certainly doesn't want to leave a bad legacy behind him. He was exposed to the worse financial crisis in 70 years and Republicans certainly did not make his job easy. There are elections this coming November for members of the House, and this will probably force him to postpone tougher, nonpartisan decisions, till later. However, I believe that many economy-driven decisions, perhaps unpopular in his own party, will move ahead to ensure he leaves the U.S. on a strong economic footing. Projects like the Keystone pipeline and the creation of a new energy policy as well as a new fiscal platform for corporations are surely in the cards. The achievement of all or part of these would provide a huge confidence booster on the corporate side, resulting in wealth creation. As mentioned earlier, these positives feed on themselves, fuel lending and ignite the velocity of money (or money multiplier), until irrational exuberance and greed settle in and create yet another asset bubble.

## SUMMARY AND CONCLUSION

It is our belief that stocks are currently slightly overpriced and that we may retest the recent January lows. However, there are many reasons to believe that this bull market still has legs and positive momentum should return as confidence builds. It is important to note that the last leg of a bull market is usually driven by loan growth led by corporations, the return of mergers and acquisition activity and the resumption of inflationary pressures. The beginning of an inflation cycle is generally well perceived, as it is the Fed's main objective in order to avoid a worse evil, deflation. Asset inflation unfortunately leads the way to wage inflation and that is when things start to deteriorate as it is perceived as "nasty inflation". Companies typically pass on wage inflation through the cost of goods, multiplying the impact of higher wages. Then the inflation spiral feeds upon itself, which drives interest rates ever higher. We obviously are very far from that, but interest rates artificially held at extreme low levels will become history soon.

Chart 7 shows what the investor sentiment cycle looks like. We believe we are currently at the optimism stage of the cycle.

**Chart 7**




Source: Westcore Funds/ Denver Investment Advisors LLC, 1998

It is to be noted as well that world tensions and geopolitical issues could have a significant impact on a fragile but improving world economy. Prudence in your asset allocation is your best defense against excessive leverage, which increases financial risk, and also against unpredictable events.

We believe that the most important economic indicators to watch for at the moment are:

- Sales growth (consumer behavior)
- Corporate loan growth (corporate behavior)
- M&A activity
- Real estate prices
- Wage inflation
- Government initiatives

GO CANADA GO, G'OBAMA GO!

## Investment Strategy

In line with the drivers of the last leg of a bull market are industrials, technology, financials, energy and later, gold. Pharmaceuticals as well as consumer staples are not only safe to own but some offer good growth potential. Portfolio weightings of interest-sensitive stocks such as real estate and utilities should be reduced as we advance in the cycle. Some selected consumer discretionary stocks may benefit from wealth creation, but caution and selectivity are the key as they would not represent a long-term investment in most cases. Here are our suggested weightings:

**Table 1**

| Sectors | Recommanded Weighting March 2014 | Trend |
|---|---|---|
| **Consumer Discretionary** | 0% | ⇧ |
| **Consumer Staples** | 7% | |
| **Energy** | 7% | |
| **Financials** | 17% | ⇧ |
| **Health** | 5% | |
| **Utilities** | 8% | ⇩ |
| **Industrials** | 8% | ⇧ |
| **Materials** | 4% | |
| **Technology** | 4% | ⇧ |
| **Telecom** | 5% | |

*Please note that our suggested weightings are subject to a 65% equity and 35% fixed income portfolio and must be modified to fit your personal investor profile.

| RECOMMENDED ASSET MIX | | | | |
|---|---|---|---|---|
| **INCOME PORTFOLIO** | | | **BALANCED PORTFOLIO** | |
| Oct 2013 | Apr 2014 | | Oct 2013 | Apr 2014 |
| 10% | 10% | CASH (Maturities ≤ 12 months) | 10% | 7% |
| 50% | 50% | Fixed Income (Bonds & GICs) | 30% | 30% |
| 15% | 15% | Convertible Debs. and Income Generating Securities | 15% - | 13% |
| 10% | 10% | Equities | 25% + | 25% |
| 15% | 15% | Foreign | 20% + | 25% |
| *Disclaimer: Subject to an evaluation of the risk profile of individual clients* | | | | |

**Sources:**

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# Meet Our Team

**Pierre Morin**
Senior Vice President,
Senior Investment Advisor
and Financial Planner
514-282-5828
pierre.morin@nbpcd.com

**Josee Dupont**
Investment Advisor and
Financial Planner
514-282-5707
josee.dupont@nbpcd.com

**Hugo Lessard**
Associate Investment Advisor
Financial Planner
514- 282-5861
hugo.lessard@nbpcd.com

**Brenda Walls**
Investment Representative
514- 282-5887
brenda.walls@nbpcd.com

**Patrick Delaney**
Investment Representative
514- 282-5847
patrick.delaney@nbpcd.com

**Neela Patel**
Investment Representative
514- 282-5840
neela.patel@nbpcd.com

**Nancy Landry**
Administrative Assistant
514-282-5801
nancy.landry@nbpcd.com

For more information, please contact:


## Morin Dupont Lessard & Associates

Investment Advisors

BMO Nesbitt Burns
1501 McGill College, suite 3000
Montreal, Quebec, H3A 3M8

Tel: 514-282-5828
Toll Free: 1-800-363-6732
Fax: 514-282-5838

**www.morindupont.com**


Morin Dupont Lessard
& Associates