Morin Dupont Lessard & Associates

Sound advice with outstanding service

Newsletter #52 October 2014

Don’t rock the boat…calmer seas ahead

(Excerpt)

Morin Dupont Lessard
& Associates

Table of Contents

- The Economy and review of the Markets
  - Pierre's comments
  - Conclusion
- Recommended Asset Mix
  - Balanced Portfolio
  - Income Portfolio
- Review and Analysis of our Model Portfolio
  - High yield equities and convertible debentures
  - Growth and income equities
  - Aggressive growth, mutual funds and ETF
- Model portfolio selections covered in this newsletter
  - Special updates
- Tables and Charts
- Historical performances and benchmark

Pierre's comments

Over the past several months, if not years, investors and experts alike have been restlessly expecting an inevitable correction. After reaching new all-time highs no less than 52 times last year, the Dow Jones is on track to beat that record in 2014. Deciding whether to invest or to wait is always difficult. Maintaining a proper balance and diversification by asset class has been your best option; overweighting equities is much more dependent on your need to withdraw capital (in addition to your other revenues) than on market levels.

Investment horizon is the key. If you depend on your capital, sooner than later, timing can be relevant. If you can survive on your investment income among other sources of income without touching your capital, you are in a better position because you do not depend on timing the market. Even the best portfolio managers in the world have been challenged repeatedly in timing the market. Time is your friend in portfolio management.

Between 1980 and 1987, the market doubled, although interest rates were at all-time highs, hovering around the 20% mark. From 1987 to 1994, the market doubled – even taking into account a crash in which the market plummeted 22.6% in a single day. The market doubled again in the following three years (1994-1997), although the interest rates rose seven times in 1994. It took no less than 16 years (1997-2013) for the Dow Jones to double one more time. True, the 2008 financial crisis created a setback, but that still gives us 11 years. If the new trend is to double every 16 years, that still gives us a 4.5% annual return, plus dividends, for a total return of over 6% per year. This compares favorably to most current fixed income products. I do realize that this evaluation is quite simplistic, but sometimes it helps to put things in perspective. The good news is that there are significant fundamental reasons that support a continued market expansion. However, investment behaviour should never be driven by anxiety. This is where a proper balance reduces the risk of making disruptive emotional decisions.

There are four main players that influence the economy. Looking back to 2008, to the start of the financial crisis, I thought it might be interesting to chronologically analyze the behaviour of these players: the government, the Central Bank (Fed), corporations and consumers. Perhaps this exercise will allow us to better understand where we stand today and to extrapolate and better predict future market behaviour.

Government

When the crisis hit, all four groups reacted. For the government, saving the financial system and ensuring its sustainability were the most critical issues. They encouraged bank mergers, an otherwise unthinkable scenario, to avoid financial collapse. In addition, the US government used more than $150 billion in public funds, as a last resort, just to save AIG (American Insurance Group) and avoid a probable domino effect in the financial industry. The government then established new sets of rules and regulations to counter the risks of such events happening again and to prioritize the repayment of public funds. Other interventions were necessary in order to save the maximum number of jobs as possible. Directly injecting in excess of $550 billion in additional public funds as well as providing subsidized programs and tax relief to large employers, such as those in the auto, housing and airlines industries, were all on the table. Our last newsletter included a chart that showed some of major financial interventions by the government using public funds, where all capital advanced had been repaid. However, the US government has yet to reform its fiscal policy, an increasingly urgent necessity in order to preserve the long-term competitiveness of the world's largest economy. We will address this issue later as it is the next logical step for the US government, to ensure its world leadership in the decades to come.

Central Bank (Fed)

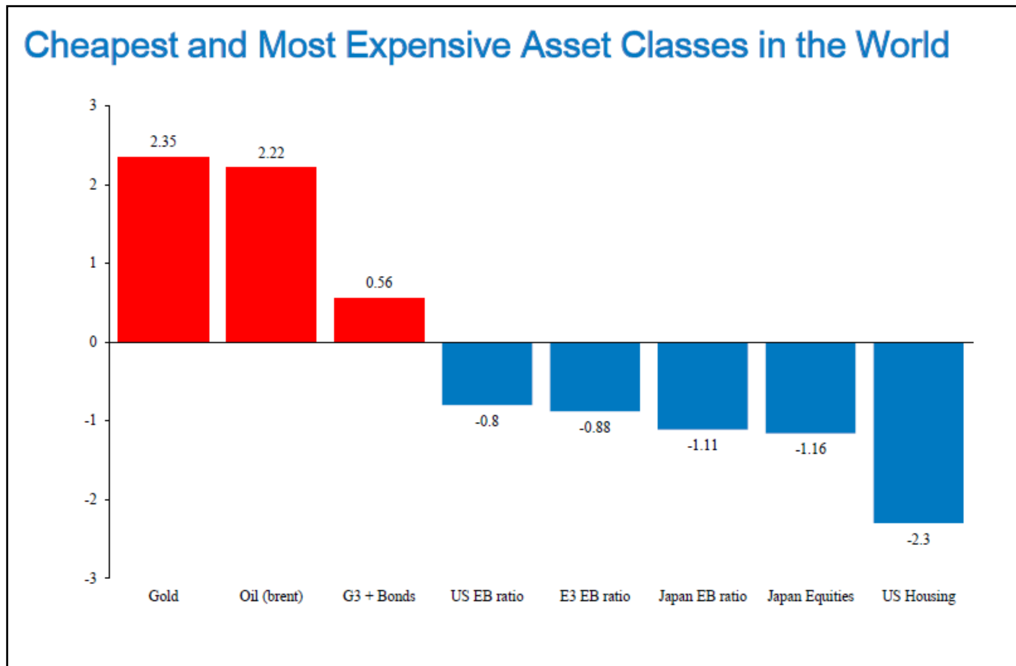
Meanwhile, the Fed also had to step up to the plate quickly when the crisis began in order, to reassure consumers that the banking system was well funded and cut the cost of debt as swiftly as possible. Then Chairman of the Fed Ben Bernanke, well-known for his work on how the Great Depression of the 1930s could have been avoided, had a chance to put his theories to the test. First, he brought the interest rates down to 0% and embarked on an unprecedented quantitative easing (QE) monetary policy. In other words, he began to freely print money. That freshly printed money was made available to chartered banks to offset large amounts of lost capital and revenues due to unrecoverable loans mainly from the formerly overheated real estate industry. QE1 was soon followed by QE2, then by QE3. While these actions helped it eventually bottom out, the real estate industry still need an additional boost to reignite demand and clear the huge inventories of foreclosures held by the banks. Eventually, housing inventories began to shrink, and QE3 started to help house prices lift again. At this point in time, QE3 is being phased out (by November 2014) as its support no longer seems needed.

Gross domestic product (GDP) is finally growing at a better pace (above 2%), having reached 4.2% in the second quarter of 2014. It seems to us quite obvious that the Fed was successful in its monetary policy to set itself up for a major housing recovery which should sustain US economic growth for the next few years. While Chart 1 shows a significant gap in real estate prices between the US and Canada, Chart 2 shows US housing as the cheapest asset class in the world today.

Chart 1

Source: BMO Capital Markets

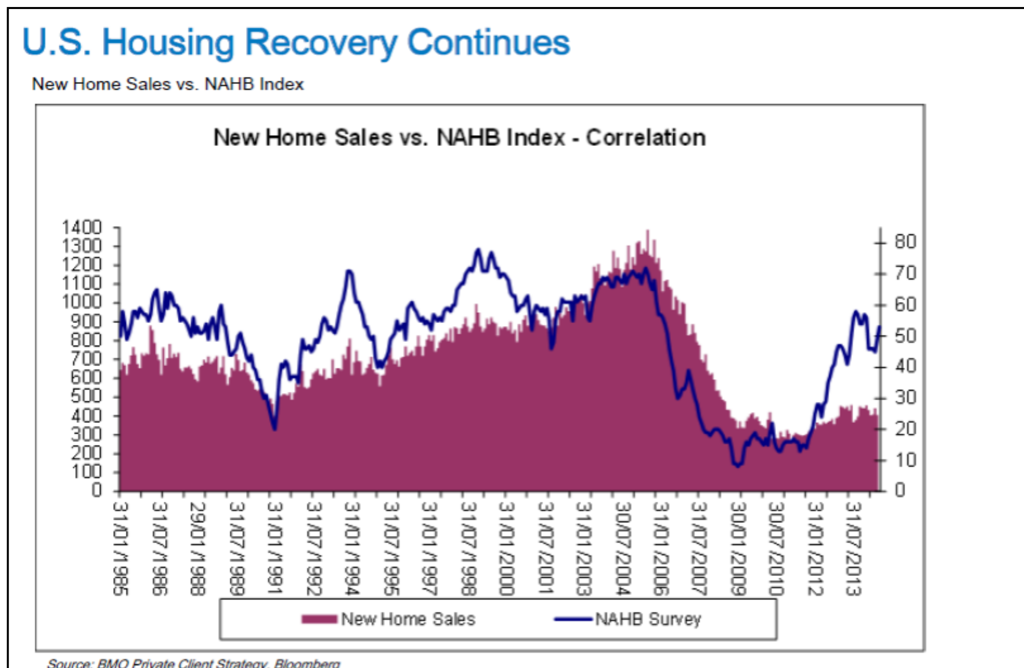
Chart 2



Source: BMO Capital Markets

Chart 3 shows the unsustainable lag in new housing, most likely caused by excess inventories following the crisis which have now mostly vanished.

Chart 3



Source: BMO Capital Markets

This catching up will have a huge impact on job creation and consumer confidence. Once QE3 has ended and we have confirmation that the recovery is self-sustaining, what will the Fed's next logical step be, and how will it affect equity markets? The yield curve will normalize, and short-term rates may slowly rise in response to a faster growing economy. The US dollar will strengthen, thanks to rising rates, and commodity prices (all in US dollars) will come under pressure. Interest-sensitive investments as well as commodities may underperform, while consumption should benefit from a rising purchasing power and a growing economy. It may take some time for the economy to digest the QE3 EXIT which could raise a doubt in investors mind and result in a correction. Furthermore, the weakening European economy may as well contribute to a market readjustment. Expect however, that the ECB would probably react and introduce its own QE in due course.

Corporations

As for corporations, many found themselves in a position of strength at the beginning of the crisis, as they held very little inventory in comparison with the Great Depression of 1929 levels. In fact, new inventory technology or the "just-in-time" production method and Quantitative Easing as a monetary policy are two of the key differences between the Great Recession (2008) and the Great Depression (1929). Another important factor was the Fed's ability to print money in 2008. This was illegal in 1929, as money could only be printed to the extent it was backed by gold reserves (this law was repealed by President Nixon in 1971). Thus, businesses weren't forced to close up shop, sitting on inventories that were unsellable even if they tried selling at a loss. In fact, arguments suggest that we needed World War II to finally clear inventories and create jobs, while forcing workers to save by providing coupons for the essentials. After the war, people had jobs and therefore money, so the desire and ability to consume returned. Growing consumption helped both businesses and the government to get back on their feet. How is it different today? The difference is that we didn't have to go to war and wait 15 years to get to a quite similar result. The government is running high deficits and debt, and there is a need to improve infrastructures to create jobs, but today's corporate balance sheets are in great shape. Businesses were quick to react at the beginning of the crisis and were able to avoid the huge inventory surpluses that were a huge stumbling block during Great Depression. They were able to cut staff and expenses, and to slow production, thereby maintaining decent profit margins. Excess cash flows were first used to pay off debts. Then, the best use of surpluses was to buy back stocks and raise dividends rather than growing production as demand remained slow. These actions increased the value per share and improved financial ratios. Expanding production through capital investments will be a function of demand growth. The problem is that banks are now flush with cash, thanks to Quantitative Easing, but corporations are unwilling to borrow to boost production. Always creative, investment banks have come up with a solution to help corporations further reduce costs (namely taxes) and improve margins: the strategy is called "tax inversion". The idea is to buy a competitor headquartered in a country that has a lower corporate tax

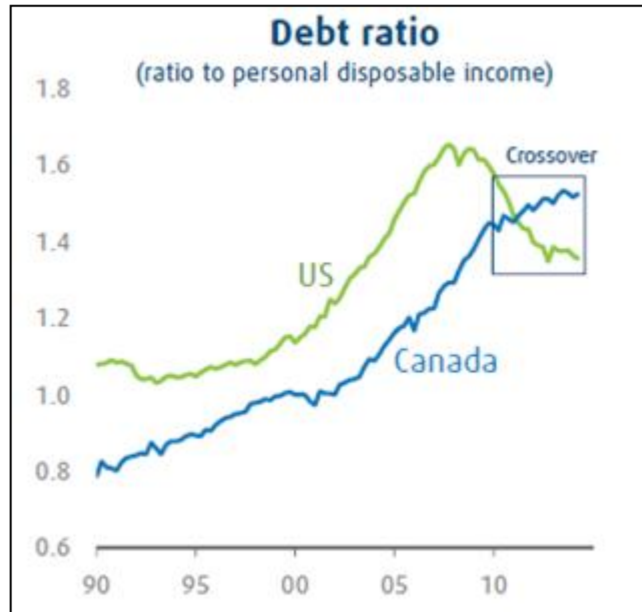
rate than in America, which has the highest corporate tax rate in the world at roughly 35%. This concept was first introduced in the UK and eventually forced the government of that country to implement tax reform or otherwise risk the erosion of its tax base. Inversions are symptomatic of a distorted corporate tax system that is riddled with loopholes. Furthermore, once a corporation has inverted, it is gone. The damage is permanent, thus the importance of acting promptly on this matter.

At the time of writing this document, US Secretary of the Treasury Jack Lew and President Obama wanted to introduce tax legislation to stop tax inversions deals. An unwanted side effect of such a law could reduce the ability and effectiveness of US companies to compete in a global economy. To stop the hemorrhaging temporarily while working to achieve a tax overhaul with specific deadlines is, to me, the right approach. Without this, there may be no corporate tax base left to reform! On September 23rd, the US government introduced a new set of rules that basically nullifies most of the benefits of tax inversions. In addition, Secretary of the Treasury Jack Lew confirmed the administration is seeking congressional action for a comprehensive tax reform with anti-inversion provisions. That was a first step in the right direction. While a whisper of hope in the right direction could propel the markets to the next level, an impasse could become the catalyst for a major US correction. While the current US tax system encourages corporations to keep cash offshore and expand elsewhere, the continuous exodus of US corporate headquarters could trigger a geographical re-balancing of investable assets towards the foreign jurisdictions. It would be the complete opposite if we provide a better and simpler corporate tax platform which would repatriate some US$2 trillion held offshore and invest it domestically, while creating jobs and attracting foreign corporations to participate in the economic renaissance of the US! The next logical step on the corporate front will be a consequence of the government's next step. This is where the US stands at this time. After the midterm elections this coming November, tax reform should be at the forefront of priorities, and nothing should stand in the way of a complete tax overhaul as President Obama enters the last turn, wishing to secure his legacy.

Consumers

Our last player – the consumer – is the one that carries the biggest weight, as his decisions will drive the path of recovery in a "consumer-led" economy such as ours. His abuse in indebtness of the last cycle caused a major shift in his behaviour. From a debt of $1.65 per dollar of income, the American consumer has re-aligned his priorities and started to pay down debt. The spending cut certainly did not help the economic recovery in the short-term, but it did save the house in most cases. While the American consumer's debt has decreased, and is heading in the right direction, on the Canadian side, debt has expanded and is approaching $1.60 per $1 of income!

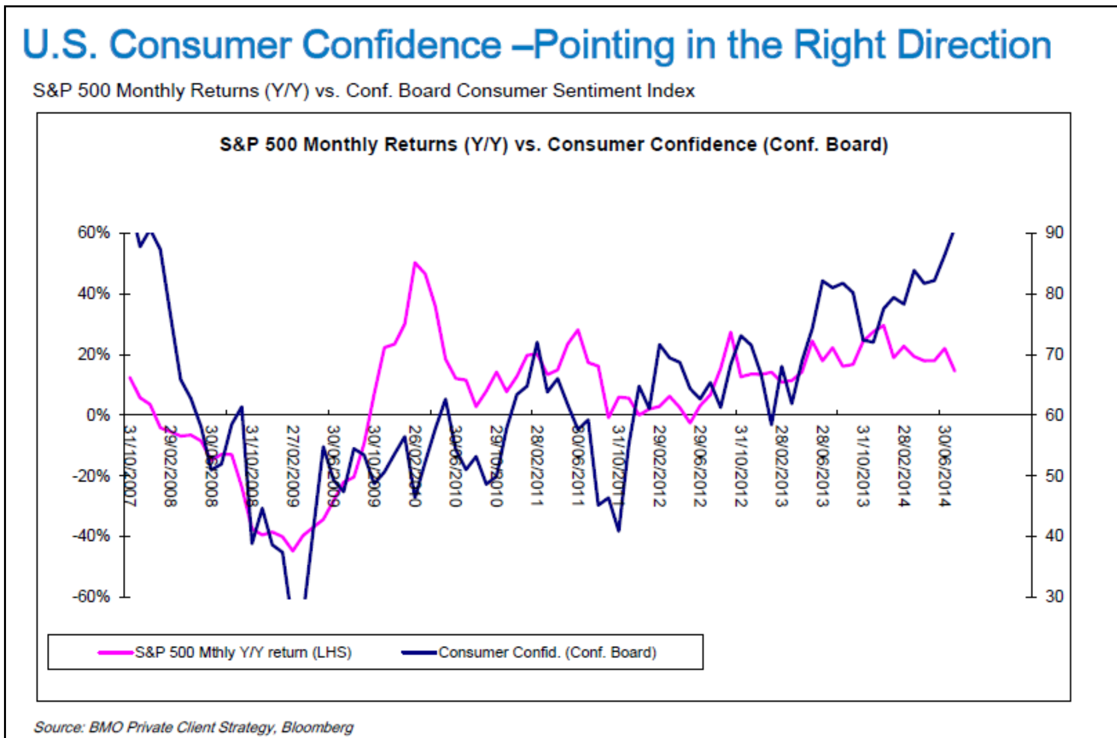
Chart 4



Source: BMO Capital Markets

The spending capacity of Canadians will not be anywhere near that of the Americans' in the medium-term, nor do they have a comfortable nest egg to protect them against a bad turn of events. Canadians' priorities might change for the better (saving rather than spending), but that behaviour will not help our economy. As American consumers have mostly re-financed their homes at affordable payment levels, found new jobs and reduced their debt loads, they will reach a new comfort zone. As wealth reappears, spending cautiously increases and consumer confidence builds (chart 5).

Chart 5



Source: BMO Capital Markets

That is where consumers stand today. At this point, the logical behaviour – to increase spending – encourages businesses to expand and hire, which in turn encourages more spending... But lower unemployment also means wage growth and inflation… and this will lead the Fed to accelerate interest rate hikes to keep inflation in check. We believe we are perhaps a couple of years away from steepening inflation, but the Fed will be working on normalizing the yield curve next year as GDP growth expands. The ace in the hole here might be lower energy prices, which could hold inflation in check much longer and provide more disposable income in the hands of consumers.

The consumers' logical next step would be to buy a house as this is the cheapest asset in the world now, and take advantage of extremely low mortgage rates while they last.

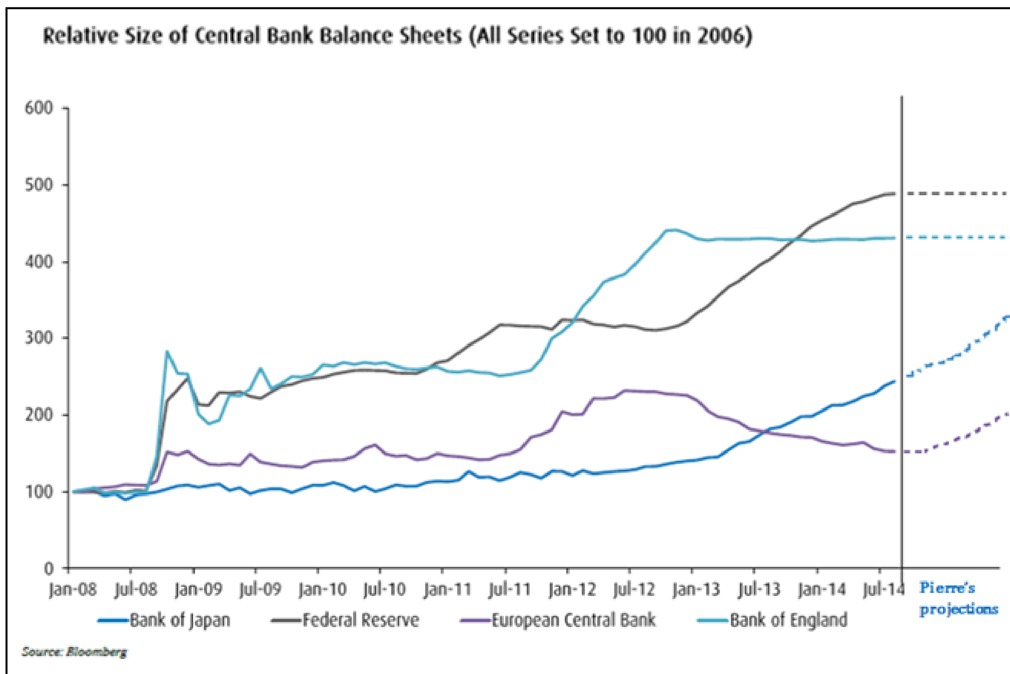
Summary

While the US government has avoided the risk of an eroding tax base, its priority now shifts to the implementation of a new tax structure. A ‘’patriotic deal’’ would be one that allows US corporation to retain their world supremacy and leadership by expanding operations domestically, create local jobs, and pay US taxes at a competitive rate. The elimination of loopholes would allow for the broadening of the tax base at a lower tax rate. Although these actions may be revenue-neutral from the start, they have the potential to raise US competitiveness and entice companies to expand in the US… Companies that strive on efficiency and productivity will embrace such a deal. Through consolidation, good cost controls, low interest rates and a pick-up in demand, profitability should be at the rendezvous. Global companies are able to capitalize on worldwide opportunities. Although they may suffer from time to time from swift currency movements, they do provide a better safety net.

As for consumers, the logical solution is to slowly return to consumption as jobs are being created. While restoring consumer confidence is the Fed’s biggest objective, it is the fundamental driver of an economic recovery which I believe is only at the starting gate.

Meanwhile the Fed is likely to ensure the reestablishment of a normal yield curve next year without disturbing economic growth as it succeeded in doing so while tapering QE3 in 2014. Chart 6 shows the world central banks’ balance sheets.

Chart 6



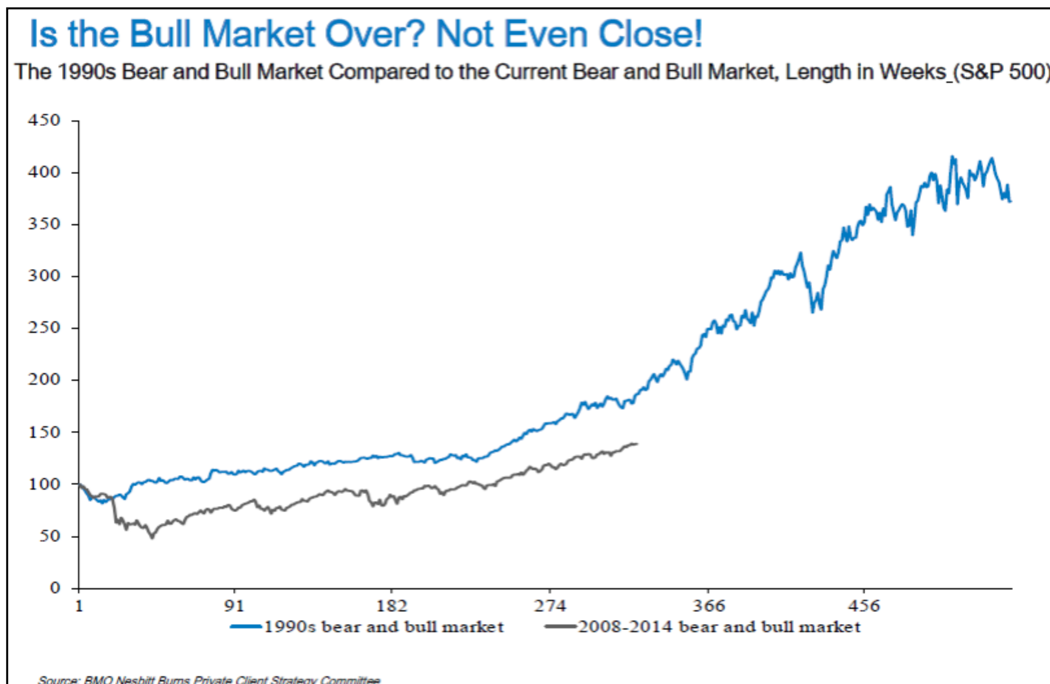
Source: Bloomberg

While the US Fed is the one that expanded the most, it is also the economy that is performing best at the moment. Both the US and UK central banks are now at a standstill, leaving Japan's central bank the only one expanding for now. It took more than 20 years for the Japanese to apply Mr. Bernanke's solution. Now, under President by Shinzō Abe and "Abenomics", Japan central bank is expanding its balance sheet. We do believe that Mr. Draghi, Europe's central bank chairman, will follow suit, introducing Quantitative Easing policy to provide additional liquidity, strengthening the chartered banks capital ratios and consequently stimulating the Eurozone economy. Europe's economy is where the US stood a couple of years ago. P/E ratios are lower than in the US, as economic expansion remains slow. We believe a European QE program would trigger a geographical re-balancing of assets weighing in favor of Europe. A weakening Euro caused by QE would also make them more competitive and profitable, while a counter balancing stronger US dollar should pressure commodity prices on the downside and strengthen the US consumer's purchasing power.

Conclusion:

While it seems that the next logical step of each player is about to converge, fundamental analysis suggests the market is neither overpriced nor underpriced. Historical comparisons are also quite supportive of a prolonged bull market. Chart 7 speaks for itself. It should be noted that the 90's cycle was accompanied with low commodity prices and a strong US dollar, which we believe could be repeating itself.

Chart 7



Source: BMO Capital Markets

For those who worry about the length of the current Bull Run, amidst the risk of occasional, hard to time, corrections, we should ride the wave and stay invested. Chart 8 demonstrates why our Senior Strategist Brian Belski believes the US has entered a 15-year bull market.

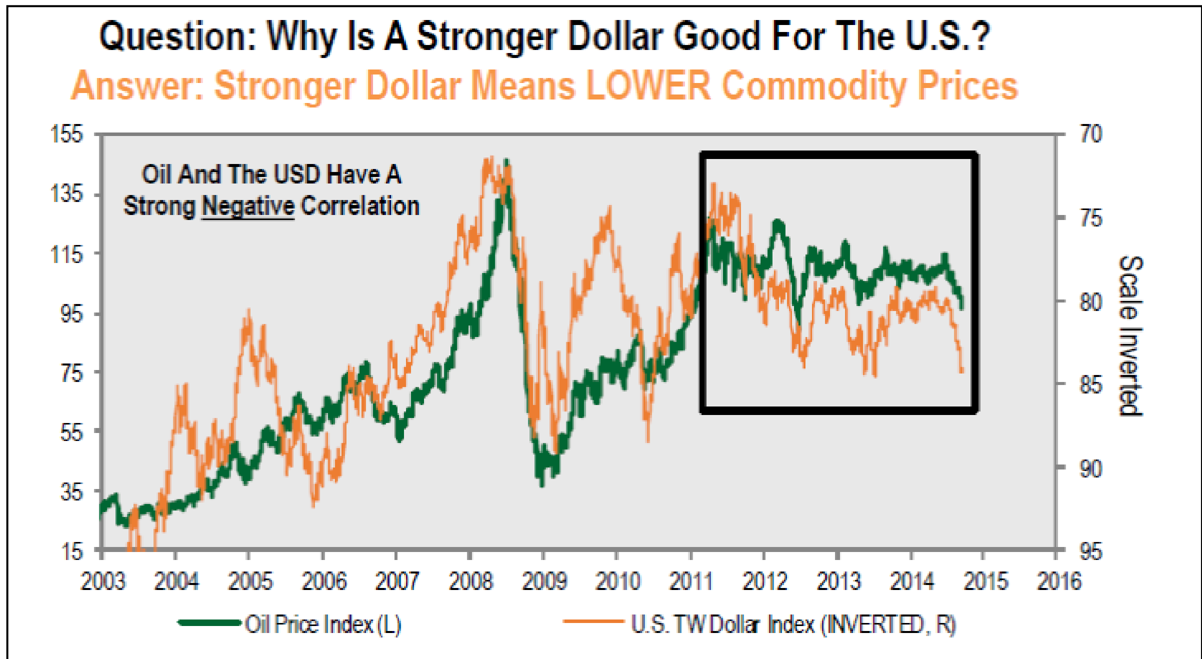
Chart 8

Source: BMO Capital Markets

The end of QE3 and most probably an extended accommodative monetary policy in Europe bodes well for a strong US dollar. In addition, demand for raw materials from emerging markets is slowing while supply is increasing on the heels of massive investments to increase supply prior to the financial crisis of 2008. The 1982 to 1998 cycle was one with low commodity prices when supply was plentiful. With the US economy becoming energy self-sufficient, oil prices could be held in check for some time. As the US economy leads the world recovery, the yield curve will adjust accordingly (rise to normal) which will sustain a strong US dollar and weak commodity prices in US dollar terms. Corporate revenues and earnings growth will drive P/E ratios to expand further and, thanks to US corporate tax reform (we hope), the US will retain its safe haven status and will continue to attract foreign investment capital.

Chart 9 shows the negative correlation between the US dollar and oil prices.

Chart 9



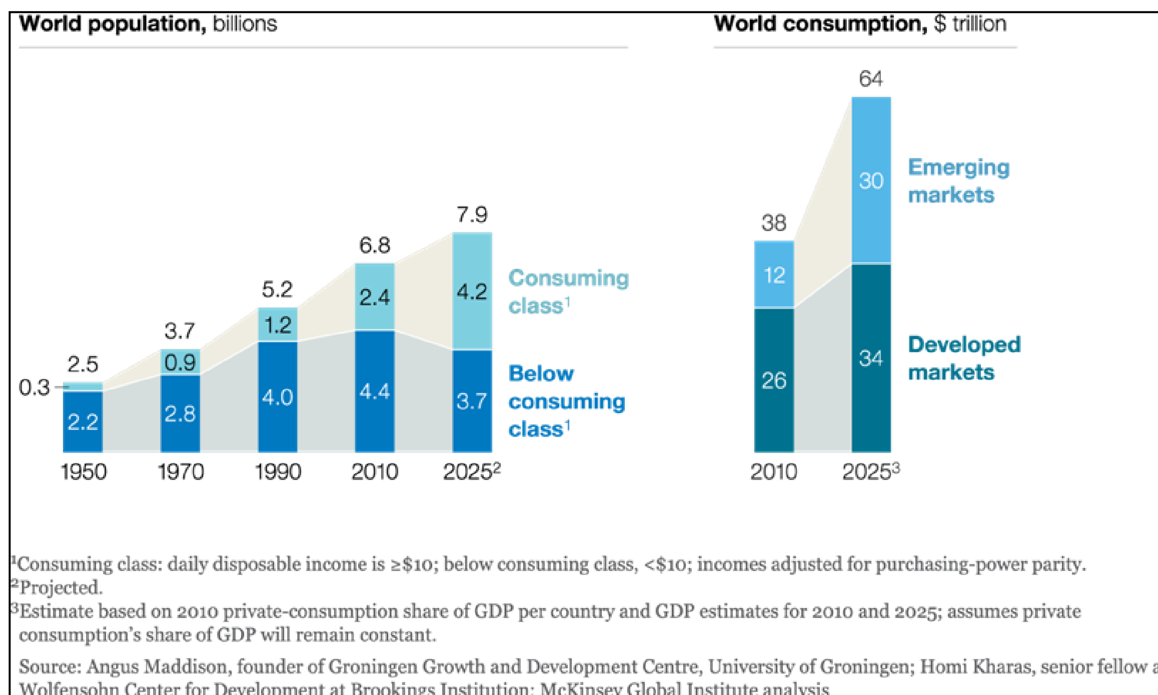
Source: Cornerstone Macro, Contrarian Ideas for a Consensus World Part 4- September 18, 2014

Note that the US dollar index is inverted. For Canadians, lower oil prices mean a lower Canadian dollar. For Canadian oil producers, although they may be selling oil for fewer US dollars, most of the spread is usually compensated for by the exchange rate. Low cost producers may be an important element going forward.

Canadian investors should be increasingly concerned with their geographical asset mix given the likelihood of a weaker local currency environment. We will continue to increase our foreign content in the equity component of your portfolio. Furthermore, we will focus on Canadian companies that have multinational exposure to capture exchange gains and expanding economies.

Chart 10 gives you a sense of the world consumption base by 2025.

Chart 10: Emerging Market Consumption: The Biggest Growth Opportunity in the History of Capitalism (As Quoted From McKinsey, figures in USD)



Source: McKinsey

Demographics don't lie. Although these are estimates, note the consumption growth in emerging markets versus developed markets. Global companies are better positioned to capture that growth. They are less affected by the US corporate tax system; however they may not benefit as much with tax reform, and may have currency issues in their reporting from time to time.

Investment Strategy

A strong US dollar puts negative pressure on commodities and, as such, we believe we should reduce our exposure to materials while increasing the consumer discretionary sector. Interest-sensitive stocks may continue to suffer as bond yields readjust to normal levels. We favor insurance stocks over banks given that economic condition. Furthermore, industrials and housing-related businesses should benefit most from the continued economic expansion. For example, a Canadian lumber company would not only benefit from the US housing recovery but would be advantaged from a lower Canadian dollar. Exporting Canadian companies with international exposure should benefit most from a weakening Canadian dollar as well. In addition, a pure European exposure of at least 5% is becoming a necessity.

For properly balanced portfolios, there is no need to rock the boat as we go through rough waters. Interest rates as well as inflation will remain low as long as economic growth is not overheating. Calmer seas are in the horizon!

Table 1

Sectors	Recommended Weighting Sep-14	Trend
Consumer Discretionary	2%	⇧
Consumer Staples	8%	
Energy	7%	
Financials	17%	
Health	4%	
Utilities	7%	⇩
Industrials	8%	
Materials	3%	⇩
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**	
Apr 2014	Oct 2014		Apr 2014	Oct 2014
10%	5%	CASH (Maturities ≤ 12 months)	7%	5%
50%	50%	Fixed Income (Bonds & GICs)	30%	30%
15%	15%	Convertible Debs. and Income Generating Securities	13%	10%
10%	10%	Equities	25%	25%
15%	20%	Foreign	25%	30%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Sources:

BMO Capital Markets Equity Research Reports
BMONB Canadian Equities Guided Portfolio – June & September 2014
BMO NB US Equities Guided Portfolio- September 2014
Before the Bell
The Economist
The Wall Street Journal
Phases & Cycles
Bloomberg News
Fortune Magazine
Advisor.ca
The Motley Fool
The Atlantic
Boston Globe
Harvard Gazette
CNN Money
Cornerstone Macro
Bloomberg Businessweek
The Globe and Mail
JP Morgan North America Equity Research
RBC Dominion Securities Research
Advisor Analyst
ETCNBC.com

The calculation of performance data set forth herein has been prepared by the author as of the date hereof and is subject to change without notice. The author makes every effort to ensure that the contents have been compiled or derived from sources believed to be reliable and contain information and opinions, which are accurate and complete. However, BMO Nesbitt Burns Inc. ("BMO NBI") makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions which may be contained herein and accepts no liability whatsoever for any loss arising from any use of or reliance on this report or its contents. Information may be available to BMO NBI or its affiliates that is not reflected herein. This report is prepared solely for information purposes. Please note that past performance is not necessarily an indicator of future performance. The indicated rates of return are gross of fees or commissions. Individual results of clients' portfolios may differ from that of the model portfolio as fees may differ, and performance of specific accounts is based on specific account investiture. The noted model portfolio may not be appropriate for all investors.

This report is not to be construed as an offer to sell or a solicitation or offer to buy any securities. BMO NBI, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities mentioned herein as principal or agent. BMO NBI may act as financial advisor and/or underwriter for certain corporations mentioned herein and may receive remuneration for same.
® "BMO (M-bar Roundel symbol)" and "Making Money Make Sense" are registered trade-marks of Bank of Montreal, used under licence. ® "Nesbitt Burns" is a registered trade-mark of BMO Nesbitt Burns Inc. BMO Nesbitt Burns Inc. is a wholly-owned subsidiary of Bank of Montreal.

[1]The opinions, estimates and projections contained herein are those of the author as of the date hereof and are subject to change without notice and may not reflect those of BMO Nesbitt Burns Inc. ("BMO NBI"). Every effort has been made to ensure that the contents have been compiled or derived from sources believed to be reliable and contain information and opinions that are accurate and complete. Information may be available to BMO NBI or its affiliates that is not reflected herein. However, neither the author nor BMO NBI makes any representation or warranty, express or implied, in respect thereof, takes any responsibility for any errors or omissions which may be contained herein or accepts any liability whatsoever for any loss arising from any use of or reliance on this report or its contents. This report is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities. BMO NBI, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities mentioned herein as principal or agent. BMO NBI -will buy from or sell to customers securities of issuers mentioned herein on a principal basis. BMO NBI, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO NBI or its affiliates may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same. A significant lending relationship may exist between Bank of Montreal, or its affiliates, and certain of the issuers mentioned herein. BMO NBI is a wholly owned subsidiary of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Nesbitt Burns Corp. Member-Canadian Investor Protection Fund.

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