# Morin Dupont Lessard & Associates

Sound advice with outstanding service

Newsletter #54

October 2015

# WHAT TIME IS IT?

## (Excerpt)


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# Pierre's comments

## WHAT TIME IS IT?

Since August 2015, investors have been confronted by two new realities: a fundamental one and a technical fragment. Globalization and the world's interlinking economies have created an environment that is becoming increasingly interdependent. When a major player in the equation sneezes, speculators catch a cold, worrying about the risk of contagion and adjusting their bets accordingly. A simultaneous decision to act on the buy or the sell side can create huge volatility and major disruptions in the market. Accordingly, investor confidence can be shaken, triggering even more volatility and increasing the risk of a 1987-style self-inflicted crisis. In this letter, I will first highlight our assessment of the current macro-economic picture, which can be derived from the 1998 Asian Currency Crisis – Part II. I'll then provide you with more information on the risks related to the rules (or lack thereof) of trade execution.

### Macro and North American Economies

While the US economy is now firing on all cylinders, the country seems to be alone at the party. Both Europe and Japan are going ahead with their respective quantitative easing (Q.E.) policies (printing money). These help to strengthen the banking system and provide cheap capital for corporate growth and project development. Typically, such actions also help with job creation and, down the line, consumption. Economic expansion generates more tax revenues for the country and strengthens its balance sheet… or so it is hoped. While Q.E. has its benefits, it does devalue one's currency. Currencies only have value as it relates to other currencies. While a lower currency makes one more competitive for exports, it also makes all imports more expensive. Europe's economy was slowing in 2014 and in last fall's newsletter, we predicted the introduction of a Q.E. program for early 2015.There were deflationary risks at that time which suggested that a Q.E. program could re-inflate and kick start the economy while helping local manufacturers be more competitive by providing them with enhanced pricing power. Since the introduction of Q.E. in Europe, GDP growth has improved, but not at the expected pace. The situation with Greece has put a damper on investor confidence as has the more recent migrant crisis. What has really killed momentum, though, has been the growing concern over the state of China's economy. From a growth pace of 10%-12% over the past three decades or so, the economy has been steadily slowing and was expected to fall to 7% in 2015 as the country has shifted from a manufacturing- to a consumer-based economy (chart # 1). The catalyst was the announcement by Chinese authorities of a surprise devaluation of the yuan in mid-August. Such devaluations are generally considered a last resort, not something usually used when GDP growth stands at 7%. Obviously, the decision by the People's Bank of China (PBC) sent an unexpected negative message to the world and triggered the beginning of the recent correction which has been felt worldwide.

***Chart # 1***


China is the world's second largest economy and represents more than a third of the global economy. It is also the world's largest exporter and importer of goods, with more than $2 trillion both ways. The unique feature of this economy is that it is being managed by a communist, non-transparent government… Back in 1998, in an effort to capture the largest market share in the Western world, Asian countries became embroiled in a currency war. The resulting stronger US dollar caused a drop in commodity prices, as it is usually the case in such situations. Given that all commodities trade in US dollars, they become too expensive for weakening currencies, causing demand to fall. The impact was huge on commodity-dependent exporting economies in the Western world, whose raw material shipments dropped significantly. Canada's and Australia's economies were among the hardest hit by low commodity prices (similar to today) and fell into recession. In 1998, the loonie dropped to $0.63 and again in 2001(Chart # 2).

***Chart # 2***


Meanwhile, non-commodity Canadian companies exporting goods and services to the US did very well, generating revenues in US dollars. But China was not nearly the powerhouse it is today. The shaving would be harder to swallow today as we have become a much larger oil producer than we used to be and that global oil inventories are at historical highs. Some analysts are predicting a Canadian dollar at $0.65 in the next year… How alarming is this? Not too bad if a Canadian company has US revenues, but not so grand if its costs in US dollars exceed those US revenues! Imports are getting more expensive and cocooning is becoming the new norm. Perhaps paying down some debt could also make a comeback as the risk of rising interest rates becomes more apparent. Canadians should bare in mind that there is a 93% correlation between Canadian and U.S. interest rates... (Chart # 3, 4)

***Chart #3 (Debt/Household US vs CDA)***

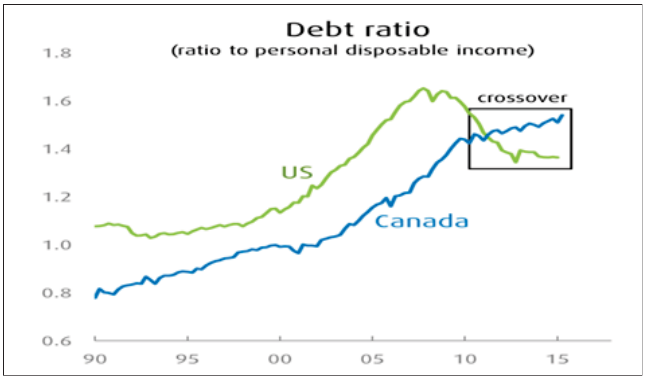
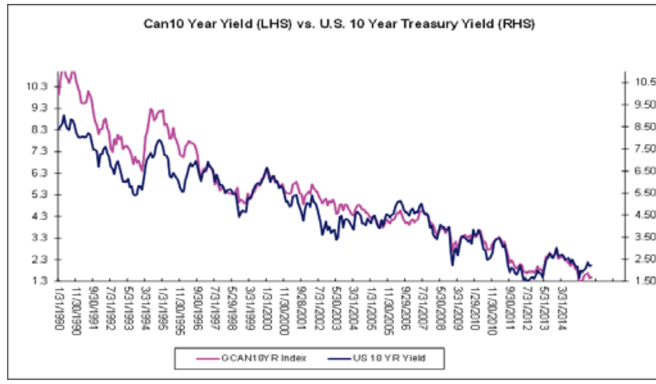



***Chart # 4 Correlation US vs CDA 10 yrs. Bond Yields***




While Canadians' indebtedness per dollar of revenue is reaching all time highs, Americans are now in a position to expand their use of credit, which bodes well for the US economy. The strong US dollar provides huge purchasing power for Americans while keeping inflation in check. Low commodity prices also increase the affordability of big ticket items, including homes and cars, the purchase of both of which consumers have been putting off since the 2008 financial crisis. The average age of the US car fleet is above 10 years, while home inventories are at their lowest since a decade (chart # 5, 6).

***Chart #5***

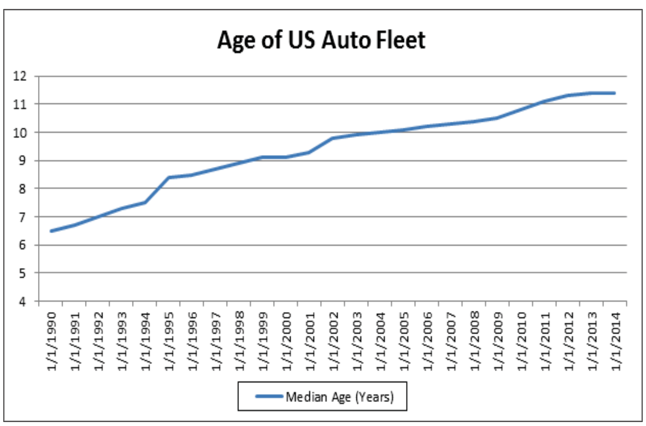



***Chart #6***


Retail sales figures support the healthy state of the US economy. Unemployment has reached very low levels, and recent wage increases suggest near full employment (chart # 7, 8).

***Chart #7 Retail Sales***

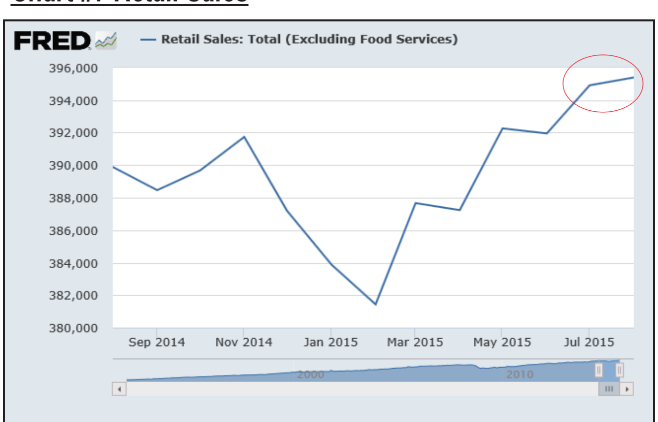
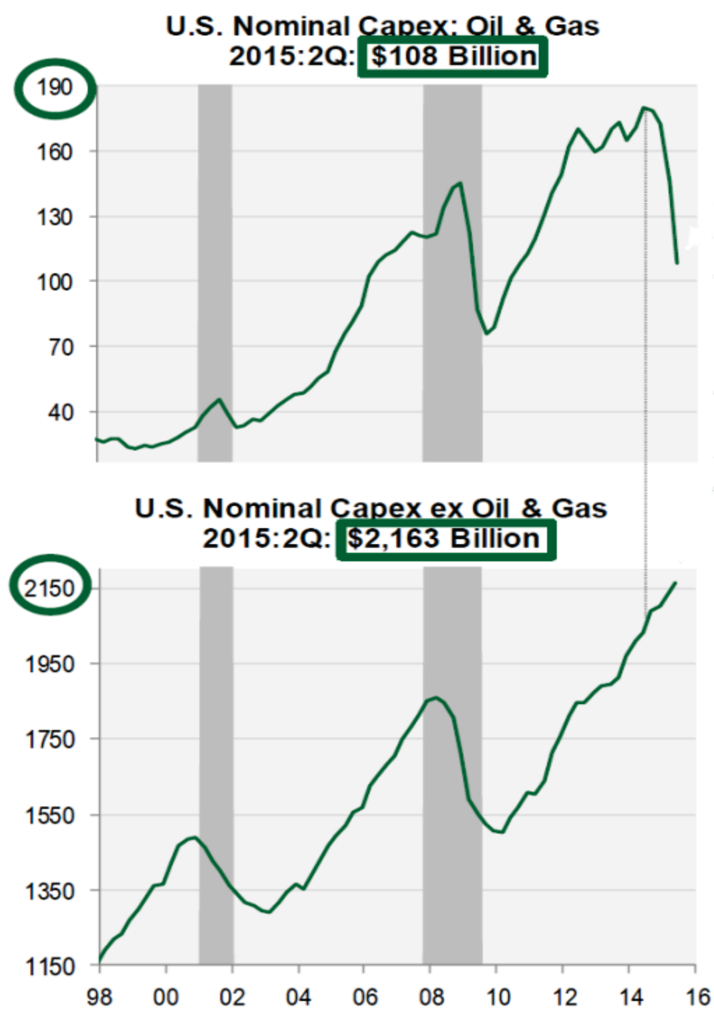



***Chart #8 Unemployment***

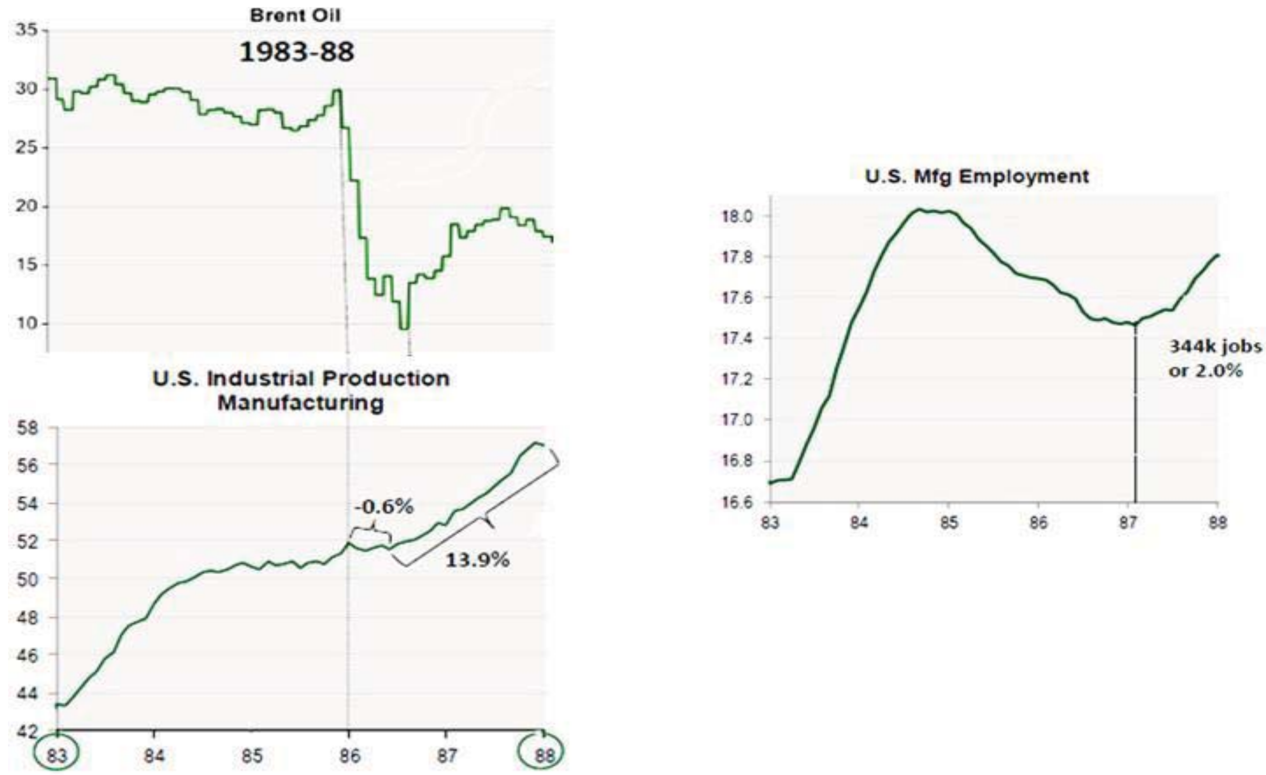
This mostly rosy picture of the state of the US economy also spells a Federal Reserve Board intervention and a new rising interest rates trend. The question here is not **if** but **when**! Domestically, it would matter if the Fed falls behind. If the largest beneficiaries of 0% interest rates are the activists and financial engineers, then why would we expose the country to the risk of asset bubbles? Some experts have suggested that the trend is already set. However, corporate debt has not yet nearly expanded to the point of creating bubbles, although M&A activity is growing at a record pace for 2015. The real cause for concern here is how much of a Chinese slowdown are we really facing? Will it be a hard landing for China dragging along with it the rest of Asia? Has China entered a currency war with regional competitors? On the morning of Thursday, August 20, Vietnam followed China's lead, announcing its own currency devaluation. US markets dropped sharply that day and during the next two trading sessions, including the so-called "flash crash" at the opening on Monday, August 24. The perception is that global growth is at stake and, although domestically things look positive, the US is more dependent than ever of the health of the world's growth. A Fed decision to tighten monetary policy would strengthen the U.S. dollar further. This could drive commodity prices even lower, hurting US exports, but stimulating non-export manufacturing and industrialization. Goldman Sachs has recently made a case of the possibility that oil prices could fall to $20/barrel. At this level, cash flows may no longer be sufficient for many highly indebted energy companies or high cost producers. Bankruptcies would follow and capital spending in this sector would tank. It would have a significant impact in certain regions where oil production is the main source of economic activity, but nationwide oil and gas related capital expenditure (CAPEX) represents only 5% of total CAPEX or, in other words, around 1% of GDP (chart # 9).

***Chart # 9***



As such, capital spending for much needed infrastructure in the US could well become the main driver of the next cycle, given the low cost of energy. If history is a good reference, from late 1985 to mid-1986, oil prices fell 68%, (very comparable to the drop over the past 10 months from $100 to roughly $40). During the following year and a half, US manufacturing industrial production rose by nearly 14% and 344,000 jobs were created (chart # 10).

***Chart # 10***




Consider that with North American free trade agreements now in place and the weakness of the peso and Canadian dollar, the temptation will be great for US CEOs to expand at home or nearby. Corporate leaders have demonstrated their will for “re-shoring” – the desire to get products to market faster and respond rapidly to customer orders. Savings on transportation and warehousing, improving quality, protecting intellectual property, the massive North American energy cost advantage and technical innovations such as robotics are all supportive of this new trend. Companies such as GE, 3M and Google are among those who have been shifting production back to North America. All this sounds great – a domestic resurgence in manufacturing and industrialization – but the world has to be able to afford our homemade products. A lack of buyers may result in lackluster revenue growth. Accordingly, the Fed’s decision must consider world’s GDP growth as part of the formula. History shows that the Fed has always implemented monetary policies based on its domestic economic environment, with the exception of 1998, i.e. during the last Asian currency war, at a time when those economies represented less than what they do today. This is precisely why the Fed’s decision to raise rates sooner rather than later is particularly difficult and why opinions are so split.

**Technical Trading Similarities with 1987**

The October 19, 1987 market crash could have been just a correction. The market was having a great run after rebounding from the deep 1982 recession and high double digit interest rates (20%+). In the mid 1980s, major tax reforms were put in place by President Reagan. Computerization was in full swing and sophisticated “program trading” software was rapidly becoming the norm for institutional trade execution. These new and powerful tools had not been tested in extreme circumstances, so no regulations were in place to deal with them. As of August 1987, overheated markets started to show signs of fatigue as valuations started to be excessive. Nervous investors and traders became more reactive and as volatility picked up, markets became more erratic. Between August and mid-October 1987, there were several 100-point swings on the Dow Jones from a more or less a 2000-point base (a 5% market move).

The last 5% dive took place on Friday, October 16 and found support at the closing bell. Although there were fundamental reasons justifying a correction, nobody really knew the consequences of letting those computers take over the decision-making process. The lower the stocks fell, the more the computers increased selling… but if all computers are selling at once, who's left to buy? A self-feeding spiral created a liquidity crisis on the following Monday – which became known as Black Monday – and the market dropped 22.6%, in a **single day!** In the following weeks, new rules were implemented and "circuit breakers" were introduced. In essence, when the market moved more than specific percentage in a day, computer trades could no longer be executed, i.e. manual trades only were permitted… This would reduce the excessive one-sided volumes, reduce volatility and restore confidence. Markets eventually rebounded, and October 19, 1987, became the best one-time opportunity to buy stocks at deep discount prices… Back in the 1930s, a similar situation occurred and rules and regulations were instituted to avoid any recurrences. For example, margin requirements were very small back in the 1920s. You could, for instance, borrow up to 90% of the market value of your stocks for investment purposes. After the crash of 1929, that percentage dropped significantly. One could no longer borrow more than 50% on stock for investment purposes; the panic selling and subsequent crash were mostly the result of excessive leverage.

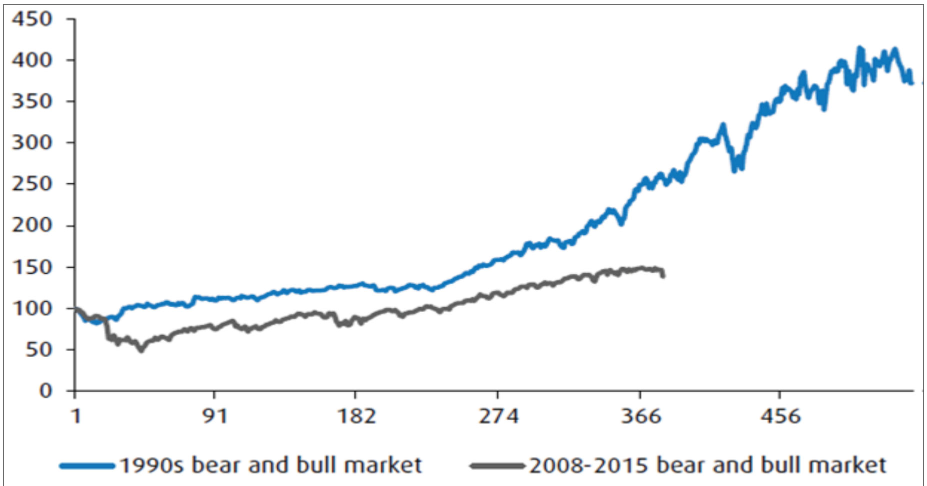
During downward spirals, some trading specialists will sell short in order to make money on the way down. A short sale is the action of selling **before** buying. For instance, let's take an investor who believes a stock or an index will fall. That investor could sell at current price, say $100, and repurchase the same instrument at, say $80, pocketing a$20 profit… Technically, there is more to it than that, but that's the strategy in a nutshell. Excessive use of this strategy, especially using computers, can be disastrous for the market given the more sellers the lower the price and the self-feeding spiral… In reaction to experiences of excessive short selling practices in the 1920s and 30s, the "uptick rule" was introduced. This rule does not allow a short sale to take place unless the previous trade on a stock was on an uptick (i.e. higher than the previous trade). This rule acts like a circuit breaker and reduces the risk of a spiral and panic. Unfortunately, this uptick rule was eliminated in 2007 and has not been reintroduced since. Perhaps the 2008-09 spiral could have been less damaging had the rule been in force at that time… who knows?! The reality however, is that on August 24, 2015, the new era of programmed trading (which now bears the more sophisticated name of "algorithm robotics" or "smart beta equity strategies") combined with a certain complacency in trading rules in favor of the institutional accounts has damaged investors' confidence in the system: the market dropped 1089 points, or over 6%, in just 4 minutes! A panic **sell** at the opening was transformed in a panic **buy** in the next seven minutes as short sellers at the opening sought to cover their short (buy the position back) in the following 7 minutes and wound up losing money on the trades. Fundamentally, how can a company the size of GE and J&J lose 20% of its value in 4 minutes? The lack of rules in trade execution is a cause for concern for anyone who has worked hard during their lifetime to save for their future retirement. What good does that kind of erratic activity in the market place do to investor confidence? These "sophisticated strategies" helped the average hedge fund experience their worst single-month performance in August! A senior JP Morgan strategist wrote in late August that these technically-led strategies (also called risk parity strategies) can push markets away from fundamentals. "The obvious risk is if these technical flows outsize fundamental buyers" said Marko Kolamovic. According to Eddie Perkin, Chief Equity Investment Officer at Eaton Vance (US), "There is not enough liquidity when all the elephants are trying to squeeze through the door." Red flags are definitely present. Excessive volatility, China's economic woes, currency wars, the Federal Reserve Board interest rate decisions, mutual fund cash reserves at very low levels, questionable global growth projections, the economical impact of the refugee crisis, the U.S. debt limit to be reached this fall and more. Is this the time to buy or the time to sell? Rebalancing seems to be the more prudent approach. Corrections are defined by a market drop of more than 10%. The average correction, as defined above, is 19%. From its peak, the average correction would bring the Dow Jones down to roughly 14,700, reaching near 1650 for the S&P 500 and close to 12,600 for the TSX. When the time to buy occurs you need cash…. Markets usually hate uncertainty and, as long as the picture doesn't become somewhat clearer, we feel it's time to be cautious. We believe the time is right for shedding some light on some of the new risks we are exposed to as well as all the future potential.

**Investment Strategy and Conclusion**

Although we are prudent in view of the current global economic environment and recent erratic trading volatility, we still believe the US has built a solid foundation for an extra long economic cycle without significant inflation worries and relatively low interest rates. We support the case of comparing this current cycle to the epic 1990s bull market which was characterized by low inflation, low interest rates, job growth and the acceleration of technical innovation. Comparing the 1990s market cycle with today can guide us as to our current chronological positioning (chart # 11).

***Chart # 11***

**Comparing the Current Bear/Bull Market Cycle to the 1990 Bear/Bull Market Cycle**



Source: Bloomberg

We caution our readers that in the late 1990s, price/earnings multiples had reached hugely excessive levels (in excess of 30 times), which we do not believe is realistic today. Still, the potential is definitely there, and investors must be aware of that. The key remains a global recovery. Under that scenario, the strongest economies will outperform. The manufacturing renaissance in the US leads us to believe that it is the place to be, at least until commodity prices firm up again, which will take some time. The drivers behind the rebirth of manufacturing activity in the US are an expanding consumer spending supported by low unemployment, the relatively low use of leverage (low debt), and low energy prices (and the country's low dependency on foreign oil). Although consumer confidence can quickly shift in certain circumstances, we believe that the virtuous cycle that drives long-term economic growth is in place in the US, namely that more manufacturing activity = more jobs =more disposable income = more consumers spending = more jobs… The housing and auto industries (consumer discretionary) are likely to be among the biggest beneficiaries. Defensive sectors such as utilities (especially in Canada), consumer staples, health care, telecoms and the financial sector should continue to provide security as well as good dividend income. Information technology will remain a high growth and highly volatile sector fueled by innovation, disrupters and obsolescence. Energy and materials should be underweighted in most portfolios for the time being, unless one has a long-term view or a belief that the refugee crisis, ISIS and/or Russia's support of Syria could trigger political instability. Otherwise, fundamentally, a positive case for energy and commodities is difficult to make at this time**.** If you are overweight equities and you don't like riding waves, now's the time to rebalance your portfolio.

| Sectors | Recommended Weighting October 2015 | Trend |
|---|---|---|
| | | |
| **Consumer Discretionary** | 2% | ↑ |
| **Consumer Staples** | 8% | |
| **Energy** | 4% | ↓ |
| **Financials** | 18% | |
| **Health** | 4% | |
| **Utilities** | 7% | ↓ |
| **Industrials** | 10% | |
| **Materials** | 2% | |
| **Technology** | 5% | ↑ |
| **Telecom** | 5% | |

- The suggested weightings are appropriate for a 65/35 equity/fixed income portfolio and should be adjusted based on your investor profile.

| RECOMMENDED ASSET MIX | | | | |
|---|---|---|---|---|
| **INCOME PORTFOLIO** | | | **BALANCED PORTFOLIO** | |
| Apr 2015 | Oct 2015 | | Apr 2015 | Oct 2015 |
| 5% | 5% | CASH (maturities ≤ 12 months) | 5% | 5% |
| 50% | 50% | Fixed income (Bonds & GICs) | 30% | 30% |
| 15% | 15% | Convertible Debs. And Income Generating Securities | 10% | 10% |
| 10% | 10% | Equities | 20% | 20% |
| 20% | 20% | Foreign | 35% | 35% |
| *Disclaimer: Subject to an evaluation of the risk profile of individual clients* | | | | |

## Sources:

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•Fox News
•Globe and Mail
•Gov't of Canada website (www.budget.gc.ca)
•JP Morgan
•Mauldin Economics
•Morgan Stanley
•National Post
•New York Times
•Phases and Cycles
•Standard & Poor's Capital IQ Equity Research
•The Economist
•The Wall Street Journal
•Thompson One (Reuters)

# Performance - T-Bills vs SP TSX vs Model Portfolio

| Year | T-Bills (return) | SP TSX[1] | SP TSX[2] | MODEL (return) |
|---|---|---|---|---|
| 1990 | 13.20% | -17.96% | -14.80% | **5.94%** |
| 1991 | 9.35% | 7.85% | 12.02% | **22.14%** |
| 1992 | 6.67% | -4.61% | -1.43% | **10.50%** |
| 1993 | 4.68% | 28.98% | 32.55% | **34.91%** |
| 1994 | 5.19% | 2.50% | -0.18% | **6.09%** |
| 1995 | 6.42% | 11.86% | 14.53% | **8.09%** |
| 1996 | 3.93% | 25.74% | 28.35% | **16.21%** |
| 1997 | 2.85% | 13.03% | 14.98% | **21.05%** |
| 1998 | 4.56% | -3.19% | -1.58% | **1.87%** |
| 1999 | 4.67% | 29.72% | 31.71% | **1.96%** |
| 2000 | 5.23% | 6.18% | 7.41% | **30.40%** |
| 2001 | 3.73% | -13.94% | -12.57% | **9.54%** |
| 2002 | 1.75% | -13.97% | -12.44% | **3.61%** |
| 2003 | 2.22% | 24.29% | 26.72% | **22.23%** |
| 2004 | 1.84% | 12.48% | 14.48% | **13.87%** |
| 2005 | 2.53% | 21.91% | 24.13% | **15.73%** |
| 2006 | 3.52% | 14.51% | 17.26% | **14.30%** |
| 2007 | 3.59% | 7.16% | 9.83% | **8.06%** |
| 2008 | 1.77% | -35.03% | -33.00% | **-28.07%** |
| 2009 | -0.75% | 30.69% | 35.05% | **29.37%** |
| 2010 | 1.51% | 14.45% | 17.61% | **21.05%** |
| 2011 | 0.58% | -11.07% | -8.71% | **4.18%** |
| 2012 | 0.25% | 4.00% | 7.19% | **7.38%** |
| 2013 | 0.30% | 9.55% | 12.99% | **18.14%** |
| 2014 | 0.43% | 7.42% | 10.55% | **16.43%** |
| 2015 | 1.48% | -9.06% | N/A | **-0.25%** |
| | | **Return Compounded as of December 31, 2014** | | |
| 3 years | 0.33% | 6.97% | N/A | 13.88% |
| 5 years | 0.61% | 4.49% | N/A | 13.25% |
| 10 years | 1.36% | 4.70% | N/A | 9.50% |

**Average return since inception** …………………………………. **12.26%**

* (YTD): Year To Date (September 30, 2015)

$100,00 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

1: Does note include income or dividend

2: Includes income and dividend

BMO Nesbitt Burns

*September 2015*

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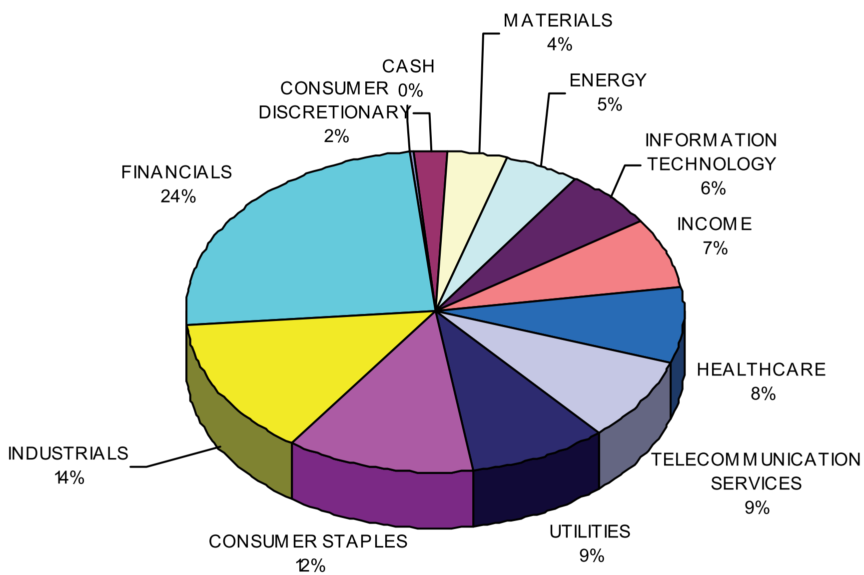
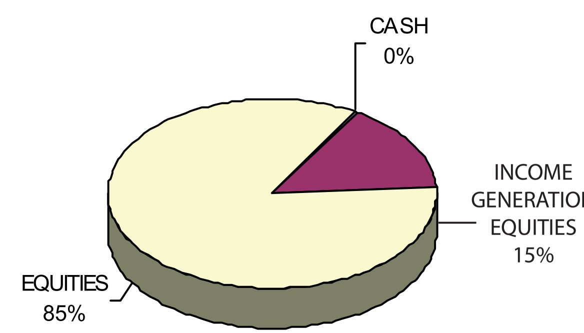
# PORTFOLIO HOLDINGS AND ASSET MIX




By Sub-Index %




By Category %

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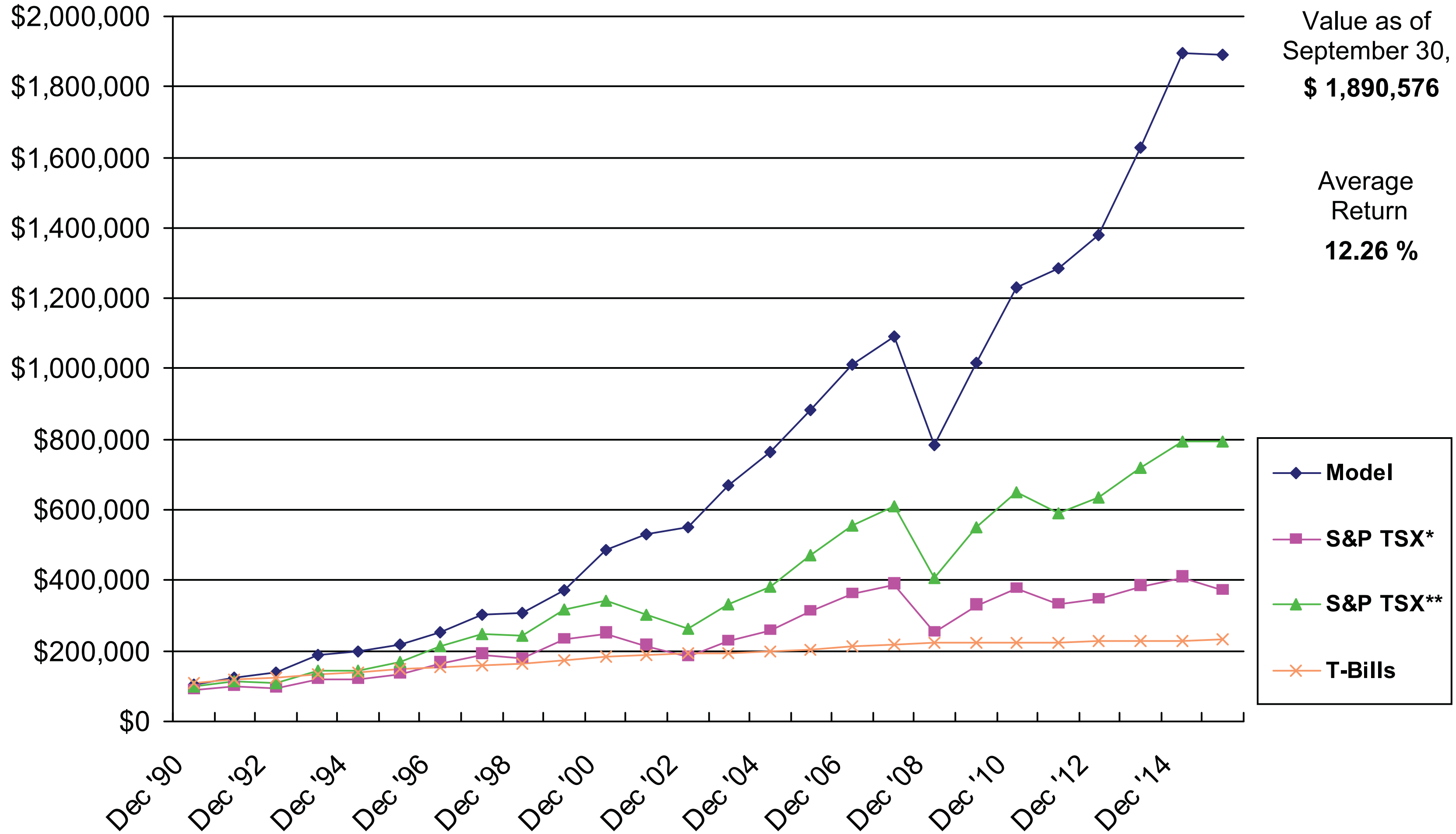
# Portfolio Return




*$100,000 invested on June 1st 1990*

*The returns are compounded monthly and revenues are reinvested.*

**Does not include income or div*

***Includes income and div*

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