Morin Dupont Lessard & Associates
BMO Nesbitt Burns

Sound advice with outstanding service

October 2018 – Excerpt # 60

Hmmm... which way is up?

BMO Wealth Management
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& Associates

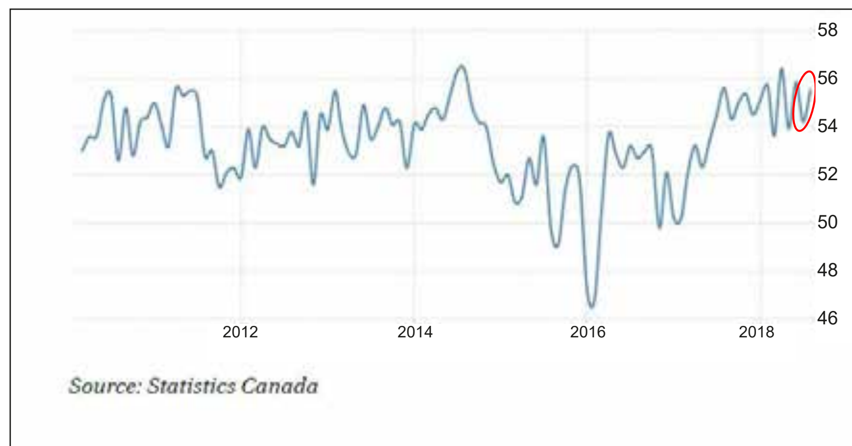
Pierre's Comments

IT'S A LONG WAY UP...

So far, 2018 has been a tough year for Canadian investors. With the TSX returning slightly above 1% as of September 30, 2018, and with fixed income yielding basically the same return, it is difficult for Canadians to feel excited.

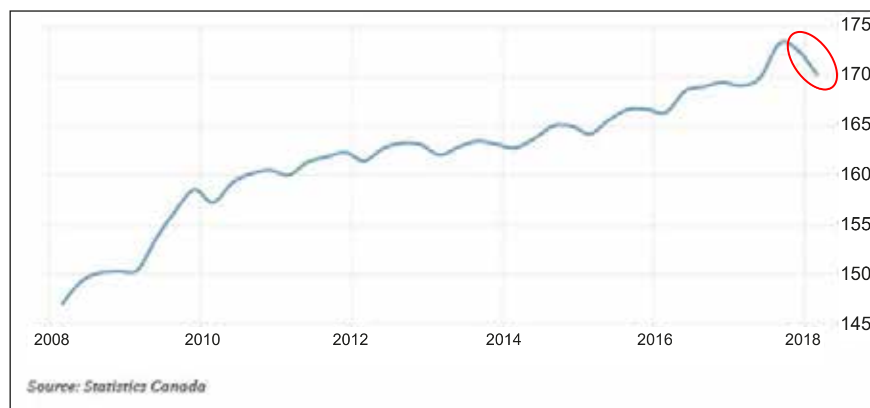
Canadian consumer confidence, on the other hand, while not as strong as in the U.S., is still at the top end of the range recorded over the past decade. **(Chart 1)**

Chart 1: Canadian consumer confidence



Obviously, if it doesn't pay to save, let's spend! Or perhaps, if we're a bit wiser, pay down debt...
In fact, for the first time in a decade as well, "credit growth has moderated and the household debt-to-income ratio is beginning to edge down," according to the governor of the Bank of Canada in a recent speech during the Fed meeting in Jackson Hole, Wyoming last month. **(Chart 2)**

Chart 2: Canadian Household debt to disposable income



A tightening monetary policy and more stringent rules for mortgage applicants introduced earlier this year are probably pushing Canadian consumers to pay more attention to their debt levels.
Canadians may also feel insecure given that we, as a nation, are being challenged by America's most recent protectionist movement. NAFTA, for one, is a key element of continued growth or complete chaos.

Trade agreements with any other part of the world would never offset the one we have with the world's largest economy and military power, the bearer of the international currency… and our nearest neighbour!

The U.S. is the financial capital of the world, with the largest and most capitalized banks. As the U.S. was able to take swift and determinate action during the 2008 financial crisis, it succeeded in kick starting its economy, leading the world to recovery. It also led the world to the disaster in the first place… And that's what capitalism does… Every situation creates opportunities which are seized and exploited until bubbles are created and/or debt levels become excessive.

Meanwhile, the European Union (EU) includes many more nations than America, making it that much more difficult to reach a consensus, and making any initiative less efficient. It took the EU three years to introduce its quantitative easing (QE) measures – which are still ongoing, by the way – whereas the U.S. phased out its QE program three years ago. As a result, Europe's banking system is not as strong as the U.S. Furthermore, it has almost three times the exposure to emerging market loans than the U.S.

At this time last year, we were hoping for a synchronized world recovery, which seemed to be developing. In late January, at the World Economic Forum in Davos, Switzerland, most of the economies of the G20 countries were expanding and pulling in the same direction. January also coincides with the Dow Jones's high of the year, which was barely surpassed in the third week of September and translates into a flat performance for the Dow since the third week of January…!

Once corporate tax reform was accomplished, it seems that President Trump's focus was to address the trade deficit. As such, he set his new priorities on NAFTA, the EU and China. Tariffs were introduced and tough negotiations began, using tariffs as a means to negotiate, which consequently killed the synchronized recovery. This resulted in a major repositioning of assets from Europe and emerging markets to the U.S., ultimately making it the only game in town. **Table 1** shows World index performances year to date (YTD) as of august 31st.

Table 1: World index performances as of 31-08-2018

Index	Total Return % Change YTD (as of 31-08-2018)	Index	Total Return % Change YTD (as of 31-08-2018)
MSCI Europe	-2,81	S&P TSX	2,28
MSCI EAFE	-1,88	Dow (DJIA)	6,73
MSCI Emerging Markets	-6,99	S&P 500	9,94
China Shanghai	-15,72	India	14,55

World indices, and most notably emerging markets, have suffered setbacks since last spring, when the U.S. introduced tariffs on steel and aluminum while threatening a whole range of new tariffs on imported goods. Those actions triggered a shift towards a safe haven and the U.S. dollar began to rally. **(Chart 3)**

Chart 3: USD Index

https://www.marketwatch.com/investing/index/dxy/charts

Typically, a strong currency attracts capital, and when the world's international currency (the U.S. dollar) strengthens, the cost of all projects for the rest of the world goes up in local currencies. This phenomenon has a dampening effect on developing nations and mostly on emerging economies. During periods of low growth and risk aversion, rather than borrowing U.S. dollars at a high cost, emerging countries will tend to pay down U.S. dollar-denominated debt, pushing the dollar higher as well.

Although President Trump will never admit it, he prefers a weaker dollar in order to be more competitive on the manufacturing side, and to reduce the pressure on trade deficits. He is also a big believer in low interest rates, which is consistent with a lower dollar. As such, he would love to control the Fed as well…

Unfortunately for President Trump, he will not gain the control of the Federal Reserve Board and will have no say on monetary policy. Mr. Jerome Powell, the current chairman of the Fed, will slowly but surely adjust interest rates upward if he feels that the economy is overheating and inflationary pressures are building too quickly. However, it is easier to justify raising interest rates when we are in a synchronized world recovery than when the U.S. is the only guest at the party….

Accordingly, Chairman Powell may delay or slow the pace of raising rates to ensure that the only expanding economy stays afloat. Although tariffs and trade wars will do nothing to stimulate the global economy, the opposite is true. And since the U.S. is just about the only growing economy, they are negotiating from a position of strength…. For the moment. Perhaps "negotiating" is too strong a word, but President Trump would love to sign new deals before the midterm elections in November, subsequently reducing tensions and uncertainty and getting the global economy back on the right track.

The Market Cycle

On August 21, 2018, the current bull market – which began on March 9, 2009 – surpassed the previous 1990s cycle, which lasted 3,452 days. **(Chart 4)**

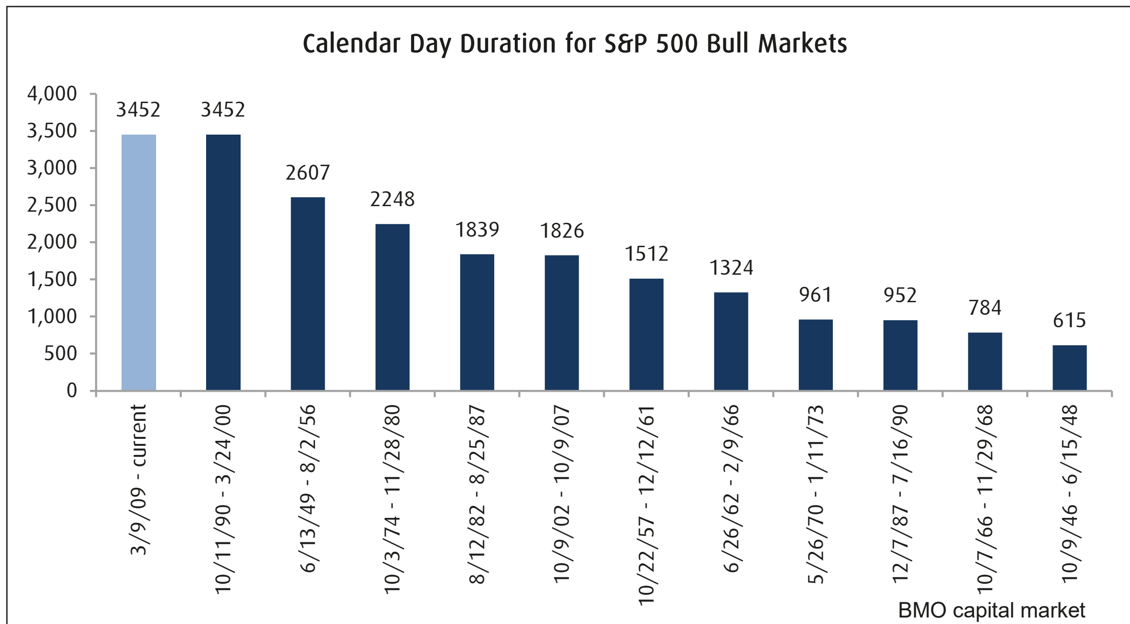
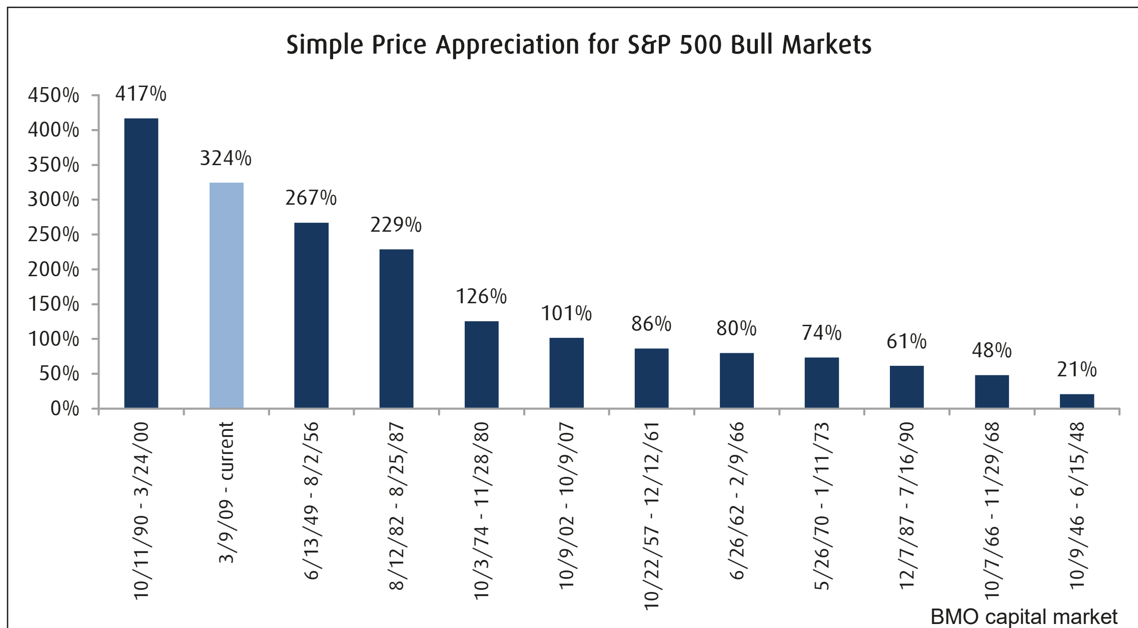


Chart 5 shows that simple appreciation has yet to match the bull market of the 1990s.



Although this cycle has benefited from extremely low interest rates, growth has remained anemic and inflation feeble. Perhaps investment confidence was shaken to an extreme during the last financial crisis, delaying consumer spending and corporate commitments to expand. For the past year, however, the U.S. has seen both consumer and investment confidence roaring back as shown in the PMI figures below. **(Tables 2 and 3)**

Table 2: US PMI Last 12 Months

Month	PMI	Month	PMI
Aug 2018	61,3	Feb 2018	60,8
Jul 2018	58,1	Jan 2018	59,1
Jun 2018	60,2	Dec 2017	59,3
May 2018	58,7	Nov 2017	58,2
Apr 2018	57,3	Oct 2017	58,5
Mar 2018	59,3	Sep 2017	60,2
Average for 12 Months ,High-61,3, Low-57,3			

Instituteofsupplymanagement.org, (ISM)

Table 3: US ISM New orders

New Orders	Index	New Orders	Index
Aug 2018	65,1	Feb 2018	64,2
Jul 2018	60,2	Jan 2018	65,4
Jun 2018	63,5	Dec 2017	67,4
May 2018	63,7	Nov 2017	64
Apr 2018	61,2	Oct 2017	63,4
Mar 2018	61,9	Sep 2017	64,6

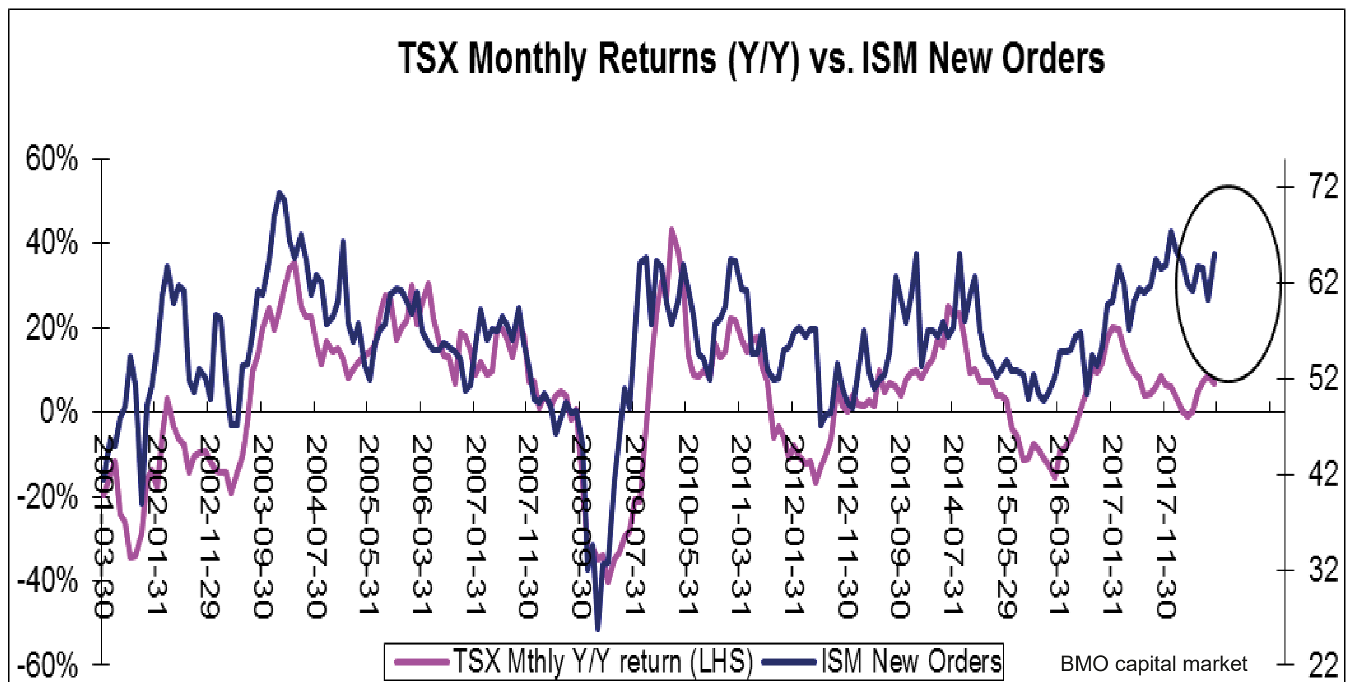
Instituteofsupplymanagement.org, (ISM)

We favor the PMI (Purchasing Managers Index) over GDP (gross domestic product) because it provides accurate current statistics compared to the late computation of quarterly GDP results, which are subject to revision most of the time. A PMI above 43.2% generally indicates an expansion of the overall economy. Our comfort zone for growth is above 50, when expansion is at or above 2%. Past relationships between the PMI and the overall economy indicate that a 61.3% result (August) corresponds to a 5.6% increase in real GDP on an annualized basis. New orders are also confirming the continued strength of the economy. Obviously this level of growth may not be sustainable, but if we believe that President Trump uses tariffs as a negotiating tool and that he successfully signs new agreements with Canada and potentially China, the world's second-largest economy, then this bull market may be far from over. This is perhaps idealistic, but any step getting us closer to a trade agreement alleviates uncertainty. On the flip side, President Trump's aggressive strategy could fail, driving corporate earnings and equity markets lower…

With the exception of 2016, Canada has underperformed over the past several years, having failed to leverage a Canadian dollar at or near par to become more productive and efficient. Our productivity gains are mostly a result of the devaluation of the loonie rather than technology-driven. Hopefully, with NAFTA out of the way, the Canadian government will introduce some tax relief measures, allowing Canadian corporations to enhance their competitiveness just in time for the next federal elections. Such

a move, although it has yet to occur, could rekindle the Canadian business community's confidence, resulting in an increase in long-overdue capital spending and generating subsequent growth in Canadian equity markets**. Chart 6** shows the recent gap between the TSX's monthly returns and the ISM New Orders index. These highly correlated factors tell me something will have to give… Perhaps the TSX has fallen behind, providing an attractive entry point for new money if the above-mentioned bull case materializes.

Chart 6: Correlation between TSX and ISM New Orders



Red flags

Comparing today's economic conditions with those of a couple of years ago forces the investor to reflect further. It is true that bull markets don't usually die of old age but, as red flags appear, we cannot let greed take over reason. Rising interest rates, a very tight labour market, especially in the U.S., wage inflation starting to appear, a flattening yield curve, and peaking real estate prices are all late cycle flags. Some analysts are of the opinion that interest rates have stayed too low for too long and that there is a lot of room for returning to a "normal" level. Others argue that a quarter-point increase from a very low level, say 1%, has a larger impact on economic growth than a quarter-point increase staring a 10% level.

As well, as mentioned earlier, Canadian consumers are extremely leveraged. As a result, the Bank of Canada may not need to raise interest rates in any significant way to curb their appetite. Already we have witnessed a bit more financial responsibility from Canadians in recent months, with the debt-to-revenue ratio decreasing from 1.75 to 1.70. I admit there is a long way to go before we get to U.S. consumer levels of less than 1.30, but slowing the economy too much could hurt even more, as jobs may be lost and foreclosures begin to rise… this is why Bank of Canada Governor Stephan Poloz will keep a close eye on Canada's PMI and economic velocity to ensure a soft landing and continued growth.

Another red flag for Canada comes from its lack of fiscal support of small businesses to offset U.S. tax reform. Canada's corporate tax rate is on average 27% while the U.S. has cut its rates from 35% to 21% as of 2018. Including state taxes, U.S. corporations pay roughly 25.8% which makes Canada far less competitive for such a foreign investment dependent country. As a comparison, Ireland's corporate tax rate stands at 12.5%. Canadian corporations are bound to expand their business in the U.S. in view of lower tax rates and transportation costs, border delays, duties and tariffs, and NAFTA uncertainty. The bear case for Canada is a status quo on fiscal policies and continued tightening monetary policy.

The reality is most probably somewhere in between these extremes, as usual. Canada is the second largest country in the world with the smallest population among G7 countries.

Per capita, we are extremely rich in resources of all kinds…but we are extremely dependent on foreign investments. We must therefore remain very competitive to attract worldwide investments, develop our nation, grow our economy, create jobs and… pay taxes, a lot of taxes! Remember, there are only a few of us (±35 million inhabitants) to pay the tab for this oversized country. We must protect our economy, our jobs, our environment and our unique culture… a very difficult juggling act indeed!

On the eve of another election year, we can expect Prime Minister Trudeau to be economically and socially very supportive. With most of the $35 billion still sitting in the Infrastructure Bank since last year, 2019 may be remembered as a "ribbon-cutting year." This bodes well with our bullish case, but it is also potentially worrisome for Canada's balance sheet.

The presence of red flags is to be monitored as the economy expands. We all know this economic cycle will come to an end. We should all be aware that the market cycle is a forward indicator of the economic cycle. Chart 7 shows past recessions in the form of vertical grey bars. Note that equity markets tend to discount ahead an upcoming recession. This tendency is noticeable throughout the last century.

Chart 7: stock market since 1997

dow-jones-100-year-historical-chart-2018-09-26-macrotrends.jpg

Given that over 80% of equity volumes are institutionally driven, smaller investors risk being caught holding the bag. We are humble enough to admit that we cannot time the market perfectly, as it's impossible to know which catalyst will trigger a significant sell-off. Therefore, common sense must prevail. As the cycle grows older and red flags start to appear, we should be thankful we were able to participate in the market recovery and revert to our original asset mix that reflected our risk tolerance level of 10 years ago, i.e. while we were in the midst of the financial crisis. As we took advantage of the recovery, our equity exposure grew because it outperformed our fixed income returns of roughly 2%. We also took advantage of high-dividend stocks, which became attractive because interest rates were maintained artificially low for a prolonged period of time. That was good… but the environment is changing, and we are 10 years older … 10 years closer to retirement... when no more paychecks come in and we become dependent on our savings… So take some profits now and start reducing some of your equity exposure over the next six months.

Investment strategy

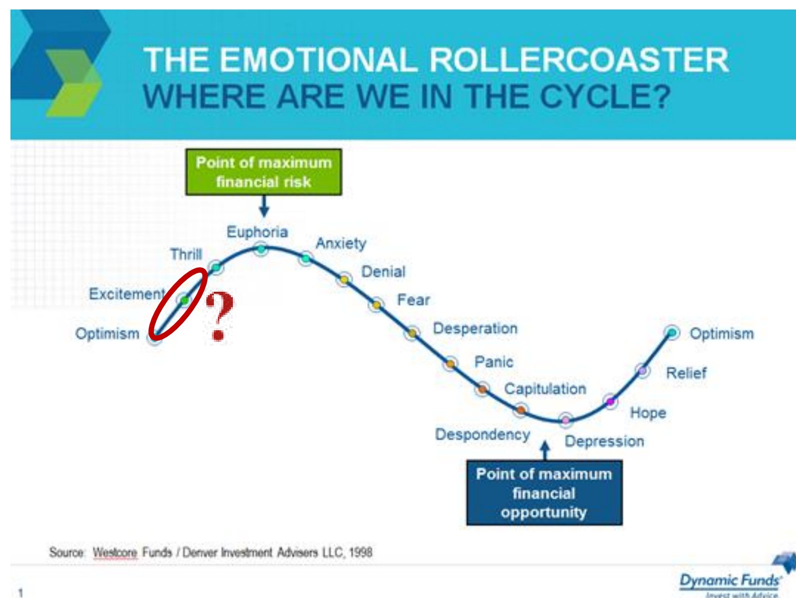
Fundamentals are always the most important determinant of our investment strategy. Although this cycle is getting old, we do not believe equities to be overpriced in general. The U.S. market is trading at roughly 17 times earnings, which we feel appropriately reflects the low interest rates and low inflation environment. However, the 24% earnings growth achieved by U.S. companies this year is not sustainable, and the market knows it. Last year, P/E multiples stood at 19 times, discounting this year's earnings growth which is supported by corporate tax cuts. Next year's earnings growth is forecasted to be in the high single digits, which explains the P/E multiple contraction. Historically, Canada outperforms the U.S. market late in the cycle. This would only coincide with a global synchronized recovery. As a result, we would have a weighting in U.S. equities of 35% of the equity component and perhaps 5% higher for "snowbirds." The two main elements that would influence adjusting our weightings are the NAFTA agreement and a significant Chinese stimulus package. We may increase our emerging market component while reducing some of our U.S. exposure as such a change would alleviate uncertainty and justify a resumption in the downward trend of the U.S. dollar index. As uncertainty dissipates, capital expenditure programs might become the story of 2019 as well as a surprising return of inflation. As for our sector weightings, we remain mostly neutral as compared to our last newsletter, with the exception of a slight reduction in telcos and electric utilities in favour of pipelines and energy more inflation sensitive. (See p. 10)

Conclusion

Although we are in the presence of more red flags than at any other time in this cycle, they remain benign for the moment. Prudence is the appropriate strategy, but what is the best fiscally responsible way to reduce equity exposure? For those of you in your 60s, you are within 10 years of being required to withdraw from your RRSPs. The RRIF (the extension of your RRSP when you turn 71) becomes one of your main sources of income. If you rely on that income to live, then you should first consider reducing your equity component in your RRSP without triggering a capital gains tax. In this way you will better protect your future annual income (your RRIF annuity) as a solid and predictable source of revenue.

For the younger age groups, your priority should be to pay down debt if you have any. The sooner you are debt-free, the sooner you can begin to build up savings in addition to your RRSP and TFSA – a useful cushion that you can use to fill the gap between the year you retire and your first withdrawal from your RRIF at age 72. To ensure a fiscally responsible, secure retirement, you must have savings in a personal regular account to cover your cash flow needs until you reach 72, unless you have a defined benefit pension plan.

Your personal risk tolerance level will determine your equity exposure. However, humans tend to extend their tolerance when times are good and restrict equity exposure when times are difficult. It is important to respect your true tolerance level throughout the cycle with some tactical adjustment. The emotional investment cycle could be a good guideline for realigning your asset mix. **Chart 8** could help in rebalancing your portfolio, simply by figuring out where we potentially stand in the emotional cycle…



The bull is getting old and quite hairy and doesn't seem to be certain which way is up and if he can make it to the top …!?! Hopefully he chooses to delay a quick « hair cut »...!

Sectors	Recommended Weighting October 2018	Trend
Consumer Discretionary	2.5%	↓
Consumer Staples	5.5%	
Energy	4.5%	↑
Financials	14.5%	
Health	4.5%	↑
Industrials	9.5%	
Materials	3%	
Real Estate	3.5%	
Technology	7.5%	
Telecom	3.5%	↓
Utilities	6.5%	↓
Total Equities	**65%**	

- *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 2018	Oct 2018		Apr 2018	Oct 2018
10%	7.5%	CASH (maturities ≤ 12 months)	10%	7.5%
45%	47.5%	Fixed income (Bonds & GICs)	30%	32.5%
15%	15%	Convertible Debs. And Income Generating Securities	10%	10%
20%	20%	Equities	30%	35%
10%	10%	Foreign	20%	15%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Sources:

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• BCA research
• Bank of Canada website
• Barrons
• BMO Capital Markets Equity Research Reports
• BMO Financial Group Economic Outlook
• BMO Nesbit Burns
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• BMO NB Canadian Equities Guided Portfolio – September 2018
• BMO NB US Equities Guided Portfolio – September 2018
• BMO NB North American Equities Guided Portfolio – September 2018
• BMO NB Dividend and Income Guided Portfolio – September 2018
• CIBC capital markets
• Cornerstone Macro
• C.D. Howe institute
• CNBC
• Dow Jones Newswires
• Instituteofsupplymanagement.org , (ISM)
• Financial Post
• Globe and Mail
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• National Post
• National Bank financial Markets
• New York Times
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• RBC Capital markets
• Standard & Poor's Capital IQ Equity Research
• The Economist
• The Wall Street Journal
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• US Census Bureau
• Ycharts.com

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Performace - T-Bills vs SP TSX vs Reference Portfolio				
Year	T-Bills (return)	SP TSX[1]	SP TSX[2]	Portfolio(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%	**19.96%**
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	1.50%	-35.03%	-33.00%	**-28.07%**
2009	0.29%	30.69%	35.05%	**29.37%**
2010	0.60%	14.45%	17.61%	**21.05%**
2011	0.92%	-11.07%	-8.71%	**4.18%**
2012	0.97%	4.00%	7.19%	**7.38%**
2013	0.97%	9.55%	12.99%	**18.14%**
2014	0.92%	7.42%	10.55%	**16.43%**
2015	0.50%	-11.09%	-8.32%	**6.36%**
2016	0.50%	17.51%	21.08%	**16.75%**
2017	0.71%	6.03%	9.10%	**13.16%**
*2018	0.97%	-0.84%	1.36%	**6.25%**
Return Compounded as of December 31, 2017				
3 years	0.57%	3.47%	6.59%	12.04%
5 years	0.72%	5.45%	8.63%	14.12%
10 years	0.79%	1.60%	4.65%	9.33%
Average return since inception (YTD) ……………………………….				**12.49%**

* (YTD): Year To Date (September 30th, 2018)

$100,00 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

1: Does not include income or dividend

2: Includes income and dividend

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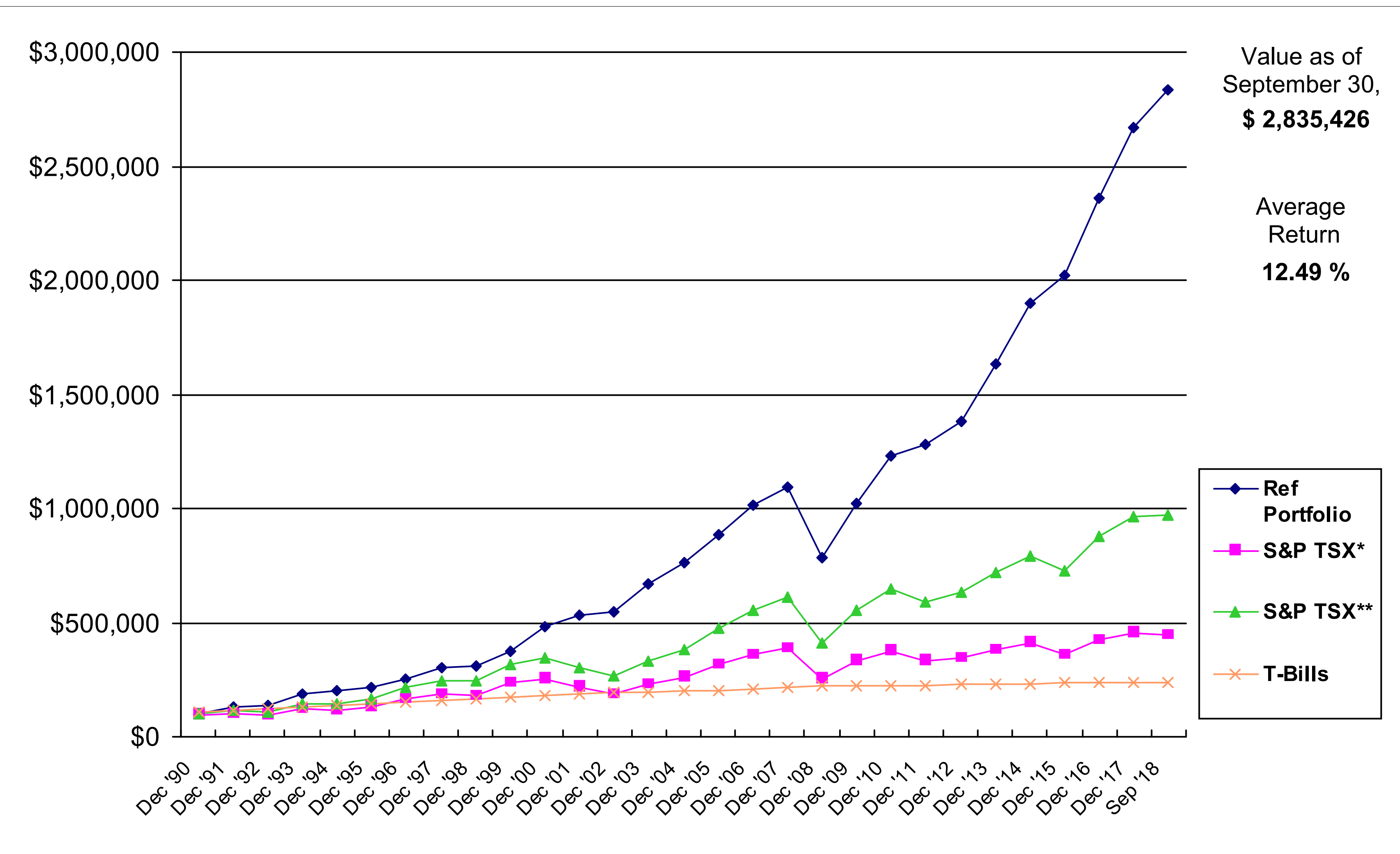
Reference Portfolio Return



$100,000 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

**Does not include income or div*

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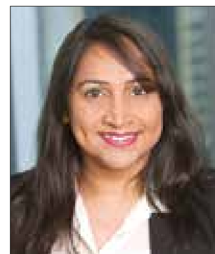

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