Morin Dupont Lessard & Associates
BMO Nesbitt Burns

Sound advice with outstanding service

October 2017 – Newsletter # 58

CONSULTING OR DECOUPLING ?
(Excerpt)

BMO Wealth Management
BMO Nesbitt Burns

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& Associates

Pierre’s Comments

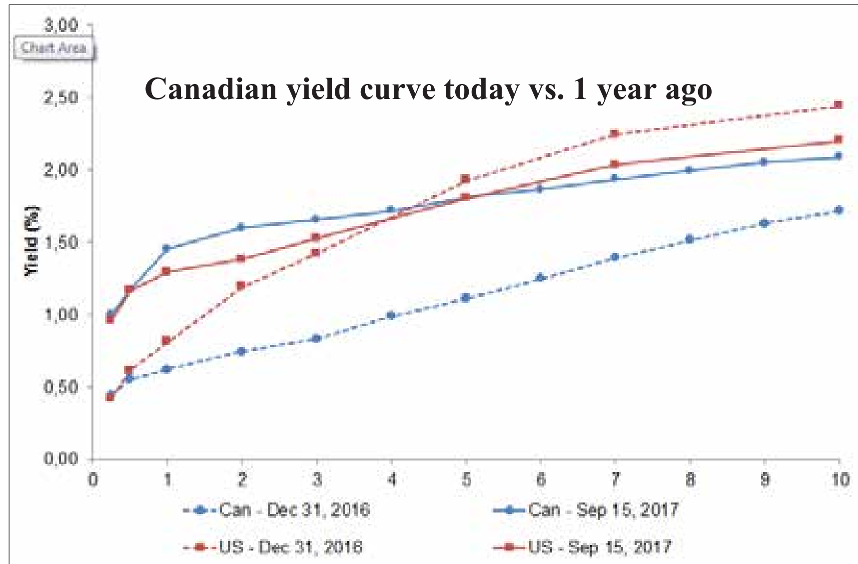
By the time you receive this newsletter, we will be marking the 30-year anniversary of the 1987 market crash. What became known as “Black Monday” was also the abrupt end of a five-year bull market. The 22.6%, single-day correction on the Dow Jones would represent a drop of roughly 5,000 points, from the 22,000-level where the Dow stands today. Can you imagine?!

It was in the aftermath of the crash that Josée and I changed our approach to investing. This lesson in humility at our young age forced us to re-invent ourselves and invest in our future. We computerized ourselves, created our “model portfolio”, quite innovative at the time, and wrote to our clients about our new investment philosophy and investment opportunities as a function of the existing economic environment. This initiative resulted in the introduction of our very first semi-annual newsletter. Warren Buffett was a huge influence in our philosophy, showing us the path to investing in industry leaders with proven management teams, expanding worldwide without exposing the company to excessive leverage. With a good cross-sector selection and a proper asset mix, you can perform very well over time, and go through peaks and valleys without panic. It took us 2½ years to re-focus and build our new platform. Our Model Portfolio was officially established May 1, 1990.

Model Portfolios today have evolved into standardized platforms, where all their participants (i.e. investors) have exactly the same stocks with exactly the same weighting per stock. They will respect your personal asset mix, for instance 60% of your savings in an equity model portfolio and 40% in a fixed income model portfolio, but nothing is personalized with regards to the weighting of individual securities in the client’s portfolio. It is purely a disguised “mutual fund”, also called “pooled funds”, with fees being charged in your account to make them tax deductible. Given that this is not what we do, the time has come to change the name of Model Portfolio to the “ Reference Portfolio”, from which we select the securities that offer the best fit based on your investment objectives, as well as a personalized weighting that meets your specific needs, i.e. that focus on income or growth. Hopefully, this appropriate change won’t jinx the ongoing 102-month-old bull market and make us live through another 5000-point correction in one day!

There is a precedent to this long bull market and ironically, it is the period that followed Black Monday and the consequential recession. Indeed, October 1990 to March 2000 marked the previous longest recorded bull market, one that lasted 113 months. A bullish cycle ends with the anticipation that the economy is heading towards a recession. An overheating economy forces central bankers to raise interest rates in order to slow it down…At the beginning, bond yields tend to adjust upward along with the bank rate. However, when investors perceive the Central Bank is overreacting, stocks start selling off and the proceeds move to a safer haven, namely bonds. More bond purchasers pushes prices up and yields down, most notably on longer-term maturities (10 years +). The yield curve flattens, and the more it does, the more there are believers, increasing the odds of a recession. The vicious spin feeds on itself and investor behavior contributes as well to the slowdown. Consumers reduce their spending; corporate CEOs slow their capital spending, freeze hiring, and eventually “shorten the bench” through layoffs.

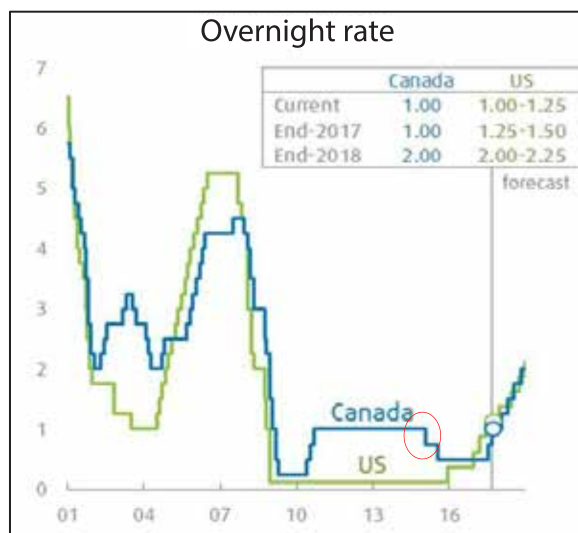
Chart 1



Source: BMO portfolio strategy

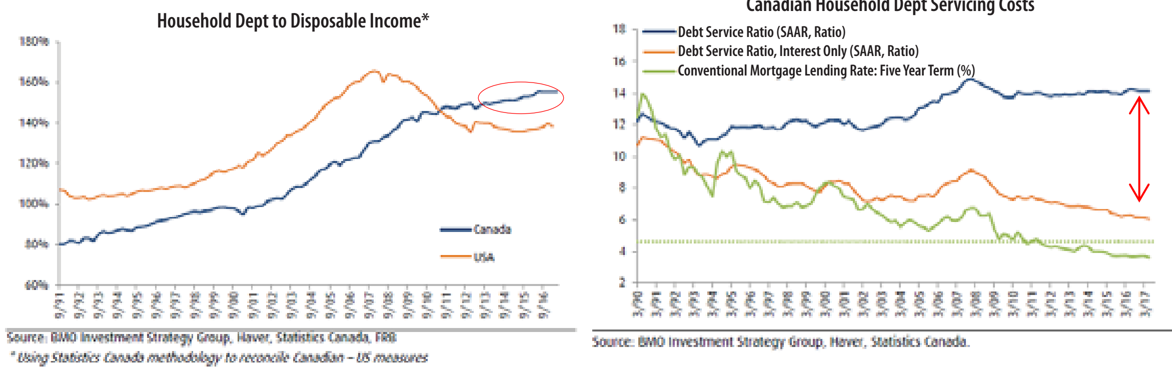
Chart 1 shows that the full lines (2017) are flatter than the dotted lines (2016), suggesting an increasing risk of a recession or a maturing economic cycle. Although we aren't seeing any immediate signs of recession, it is important to note the swift change in monetary policy made this summer by our very own Bank of Canada (BoC) governor Stephan Poloz. When such a process begins, it is usually followed by an eventual slowdown in earnings growth… However, the current move is one of "normalization". The "super accommodative" policy which begun in early 2015, was implemented to avoid deflation after oil prices collapsed in 2014, had brought the Canadian bank rate down from 1% to 0.5%. See red circle in chart 2.

Chart 2



The recent move is mostly justified as an effort to avoid an asset bubble, in this case real estate, given that Canadian consumer debt has reached uncomfortable levels. (Charts 3 and 4)

Charts 3 & 4: Debt charts



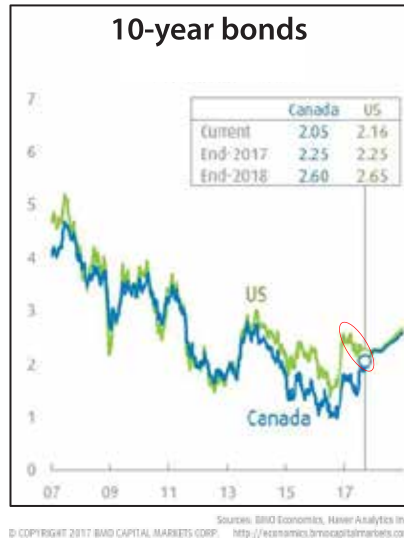
In the U.S., equity markets have been on a tear, much more so than the real estate market. Indeed, the recent 2008-2009 financial meltdown caused by the collapse of the real estate pricing bubble is still fresh in the U.S. consumer's mind. At 19 times earnings, U.S. stock prices are more vulnerable to a rise in interest rates, but the Fed doesn't seem worried for now. U.S. GDP growth is not overheating, hovering around 2%... Monetary policy is not the only contributor to economic growth… Deregulation and fiscal policy changes could certainly impact economic expansion in the U.S. in the months ahead. Recession is not on the horizon in the U.S. for now, but stock prices may be slightly overpriced, without some form of tax agreement…

The U.S. led the world out of the Great Recession, but growth has remained anemic, solely supported by accommodative monetary policy. The rest of the world fell behind, with late acceptance of the U.S. monetary policy model and the introduction of quantitative easing (QE i.e. printing money) during the Great Recession. In our last two newsletters (#56, #57), we had expressed our positive views on foreign markets given that four of the five biggest world economies (China, UK, Europe, Japan) were expanding their money supply through QE. The paradox is that printing money should have a dilutive effect on the value of the underlying currency, but most of them have strengthened against the U.S. dollar. The Trump leadership has brought a new sense of fear and uncertainty worldwide on many fronts, including immigration, geopolitics and trade. This destabilization has had significant repercussions on the value of the U.S. dollar, which has plummeted over 10% (chart 5) against a basket of other developed nations currencies, more than offsetting the devaluation impact of QE.

Chart 5

Furthermore, 10-year U.S. Treasury yields have come down significantly since President Trump officially took office in January 2017. (Chart 6)

Chart 6



Remember that bond yields go down when prices go up… If prices go up, it means more buyers than sellers… Why would smart investors suddenly buy bonds? For a good return… @ 2.2 % for 10 years? Or out of fear…? Meanwhile, the Federal Reserve Board (the Fed), the U.S.'s central bank, in a tightening mode of late, is now slowing the momentum in reaction to the sluggish economic expansion, suggesting a continuation of a slow economic growth in the U.S. As mentioned in the past as well, monetary policy alone cannot stimulate a strong and sustained recovery. Without fiscal stimulus and infrastructure spending, the U.S. economy could remain in a slow growth momentum. The underlying effect of a lower U.S. currency is that all commodities, which trade in U.S. dollars, become cheaper to the rest of the world. It acts as a stimulus for other developed and emerging markets. The combined effect of a lower U.S. dollar and QE stimulus of their own has resulted in better than expected GDP growth worldwide. (Charts 7-8)

Chart 7

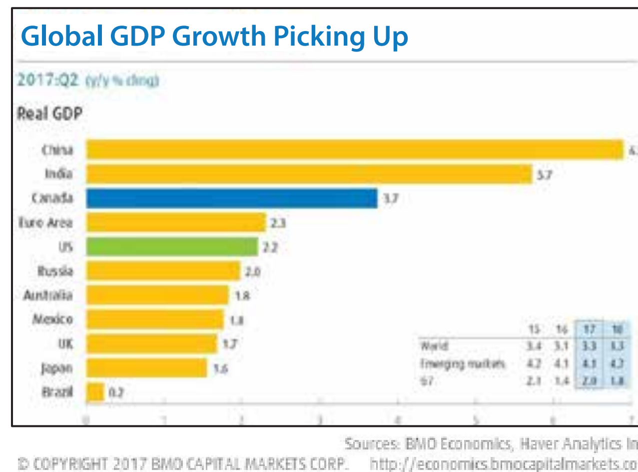
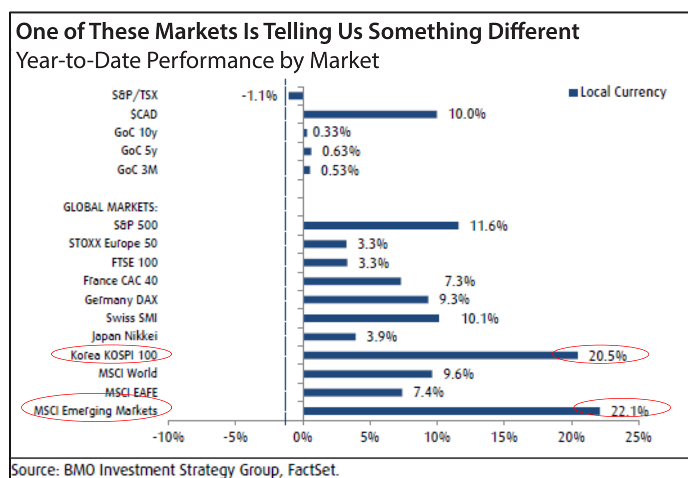


Chart 8



Yet price/earnings multiples are still lower in Europe, Asia and the Far East than in the U.S. This suggests that it is still a good time to expand our exposure geographically. It also suggests that a successful tax reform, including a repatriation tax, would provide a much needed stimulus in the U.S. In such circumstances, the U.S. dollar could rebound somewhat as it is oversold at this point. The “short interest”, which basically expresses the amount of contracts betting against the U.S. dollar, is currently very high, reflecting pessimism in the realization of tax reform. Typically when such a situation occurs, it does not take much good news to have all those speculators buying the U.S. dollar back to cover their short positions. This is exactly what happened when our Canadian dollar rebounded from $0.72 to $0.80 as a record number of short contracts had to be repurchased (May and June 2017). Beware that a rebound in the U.S. dollar could also rattle the emerging market recovery.

The polarization of Canada vs. the U.S.

Both Canada’s and the U.S.’s economies have been for the most part running hand in hand. Currently, however, the policies of these two countries seem to be diverging or decoupling.

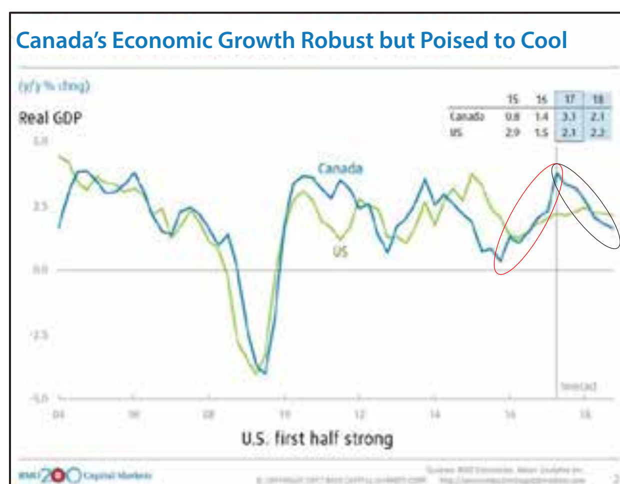
Table 1

	CANADA		U.S.
A	1% ↑	INTEREST RATES	0.75% --
B	↑	TAXES (CORP & PERS.)	↓
C	$1.75 ↑	DEBT/REVENUE	$1.22 ↓
D	↓	REAL ESTATE PRICES	↑
E	↑	RULES & REGULATIONS	↓

A) While BoC Governor Stephen Poloz increased the prime rate twice in July and again in September, the Fed is reacting to lower bond yields and delaying its next move forward. Canada’s GDP growth rate has accelerated over the last two quarters, averaging 4%, enough to trigger the BoC’s actions. (Red circle in chart 9) However, we perceive that Canada’s economic expansion is not broad based while consumers are highly indebted. As a result, and given the impact of the rise

of the Canadian dollar, we believe that Canada's economic expansion could stumble relatively quickly. (Black circle in chart 9)

Chart 9



B) In addition to the BoC's action to constrain economic expansion, our Finance Minister Bill Morneau has tabled a bill to take away major tax incentives to private corporations and small businesses. If these proposals are fully implemented, it could have a serious impact on much needed foreign investment and become a deterrent to entrepreneurship in this country. It is worth noting that small business is the biggest creator of jobs. Basically, we are going exactly in the opposite direction than our neighbours to the South. Entrepreneurs need tax incentives to offset the risk and the huge cost of retirement. Unlike public workers, entrepreneurs do not have a secure, lifelong indexed defined benefit pension plan. They must build their own. Their contribution is in the form of job creation and taxes are collected by the government for all these workers, along with their economic impact. We also must remember that approximately 2/3 of all small businesses are about to change hands as baby boomers plan to retire (2015 report from Equicapita). The oldest baby boomers were born in 1946 and they are 71 years old this year. The youngest, born in 1960 are 56 years old today. Limiting the value of these businesses means less consumption power, less taxes over the long-term and more dependency on social welfare. Why should anyone build a business here in Canada? Canada is rich in resources but that's highly cyclical and generates low margins. Canadians cannot afford to be simply that. The secondary and tertiary sectors of the economy, namely processing and services, have larger margins but require more capital spending, i.e. they are higher risk. Discouraging the entrepreneurial spirit would limit the full expansion of our economy and increase our dependence on our primary sector (raw materials), something that is typical of a third world country.

Given the intentions of the BoC to raise rates further this year and next, we could fall into recession territory prematurely, unless world GDP growth expands significantly in 2018 (see chart 7).

With this last possibility in mind, demand for raw materials and energy could rise, triggering an increase in commodity prices and pulling inflation and Canadian economic growth along with it. Naturally this would support ongoing tightening by the BoC.

C) While there is little room for Canadian consumers to expand further given the high debt level and the tightening of monetary and fiscal policies, U.S. consumers are by far in a better position.
D) Property values are still increasing there, as opposed to Canada. Their interest rates are remaining low for longer.
E) Furthermore, they are facing possible tax cuts as well as significant deregulation, allowing for easier access to loans. Obviously this could have positive repercussions on the Canadian economy, unless the U.S. decides to keep that growth to itself by "simply" repealing NAFTA… Now that is what I would call "decoupling"!

We won't know for a while what compromises Canada will have to commit to, but it is hard to believe in a complete about-face on trade. Even a Republican Senator for the State of Nebraska (Ben Sasse) argues the Trump administration is promoting an "18th century view on trade". The U.S. actually has a trade **surplus** of $28 billion with Canada when you exclude energy which they rely on. No less than 32 States have Canada as their largest **export** market, and an additional nine States have Canada as their #2 export market… We believe NAFTA could wind up as just another brick in the "wall"… without much impact on Canada.

Investment Strategy

Canadian markets tend to outperform U.S. markets in the late part of the cycle. As inflation picks up momentum, typically materials and energy tend to outperform. Although it may be a bit early for this trend to establish itself, we have witnessed strength in copper as well as other base metals over the last several months, in line with the weakening U.S. dollar and the subsequent recovery in emerging markets. We will therefore increase our energy exposure slowly over the next six months. As the results unfold regarding NAFTA's new terms, we could reshuffle weightings in our reference portfolio. Gold remains an insurance against geopolitical disruptions and should find a small place in portfolios as well.

Banks and insurance companies remain our favorite sector, as both benefit from a rising interest rate environment, assuming limited exposure to bad loans. They also tend to lead the market when market recovery is in the work. As for timeliness, the Canadian financial sector has just gone through an eight percent correction and is attractively priced today. In the real estate sector, we favour residential rental REITs as well as industrial REITs, less impacted by rising interest rates. We are also considering initiating a position in retirement home REITs as an alternative as well.

The Canadian government established an infrastructure bank in Toronto this year to help fund huge projects across the country. Many industrial companies as well as pipelines and other utilities may well benefit from this $35 billion Government of Canada investment. Provinces, banks and companies will finance a significant portion as well. The total value of these projects may be well beyond $200 billion over the next few years.

Consumer Staples should remain core in portfolios. Although they are not growing at the speed of sound, they do provide stable returns and represent a sound investment.

Health care and technology stocks are mostly U.S. companies. These are the two sectors set to benefit the most from the introduction of a U.S. repatriation tax. We expect significant mergers and acquisitions to accelerate if, as and when this tax reform is introduced.

Telecom and consumer discretionary stocks might be falling out of favor as they are perceived to be inversely affected by rising rates. The Telcos, however, benefit from a solid oligopoly, and margins remain very attractive. Dividend coverage is not an issue for this group.

Conclusion

Canadian investors are facing many headwinds: excessive consumer indebtedness, the aggressive and perhaps premature BoC rise in interest rates, the threat of protectionism with NAFTA being renegotiated with the U.S., and fiscal tightening by the Government of Canada with respect to its entrepreneurs and small business leaders.

This kind of environment doesn't seem to fit a "risk adverse" sentiment. However, when the risk is greater, returns could be more meaningful. The focus should therefore be on the quality of the companies we own and their ability to navigate and to adapt to a new environment. Financial strength and proven management are most important when facing unpredictable outcomes. Our Canadian currency, in the mind of most of us, will be influenced mostly by our own monetary policy or the pace which its tightening will be implemented. It will also be influenced by the realization of tax reform in the U.S. and the subsequent acceleration of economic growth driving a stronger U.S. dollar to the detriment of the Canadian dollar. This explains why both Bank of Nova Scotia and JP Morgan are calling for a stronger Canadian dollar 2018 while RBC and BMO are calling for a reversal of the Canadian dollar next year. Knowing that $0.82 has roughly been the median for the Canadian dollar over the past 100 years, we don't feel we should buy or sell U.S. dollars at this level.

Canada and the U.S. are going through a rough patch and they are parting ways. They may need a "marriage" counselor to re-establish their common goals and prepare a "comprehensive agreement", one where they could both make cohesive and coherent decisions to help one another and live together happily ever after…

D+J

Sectors	Recommended Weighting October 2017	Trend
Consumer Discretionary	2.5%	
Consumer Staples	6%	↓
Energy	4.5%	
Financials	14%	↑
Health	4%	
Industrials	9%	↑
Materials	3%	
Real Estate	3%	↑
Technology	7%	
Telecom	5%	↓
Utilities	7%	
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 2017	Oct 2017		Apr 2017	Oct 2017
7.5%	7.5%	CASH (maturities ≤ 12 months)	7.5%	7.5%
45%	45%	Fixed income (Bonds & GICs)	30%	30%
15%	15%	Convertible Debs. And Income Generating Securities	10%	10%
20%	20%	Equities	30%	30%
12.5%	12.5%	Foreign	22.5%	22.5%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Sources:

- Bank of Canada website
- Barrons
- BCA Research
- Before the Bell
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- BMO Nesbit Burns
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- BMO NB Canadian Equities Guided Portfolio – September 2017
- BMO NB US Equities Guided Portfolio – September 2017
- BMO NB North American Equities Guided Portfolio – September 2017
- BMO NB Dividend and Income Guided Portfolio – September 2017
- Cornerstone Macro
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- Financial Post
- Fox News
- Globe and Mail
- Gov't of Canada website (www.budget.gc.ca)
- Invesco Canada Blog
- JP Morgan
- 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)

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*Excerpts from the Canadian and U.S. Equities Guided Portfolio, September 2017

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17 - The issuer has paid or reimbursed some or all of the BMO Nesbitt Burns Inc. analysts travel expenses.
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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	0.48%	2.27%	4.45%	**6.16%**
Return Compounded as of December 31, 2016				
3 years	0.64%	3.92%	2.10%	13.08%
5 years	0.77%	5.04%	8.13%	12.91%
10 years	1.07%	1.71%	4.10%	8.82%
Average return since inception (YTD) …………………………………….. **12.46%**				

* (YTD): Year To Date (September 30th, 2017)

$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

Reference Portfolio Return

$100,000 invested on June 1st 1990

**Does not include income or div*

***Includes income and div*

The returns are compounded monthly and revenues are reinvested.

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