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April 2018 – Excerpt # 59

MOMENTUM SHIFT?

BMO Wealth Management
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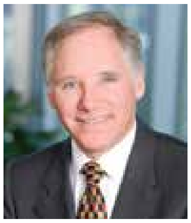


Pierre's Comments

MOMENTUM SHIFT?

It was the morning of Friday, February 9, 2018, more precisely at 7:30 a.m., when the economic data for January showed the annualized GDP growth rate reaching 5.4%, according to the Federal Reserve Board of Atlanta. This, after years of anemic growth at barely 2%, obviously seemed great, especially in the wake of the recent tax reform. Barely an hour later, more good news followed, with a better-than-expected job and unemployment report and a year-over-year wage increase of 2.9% being announced, an increase we hadn't seen in the last 10 years… Ironically, it was those great economic results that sent the market into its sharpest correction in at least five years with the volatility index reaching all-time highs!

In light of this vicious market reaction, could it be that bad news is bad news, but now good news is becoming bad news too?!

Although slow growth was not exciting, it was sustainable and perhaps more predictable. Stronger growth has its positive repercussions such as stronger job creation, lower unemployment, increasing consumption, business expansion, but it does have its downsides as well, including rising wages, inflation and higher interest rates. Accordingly, markets tend to move from expanding price earnings multiples to contraction, based on slowing earnings growth as the cost of goods and financing edges up. Although we are not at the point where interest rates or inflation are having a negative impact on profitability, we must remember that the stock market discounts these risks in advance, hence the increasing volatility.

For months, the markets have shown resiliency faced with all kinds of news. From Brexit to the North Korean missile testing, from Hillary's e-mails to Trump's election, from Russian meddling in the U.S. elections to their invasion of Ukraine and support of Syria, none of these events created big waves in the markets. If anything, the market kept moving along, feeding itself on earnings growth and the potential of deregulation and tax reform. In late December 2017, Americans' wish was granted. But there is a saying that goes "be careful what you wish for." January 2018 turned out to be the celebration of tax reform and continued deregulation. The Dow Jones and the S/P rose 5.8% and 5.6%, respectively, in January alone. Most valuation parameters, including forward P/E, price-to-sales, price-to-book value or enterprise value/EBITDA are among the highest in history, according to investment billionaire Howard Marks. In Davos, at the annual World Economic Forum held from the 23rd to the 26th of January, you couldn't find a world leader who wasn't optimistic about the business environment and excited about the prospects for the coming year.Too good to be true, perhaps, but the changing of the guards at the Federal Reserve Board combined with surprisingly strong economic indicators in early February kept pushing bond yields higher. President Trump's protectionist tactics, with the introduction of trade tariffs, were enough to reignite volatility, raising the risk of derailing the recovery. Although steel and aluminum tariffs have been waved for Canada and Mexico for the time being, we are being held hostage by President Trump during NAFTA negotiations – not a comfortable place to be for either the Canadian or Mexican governments. Furthermore, at the time of writing this newsletter, we have yet to be notified about the imposition of steel and aluminum tariffs on other nations, including Europe, Japan and Australia, all of whom are bound to retaliate in some way, reminding us all of the consequences of the last trade war and the frightening memories of the Great Depression.

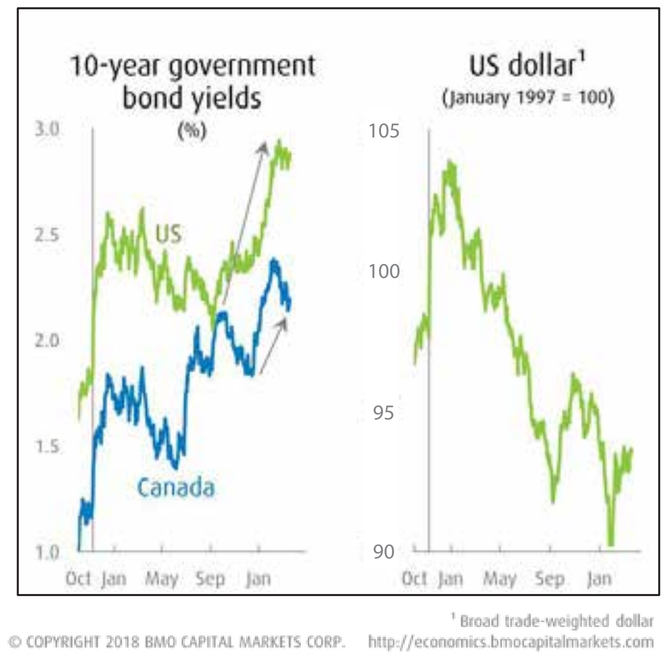
Tariffs are sold to the public as a way to protect U.S. interests but, in essence, they act like a disguised tax… As the price of steel and aluminum (and perhaps that other commodities or products) rises, so does the price of the related goods, causing inflation and chewing up the benefit of the tax cuts. In addition, the resulting higher interest rates would have an impact on the cost of mortgages, further disrupting consumers' spending and buying power. This is the rationale behind investment behaviour when economic growth becomes too strong or when you introduce protectionist measures, both of which are inflationary.

Perhaps the protectionist reflex stems from the ability – or inability – to compete. Through education, one can innovate and through innovation, one can become more productive. The U.S. has been among the most innovative nations in the world over the last century and, through R&D investments, has been able to attract the most prominent researchers in the world. The U.S. is a rich nation, but education is becoming inaccessible, student debt is getting unbearable, and tightening immigration laws doesn't help much in attracting foreign intellectual capital.

The U.S. seems to be shifting to cocooning in a world of globalization. The consequences of initiating tariffs are very wide in scope and mostly unpredictable as they could trigger domino effects and uncertainty, hence volatility.

In recent months, 10-year U.S. bond yields have gone up, supported by strong economic results, yet the U.S. dollar has continued its downward trend since Mr. Trump's election win (Chart 1). It seems foreign investors have been shifting away from the U.S. dollar in the last year or so. Foreign policy and the ballooning deficit could perhaps be the cause.

Chart 1



Meanwhile U.S. consumer confidence has reached a 17-year high in the wake of tax reform (Chart 2), but could be challenged with rising interest rates, the introduction of tariffs and the risk of a trade war. The lack of U.S. workers is contributing to recent wage pressures which, as the situation evolves, will translate into inflationary pressures (Charts 3-4).

Chart 2: Consumer confidence index-conference board

Chart 3: Unemployment rate (percent)

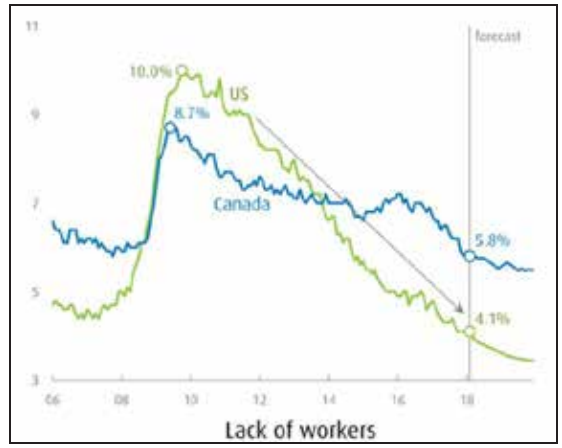
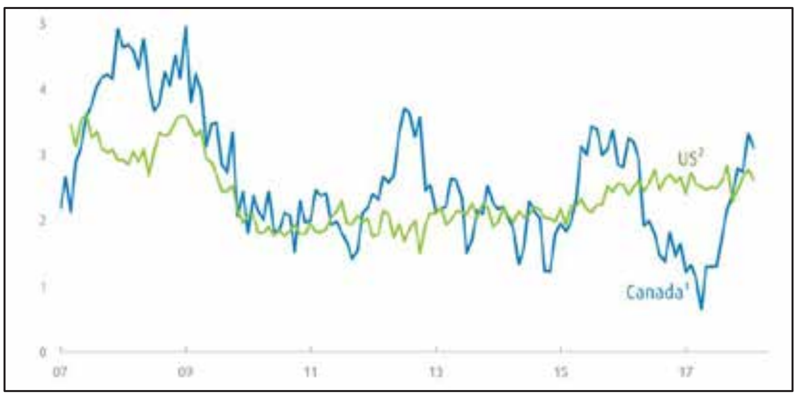


Chart 4: Wages (y/y% Change)



¹ Average hourly wage rate, ² Average hourly earnings

For the U.S., the trend is set for interest rates to rise as the economy continues to expand (Chart 5) and inflation slowly but surely accelerates (Chart 6). Given the high valuations and multiples, equity markets will be much more volatile going forward, especially in view of President Trump's unpredictable behaviour. Volatility may not be for the faint-hearted, but it is not necessarily related to bad markets. Every negative can be offset by a positive and vice versa. For example, higher interest rates mean the economy is doing better than expected; higher inflation may be perceived as improving pricing power and stronger demand or growth; but both of these could also be interpreted as an overheating economy that needs to be slowed, which usually appears at the end of every economic cycle… so is the glass half-full or half-empty? Accordingly, we remain cautiously bullish, keeping a very close eye on the yield curve, corporate revenue growth and profit margin. The theory here is that given the economic expansion and tax reform, corporations are expanding their capital expenditure programs financed at a higher cost. Margins may be at risk at some point in the future, and as a reaction to high valuations and P/E multiples, markets can be severely punished. Tariffs would put additional pressure on margins. In fact, tariffs would be even worse as they would have an impact on everyone, including corporations and/or consumers with no debt. Hopefully we can all benefit from a successfully renegotiated NAFTA?!

Chart 5: % as of March 12, 2018

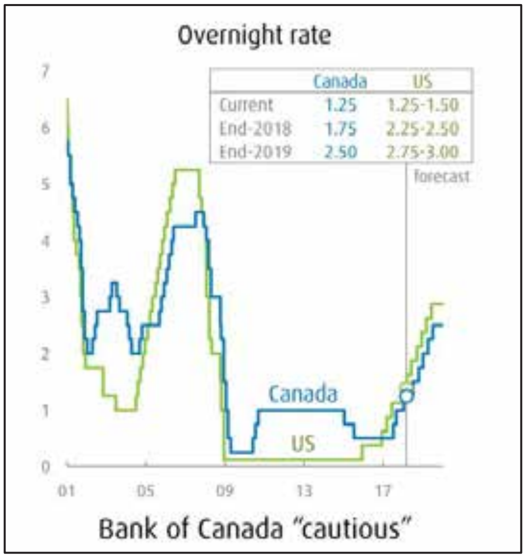
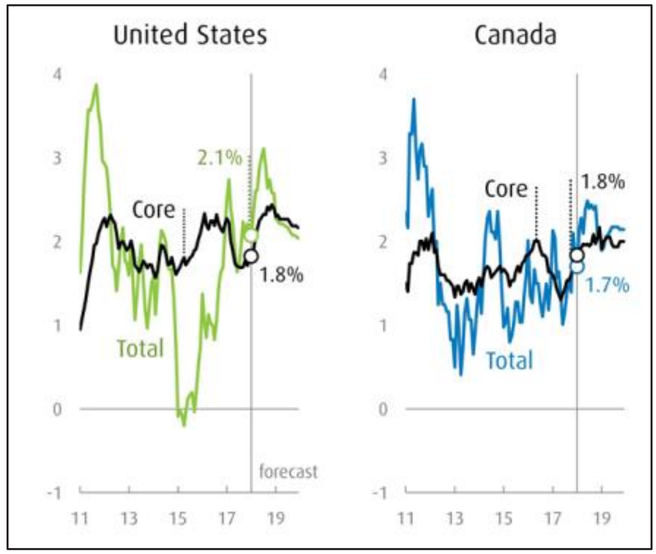
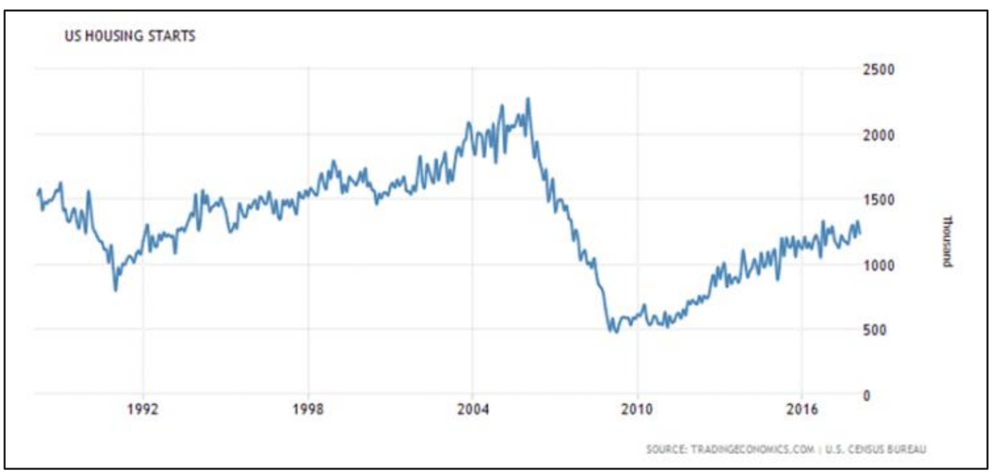


Chart 6: Consumer price index (y/y % change)



Real estate in the U.S. is another leading indicator that can be perceived as a glass half-full or half-empty, interest rates being the ace in the hole. From 1990 through 2007, single-family housing starts averaged roughly 1.5 million new homes per year. (Chart 7 Barrons).

Chart 7: U.S. Housing Starts



Since then we have barely averaged half that. The reasons for this are the huge number of foreclosures following the 2008 financial crisis and a loss of confidence from home buyers. In addition, millennials – the new generation –had witnessed the worse in real estate, were stuck with unprecedented education debt loads, couldn't afford cars, shared apartments in the city, put off getting married and starting a family. This lost decade has possibly reached a point of inflection. Chart 8 shows that a significant portion of the increase in U.S. home ownership in 2017 came from the under 35 population, namely millennials. Obviously, the increasing probabilities of rising interest rates may accelerate this trend over the short-term. Given the current low inventories (Chart 9), home prices may be well supported. Meanwhile, the cost of a 30-year mortgage has come up from an average of 3.5% in 2016 to roughly 4.35% today, which causes monthly payments to rise from $900/month to $1,000/month on a $200,000 loan.

Chart 8: U.S. Home-Ownership*

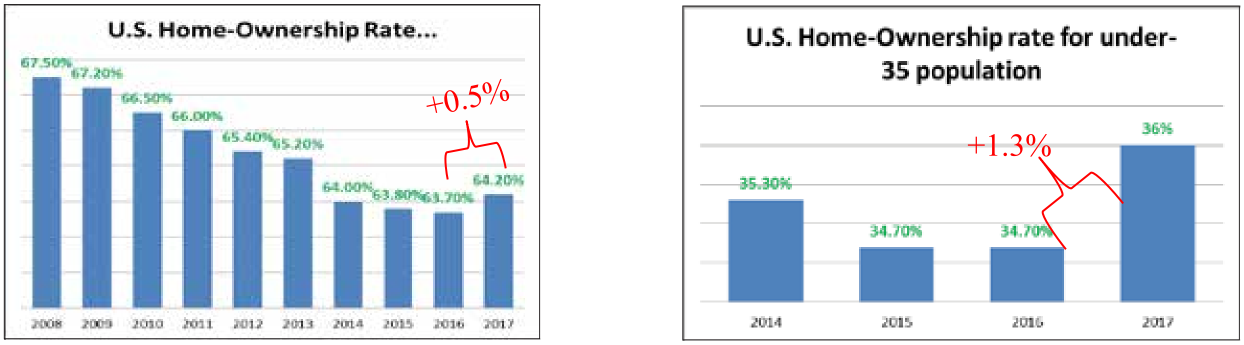


Chart 9: US. Existing Home Sales: Month's Supply

Although this appears to be a disincentive, tax cuts, wage increases and a 30-year low jobless rate can partially offset the situation. In addition, experts are forecasting a change in financing behaviour, moving away from 30-year fixed mortgages and towards 5- or 7-year terms at a lower rate, much more popular in Canada. Real estate is one of the most important pillars of the economy, as it involves the construction industry, creates jobs and stimulates consumption. It could well be a good leading indicator of the strength of the economy going forward.

<u>Canada, NAFTA and the loonie</u>

As of 2018, Canada's corporate tax policy is no longer as competitive as it used to be. As a result of the U.S. tax reform, the overall average corporate tax rate is 25.8%, including state taxes, down from 35%, compared to an average of 27% in Canada. Given our dependency on foreign capital as a large country with a very small population, we need to maintain a competitive landscape. Mr. Bill Morneau, our Finance Minister, has yet to react to this reality, arguing that we need to be fiscally responsible. Cutting costs and stimulating investments could also make our Canadian government fiscally responsible by collecting more tax revenues on a broader base. If we don't improve our fiscal competitiveness, it will make it tougher to attract skilled workers and potentially lose them to the U.S., as their jobless rate is at a record low. A Statistics Canada survey found subdued capital spending intentions for 2018, with private sector expenditures expected to decline for the fourth straight year. Meanwhile direct foreign investment in

*Source of Chart 8: data was taken from; tradingeconomics.com, U.S. census Bureau

Canada plunged in 2017 to a seven-year low, while investment outflows exceeded inflows threefold (and that was prior to U.S. tax reform). In this environment, only a lower loonie would make us competitive… in the short term!

Then again, if tariffs were introduced as a result of failing to renegotiate NAFTA, a lower loonie wouldn't make up for the difference.
The U.S. doesn't care where steel or aluminum is imported from, only where it originates. For example, China produced 67 million metric tons of steel in 2017, followed by India with 8.7 metric tons and Canada with 1.2 million metric tons. Meanwhile, Canada was the top seller of steel to the U.S., with China coming in 10th place!

In other words, China found ways to indirectly (and unfairly in the eyes of President Trump) export to the U.S.

Canada is a net steel importer, but it shipped a grand total of $24 billion of raw and processed steel and aluminum products to the U.S. in 2017, or 1.1% of our domestic GDP!

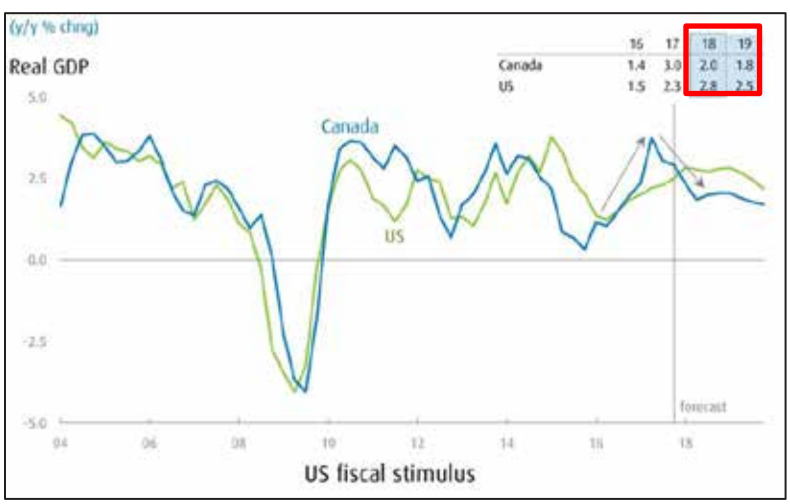
These unfair practices are what President Trump is targeting, while the U.S. is pressuring China to open its doors to U.S. goods and alleviate the U.S. trade deficit.

NAFTA becomes a very important issue for Canada over the longer term, and we are being held hostage to the steel and aluminum tariffs, putting the U.S. in the driver's seat.

Important compromises will have to be part of any new agreement and that could hurt certain sectors. Canada needs to negotiate other agreements with other nations as well, to alleviate some of the negative impacts a renegotiated NAFTA agreement could generate.

In our October 2017 newsletter #58, we outlined the diverging directions with regard to fiscal and regulatory policies. Overlooked by our Canadian government so far, the trend could prove to be very negative for long-term domestic economic growth. (Chart 10)

Chart 10: U.S. vs CAN, GDP diverging



At this point, one of Canada's few positive outlooks comes from the synchronized world expansion, which is stimulated by the last quantitative easing (QE) push in Europe and Asia. They also benefit from a weaker U.S. dollar, as the cost of commodities become more affordable. GDP growth is expected to be stronger in those countries, while valuations seem to be more attractive, notwithstanding their higher degree of volatility.

Investment Strategy

A diverging economic outlook explains why the Fed will likely raise policy rates faster than the Bank of Canada this year. With this in mind, it is difficult to see how the Canadian dollar could strengthen this year. While an unexpectedly surprising world GDP growth could drive commodity prices up with the loonie tagging along, only a weakening U.S. dollar could support a stronger Canadian dollar.

The ballooning U.S. budget deficit and/or political unrest could worry investors and cause the greenback to pull back. Political uncertainty seems to be President Trump's expertise, and a lower U.S. dollar bodes well for his goal of being more competitive worldwide and reducing trade deficits. Financing the U.S. deficit in the year to come could become a major hurdle though. If the U.S. economic growth does not materialize as the market has discounted and there is a revenue shortfall for the government, then it may cost more to finance the debt. Such an outcome could have significant repercussions on extended price earnings multiples and equity valuations. October 1987 should serve as a reminder of such a shortfall.

Fundamentally, U.S. corporations are benefiting from tax cuts allowing multinationals to repatriate billions of dollars back to the U.S. and return it in various ways to investors and workers. Another divergence is the expanding capital expenditure programs across the corporate world in the U.S. compared to a contraction in Canada. Surely the U.S. is responding to tax reforms and the lightening of regulatory burdens. Valuations in the U.S. are in record high territory as a result of all the stimulus. Volatility is therefore here to stay, and we believe in maintaining our U.S. and Canadian equity ratios at roughly 40% - 60% in favour of Canadian stocks, with a bias for those with a good U.S. exposure though wholly owned subsidiaries. As for sectors, we continue to favour the financial sector, especially regional banks in the U.S., which should benefit the most from deregulation. We must be very careful in real estate, as this is a sector that is highly interest rate sensitive. In Canada, residential rental properties are benefiting from very low vacancy rates at a time when accessibility for home buyers is getting very difficult, driving demand for rental. In addition, senior residences will benefit from favourable demographics for years to come.

Given that the only group that is seemingly eager to invest in Canada is the government, infrastructure-related companies should get the benefit of significant new projects across the country over the next few years leading right up to the time of the next elections. As part of the industrial, we continue to favour railways, in line with world GDP growth expansion. Consumer staples should remain core positions in portfolios while we become more defensive with consumer discretionary as interest rates rise.

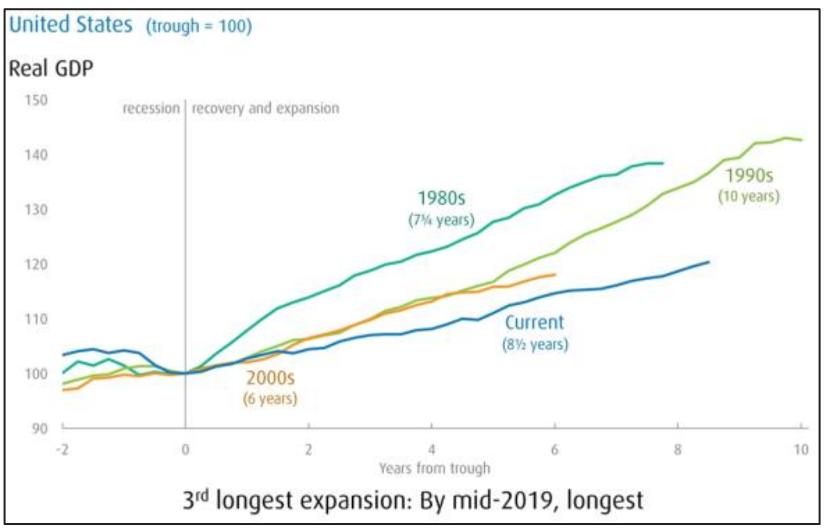
Healthcare stocks are benefiting greatly from U.S. tax reform and are the most active of companies involved in repatriation of capital, stock buybacks and mergers and acquisitions along with Technology stocks.

Telcos and utilities in Canada are oligopolies and heavily regulated. Growth can be under par from time to time, but they are generally very reliable and great dividend payers. However, they are the most interest-sensitive sectors and they have not performed well since the Bank of Canada started tightening monetary policy last year. Although we can expect more of the same in the upcoming year, they remain core in any portfolio. Weightings may be adjusted downward as we move forward. Energy and materials, namely base metals gold and forest products, are your hedge against inflation and/or a falling U.S. dollar. They also tend to act favourably to a synchronized world GDP growth scenario, which is part of the current environment. We are therefore maintaining our weightings in these sectors for now. Investors should be reminded that these sectors have higher betas than the underlying index, meaning they are more volatile. Managing that risk is very important and we should not become overly enthusiastic, specifically in those sectors.

CONCLUSION

The current economic cycle is closing the gap with the previous longest one in history, but the market cycle, tends to lead both at the beginning and the end of the cycle (Chart 11). If history repeats itself, we could enjoy another 12 to 18 months of expansion. High valuations are a way for investors to express their strong confidence as things seem to go very well. Jobs, promotions, bonuses and wage increases feed consumers' confidence and investment behaviour. But the higher the valuations, the higher the risk. Consumers don't line up to buy goods in any store that sells at a premium… but investors do buy the market at a premium! If high equity valuations are a sign of confidence, markets are, by definition, riskier.

Chart 11: 3rd Longest Expansion



Unless you consider yourself a great market timer, the strategy should be to protect some of your gains by somewhat reducing your equity exposure to a level in line with your individual investment profile and objectives. Those investors, who depend on their RRIF income to maintain a minimum lifestyle, should consider locking-in some tax free capital gains within the RRIF in order to stabilize their main source of revenue.

Momentum is shifting, although at an unknown pace. Prudence is always appropriate when red flags start to appear.

Sectors	Recommended Weighting October 2017	Trend
Consumer Discretionary	2.5%	↓
Consumer Staples	5.5%	
Energy	4.5%	↑
Financials	14.5%	
Health	4%	↑
Industrials	9.5%	
Materials	3%	
Real Estate	3.5%	
Technology	7%	
Telecom	4%	
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	
Oct 2017	Apr 2018		Oct 2017	Apr 2018
7.5%	10%	CASH (maturities ≤ 12 months)	7.5%	10%
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%	10%	Foreign	22.5%	20%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Sources:

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- Barrons
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- BMO NB US Equities Guided Portfolio – September 2017
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- Globe and Mail
- 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)
- US Census Bureau

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	0,27%	-5,19%	-4,52%	**-2,11%**
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) …………………………………. **12.40%**				

* (YTD): Year To Date (March 31th, 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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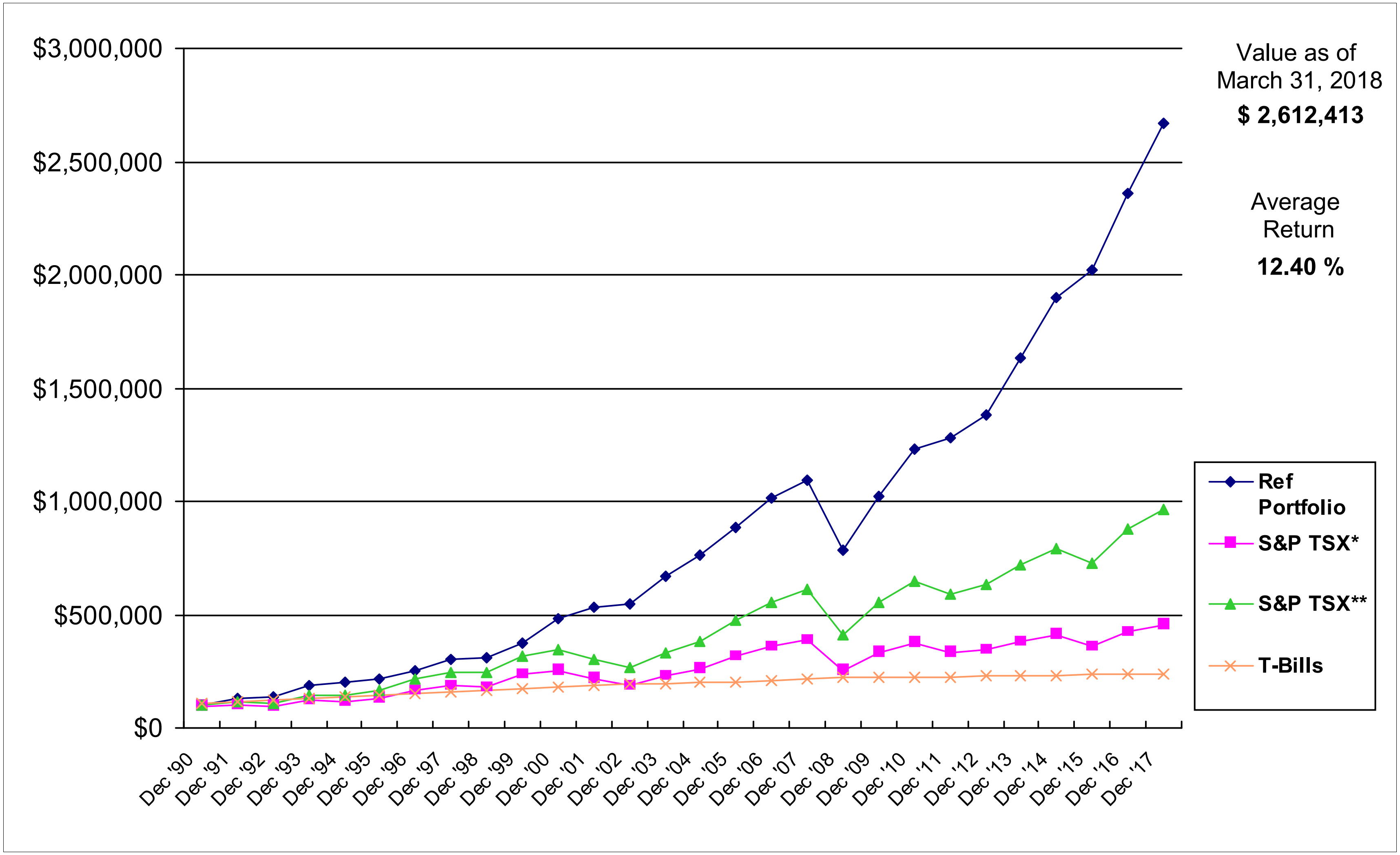
Reference Portfolio Return



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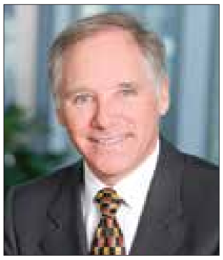
Our Team



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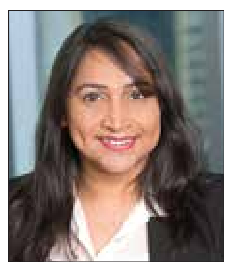

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