Morin Dupont Lessard & Associates
BMO Nesbitt Burns

Sound advice with outstanding service

April 2017 – Newsletter # 57

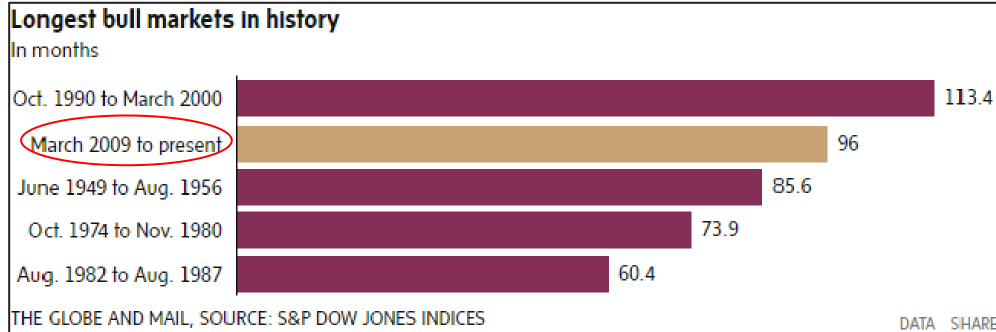
THE BALANCING ACT
(Excerpt)

Pierre's Comments

THE BALANCING ACT

The bull is eight years old! Indeed, March 9, 2009 marked the beginning of second longest bull market run ever. (Chart 1)

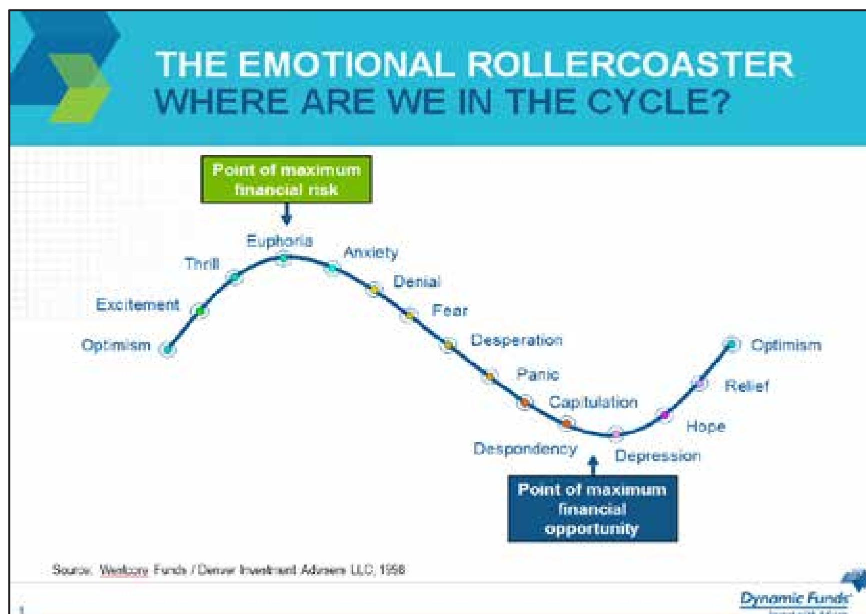
Chart 1



It is also the one that was met with skepticism by most investors as it came on the heels of the Great Recession. Investment behavior is perhaps the reason why this cycle has stretched out. It probably also explains why significant cash still remains on the sidelines.

The markets have not reached a state of "euphoria" yet (Chart 2), but the American political will and determination to set up the proper platforms to restore confidence, can certainly be felt. Investor sentiment has steadily been climbing since the U.S. elections and is well reflected in the markets.

Chart 2 (Investor sentiment cycle)



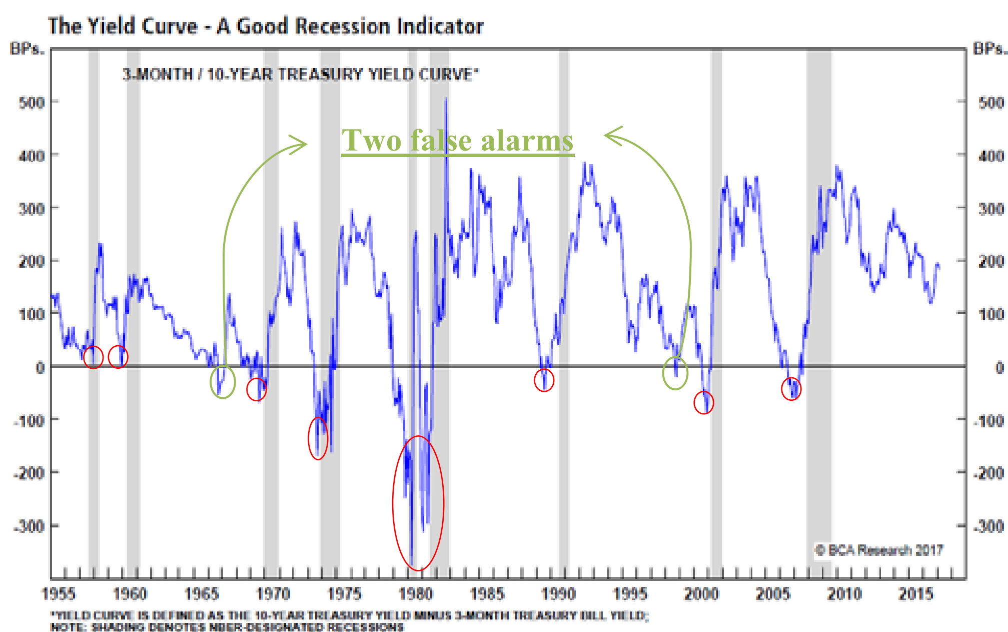
Sentiment may drive behavior, but results drive sentiment. A 2% GDP growth rate is neither exciting nor tangible. Consumers don't *feel* 2% growth. Good jobs, improving wages, promotions, rising real estate prices, savings and mortgage repayments are not as noticeable as when the GDP grows at a rate of 3% or 4%. This lack of growth has fed skepticism amongst investors, many of whom remain doubtful of its authenticity.

Mainly driven by institutional volume, markets have reached all-time highs, yet unconvinced retail investors still hold significant cash ready to be deployed as growth becomes more palpable. The market acts like an economic indicator. Smart money has bought in and is fully leveraged on the expectation of an accelerating of economic recovery.

The recent excitement in the markets, perhaps a result of "Trumponomics", might prove to be an overreaction over the short-term, but it could certainly become perceptible in every household as new policies are implemented. We believe investor sentiment will move from "optimism" to "excitement" when it will no longer take a minimum of 45 days to get a mortgage in the U.S., when loans for small businesses will be easier to get, when wages improve, when house prices move up unleashing more borrowing power… When it becomes tangible for consumers, investors historically become "euphoric".

At that point, markets will top off, the economy will overheat, inflation will show its teeth and interest rates will reach levels that will cause a contraction and most probably a recession. But remember that the market is a leading indicator…The official start of this economic cycle was June 2009, not March, like the market cycle. The markets will, in due course, discount a recession in advance. How can we forecast the risk of a recession?
The most predictable indicator of a possible recession is the yield curve. (Chart 3)

Chart 3 (BCA research, March 7th)



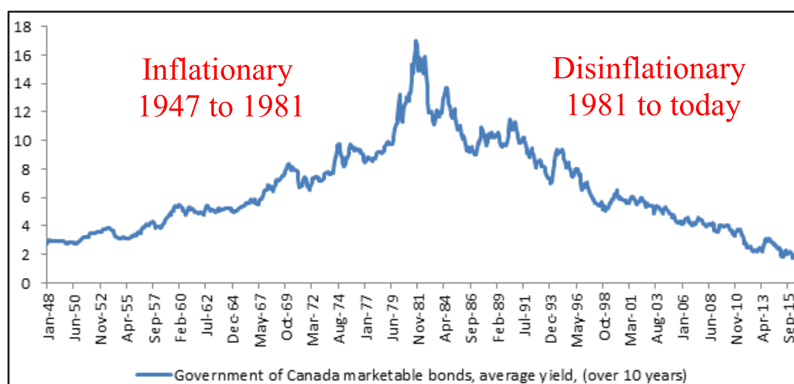
Eight times out of ten, when the yield curve flattens or becomes negative (≤ 0 on chart 3), it means a recession is in the works. This theory is explained by the reaction of the Central Bank, namely to raise interest rates in order to slow an overheating economy and curb inflationary pressures. The cost of debt goes up, margins are squeezed, workers get laid off and consumption slows. The stock market discounts this eventuality as it anticipates an overheating economy, asset bubbles and inflating prices. Although markets are expensive today, trading at nearly 20 times earnings, we do not believe that this cycle is over. A 5% to 10% correction would be very enviable, making it a better entry point for the next up leg. As mentioned in our RRSP/TFSA letter, this market looks like the mid 80s when then-President Ronald Reagan pressed on with the previous fiscal reform, one that took two years to implement. Like then, markets are ahead of themselves, driven by the optimism of finally accomplishing a complete tax overhaul. But it may take longer than expected. Enthusiasm may turn to disappointment before any rejoicing can begin. The key lies in the investment strategy.

From one cycle to the next

Compared to the 80s and 90s, the biggest difference in today's market and economic environment is the type of cycle we're going through. Today and going forward, we are in a "reflationary" environment, the opposite of the context in the late 20th century.

A disinflationary economy was accompanied by a softening of monetary policy. Although interest rates didn't go straight down, the trend was set. The bumpy road to lower rates caused the market to correct as interest rates popped back up from time to time to ensure inflation was kept in check.

Chart 4 [10-yr bond yield curve from 1948]



2016 BMO Capital Market Corp.

Back in the 80s, no one would have believed that interest rates would drop back to below 10%, never mind 7%, 5%, 3% or even 0%! In fact, every financial professional would have failed their exam had they been asked if negative interest rates were possible! Today, no less than nine countries in the G20 still have negative yields on 2-year notes! (Table 1)

Table 1 (negative rates)

Selected Global Interest Rates

Issuer	2 year	5 year	10 year
Switzerland	-0.994%	-0.703%	-0.181%
Germany	-0.794%	-0.442%	0.308%
Netherlands	-0.743%	-0.318%	0.636%
Sweden	-0.58%	-0.014%	0.623%
France	-0.59%	0.066%	0.979%
Spain	-0.34%	0.27%	1.605%
Japan	-0.221%	-0.096%	0.089%
Portugal	-0.082%	1.926%	3.997%
Italy	-0.08%	0.826%	2.157%
UK	0.088%	0.469%	1.242%
Canada	0.74%	1.044%	1.664%
US	1.169%	1.855%	2.388%
Australia	1.775%	2.172%	2.639%
Greece	9.59%	8.845%	7.603%

** Indicative yields as of February 9, 2017*

Source: Bloomberg

The risk of falling into deflation after the financial meltdown of 2008-2009 drove central bankers to use tools that had never been tried before (such as QE – quantitative easing = printing money) to ensure we would avoid the Great Depression redux. What resulted was a less threatening Great Recession. Recovery has been slow and is still ongoing.

Combining QE and extremely accommodating monetary policy, with interest rates at 0%, produces highly inflationary results. Inflation is the antidote of deflation, but as the saying goes: "Be careful what you wish for". Both are evil. The goal is to try to keep them in balance. Although we successfully avoided the worse, surprisingly, we didn't propel economic growth nor inflation quite as expected. We have been stuck with a mediocre GDP growth rate of approx. 2% at best in America for the past eight years.

The election of President Donald Trump, although quite controversial back in November 2016, has had quite an impact on the markets, one that's been the complete opposite of what the media had predicted. But the fact that both the House of Representatives and the Senate are on the same side as President Trump which, in retrospect, defied all odds, has turned out to be just what was needed to eliminate the gridlock between Democrats and Republicans and finally get things moving again in the U.S. However, it seems widely believed that it might be difficult to get the needed support from more moderate Republican congressmen as well as Republican senators to pass some more radical propositions.

So the market, as a good barometer, is basically telling us that positive changes are coming, which will have a direct impact on economic growth for the next few years. We will also find out how difficult a challenge it will be to stimulate economic growth without growing deficits and building up debt. As we all know, "Trumponomics" is about "reflating" the economy using fiscal rather than monetary policy. Corporate and individual tax cuts along with the introduction of a border tax as an offsetting tool are being considered. Border taxes have an effect similar to value-added taxes, which are common in the rest of the G20, except that they are not directly

imposed on consumers but rather on the countries exporting to the U.S. This type of tax might be reflected in the price of imported goods. Politically, it is easier to sell as a compromise, although it will inflate prices for American consumers, regardless. A “repatriation tax” is also being considered. This would allow trillions in funds held offshore by multinationals to flow back to the U.S., thereby stimulating the U.S. economy. Arguably, a low tax rate for repatriation is better than no tax at all, and its proper reinvestment in the U.S. may stimulate job creation and trigger additional tax revenue for the country.

Last but not least is “deregulation”. Regulation is good, but over-regulation has proven in the past to be a huge drag on economic growth. As it affects all sectors of the economy, look for the unleashing of entrepreneurial spirit following a significant reduction in red tape and bureaucracy and simplified access to funding and loans. The combined effect of deregulation and tax reform will add significant thrust to GDP growth and will be ***inflationary***. The 35 year bond market cycle is rolling over. Interest rates as well as inflation will now head into a very long positive slope. The beginning of an inflationary cycle is good for the markets, but it always results in higher interest rates and a recession as the Central Bank tries to slow an overheating economy. As we saw earlier in chart 3, we believe we still have a couple of years to go to reach a possible overheating economy and interest rates high enough to kill the recovery.

If we zoom in on the first and second half of Chart 4 and add the performance of both the TSX and S&P 500 equity markets, we can learn about the long-term trends we face during inflationary (Chart 5) as well as disinflationary (Chart 6) periods. At the end of 1947, the TSX was at 181 while the S&P 500 stood at 15.3. By the end of the 35 year reflationary period in 1981, the TSX had grown 11-fold to 1954 while the S&P 500 had increased eight-fold, to 122. The TSX reflects the Canadian economy, which is heavier in energy and commodities than its more wider diversified U.S. counterpart. Meanwhile, during the disinflationary period from 1981 to 2016 the TSX went from 1954 to 15,287, an increase of nearly eight times, compared to the S&P 500 which went from 122 to 2238, i.e. more than 18 times, and by far out pacing the TSX.

Chart 5 Inflationary period 1947 – 1981

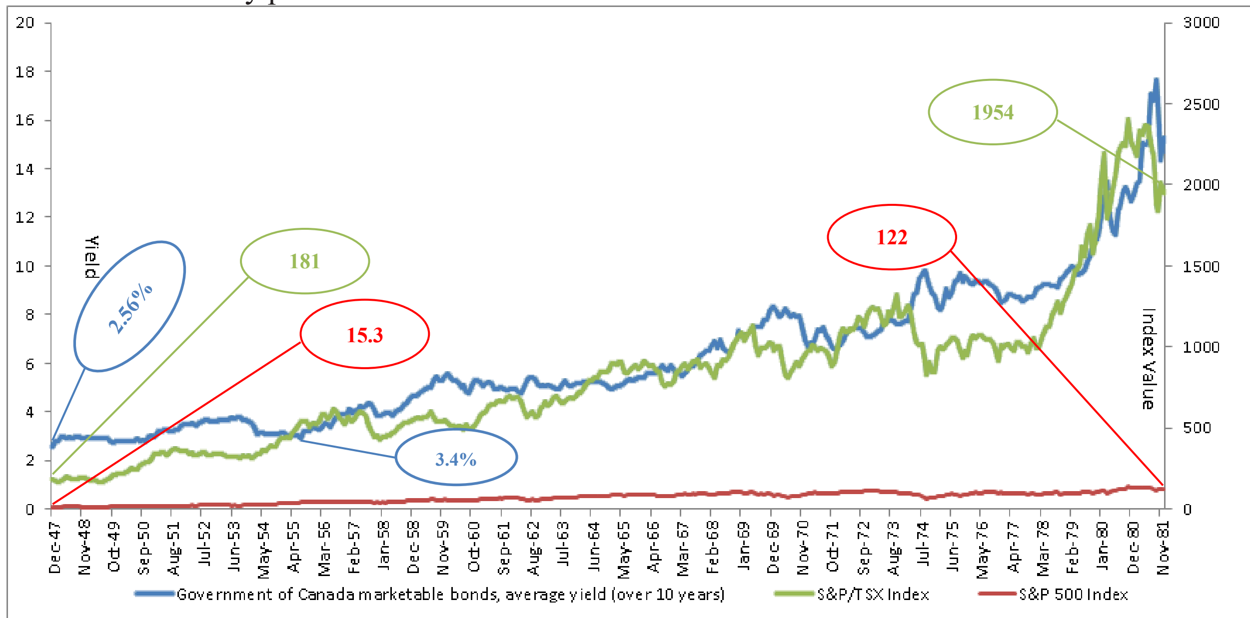


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Chart 6 Disinflationary period 1981 – 2016

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At the beginning of the reflationary period, ten-year bond yields went from 2.56% on December 31, 1947 to 3.4% by the end of 1955, never reaching above 3.8% during that period. During that same period, both the TSX and the S&P 500 tripled (from 181 to 536 for TSX and 15.3 to 45.5 for the S&P). History tells us that the beginning of an inflationary period is usually driven by faster economic growth and, although rates rise, markets can achieve quite decent performances.

Table 2 shows the key differences between the two periods.

Table 2

Period 1946-1981	Period 1981-2016
Inflation driven	**Disinflationary**
Rising interest rates	**Contracting interest rates**
Rising wages	**Flat wages**
Eroding purchasing power	**Rising purchasing power**
Contracting disposable income	**Increasing disposable income**
Contracting P/E multiples	**Expanding P/E multiples**
Protectionist tendencies	**Globalization**
Tariffs and quotas	**Free trade**

The question is; are we prepared for the next 35 years? Have we learned from past mistakes?

As we move from the last 35 years to the next 35 years, we must be reminded of the pitfalls of greed. World economy is a fragile ecosystem. Equilibrium is the key moving from one economic platform, driven by disinflationary pressures initiated by globalization, to the other economic platform driven by the mirage of benefits from reflation stimulus, such as tax cuts and deregulation and protectionist policies that invoke border tax, tariffs and quotas while eroding our purchasing power. "Although these policies unleash 'animal spirits' that encourages risk as opposed to the preservation of capital, we should be more concerned about the return "of" our money than the return "on" our money wrote Bill Gross, CEO of Janus Capital Group.

Canada's economy is basically piggybacking on the U.S. expansion. However, while President Trump is open for business for energy and favorable to Keystone Pipeline, he is also supportive of more energy production in America, which implies the risk of oversupply, excess inventories and, eventually, less demand for Canadian oil.

The key lies in world demand for oil and expanding global GDP growth to absorb excess supply. Yet the rebound from $26/barrel to $50/barrel has helped Canada record its fourth monthly trade surplus in a row, something we haven't seen since mid-2014, when oil prices were hovering around $100/barrel. Growth has therefore accelerated in other sectors, probably enhanced by a lower dollar. We do believe the loonie will remain weak until global GDP growth surprises on the upside. This would stimulate Canada's exports as well as push oil prices higher. The low end of the Canadian dollar is probably around $0.72 at which point a reduction in U.S. exposure could be considered. Domestically, after finishing 2016 with a GDP growth rate of 1.6%, we now forecast 2.3% growth for 2017.

Investment strategy
In view of the change in direction in interest rate trends, it will be critical to review the financial strength as well as the growth potential of our interest-sensitive stocks. Utilities, Telcos and consumer discretionary stocks are generally more exposed to higher interest rates as they either compete for yield with bonds, or rising borrowing costs stifles consumption. Only companies in those sectors with an attractive growth strategy and a solid balance sheet offer good protection.
The financial sector is one of the few that benefits to a certain degree from a firming monetary policy, as long as loan provisions for bankruptcies are held in check. The quality of loan portfolios, or lack thereof, will surface as rates rise. Insurance companies get better returns on their deposits, making them less vulnerable to claims.

When rates rise or begin a rising trend it is usually a sign of economic expansion. Industrials, materials and energy are cyclical in nature. They usually benefit the most from economic expansion, but are also vulnerable to their own higher costs. In other words, it costs more in energy to produce energy. Their margins are consequently erratic, and so is their volatility. Lowest cost producers as well as vertically integrated market leaders are most important in these groups.

Consumer staples and healthcare are in portfolios to stay. In these groups, we focus on multinationals with strong brand recognition and balance sheets, ones that are capable of seizing opportunities and deepening their consolidation in new markets. The technology sector is in a unique position today. As shown in Table 3, it is the sector with the most capital held offshore and stands to benefit the most from President Trump's proposed repatriation tax.

Table 3

Company	Total Cash & Equivalents	Cash Held Overseas	% of Cash Held Overseas
APPLE (AAPL)	US$237.6B	US$216B (AS OF 24-SEP)	~91%
Microsoft (MSFT)	US$136.9B	US$111.1B (AS OF 30-SEP)	~81%
Cisco (CSCO)	US$59.8B	US$59.8B (AS OF 30-JUL)	~91%
Oracle (ORCL)	US$68.4B	US$51.4B (AS OF 31-AUG)	~75%
Alphabet (GOOGL)	US$83.1B	US$49.7B (AS OF 30-SEP)	~60%
Intel (INTC)	US$17.8B	US$15.2B (AS OF 01-OCT)	~85%
Visa (V)	US$12.9B	US$8.7B (AS OF 30-SEP)	~68%
MasterCard (MA)	US$7.0B	US$4.3B (AS OF 30-SEP)	~62%
Facebook (FB)	US$26.1B	US$4B (AS OF 30-SEP)	~15%
IBM (IBM)	US$10.0B	Not Disclosed	Not Disclosed

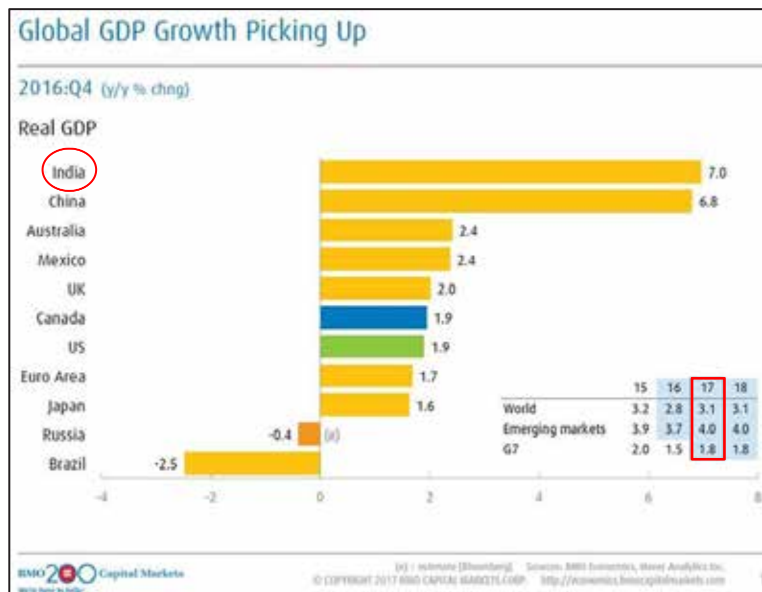
Source: Street Account

Apple, Microsoft, Google (Alphabet) and Cisco would be among the largest beneficiaries of such a policy. Although the policy is aimed at stimulating job creation in America, most of the capital might well be used to buy back stock and raise dividends as their CEO's bonuses are usually paid in shares. No conflict of interest here…? Might as well be a shareholder yourself!

Globally, things are getting better. In Newsletter 56, October 2016, I referred to "four of a kind" as being a strong enough "hand", and that you didn't need to "bluff" to put in a good bet. The four of a kind related to four out of five largest world economies that were actually printing money (QE) namely Europe, Japan, China and the UK. I figured it had to have a positive effect on the world GDP growth rate eventually. If that happens, then we won't rely solely on the U.S. to pull the world. And that would be a good thing.

Chart 7 updates the world GDP growth rate and gives a forecast for 2017 and beyond. This bodes well for portfolio performances as long as we don't close the door on free trade. Canada is very dependent on an improving global economy as its main driver is exports. A relatively weak Canadian dollar combined with growing demand from abroad is encouraging. We therefore maintain our recommendation regarding the EuroStoxx 50 index ETF and an exposure to India through an actively managed fund. India, a net importer of oil, will benefit from lower prices while Canada would hurt (reverse correlation).

Chart 7



India's demography is also the reverse of all Western countries with 65% of its population under the age of 35. Just take a look at what happened to our economy when our baby boomers were between 30 and 60 years old. Long-term it will be a great return….

Conclusion

There are not too many portfolio managers left that lived in an inflationary environment. Many investors are therefore at risk of making unwise decisions. Your financial well-being is a balancing act!

While we believe we are not facing a recession near term and that earnings momentum should continue given the fiscal stimulus in the U.S. and a reduction in regulation, we still maintain our cautious stance. Margin debt has reached very high levels and it has foreshadowed market collapses before. Since last November, margin debt has been hovering near an all-time high of $507 billion. It peaked in March 2000, a month before a market top and a subsequent 49% decline. It peaked again in July 2007, 15 months before the 2008 financial crisis that brought the S&P 500 down 57%.

Margin debt is widely used by institutional investors, hedge fund managers who try to use leverage to enhance performances. They suffered their worst performance period in the past four consecutive years as they bet the wrong direction. Meanwhile, those who don't use leverage, like you and I, might have been too conservative and have cash on hand. Margin debt does not trigger a bear market on its own, but it has the potential of increasing volatility, especially when margins are called by bankers…

Cash and gold, although not good long-term investments, do provide downside protection as they act like an insurance policy in any portfolio. The opportunity cost of holding cash and gold, as they don't pay much income, is your insurance premium. Holding them to counter balance your portfolio could protect you against a vertigo attack as we move from one platform to the next – a high wire act if ever there was one… a balancing act.

Sectors	Recommended Weighting April 2017	Trend
Consumer Discretionary	3%	↓
Consumer Staples	6%	
Energy	4%	↑
Financials	18%	
Health	4%	
Industrials	9%	
Materials	3%	
Technology	7%	
Telecom	5%	
Utilities	6%	
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 2016	Apr 2017		Oct 2016	Apr 2017
5%	7.5%	CASH (maturities ≤ 12 months)	5%	7.5%
50%	45%	Fixed income (Bonds & GICs)	30%	30%
15%	15%	Convertible Debs. And Income Generating Securities	15%	10%
15%	20%	Equities	25%	30%
15%	12.5%	Foreign	25%	22.5%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Sources:

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- The High Tech Strategist
- The Wall Street Journal
- Thompson One (Reuters)

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

Company Specific Disclosure

BrookField Ren. Energy (BEP.UN-T) 1,2,3,4,5,6AC,8
Home Depot (HD) 9,10
Lennar (LEN-N) 19 , security disclaimer 1
Microsoft (MSFT-O) 19, security disclaimer 1
Milestone (MST.UN) 1,2,3,4,5,6A,8
Proctor & Gamble (PG-N) 19, security disclaimer 1
Vermilion (VET-T) 5,6C,8
WSP Global Inc. (WSP-T) 1,2,3,4,5,6AC

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Performace - 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%	**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%	**14,43%**
*2017	0,12%	1,70%	2,41%	**6,74%**
Return Compounded as of December 31, 2016				
3 years	0,64%	3,92%	7,03%	12,32%
5 years	0,77%	5,04%	8,14%	12,46%
10 years	1,07%	1,71%	4,68%	8,60%
Average return since inception (YTD) …………………………………. 12.64%				

* (YTD): Year To Date (march 31, 2017)

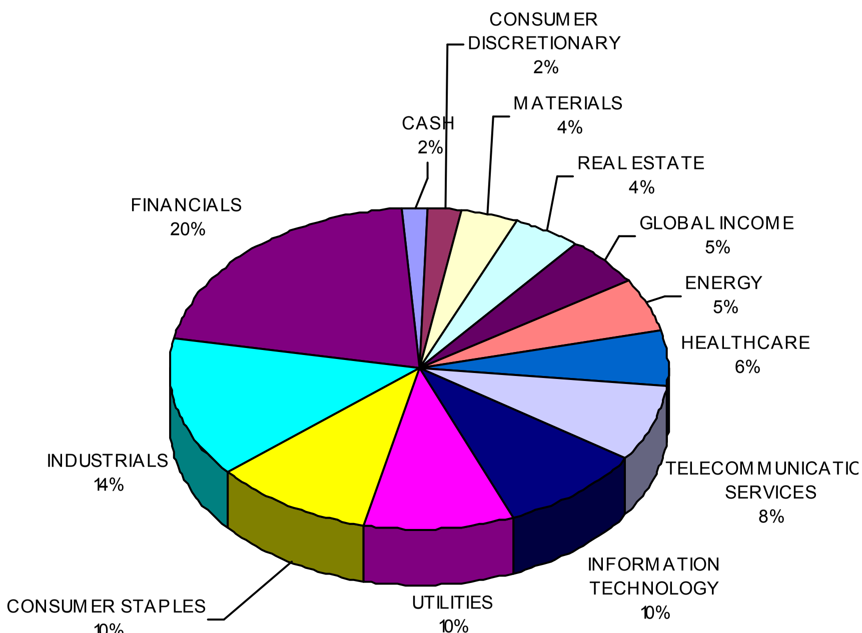
$100,00 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

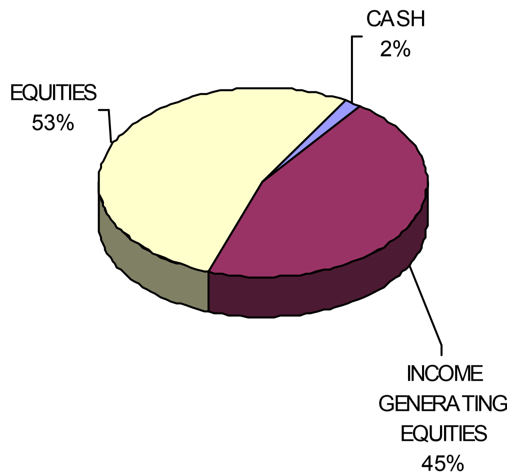
1: Does not include income or dividend

2: Includes income and dividend

PORTFOLIO HOLDINGS AND ASSET MIX



By Sub-Index %

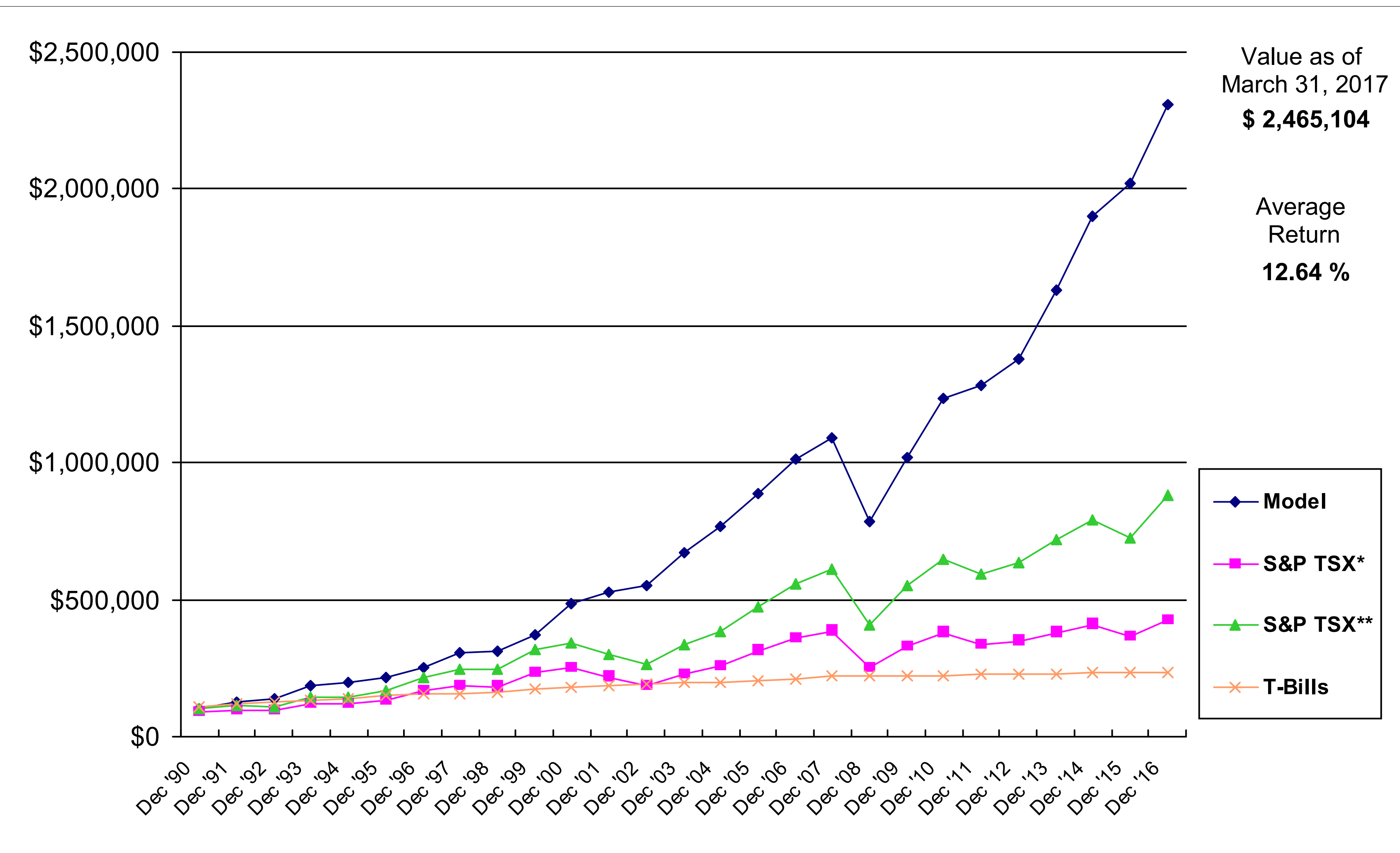


By Category %

BMO Nesbitt Burns

Morin Dupont Lessard & Associates

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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