Morin Dupont Lessard & Associates
BMO Nesbitt Burns

Sound advice with outstanding service

October 2016 – Newsletter # 56

Who's bluffing?
(Excerpt)

BMO Wealth Management
BMO Nesbitt Burns

Morin Dupont Lessard
& Associates

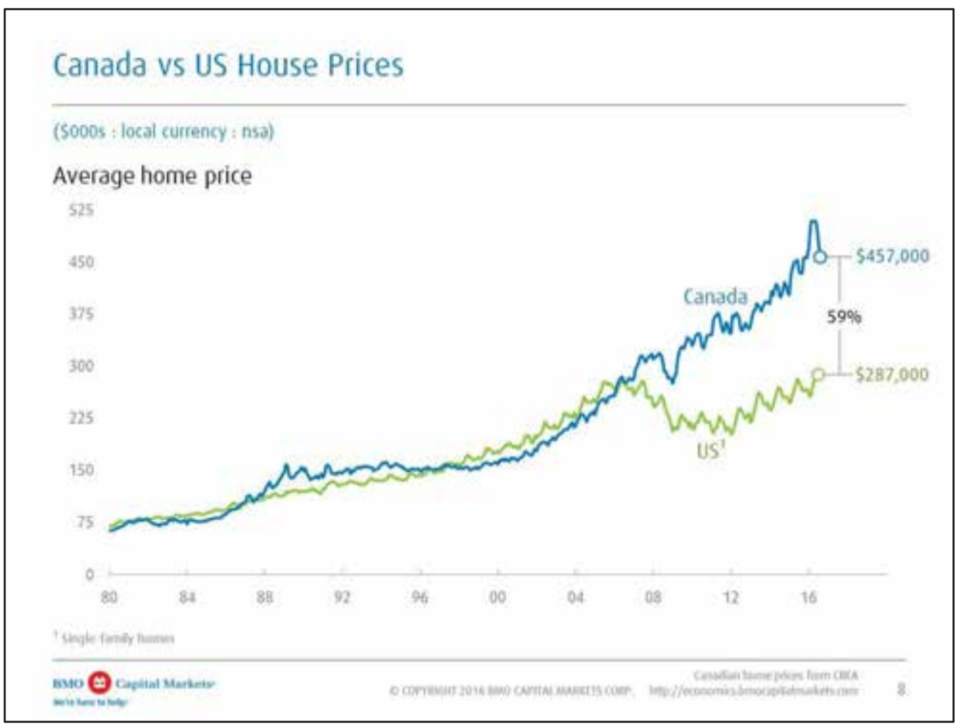
Pierre's Comments

WHO'S BLUFFING?

After enjoying a great summer, both in terms of the weather and the markets, September came with a wake-up call once again. Both bond and stock markets came under pressure, leaving little room for investors to hide. However, from an economic standpoint, a variety of indicators suggest that recession risks over the next six to 12 months remain muted. While we note the lack of overheating pressures and consumer demand, traditional monetary measures such as low interest rates don't seem to be delivering the expected. Does demography have something to do with this phenomenon? Are there any other tools left to kick start GDP growth? Is America the only game in town? If so, for how long? Perhaps Donald (King of clubs) or Hillary (Queen of diamonds) has the answer! It's all a matter of how they play their cards!

While U.S. GDP growth is expanding, it is a far cry from where we would have anticipated it to be given the unprecedented stimulus in the form of QE1 (Oct. 2008/March 2010), QE2 (Nov 2010/ June 2011) and QE3 (Sept.2012/Apr 2014), (QE= quantitative easing, i.e. the printing of money). These monetary interventions by the Federal Reserve Board should have triggered significant inflationary pressures in the system, resulting from economic expansion. While inflation in the U.S. is still below the Fed's target of 2%, it is present in another form… Indeed, cheap money has pushed stock markets to new highs and contributed in a major way in the recovery of the real estate industry in the U.S. (asset inflation). While Canadian equity markets have not reached all-time highs, being heavily weighted in Energy and Materials, Canadian real estate has been on a tear over the last decade. Since the financial crisis of 2008-2009, the spread in average home prices between Canada and the U.S. has widened to extreme levels. (Chart 1)

Chart 1



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While Canadians have pushed their debt levels to $1.71 per dollar of revenue, Americans have lowered their indebtedness from $1.65 prior to the 2008 financial crisis to $1.22 per dollar of revenue today. (Chart 2).

Chart 2

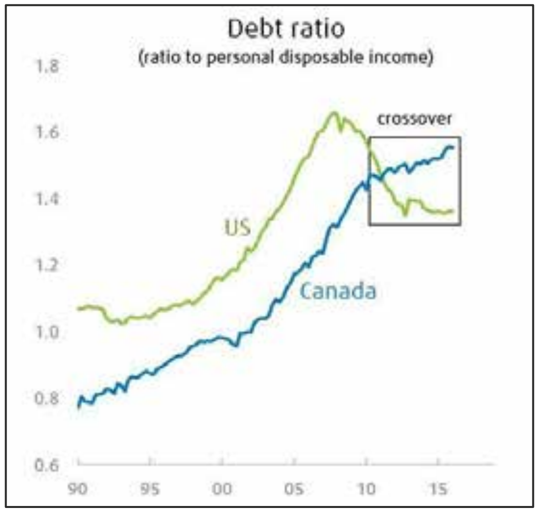

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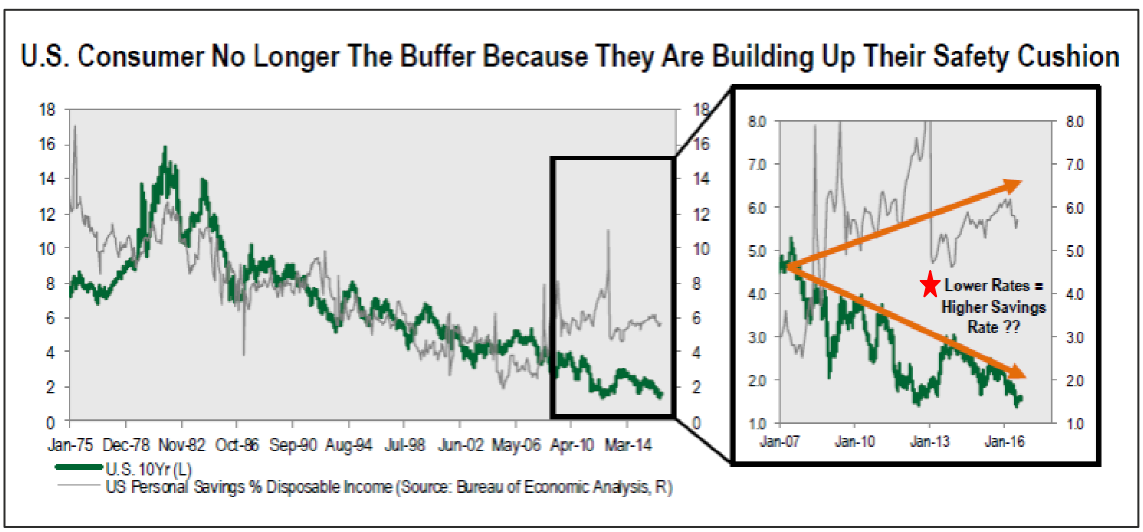
Chart 3



Cornerstone Macro Sep. 13, 2016

Actually, today Americans are saving about 6% of their income – well above the pre-crisis level of 2 ½%. (Chart 3), but still well behind the Germans, who are saving nearly 11% of their income today. This sad reality simply goes against the Fed's and the ECB's (European Central Bank) goal. The simple idea of artificially maintaining interest rate low is to discourage savings and stimulate spending and, consequently, economic expansion and inflation. Desperate to achieve this goal, the ECB went as far as buying bonds at prices above par... and now yields on all government bonds are negative. Who would buy a bond with a negative return for two, five or 10 years? Turns out that investors are prepared to pay a "premium" to secure their capital, and Germans have increased their percentage of savings… after all, they need to save more if all they're getting is a negative return!

Meanwhile, banks, insurance companies, pension plans and the whole institutional infrastructure are being undermined in what middle income earners depend on!

Negative interest rates were intended to stimulate inflation but it seems that, based on the consumer behavior, they take away the ability of savers to spend. In other words, the poor performance of existing savings forces consumers to save more!

While rates in Canada are still in positive territory, experts tell us that, at today's rates, bonds and fixed income instruments are providing negative real returns (after tax and inflation) and, as such, are poor investments. Although this can be proven mathematically, experts have yet to provide a solution, because there aren't any! Germans will tell you to save more and spend less which, economically-speaking, is deflationary. They would love to get 2% on a 5-year GIC currently available in CANADA! It seems that the financial engineers who are running our central banks might be contributing to the evil they absolutely want to avoid – deflation. Negative rates are:

1) weakening the banking system
2) further pressuring undercapitalized pension funds
3) squeezing actuarial projections for insurance companies and pension funds
4) destabilizing normal consumer behavior

These unintended consequences are expressions of monetary policy limits.

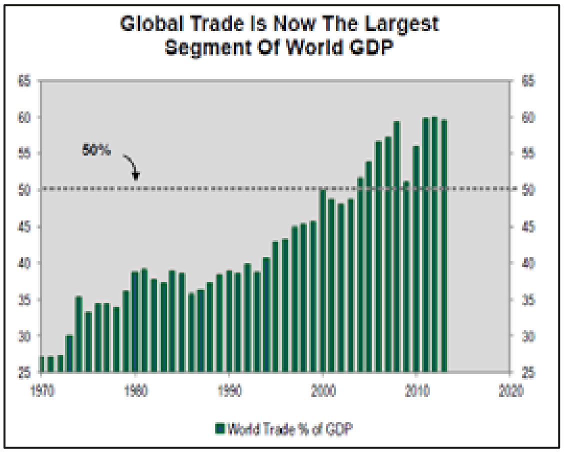
Time and again, in previous financial letters, we have stated that without fiscal intervention combined with monetary policy, the road to recovery would be sluggish. Fiscal reform in the U.S. is the one tool that can stimulate economic growth with worldwide repercussions. Here is why. (Chart 4)

Chart 4

Cornerstone Macro Sep. 7, 2016

Globalization has provided the world with access to the U.S. market in exchange for allowing U.S. businesses to set up manufacturing capabilities in emerging markets, where labour is cheap. The problem here is in the flow of funds. U.S. investment returns are not flowing back to the U.S. because of the American tax structure. So not only have they sacrificed jobs in the U.S., but capital reinvestment as well. To deny free trade access would cause a sharp rise in the cost of imported goods, which would negatively impact the amount or percentage of goods imported to the U.S., smothering any hope for a worldwide recovery. Global trade is now the largest segment of world GDP. (Chart 5)

Chart 5

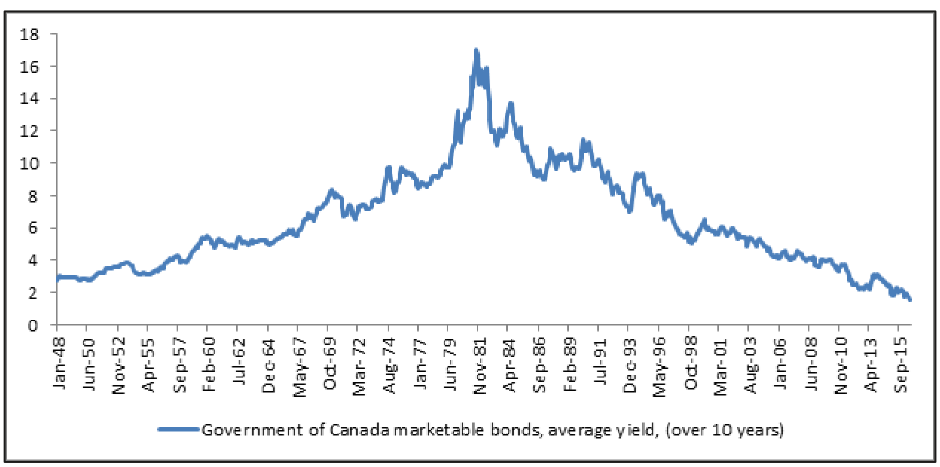


Cornerstone Macro Sep. 7, 2016

Globalization has interlinked world economies and is creating a new dependency that wasn't present in the past. The Fed, led by Janet Yellen, is quite aware of this, and has postponed several times the decision of imposing an interest rate hike in the U.S. given the weakness of other major trade partners. A rate hike in the U. S. could potentially trigger an unintended world slowdown. Old school financial experts may not recognize the full impact of a rate hike in today's environment, and that is why there is so much confusion surrounding the decision of raising rates a mere quarter of a point, up from 0.25! For many, it is debatable how badly such a small increase could destabilize world GDP growth...

Meanwhile, looking at the big picture, interest rates have been falling for 35 yrs. That's right, since 1981. The previous cycle was exactly 35 years as well, from 1946 to 1981. (Chart 6)

Chart 6



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The end of a 35 year bond bull market is a scary thing for all fixed income managers!

Imagine that the secure part of our portfolio starts losing money as bond prices fall with rising interest rates! What to do? If we can't buy bonds, do we buy stocks? 100% stocks? Perhaps anxiety levels would become as volatile as the stock market! In order to keep in line with your individual risk tolerance level while avoiding anxiety attacks, we must maintain your fixed income component in short duration bonds (1-5 years). Even less volatile would be GICs laddered over 1- to 5-year terms, as these are currently out-yielding bonds within the $100,000 insurance protection limit. This is precisely what is horrifying to bond portfolio managers, who must invest in bonds as per their mandate, while trying to preserve capital and generate a decent return…. All this while facing a possible 35-year bond bear market!

One school of thought believes that the more uncertainty there is in other parts of the world, not to mention other asset classes, the better for U.S. equities. We would be supporters of that belief as long as the U.S. supports world trade and doesn't fall into a protectionist mode as it did in the 1930s, a move that contributed to the Great Depression. As such, the U.S. electorate is about to make a political decision that could have a very significant impact on global economic expansion at a time when global sovereign debt is at all-time highs.

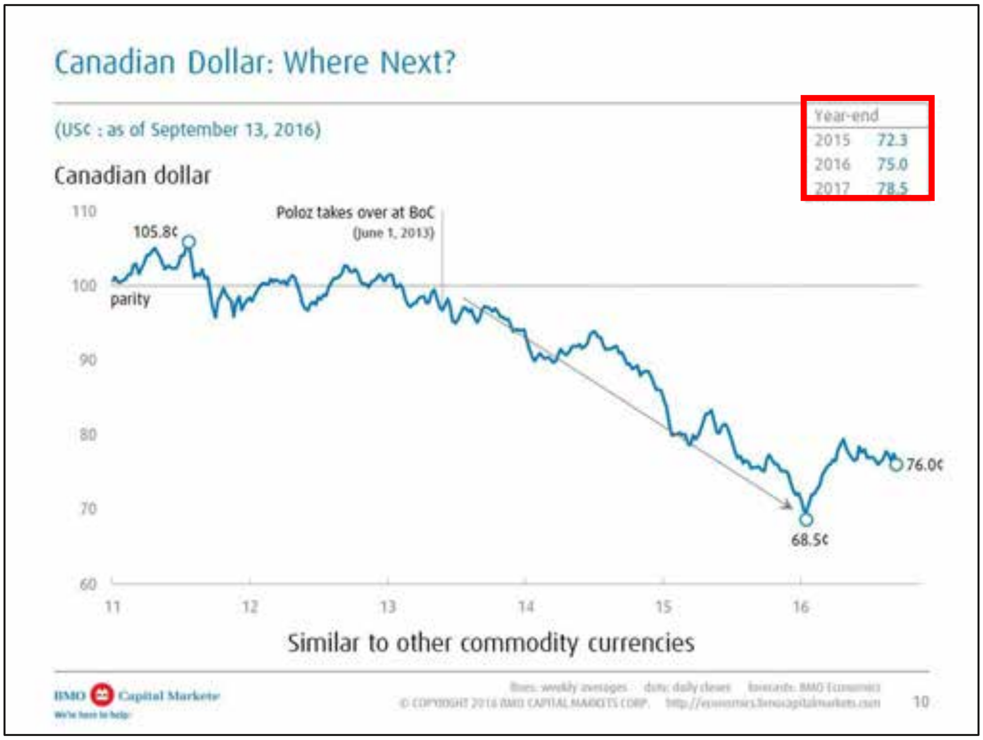
A victory for Donald Trump could be a game changer for China's economy. According to Kevin Lai, Chief Economist at Daiwa Capital Markets of Hong-Kong, a 45% tariff imposed by the US on Chinese goods entering in the U.S. would spark an 87% decline in China's exports to the U.S., representing a decline of US$420 billion in revenues. This could impact China's GDP growth rate, which could fall by as much as 4.82%, or 75%, from the current growth level of 6.5% to 7%. In addition, he estimates a probable US$426 billion in foreign direct investment repatriation if U.S. companies started to withdraw from China. Bear in mind that China is currently the second largest economy in the world. Notwithstanding Mr. Trump's political promise to renegotiate all free trade deals, and given the significance of the U.S.'s proportion of world imports, one can only imagine the potential blow to world GDP growth! The world is in desperate need of strong leadership from its leading economy, the U.S. A strong mandate, with the Senate and the House of Representatives on the President's side would ensure changes, hopefully in the right direction. Otherwise, we may need a crisis in order for Democrats and Republicans to compromise.

The two candidates are suffering from a trust deficit. Many voters in the middle class have suffered for decades and have lost their trust in government as they haven't benefited from a minimum wage increase in over a decade. The American dream is fading, as polarization of social classes continues to deepen. As such, voters may vote for change or **against** the incumbent party rather than **for** the party's new platform.
In any case, this political campaign is one of historic dimensions in many ways. Its possible outcome is a definite source of uncertainty and may enhance market volatility until November.

The impact of macroeconomics in Canada is huge but for Mr. Trump, NAFTA is the worst trade deal of all! Roughly 70% of our exports head to the U.S. Aside from energy, we also export many finished goods south of the border. The drop in the loonie from par to $0.75 combined with a much lower corporate tax rate of 15% vs. 35% in the U.S. makes Canada attractive to U.S. businesses looking to expand. Proximity, access to qualified labour, transportation and tax treaties are all considerable reasons to go north.

This may help not only our exports but also capital investment. Combined with our Trudeau government's commitment to investing in infrastructure, there is no doubt that Canada is set to outperform the U.S. in economic expansion next year. However, we shouldn't underestimate the importance of maintaining our trade relationship with the U.S. as a key to our recovery. If all goes well, as we expect, world GDP growth will pick up the pace, as will demand for energy and materials, the lifeline of Canada's economy. Our dependence on fossil fuels is not very popular with Green Party and other environmentalists, perhaps, but one would hope that investing in the development of greener energy solutions here at home could lead to their export throughout the rest of the world. We might very well witness an increase in interest rates in the U.S. before we get one here. A rise in rates is a signal that the economy is expanding. Bear in mind that there is a 93% correlation between Canadian and U.S. interest rates. This lag time will be our accumulation phase of energy and material stocks. This is also the period where our Canadian dollar will most likely hit bottom. (Chart 7)

Chart 7



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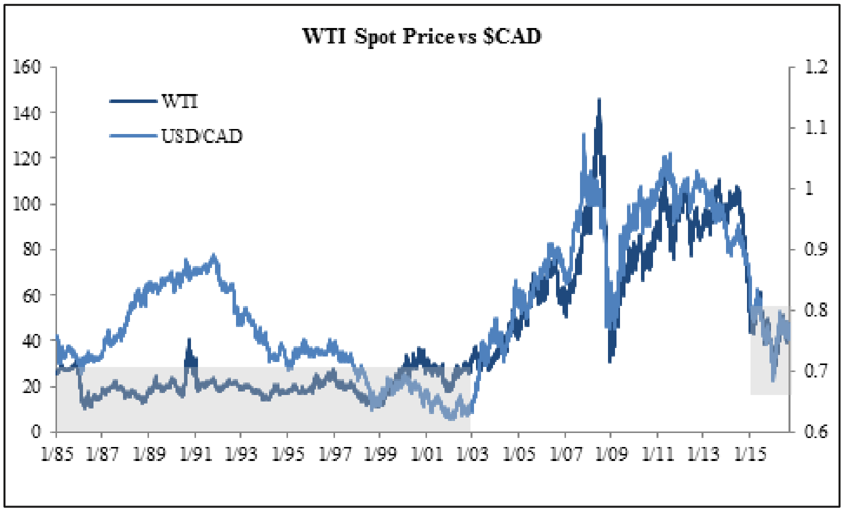
A rise in interest rates is the U.S. should favorably impact the greenback over other currencies, sending commodity prices lower as well. We believe the loonie could reach the $0.73 to $0.75 range, while oil prices could flirt once again with the $40 level. Looking forward, energy sector fundamentals suggest a transition from a demand to a supply driven management over the next several years which may range bound oil prices. This new range may well be $40 to $60 in 2017 and $50 to $70 in 2018, giving companies time to better manage costs, streamline operations, enhance productivity and invest in technology. A consolidation period in this sector may be upon us as well.

Investment strategy

Our equity component is currently split roughly 50/50 between Canadian and U.S. stocks. The following chart #8 shows the high correlation between oil prices and the Canadian dollar. As we intend to increase our energy weighting from 3% to 6-7%, we feel a good source of funds could come from a reduction in the U.S. component. As we increase our energy exposure, we would naturally hedge against our other U.S. positions. In other words, the higher oil prices go, the stronger the Canadian dollar, and a stronger dollar causes your U.S. positions to devalue. This devaluation would be partly offset by gains in your energy positions. We can assume a similar relationship with material stocks which we may build on later in the cycle. Meanwhile, gold loves uncertainty, excessive indebtness, QE, unstable political events, wars, crises, etc. We have all of that, and we should have a minimum exposure of 2% to gold.

Chart 8

High correlation between $CAD and Oil prices



In Brian Belski publication. Investment Strategy Snapshot. The Call for Fall of September 2, 2016 page 8

The search for yield is not going away, especially given the lack of investment choices once interest rates rise. Both banks and insurance companies that have scalable businesses (wealth management) should be great beneficiaries of higher rates. In addition, many of them are in a strong position to raise their dividends over time.

Defensive sectors such as consumer staples, healthcare and utilities have gotten very expensive, as fixed income capital is looking for a safe home. As safe as these sectors and companies may be, something like 22 times earnings on slow-growing companies is very expensive. Therefore we will be trimming back somewhat on staples and utilities, to the benefit of technology, industrials and energy in due course. In the consumer discretionary space, we will add to our weighting, and we particularly like anything that is related to household consumption. Priority spending will continue to be directed to renovations and cars.

CONCLUSION

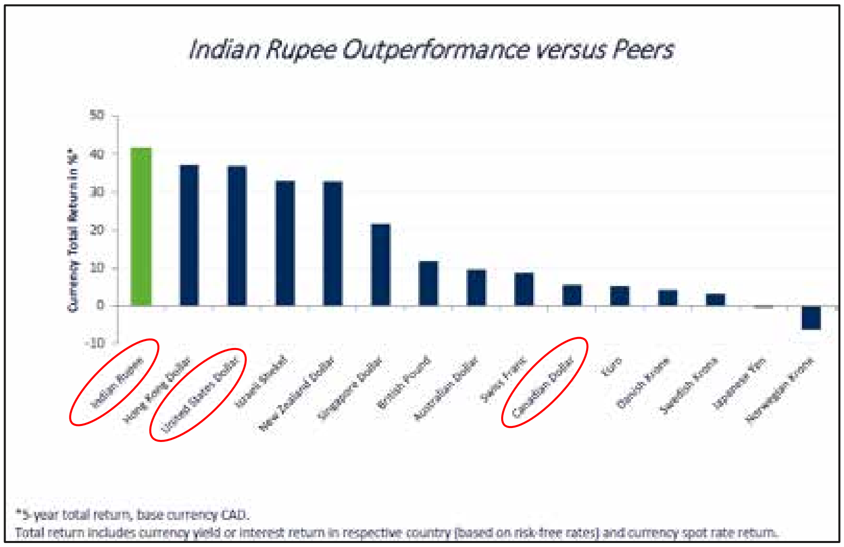
Just like Brexit, the U.S. elections are making a lot of noise, which is reflected in investor sentiment. There is always a good reason to be fearful, and the market usually doesn't respond well to uncertainty. Currently, fear in the market place is expressed in different forms:

1) Consumer savings behavior (i.e. increasing)
2) Lower interest rates no longer stimulating spending
3) High valuation of non-cyclical and dividend stocks (i.e. high price/earnings multiples of defensive stocks)
4) Increasing number of baby boomers retiring and looking for safety
5) Market volatility

We believe that fear provides investment opportunities. Fundamental conditions in the U.S. economy, in particular, are improving, and as corporate results continue their expansion, we should expect interest rates to rise. Normally a rise in interest rates tends to slow down market expansion, as stock price valuations are based on the discounted present value of future earnings. However, given the western world's demography, a rise in rates may as well help savers be less fearful and adapt their spending accordingly. Sooner or later fiscal reform will have a significant positive impact on GDP growth.

On the international front, the U.S. should continue to attract foreign investment flows anticipating a stronger U.S. dollar along with higher interest rates. The only currency that has gained in value against the greenback is the Rupee (Chart 9).

Chart 9



Excel funds, September 2016

Ever since India's Prime Minister Narendra Modi took office in May 2014, multiple reforms stimulating economic expansion have been implemented. As a result, India's GDP growth currently stands at about 7% and has the potential of reaching 10% given the country's accommodative monetary policy. Its demographics are the reverse of the Western world, with 70% of the population under the age of 30, which makes it quite attractive for long-term investment potential. No less than 1 million people per month will join the workforce over the next 15 years. Infrastructure spending is also accelerating as they are laying 30 kilometers of new roads per day…and there are more than 1 billion cellular phones active today in India.

As the saying goes, "A strong currency attracts foreign investments". Therefore as a function of globalization we must continue to broaden our investment platform and we recommend taking a participation of up to 2% specifically in India for long-term capital appreciation.

Staying the course with readily available cash will give you the chance to raise your "bet". With four of the five largest economies in the world (UK, European Union, Japan, China) providing stimulus, it's hard to believe that we should "fold" with "four of a kind". While this good "hand" should prevail, American voters face a dilemma: Who has the best hand? Who's the poker face? What is the "trump" card? Kings or Queens? Who's bluffing?

Sectors	Recommended Weighting October 2016	Trend
Consumer Discretionary	3%	
Consumer Staples	7%	↓
Energy	4%	↑
Financials	18%	
Health	4%	
Industrials	9%	
Materials	2%	
Technology	6%	↑
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 2016	Oct 2016		Apr 2016	Oct 2016
5%	5%	CASH (maturities ≤ 12 months)	5%	5%
50%	50%	Fixed income (Bonds & GICs)	30%	30%
15%	15%	Convertible Debs. And Income Generating Securities	10%	15%
15%	15%	Equities	25%	25%
15%	15%	Foreign	30%	25%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Sources:

- Barrons
- BCA Research
- Before the Bell
- BMO Capital Markets Equity Research Reports
- BMO Nesbit Burns
- BMO Nesbit Burns Part Team
- BMONB Canadian Equities Guided Portfolio – September 2016
- BMO NB US Equities Guided Portfolio- September 2016
- Cornerstone Macro
- CNBC
- CNN Money
- Daiwa Capital Markets
- Fox News
- Globe and Mail
- JP Morgan
- New York Times
- Phases and Cycles
- The Economist
- The Wall Street Journal
- Thompson One (Reuters)

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*Excerpts from the Canadian and U.S. Equities Guided Portfolio, September 2016

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Performance - T-Bills vs SP TSX vs Model Portfolio				
Year	T-Bills (return)	SP TSX[1]	SP TSX[2]	MODEL (return)
1990	13,20%	-17,96%	-14,80%	**5,94%**
1991	9,35%	7,85%	12,02%	**22,14%**
1992	6,67%	-4,61%	-1,43%	**10,50%**
1993	4,68%	28,98%	32,55%	**34,91%**
1994	5,19%	-2,50%	-0,18%	**6,09%**
1995	6,42%	11,86%	14,53%	**8,09%**
1996	3,93%	25,74%	28,35%	**16,21%**
1997	2,85%	13,03%	14,98%	**21,05%**
1998	4,56%	-3,19%	-1,58%	**1,87%**
1999	4,67%	29,72%	31,71%	**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	1,77%	-35,03%	-33,00%	**-28,07%**
2009	-0,75%	30,69%	35,05%	**29,37%**
2010	1,51%	14,45%	17,61%	**21,05%**
2011	0,58%	-11,07%	-8,71%	**4,18%**
2012	0,25%	4,00%	7,19%	**7,38%**
2013	0,30%	9,55%	12,99%	**18,14%**
2014	0,43%	7,42%	10,55%	**16,43%**
2015	1,60%	-11,09%	-8,32%	**6,36%**
*2016	0,37%	13,19%	N/A	**10,14%**
Return Compounded as of December 31, 2015				
3 years	0,77%	1,52%	4,62%	13,52%
5 years	0,63%	-0,65%	2,30%	10,35%
10 years	1,27%	1,44%	4,38%	8,58%
Average return since inception (YTD) …………………………………….. **12.45%**				

* (YTD): Year To Date (september 30, 2016)

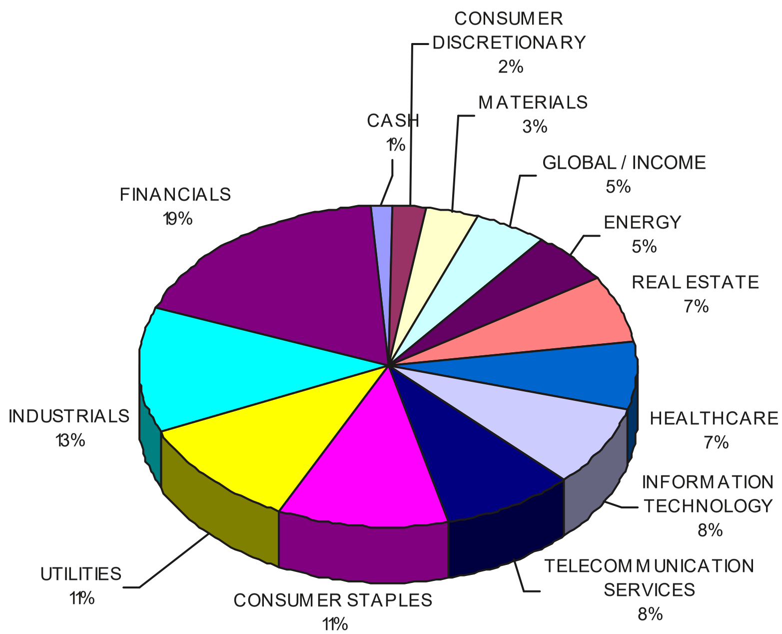
$100,00 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

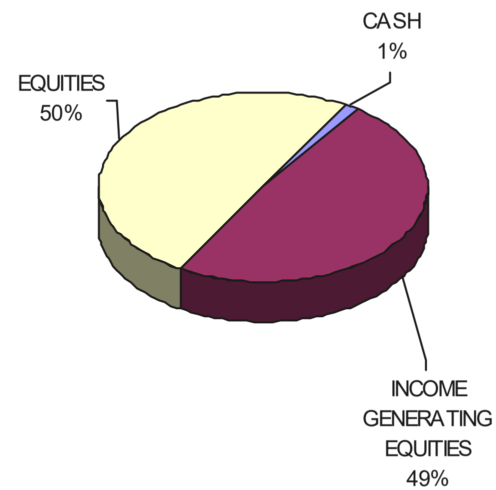
1: Does not include income or dividend

2: Includes income and dividend

PORTFOLIO HOLDINGS AND ASSET MIX

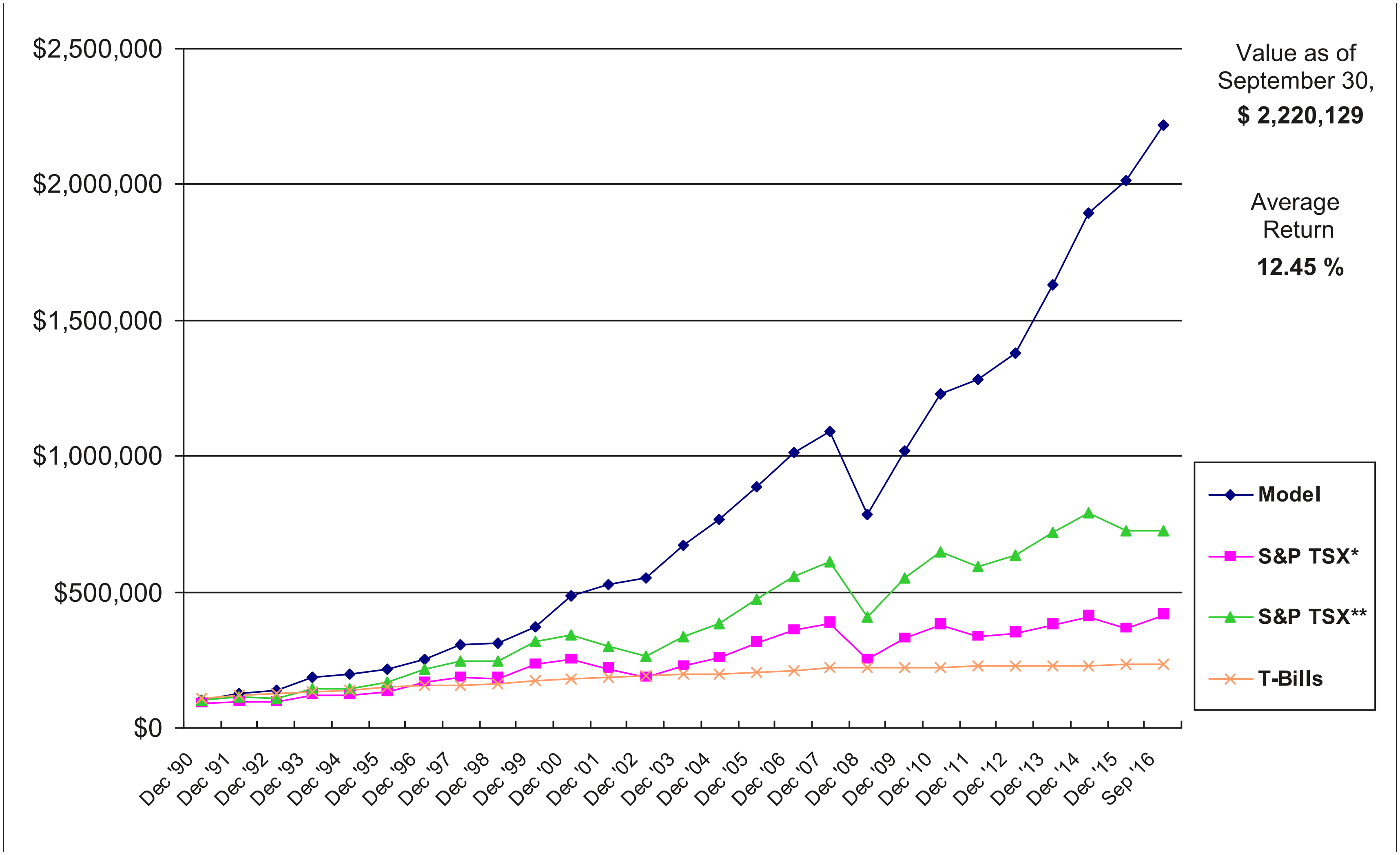


By Sub-Index %



By Category %

Portfolio Return



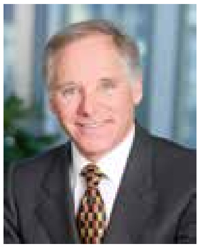
$100,000 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

**Does not include income or div*

***Includes income and dividend except for current year*

Our Team



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