MDL Associates

BMO Nesbitt Burns

April 2021 - Newsletter # 65

The Booster Shot

Economy

Stock Market

Real Estate

Inflation

Yield Curve

Taxes

Employment

Speculation

Wages

Private Wealth

BMO Nesbitt Burns

Table of contents

The Economy and review of the Markets

- Pierre's comments
- Economic "booster" shot
- Conclusion and investment strategy

Recommended Asset Mix (Table)

- Balanced Portfolio
- Income Portfolio

Recommended Sector Weightings (Table)

Review and Analysis of our Reference Portfolio

- Mutual funds and ETF
- High yield equities
- Growth and income equities

Reference portfolio selections covered in this newsletter

- Special updates

Reference Portfolio Graph and Pie Charts

Historical Performance Tables and Benchmark

Pierre's comments

I would like to take a moment before providing our usual commentary to say "welcome" to a new group of readers. As you all have been informed by now, my long-time colleague and branch manager Daniel Lebeuf and his associate Nicole Dimyan joined forces with our group to form MDL Associates, one of the largest wealth management teams in Québec and in the country. By combining our practices within BMO Nesbitt Burns now part of BMO Private Wealth, we are positioning ourselves to provide the very best client experience both on the individual and corporate levels.

As this is the first time that most of Daniel's and Nicole's clients will be receiving this publication, I thought it would be best to take a few moments to provide some context.

This 65th edition marks more than 32 years of semi-annual communications. While globalization wasn't even part of the equation back then, today it is an integral part of any investment decision process. Josée and I joined Nesbitt Thomson in 1982, but it was the crash of 1987 that caused us to change our approach to investing. Influenced by Warren Buffett and his views on the magic of compounding, we created a "model portfolio," quite innovative at the time, and communicated in writing our new investment philosophy and opportunities as a function of the existing economic environment. This initiative resulted in the introduction of our very first semi-annual newsletter. After investing in hardware (Compaq Computer with floppy disks), software (Lotus 1-2-3 and dBase II) and a programmer, we finally launched our model in 1990.

As model portfolios became the norm over time, the approach also became "one size fits all", which didn't reflect our service offer. Indeed, we build personalize portfolios based on a "reference portfolio". So, we changed its name. The personalization of a portfolio is not only a function of the individual's asset allocation. In addition to the asset mix, a tailored and customized approach includes fiscal optimization, individual stock selection as well as sectors and security weightings.
Our goal is to provide our readers, in layman's terms, our view and perception of the ongoing economic events worldwide, and how they can affect investment trends and our vision.
With this in mind, we understand reading about macroeconomics, its impact on our domestic economy and our customized investment strategies, may not be your first interest. However, I trust some of you will find some interesting information while it could well be the perfect alternative to sleeping pills for others... so; there is something in it for everyone! I hope you enjoy!

Economic "booster" shot

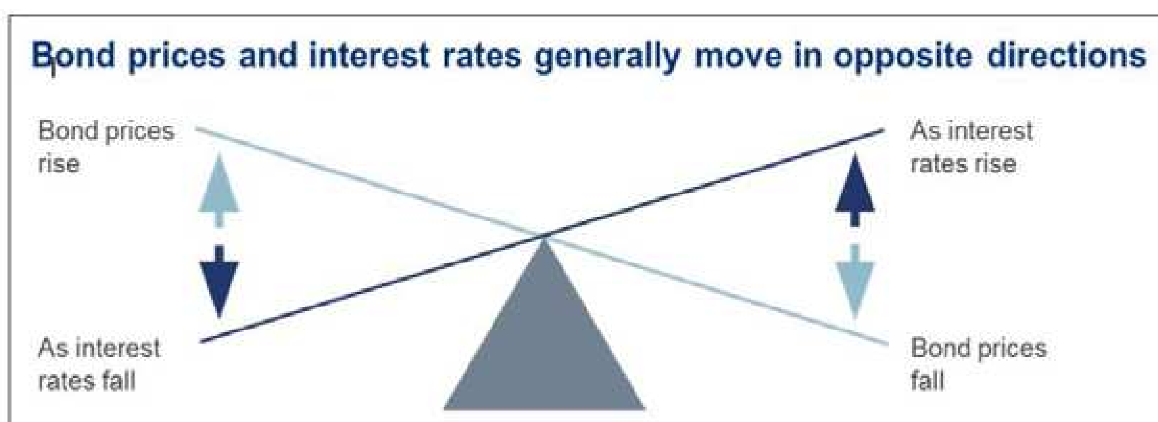
Newsletter #64, dated October 2020 and therefore prior to the U.S. presidential election, seems so far away now. We were then in the worst period of the pandemic, hoping for a vaccine breakthrough while facing political uncertainty in the world's largest economy. Six months later, at least three vaccines are circulating in the U.S., and some local economies within the United States, are fully opening up, perhaps prematurely, as vaccinations multiply across the land.

There is a light at the end of this pandemic tunnel and we can all feel the consumer's excitement as we come out of our cages after more than a year of isolation and worries. Hopefully, human behavior will remain in a defensive mode, compliant with minimal sanitary requirements to protect others, until 75% of the population is vaccinated so we can reach the herd immunity threshold. But given the outbreak of new, more contagious variants of COVID-19, there is a risk of a third wave. The next two to three months could be crucial to ensure a sustainable economic recovery. Unprecedented efforts both on the monetary and fiscal fronts have been made to help us make it through this pandemic. These worldwide interventions will most likely lead to a synchronized global economic recovery. But as this view is shared by many, it is also partly discounted by investors' quick adjustments affecting both bond and equity valuations.

Bond Market

The "yield curve" is the best tool for analyzing investor expectations. The weaker the expected economic growth or contraction thereof, the less likely an investor is to buy stocks and therefore the more likely he is to buy bonds. As we all know, when there are more buyers than sellers, prices go up. When the price of a bond goes up, its relative yield goes down, as the coupon rate remains the same (see Chart 1). The opposite is also true when investors sell bonds to buy stocks with a bullish view on the economy, which is what is currently happening. This trend is likely to continue until the risk-free return on bonds challenges investors' appetite for riskier assets like stocks.

Chart 1: Bond prices and interest rates generally move in opposite directions



Sources: https://www.lowellsun.com/2021/02/07/whats-happened-to-my-bond-funds/

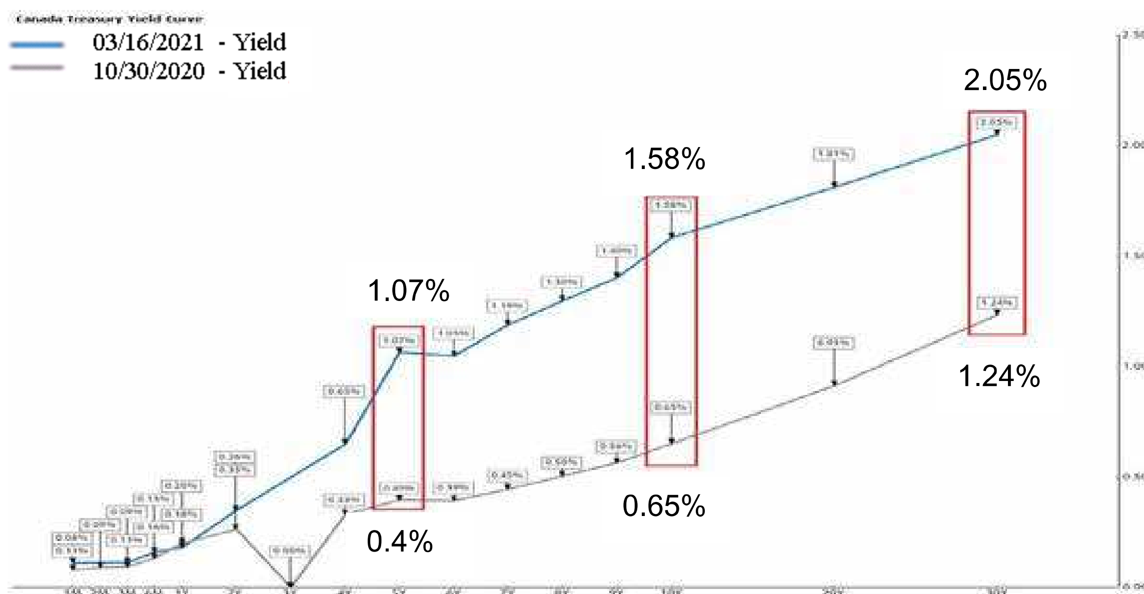
Table 1

GVT of CDA 2% April 2031 (10 years)				
Purchase price	**Coupon**	**Capital Gain\Loss**	**Approx. Yield to maturity**	**Maturity Value (April 2031)**
$95.00	2.00%	$5.00	2.50%	$100.00
$100.00	2.00%	$ -	2.00%	$100.00
$105.00	2.00%	$5.00	1.50%	$100.00

For explanatory purpose only

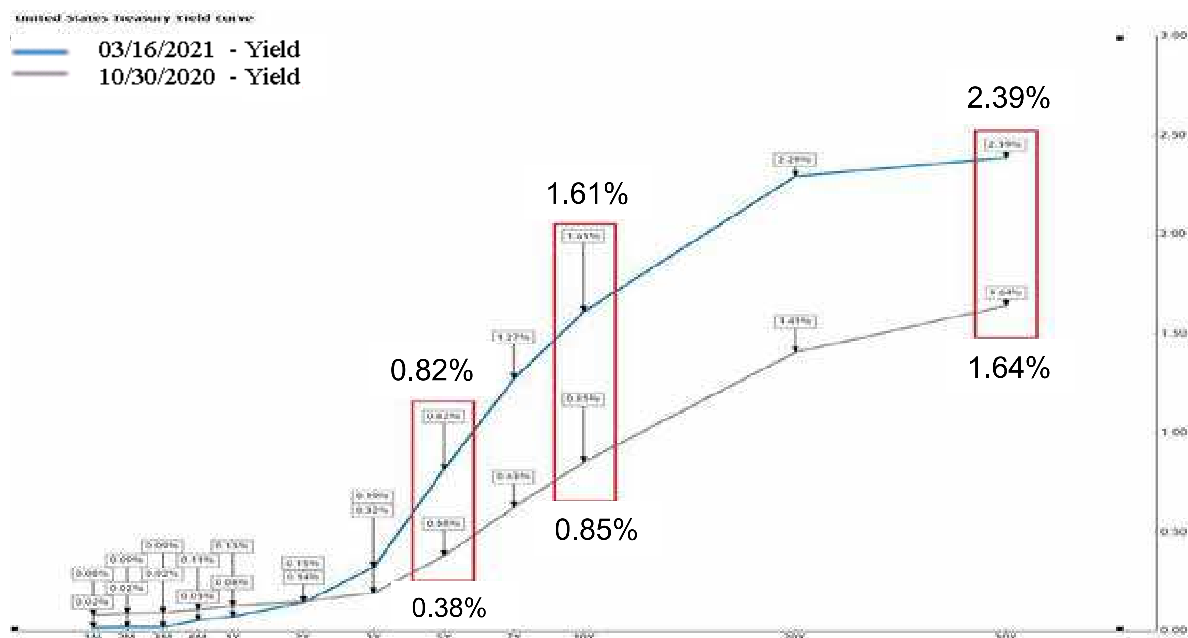
In this example (Table 1), as the bond price moves higher, the yield decreases, as the investor is exposed to a capital loss at maturity. Losing $5 over 10 years represents 0.5% per year in losses, resulting in a lower yield.

Chart 2: Canada Treasury Yield Curve, November 2020 vs. February 2021



Sources: Fact set

Chart 3: U.S. Treasury Yield Curve, November 2020 vs. February 2021



Sources: Fact set

Equity Market

We've recently been witnessing one of the steepest increases in bond yields both in Canada and the U.S. (Chart 2 and 3).The 10-year U.S. Treasury bond yield rose from 0.85% on Election Day, November 3rd, to 1.6% over a 4-month period. Meanwhile, the S&P 500 grew from 3270 to 3820 (March 3rd), a stunning gain of 16.8% over

the same period. This is a huge vote of confidence, as the market is discounting significant earnings growth in advance. It is also the consequence of money supply growth and the low cost of money (interest rates). The S&P 500 now trades at more than 30 times earnings which, historically, is on the high side, reflecting that optimism.

Reflation

The driving force is, of course, all the accommodations, including low Fed funds rates, the printing of money and consumers forced into savings by the need to stay at home for a full year. Come to think of it, the situation isn't very different from what it was after the Second World War, i.e. at the very beginning of a new inflationary cycle that lasted 37 years (from 1944 to 1981). That inflationary cycle ended with 11% inflation and interest rates at 21% (the level that Paul Volcker, the then chairman of the Federal Reserve Board, needed to reach to break the nasty inflation's back).

But inflation, in its early stages, is perceived by many investors to be a good thing, because its presence is first felt at the asset level. Both real estate and stock markets tend to lead inflation, which in turn creates an illusion of enrichment, a financial comfort zone that stimulates consumption... until inflation evolves and moves into products and services. By then, central banks may hint at raising interest rates to contain excess demand and restrain inflationary pressures, resulting in market pullbacks.

According to many pundits, we are far from a central bank intervention to raise short-term rates. But while the steepening yield curve is sending a strong buy signal for equities, it is also revealing that the cost of borrowing is going up. Excessive corporate indebtedness may become a significant concern in stock selection moving forward.

New U.S. Government, New U.S. Policies

With the new Biden administration in place, no less than 74 executive orders were issued in the first three days following the January 20th inauguration.

Among them, one pledges to increase the minimum wage to $15 an hour. For Canadians, this is right up our alley, but for the U.S., it's quite a shift. The current federal minimum wage is $7.25 an hour in the U.S. It is proposed to increase minimum wage to $9.50 an hour at first, then gradually to $15 an hour over the following 4 years. While this is still being debated at the time of writing, it could squeeze some of the corporate earnings growth momentum. A second proposal aims to raise corporate taxes back to 35% (28% at the federal level + 7% average state tax), where they stood prior to President Trump's 2018 tax cut. This move could also result in softening corporate margins and may also make America less competitive on manufacturing. Currently, the U.S. corporate tax rate averages about the same level as Canada, i.e. 28%, the median of industrialized nations. By comparison, Ireland's corporate tax rate is 12.5%. Hopefully these proposed policies will generate more tax revenue for the Biden administration without triggering a corporate manufacturing exodus, a situation that could have the unintended consequence of fewer jobs and tax revenue opportunity loss.
Although we strongly believe in explosive economic growth as we move beyond the COVID-19 pandemic, there is a shift in sentiment as to what form the recovery will take and, and which sectors would benefit most. China was at the root of the pandemic and was the first out of its grip. Asia and the Far East are getting an early start on the path of recovery and provide a good glimpse of what is taking place. Not surprisingly, infrastructure spending is at the forefront, and the sharp rise in commodity prices is a good reflection of that. Oil

prices as well as base metals, copper, silver, iron ore and forest products, among many others, have already gone up significantly. Supply may be tight for now, but should pick up at one point. However, new supplies are getting difficult to find and produce in a timely matter and at a reasonable cost: environmental constraints and lack of exploration over the last 20 years are among the main barriers. It is foreseeable that commodity prices remain firm until the Fed intervenes by either raising interest rates or more probably gradually tapers its bond buyback program.

The new Biden administration policies also had an impact on the U.S. dollar, which is down roughly 4% since the election and down 10% from its peak last year.

Chart 4: U.S. dollar; Short-term pause in USD selloff

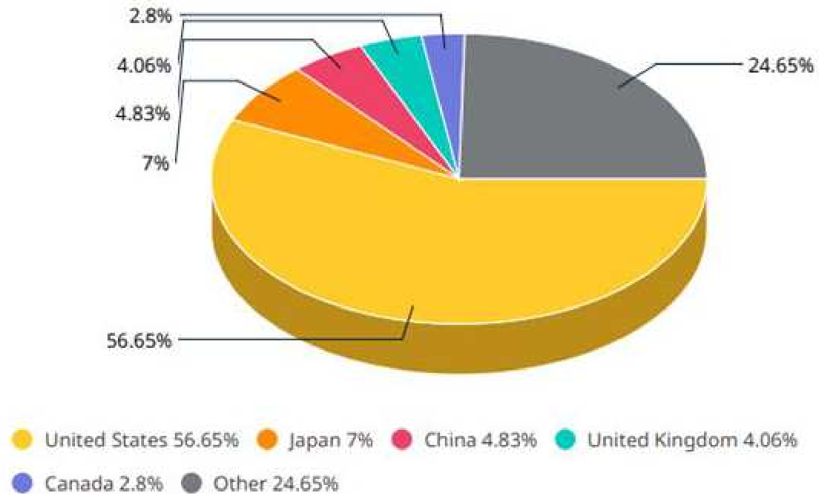
Sources: U.S Treasury, Bloomberg, RBC GAM as of January 31, 2021

U.S. Dollar Bear Roadmap

According to the RBC research team, the U.S. dollar is one year into a multi-year downtrend. Although countertrend rallies are expected, they should be used as opportunities to sell the greenback according to RBC. In such an environment, history shows that all G10 and Emerging Market (EM) countries have posted positive returns over these periods. A lower U.S. dollar further stimulates foreign economies, as the cost of materials and energy becomes cheaper in local currencies (it takes less of the local currency to buy a U.S. dollar). By contrast U.S. consumers feel the full impact of higher commodity prices as they do not benefit from a stronger local currency. The rising cost of imports as the U.S. dollar weakens further pressures U.S. inflation and adds more stress on U.S. corporate margins. This view pushes my thoughts a little deeper. If I was a global portfolio manager based in Geneva or elsewhere, I would probably review my current geographical asset allocation based on the benchmark's (MSCI world index) potential trend...

Chart 5: Current MSCI World Mix

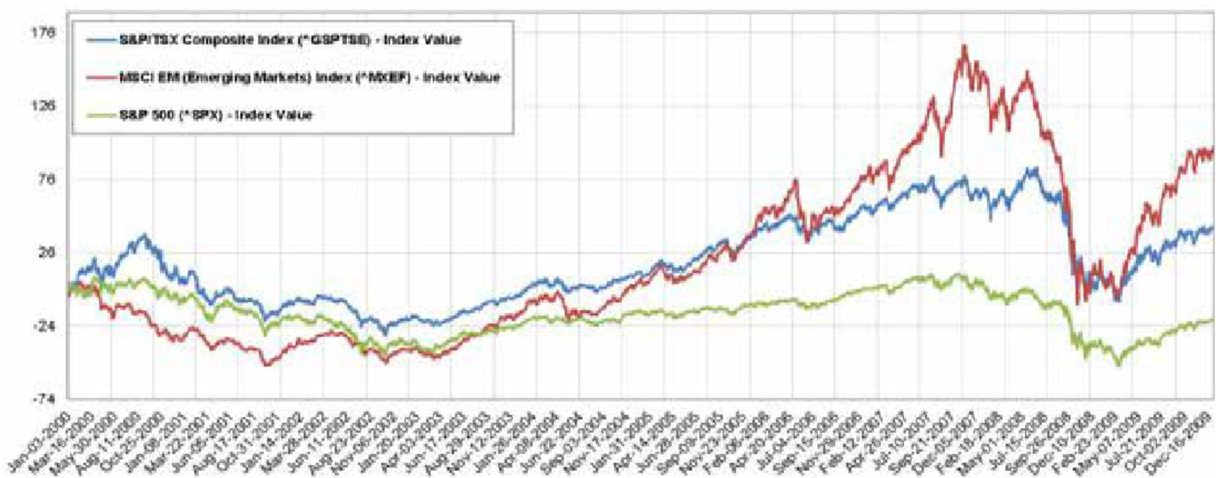
The MSCI ACWI Investable Market Index (IMI) captures large, mid and small cap representation across 23 Developed Markets (DM) and 27 Emerging Markets (EM) countries*. With 8,939 constituents, the index is comprehensive, covering approximately 99% of the global equity investment opportunity set.



Source: https://www.msci.com/documents/10199/b93d88ef-632f-4bdb-9069-d7c5aecd9d6d

The current MSCI All Countries World Index geographical allocation indicates a near 57% weighting in the U.S., almost a record high concentration in a single country (Chart 5). This phenomenon can well be explained by the fact that the U.S. has been the world's strongest economy in the past decade. This massive U.S. weight expansion happened in the aftermath of the "lost decade" (2000-2010), when U.S. securities were trading as low as 12 times earnings, and most foreign markets, including Canada, outperformed the U.S.(Chart 6)

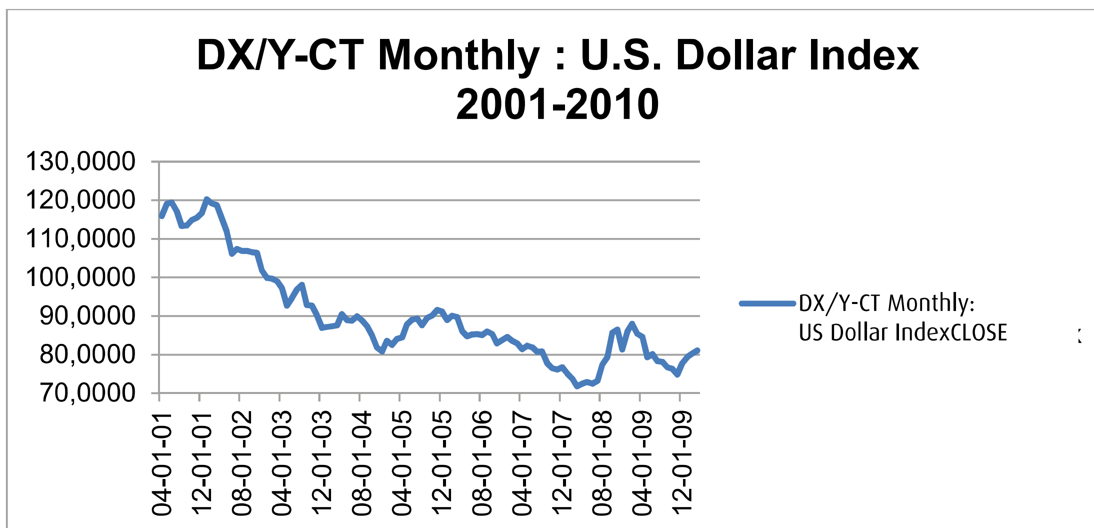
Chart 6: U.S. Market (S&P 500) vs. CDA vs. EM, 2000-2010 – America's "lost decade" –



Sources: capital IQ

It also coincides with a falling U.S. dollar (Chart 7).

Chart 7: USD Index, 2001-2010



Sources: Thompson one

America's lost decade followed the dot-com bubble burst, a bubble fueled by the adoption and the growth in use of the Internet. That period was then thought to be and rightfully so, the beginning of the "New Economy". Looking back at newsletter #35 from April 2006, I noted that the MSCI world index's U.S. allocation had been slipping from the 58% all-time high of the late 1990s to 55% in July 2004 and to 51% in April 2006. Was this a natural reaction to a falling U.S. dollar (Chart 7)? Or, was it a function of better than anticipated growth and lower valuations elsewhere? Perhaps these come as a pair...

After the financial crisis of 2008, the U.S. economy was first out of the blocks, recapturing investors' attention, leading the world recovery. Consequently, the combination of earnings growth and P/E multiple expansions from 12 to 30 times earnings contributed largely to the U.S. market outperformance of the last 10 years (Chart 8).

Chart 8: U.S. Market (S&P 500) vs. CDA vs. EM, 2010-2020 – America's "Recovery Decade" –

Sources: Capital IQ

Although using the past to predict the future isn't an exact science, it does provide important clues. No two periods are the same, and I certainly don't believe that the U.S. is facing another "lost decade" in the current environment. On the contrary, the U.S. is bound to take part in the world recovery, given the unprecedented fiscal commitments and an accommodative monetary policy. But if history can help us remember, demand for commodities went through the roof during that American lost decade... Just imagine how demand could overshoot supply as the world grows simultaneously, including the U.S., on the heel of 20 years of exploration drought and a destabilized post-pandemic supply chain! Now, that sounds like post-World War I, which was post-Spanish flu pandemic as well, and which led to the Roaring 20s. That was well before globalization, although it did create a huge protectionist wave... Similarities perhaps, but when there is a shortage of anything, humans have a tendency to protect themselves. As the world evolves, so do trade negotiations. Today's macroeconomics is an essential part of any investment strategy. It helps in establishing a vision and long-term trends.

Conclusion and Investment Strategy

While the U.S. economy is bound to recover sharply, it does face internal and external challenges going forward.

Internal

- Higher taxes
- Higher cost of debt (yield curve)
- Higher wages
- Higher cost of goods and materials

External

- Lower U.S. dollar
- Higher cost of imports
- Higher trade deficit
- World geographic reallocation

While these challenges are foreseeable, they are manageable. However, not all countries are facing all these challenges at once. Canada for one, will always benefit from the U.S. as the world's largest economy and its predominant exporting destination, but it is as well drawing huge benefits from being one of the two largest exporters of raw materials, the other being Australia. Canada could be immensely solicited worldwide for its significant supply capacity, throughout the recovery. Investing in Canada for the coming years may be less risky as the loonie strengthens all along. We can expect a wave of consolidations within the energy sector, as well as all materials, based on clean balance sheets and strong cash flows. Old mines may reopen, as this may be the most efficient way to increase production within a reasonable timeframe at a manageable cost. ESG conscientious companies (Environmental, Social and Governance), will attract most responsible investors. Infrastructure spending will continue, perhaps at a faster pace, after the pandemic slowdown. Industrials and transport companies stand to benefit from the usual roads and bridges capital expenditures, but broadband will as well, in a more meaningful way.

Consumer discretionary spending will “take off” with a vengeance, but will “land” hopefully at a higher altitude. Many travel-related businesses, however, will be facing a pile of debt, perhaps making this only a trading opportunity.

The financial services sector will benefit on all fronts: higher net interest margins from a rising yield curve, loan growth, and a recovery in bad debt provisions. We should expect Canadian banks to be active on the acquisition front and insurance companies to take advantage of higher interest rates as well.

Electric utilities have been the darlings of the last year. High valuations and rising interest rates may constrain future growth but they remain a great source of stable cash flow for investors. A good balance sheet and a strong management team justify a long-term investment approach.

The communication services sector will remain attractive for its dividend yield and growth prospects. Along with consumer staples and healthcare, it provides stability for the portfolio and somewhat offsets the volatility of more cyclical stocks as their weighting increases.

Last but not least are the technology stocks. Over-loved, over-owned and overpriced, they remain the reflection of our future. Domestic U.S. companies may have fewer tools than multinationals to offset some of the newly introduced policies by the Biden administration. We have a preference for tech companies with a commercial focus (B to B) rather than a consumer product bend (B to C), and we would favor companies with an established earnings momentum at this juncture.

As we all wait for our vaccine “booster” shot in the arm, it seems equity markets are already celebrating COVID-19’s defeat!

Recommended Asset Mix				
Income Portfolio			**Balanced Portfolio**	
Oct 2020	Apr 2021		Oct 2020	Apr 2021
10%	10%	CASH (maturities ≤ 12 months)	7.5%	5%
47.5%	42.5%	Fixed income (Bonds & GICs)	35%	30%
10%	15%	Convertible Debs. And, Income, Generating, Securities	10%	15%
25%	25%	Equities	37.5%	40%
7.5%	7.5%	Foreign	10%	10%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Recommended sector weightings-April 2021			
Sectors	**Rec'd weighting**	**Trend**	**Rational**
Communication Services	4.50%		Remains our favourite yield play, despite challenges of yield strategies, given secular dividend growth, recent underperformance provides timely longer term opportunity
Consumer Discretionary	2.00%	↑	Cyclical with long outperformance tail suggest persistent outperformance, overweight names with strong US growth exposure.
Consumer Staples	5.50%	↓	Expensive sector but earnings growth remains stable. Be increasingly selective within US focused names
Energy	2.50%	↑	Structural challenges persist, but contrarian rebounds are often sharp and difficult to anticipate. Continue to favour higher quality large cap Energy stocks that have shown operational resilience in a range bound oil price environment.
Financials	14.00%		Steadfastly maintaining holdings in the broader sector, however we prefer those companies with strong US platforms – especially within banks (commercial banking + wealth management).
Healthcare	5.00%	↓	Significant price correction and Regulatory tailwinds within Cannabis suggest neutralized position. Prefer U.S for diversity
Industrials	6.50%	↑	Well positioned for cyclical recovery, Focus on the rails, select manufacturers and waste companies – especially those leveraged to the US.
Information Technology	7.00%		Prefer the US; very select positions in Canada that are levered to secular trends.
Materials	4.00%	↑	Epic stimulus = continued upward commodity price pressure. Fundamentals remain well positioned to benefit from strong commodity prices.
Real Estate	4.00%	↑	Structural issue to persist 2021 and yield strategies likely to remain challenged as yield grind higher.
Utilities	8.00%		Rising yields, low organic growth and high payout ratios are a tough combination.
International Equities	2.00%		Be aware of exchange rates. We favor Emerging Market.
Total actions	**65.00%**		Average equity weighting.

- The suggested weightings are appropriate for a 65/35 equity/fixed income portfolio and should be adjusted based on your investor profile.

Sources:

- Bloomberg
- BMO Capital Markets Equity Research Reports
- BMO Capital Markets North American outlook
- BMO Financial Group Economic Outlook
- BMO Nesbitt Burns
- BMO Nesbitt Burns Part Team, portfolio advisory team
- BMO NB Canadian Equities Guided Portfolio – March 2021
- BMO NB US Equities Guided Portfolio – March 2021
- BMO NB North American Equities Guided Portfolio – March 2021
- BNN
- CNBC
- Dow Jones Newswires
- Globe and Mail
- Goldman Sachs
- Morgan Stanley
- Phases and Cycles
- RBC Global Asset Management
- Standard & Poor's Capital IQ Equity Research
- The Barons
- The Economist
- The high-tech Strategist
- The Financial times
- The Wall Street Journal

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*Excerpt from BMO equity research, capital market, In fact, In Depth and In Front, Red Sheet

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BMO Private Wealth

BMO Nesbitt Burns

Reference Portfolio Return

$4,000,000
$3,500,000
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0

Dec '90 Dec '91 Dec '92 Dec '93 Dec '94 Dec '95 Dec '96 Dec '97 Dec '98 Dec '99 Dec '00 Dec '01 Dec '02 Dec '03 Dec '04 Dec '05 Dec '06 Dec '07 Dec '08 Dec '09 Dec '10 Dec '11 Dec '12 Dec '13 Dec '14 Dec '15 Dec '16 Dec '17 Dec '18 Dec '19 Dec '20

Ref Portfolio
S&P TSX*
S&P TSX**
T-Bills

Value as of
March 31, 2021
$ 3,746,049

Average
Return
12.43 %

$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***

BMO Private Wealth

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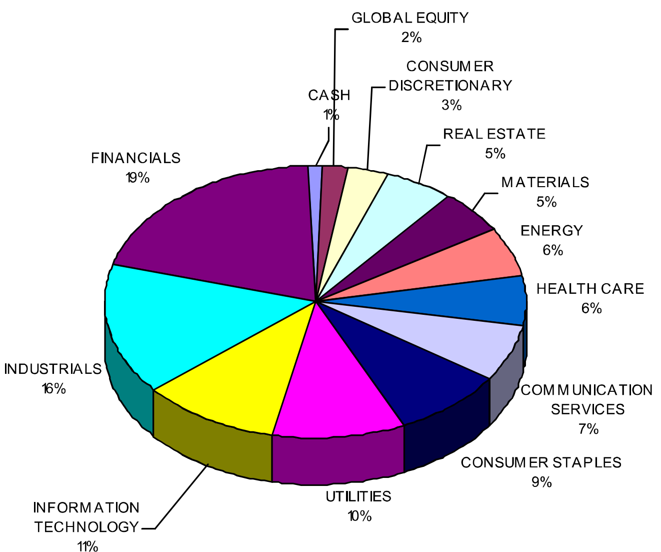
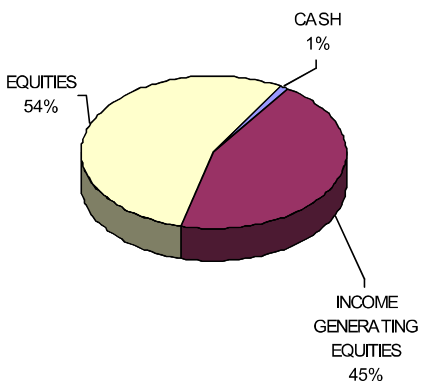
March 2021

REFERENCE PORTFOLIO HOLDINGS AND ASSET MIX



By Sub-Index %



By Category %

Performance - 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%	**13.26%**
2018	1.40%	-11.64%	-8.89%	**-3.26%**
2019	1.67%	19.13%	22.88%	**26.19%**
2020	0.39%	2.17%	5.60%	**7.13%**
*2021	0.10%	7.27%	8.05%	**7.32%**
Return Compounded as of December 31, 2020				
3 years	1.15%	2.46%	5.74%	9.36%
5 years	0.93%	6.03%	9.33%	11.58%
10 years	0.90%	2.63%	5.76%	10.97%
Average return since inception (YTD)				**12.43%**

* (YTD): Year To Date (March 31st 2021)

$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

The Team

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