Morin Dupont Lessard & Associates
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Sound advice with outstanding service

April 2019 – Excerpt # 61

Dawn or Dusk

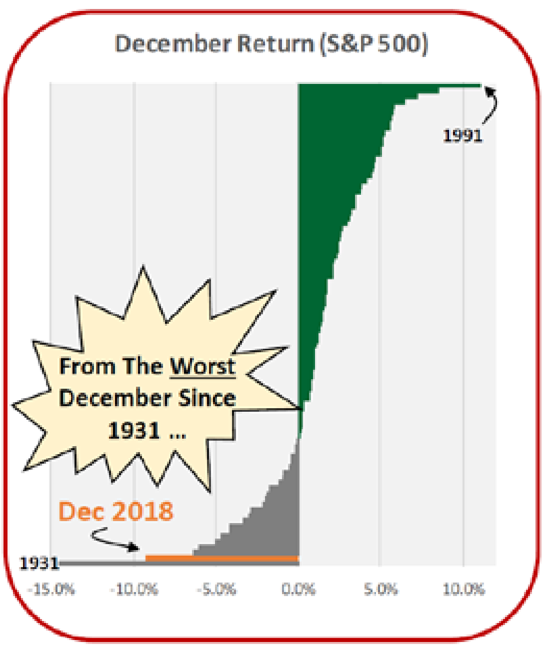
Pierre's Comments

"Dawn or Dusk"

It has been 10 years since the financial crisis, commonly referred to as the Great Recession. The market began its longest bull cycle in history after hitting bottom on March 9, 2009. In the midst of the meltdown, I remember hearing a mocking holiday season wish: "Merry Crisis and Happy New Fear"… This past December, equity markets had their worst December performance since 1931… (CHART 1) and the sarcastic holiday wish popped back into mind… Then, January had its best start in 28 years! (CHART 2)

I don't need to tell you that volatility is back!

Chart 1:



www.cornerstonemacro.com

Chart 2:

www.cornerstonemacro.com

Regardless of what we think about the markets, portfolio management must first respond to investors' individual fear factors or tolerance thereof. One of the easiest ways to manage this volatility is through a proper and <u>personalized</u> asset mix. The performance of your portfolios will reflect your level of tolerance and consequently will be more or less volatile. Last December's nearly 20% correction and rebound in two or three months should be a reminder of the importance of rebalancing your portfolios. Given that your appetite for risk may change in your individual lifecycle, it is important that we are made aware of the changes in your resistance to and tolerance of volatility.

As per our TFSA/RRSP newsletter of last January, this recent volatility was mostly caused by the shifting of the U.S. Federal Reserve Board's (Fed) monetary policy, or at least its rhetoric. The Fed's Chairman, Jerome Powell, in his ultimate goal to "normalize" interest rates, communicated last December that rates were still "a long way" from normal, and expected to raise rates two to three times in 2019, arguing that the domestic economy was striving with low unemployment (3.9%), rising average hourly earnings (3.2%), etc.

Being the only economy expanding at good clip, the U.S. could force the world into recession should the U.S. dollar be allowed to climb along with interest rates. Bear in mind that all commodities trade in U.S. dollars, the international currency, the cost of which may become out of reach for weakening foreign economies, resulting in slower global growth. Consequently, the markets responded viciously to the Fed comments last December. David Rosenberg, an influential senior economist at Gluskin Sheff, commented on the change in interest rates rather than the level thereof. According to him, central bankers should not be focusing on an appropriate level per se, as the environment is evolving, but rather on the changes in rates to which the economy tries to adapt itself.

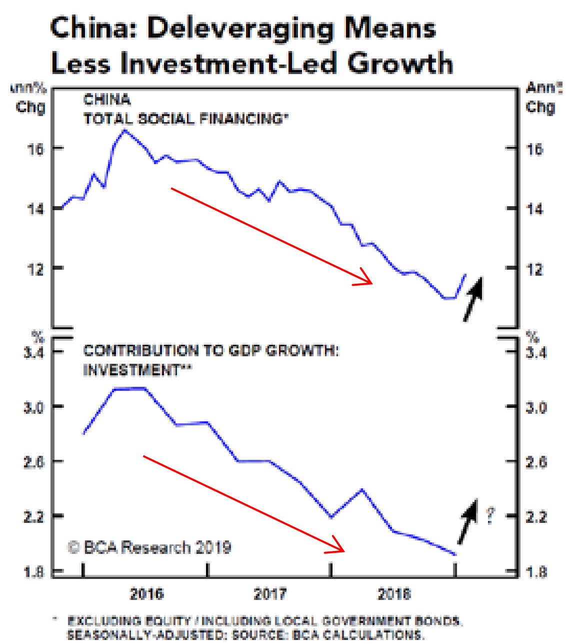
The Fed corrected its course in early in January, noting that uncertainty caused by the trade war with China and the impact of the Brexit crisis in Europe were causing these economies to stumble, which could negatively impact U.S. economic expansion. Powell stated that he would pause his rate hikes and be data-sensitive before making his next move. Those comments caused the markets to rebound.

As the Fed is now more sensitive to world economies, we should focus our attention on those as well.

<u>CHINA AND THE FAR EAST</u>

While China's weaker growth is naturally explained by the trade war, it has also been impacted by the sharp rise in oil prices, which have gone from a low of $55.00 in October 2017 to $85.00 in October 2018, and the increase in 10-year U.S. Treasury yields, which have risen from 2.05% to 3.23% over roughly the same period. As a net oil importer, China's costs have gone up, and so have the country's financing costs. As well, as U.S. treasury yields move up, underlying bond prices go down, and China is the largest holder of U.S. bonds. As costs increased, new government capital spending slowed even more, as the country had been banking on a more consumer-led economy until very recently. (chart 3)

Chart 3:



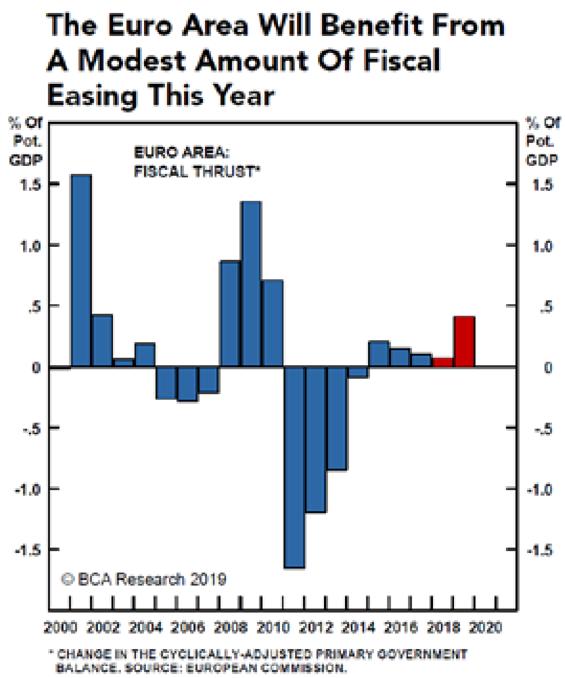
Noting the very poor GDP growth performance for 2018, the Chinese government introduced fiscal stimulus in the fall of 2018 as well as other measures in late February 2019, hoping to kick start its economy. This change, combined with the Fed's relaxed monetary policy, could have a significant impact on the world second-largest economy. Perhaps these initiatives on both sides were put in place to help both parties declare victory regarding some future trade agreement. Nevertheless, if, as and when the two nations come together on a deal, and tariffs are lifted, these measures would be a great catalyst to rejuvenate world economies and synchronized growth.

<u>EUROPE</u>

Not immune to hawkish U.S. monetary policy (rising interest rates) over the past couple of years, Europe's economic growth has felt its impact as well. U.S. tariffs on steel and aluminum combined with Brexit's unpredictable outcome have scared away capital spending and dampened investment momentum.

In an effort to somewhat offset these negative economic impacts, the European Commission introduced fiscal measures, which it expects will provide a 0.4% boost to GDP this year. (chart 4)

Chart 4:



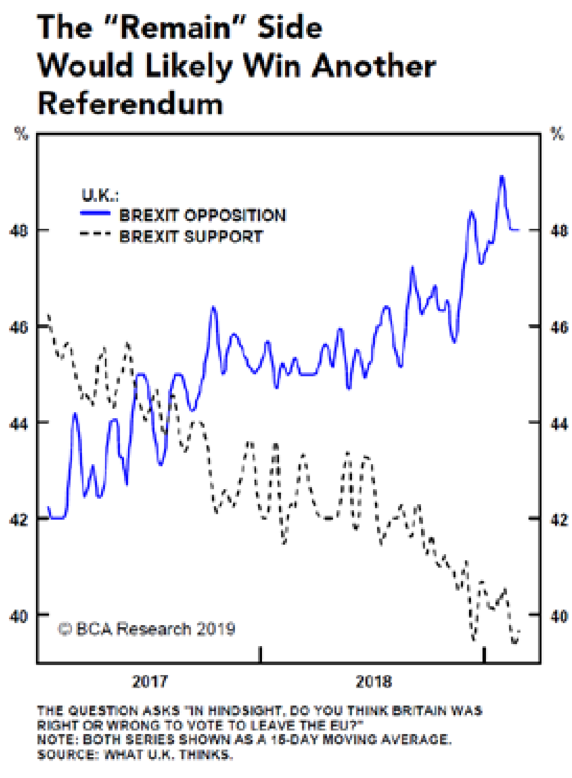
In addition, on March 8, 2019, with a view to reviving the eurozone economy, the European Central Bank President, Mr. Mario Draghi, changed tack on its monetary policy, delayed any tightening until 2020 at the earliest. He also introduced a fresh round of cheap loans to chartered banks in order to support expansion. This unexpected move matches a world trend, and comes only a few months after the ECB announced the end of a four-year bout of asset purchases (stimulus) to support the market. This demonstrates the economic fragility of certain parts of the world and their interconnections resulting from globalization. It also enhances the burden and responsibilities of the U.S. Fed as it is the world's largest economy and the international currency. The Fed's decisions, therefore must, more than ever, consider the state of world economies. Macroeconomic complexity will contribute to increased volatility in the market place. As for Europe, it must maintain a strong centralized position of control in order to preserve its unity. A weak settlement with England could open the flood gates for other countries to exit.

Italy, Europe's third-largest economy, has fallen into recession after two consecutive quarters of GDP declines in late 2018. However, Italian 10-year bond yields have now declined from 3.8% to 2.8%, a more reasonable level. Combined with lower oil prices, Italy could be on its way back to growth.

Meanwhile, England is getting "Brexhausted." Their domestic economy is suffering enormously from political and policy uncertainty. The U.K. parliament massively voted against three proposed Brexit deals, but also voted against a "no deal" Brexit. Meanwhile, the U.S. has published a post-Brexit proposed trade agreement with the U.K., joining India, Japan and South Korea in doing so. The common denominator is the significant concessions demanded of the U.K. in exchange for a deal, and that highlights how weak Britain's bargaining position is while facing a no deal Brexit. It seems that the pro-Brexit campaign's promise to "take back control" is everything but that!

Consequently, local polls now show that the "Remain" side would likely win another referendum. (Chart 5)

Chart 5:

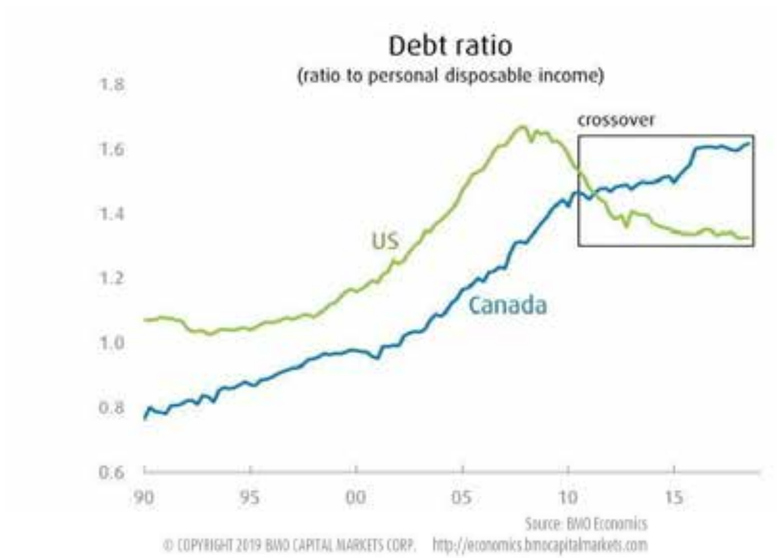


CANADA

The Canadian economy has also been contracting following its best showing in years in 2017, when a 3% GDP growth rate triggered a monetary policy change from dovish or accommodative to hawkish or restrictive (higher interest rates). Normalization in terms of interest rates may not necessarily mean returning to where we came from…

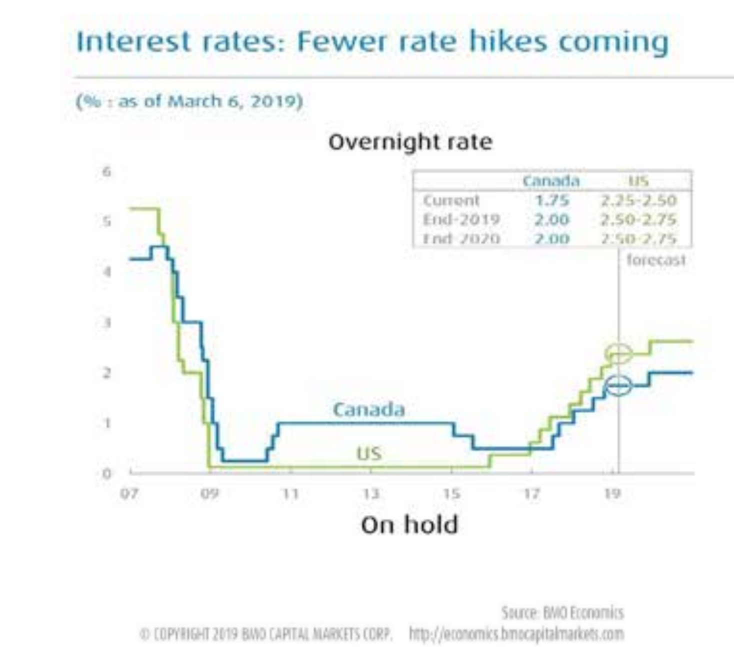
In other words, starting from a very low base, say 1%, a one-quarter point increase (0.25%) may have a more significant impact than the same increase from a 5% or 10% base. We have had no less than five quarter-point increases from a base of 0.5% in 2017. Our base rate has therefore more than tripled over a little more than a one-year period. Combined with a domestic oil crisis, resulting from huge inventory build-ups and bottlenecks caused by the lack of transport facilities (pipelines), our economic growth has suffered significantly. It is quite debatable whether the Bank of Canada's (BoC) Governor Stephen Poloz, who last raised the bank rate a quarter of one percent on October 24, 2018, went too far. Canada's Q4 GDP growth rate was a mere 0.1%, which equates to an annualized growth rate of 0.4% Given this very weak result, we may see a change in monetary policy in Canada towards a more dovish stance as well. Canadian consumers also carry a very weak balance sheet of their own, with debt to personal income levels standing at 174% – that means Canadians on average owe $1.74 for every dollar of disposable income.(chart 6)

Chart 6:



This is $0.10 more than our American counterparts before the financial crisis 2008-09. And that means that Canadian consumers cannot afford significant rate hikes, which is why the BoC stopped raising rates after five quarter-point moves (as opposed to nine hikes by the Fed). (chart 7)

Chart 7:



Unlike the U.S., Canada cannot count on its domestic consumers for growing its economy unless the government intervenes… and this is an election year. Our government tabled a new budget on March 19, and introduced some favorable fiscal policy changes. In addition, we expect major infrastructure spending in the coming year using the previously approved $35 billion that has been sitting in the infrastructure bank for the last two years.

Only one project has gotten the go-ahead using that capital at this point. The REM in the Montréal area, Prime Minister Trudeau's backyard, is the first of several major contracts to be announced, conveniently this election year. Among the beneficiaries of this infrastructure bank are engineering firms, including SNC-Lavalin. Perhaps the delays in granting infrastructure projects had something to do with this…

As I expect a "ribbon cutting year" along with a more dovish monetary and fiscal policy, I believe our economy will improve in the second half of the year, especially with the world's synchronized stimulative measures.

<u>THE CANADIAN DOLLAR</u>

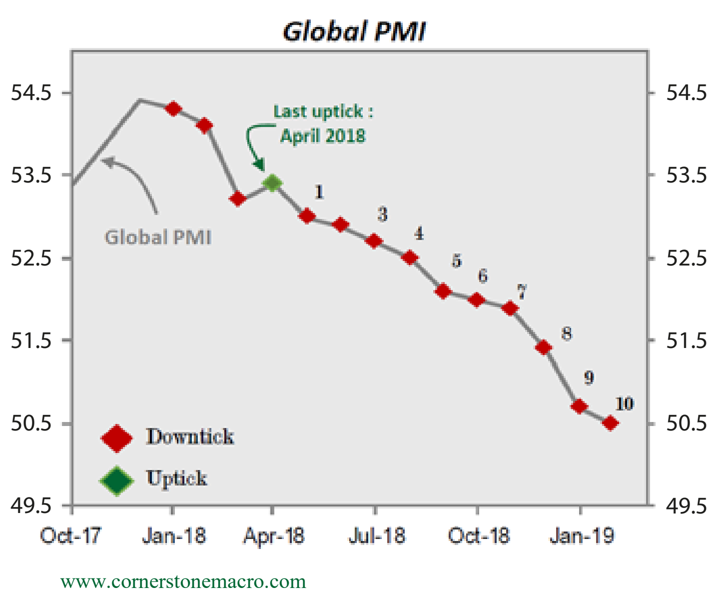
Over the short-term, the loonie could suffer somewhat from very slow relative economic growth, which may push the BoC to intervene with lower interest rates. We are not there yet, but this perception alone may cause weakness in our currency, which may be appropriate for the current government. However, as world economies resume growth momentum later in the year, Canada will be a large beneficiary, as it is mostly an exporting nation, which will boost our growth prospects. We expect the loonie to regain strength in the later part of the year.

Globally, we can track growth using the Purchasing Managers Index (PMI), which gives us a snapshot of the <u>current</u> state of economic growth. An index reading of 50 or more indicates a sign of expansion in the economy.

As shown in chart 8, global PMI has been on a downward slope for a while. In fact, only once since 1998 have we witnessed more than 10 consecutive declines, and that was in 2008. As well, out of the last 14 readings, only one was positive and that was in April 2018.

The good news is that we haven't fallen below 50 and this downtrend is currently being addressed worldwide. However, there is a lag before the various stimuli and measures start to take effect. As the global money supply grows again, we will see improvements, and uncertainty should slowly dissipate.

Chart 8:

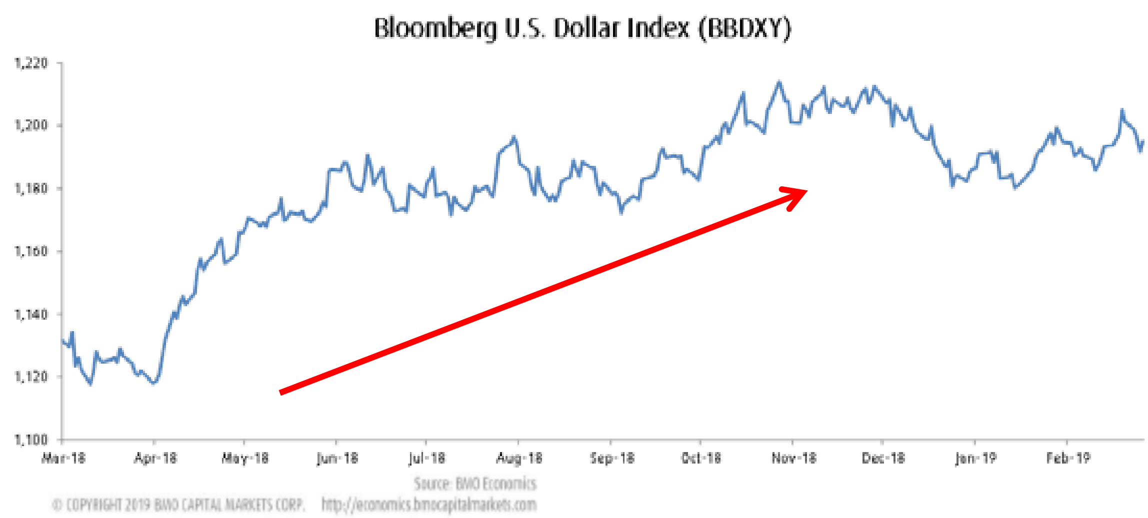


INVESTMENT STRATEGY

Simply stated, our base case is short-term pain for long-term gains. The recent sharp rebound brought markets out of reach, overpriced with high multiples. As mentioned in our RRSP/TFSA letter, we expect S&P 500 earnings to grow only mid-single digit this year and that shouldn't call for a higher than 17x P/E multiple. Given an expected $170 of earnings, this would put the S&P 500 at 2,890 points which is close to the current level. We believe, however, that buying on weakness while focusing on safe dividend income is the proper strategy. Higher and stable dividend stocks should help taper volatility. We would also consider increasing European and Emerging market exposure once Q1 results are in, combined with signs of improvement in global money supply and PMI. Associated with current weakness in global economies, we believe the U.S. dollar could strengthen somewhat before resuming a downtrend as stimulus makes its way in the global system. The Canadian economy should follow that pace as well, with a weakening currency early in the year, strengthening along with commodity prices in the second half.

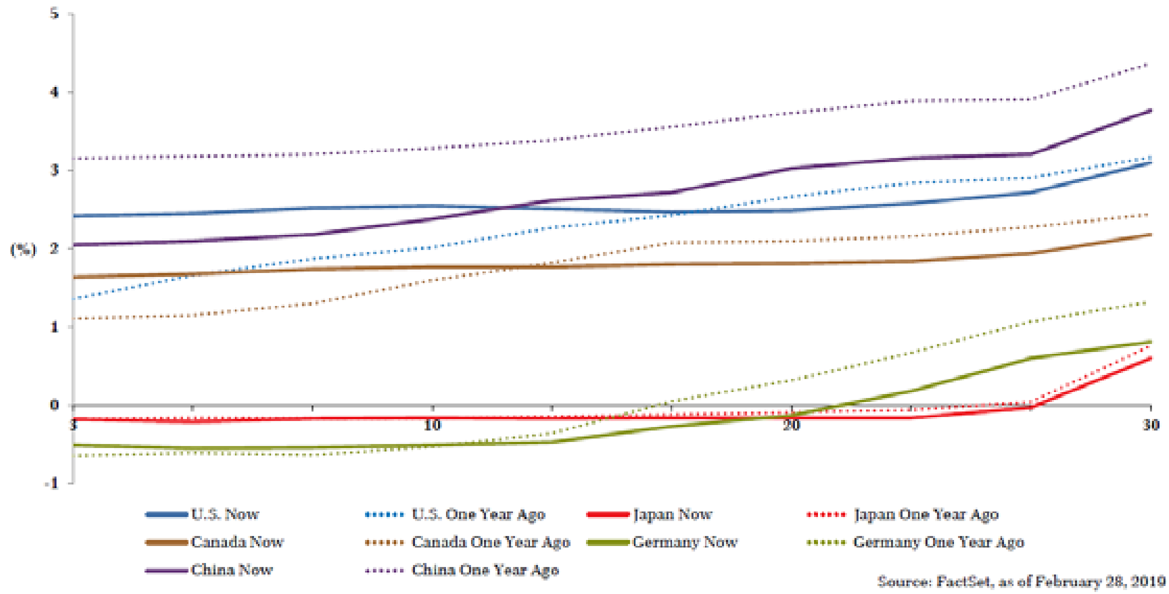
It is also to be noted that while President Trump's protectionist policies aim to reduce the U.S. – China trade deficit, the U.S. has recorded its largest increase in its trade deficit in 10 years. From a high of $360 billion in Obama's last year in office, it reached $400 billion last year, half of which is due to the China - U.S. situation. This phenomenon is explained by China's significant reduction in oil imports from the U.S. because of its economic slowdown, while U.S. consumers' appetite for Chinese goods, reflecting strong U.S. consumers' confidence last year, expanded considerably. At first glance, it seems that the unintended consequence of the tariffs on steel and aluminum as well as on other specific Chinese goods, was to increase the trade deficit rather than reduce it. The stronger U.S. dollar throughout 2018 also contributed to the widening trade deficit. (chart 9)

CHART 9 (U.S. $ index)



It would clearly be to everyone's benefit to have a boost in global GDP growth as this would reduce the pressure on the greenback, further boosting foreign economic expansion and reducing the U.S. trade deficit. As expressed in previous newsletters, the most accurate leading indicator in predicting a recession is the yield curve. When the spread between the 1- and 10-year yields becomes negative – meaning you would be paid less for locking your money in for 10 years rather than one – eight times out of ten, a recession is around the corner. Although most yield curves around the world have flattened compared to a year ago, they all remain positive. CHART 10

Chart 10: Global Yield Curve



Note that most of the short-term rates are higher, while longer-term yields are lower. This unusual phenomenon can perhaps be explained by "smart money's" lack of confidence in central bankers' tightening monetary policy. Led by the U.S. with no fewer than nine straight increases, large pools of funds worldwide may believe it has been too much too fast, the result of which justifies locking in higher yields for a longer term if they expect interest rates to change direction. If this tendency continues, it could drag the yield curve to negative and that would represent a vote of non-confidence in the market.

Truly, an inverted yield curve is an excellent forward indicator of recession. However, we have witnessed a wide range of lead times prior to previous recessions (see table 1). Although lead times average roughly 20 months, the market react well ahead of that, in anticipation. This investment behavior is expressed by an increase in volatility. Given that the world's largest economies are already addressing the issue using various stimuli, both fiscal and monetary, we believe a softer landing is possible, accompanied by mixed indicators.

Table 1: Is the yield curve a good predictor of recession?

Recession	Curve Inverted	Recession Started	Lead Time
1980	August 1978	January 1980	1 Years, 5 months
1981-1982	September 1980	July 1981	10 months
1990-1991	January 1989	July 1990	1 year, 6 months
2001	June 1998	March 2001	2 years, 9 months
2007-2009	December 2005	December 2007	2 years

Overall, we remain bullish, but we are expecting a short-term pullback which may occur at any time. The longer this bull market lasts, the more nervous investors get, enhancing volatility. Your performance this year may be mostly generated by your dividends. Catalysts such as no trade deal with China or a no-deal Brexit may drive this market lower, but the reverse is possible as well. We therefore recommend maintaining most sector weightings as they are. (see page 14 for review)

CONCLUSION

If excess volatility matters to you or if your resiliency to fear has diminished, then you must consider rebalancing your portfolio in favor of risk-free assets, fixed income. Only your asset mix allows you to reduce your portfolio's volatility in a simple fashion. It is true that one could use hedging instruments and derivative products to counter large market swings, but they can be confusing and costly to the common investor. A well-thought investment strategy, supportive of your needs and risk tolerance level, combined with a good financial plan covering both retirement and estate projections represent your most reliable approach. Your financial future depends on our ability to guide you and on your understanding of your own risk tolerance and the related expected return. Although the sun may be setting in the horizon, it is rising in another part of the world...

Sectors	Recommended Weighting April 2019	Trend
Communication Services	3.5%	
Consumer Discretionary	2%	
Consumer Staples	5%	
Energy	4%	
Financials	14%	
Health	4.5%	
Industrials	9%	↓
Information Technology	7.5%	
Materials	2%	
Real Estate	4%	↑
Utilities	6.5%	
Global Equities	3%	
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 2018	Apr 2019		Oct 2018	Apr 2019
7.5%	7.5%	CASH (maturities ≤ 12 months)	7.5%	7.5%
47.5%	47.5%	Fixed income (Bonds & GICs)	32.5%	32.5%
15%	15%	Convertible Debs. And, Income, Generating, Securities	10%	10%
20%	20%	Equities	35%	35%
10%	10%	Foreign	15%	15%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Sources:

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Performace - T-Bills vs SP TSX vs Reference Portfolio				
Year	T-Bills (return)	SP TSX[1]	SP TSX[2]	Portfolio(return)
1990	13.20%	-17.96%	-14.80%	**5.94%**
1991	9.35%	7.85%	12.02%	**22.14%**
1992	6.67%	-4.61%	-1.43%	**10.50%**
1993	4.68%	28.98%	32.55%	**34.91%**
1994	5.19%	-2.50%	-0.18%	**6.09%**
1995	6.42%	11.86%	14.53%	**8.09%**
1996	3.93%	25.74%	28.35%	**16.21%**
1997	2.85%	13.03%	14.98%	**21.05%**
1998	4.56%	-3.19%	-1.58%	**1.87%**
1999	4.67%	29.72%	31.71%	**19.96%**
2000	5.23%	6.18%	7.41%	**30.40%**
2001	3.73%	-13.94%	-12.57%	**9.54%**
2002	1.75%	-13.97%	-12.44%	**3.61%**
2003	2.22%	24.29%	26.72%	**22.23%**
2004	1.84%	12.48%	14.48%	**13.87%**
2005	2.53%	21.91%	24.13%	**15.73%**
2006	3.52%	14.51%	17.26%	**14.30%**
2007	3.59%	7.16%	9.83%	**8.06%**
2008	1.50%	-35.03%	-33.00%	**-28.07%**
2009	0.29%	30.69%	35.05%	**29.37%**
2010	0.60%	14.45%	17.61%	**21.05%**
2011	0.92%	-11.07%	-8.71%	**4.18%**
2012	0.97%	4.00%	7.19%	**7.38%**
2013	0.97%	9.55%	12.99%	**18.14%**
2014	0.92%	7.42%	10.55%	**16.43%**
2015	0.50%	-11.09%	-8.32%	**6.36%**
2016	0.50%	17.51%	21.08%	**16.75%**
2017	0.71%	6.03%	9.10%	**13.26%**
2018	1.40%	-11.64%	-8.89%	**-3.26%**
*2019	0.42%	12.42%	13.29%	**15.46%**
Return Compounded as of December 31, 2018				
3 years	0.87%	3.26%	6.37%	8.56%
5 years	0.81%	1.01%	4.06%	9.64%
10 years	0.78%	4.77%	7.92%	12.62%
Average return since inception (YTD)				**12.46%**

* (YTD): Year To Date (march 31st, 2019)

$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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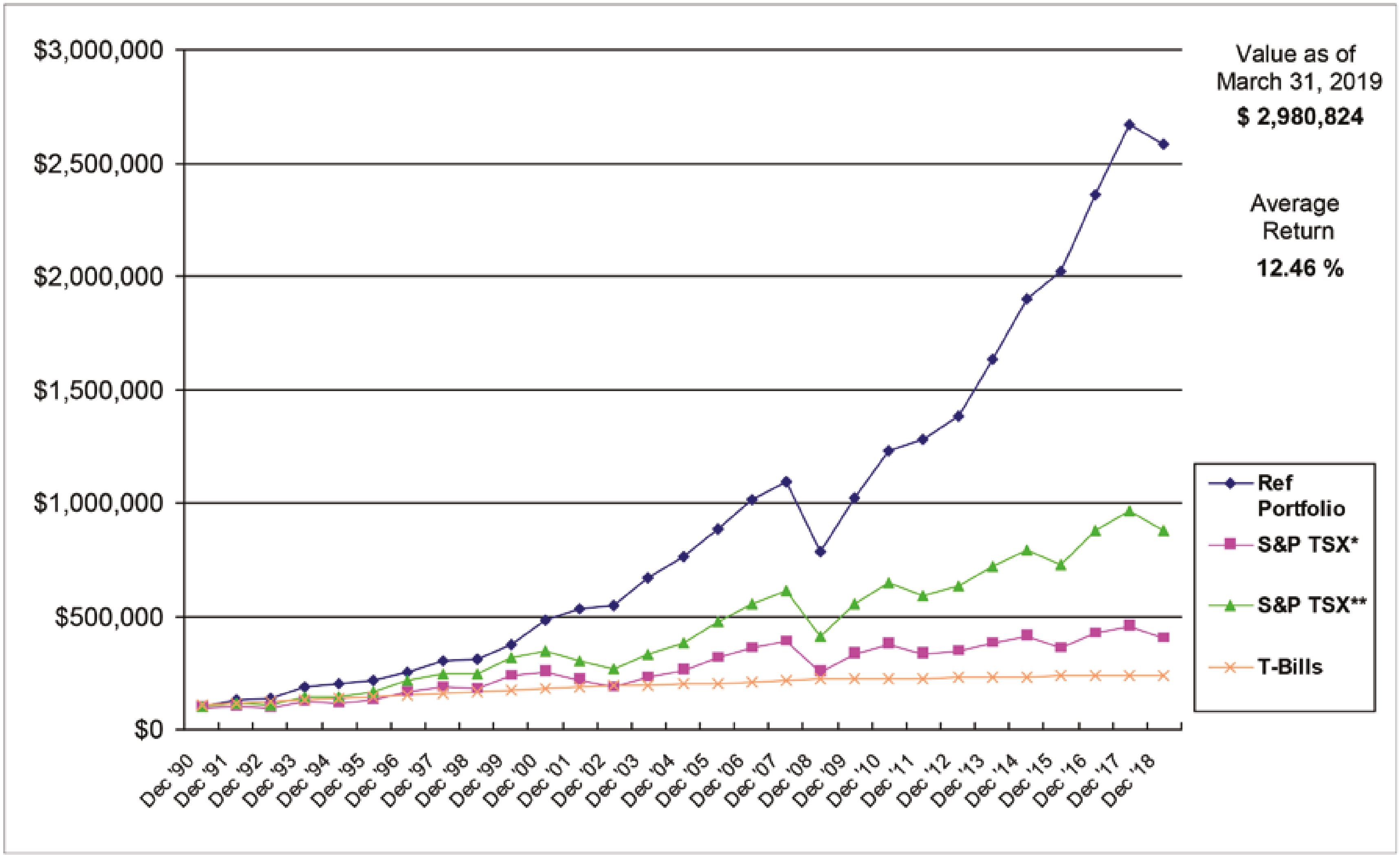
Morin Dupont Lessard & Associates

Reference 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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