Morin Dupont Lessard & Associates
BMO Nesbitt Burns

Sound advice with outstanding service

October 2019 – Newsletter excerpt # 62

Driving through tensions

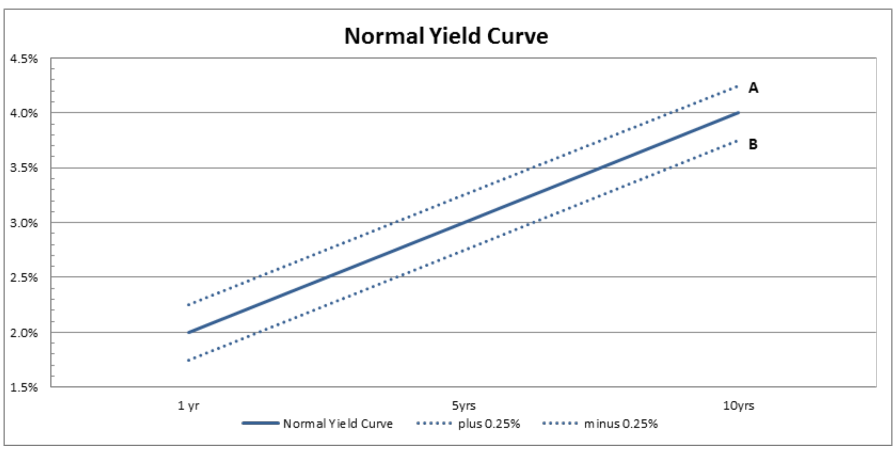
Pierre's Comments

In recent newsletters, namely those of April 2017, October 2017 as well as April 2019, we referred to the "yield curve" as one of the most accurate indicators to predict recessions. Perhaps now would be a good time to explain in layman terms what a "yield curve" is and how it can guide us in our investment strategies.

As a starter, if you were to lend money to someone you judge credit worthy, you would ask the borrower to at least cover your cost of money.

That cost – also known as an opportunity loss – is at least equivalent to what that money would have earned had it been invested. If you were to lend money for a short period of time, you could base your rate on a similar short-term guaranteed income certificate (GIC), which rate is established based on the Central Bank rate. However, the longer the loan term, the higher the rate would be, as it reflects a higher risk of not being repaid and not having access to that money until the term is up. This natural phenomenon is called a "normal" yield curve.

Chart 1 – Example of normal yield curve

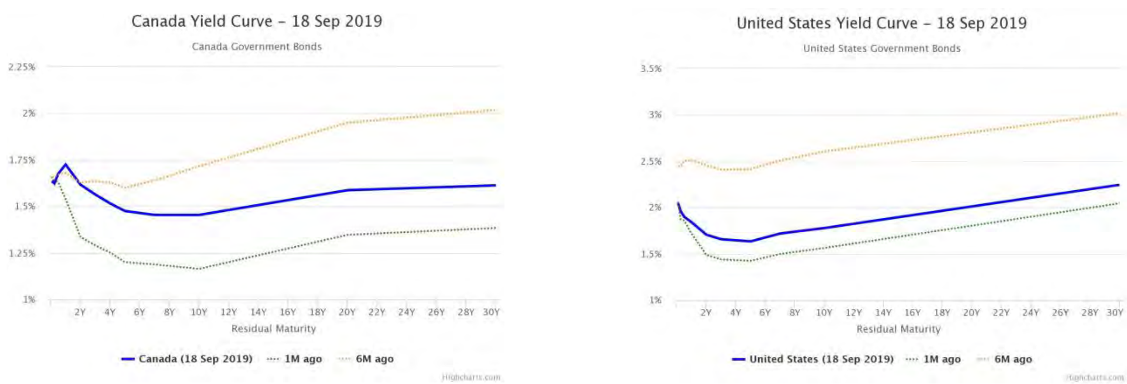


Source: BMO Capital Markets

The Fed, or Central Bank, controls the short-term rates, whereas market forces (buying or selling of bonds on the open market) will influence the yields on longer-term bonds. Everything else being equal, the whole yield curve would move up or down one quarter point along with the Central Bank's decision to cut or raise interest rates (like A or B). But the reality is that investors and speculators may forecast that the rise by the Central Bank may trigger an economic slowdown that could cause stocks to tumble. As a reaction, investors may sell stocks now and secure their money in bonds with a higher rate, i.e. 5- or 10-year bonds. These actions may cause the stock market to correct (more sellers than buyers) and the bond market prices to go up (more buyers than sellers). This is where it gets complicated and confusing to many. When bond prices go up, yields come down. For example, a 5-year bond with a 5% coupon rate (or interest rate) has a par value of $100. In other words, you are guaranteed to get your $100 back in 5 years. But, because of the surge of buyers, the bond price has gone up to $105.00. At $105.00 the buyer is guaranteed to lose $5 on $105 or approximately 5% over 5 years or 1% per year. Given the 5% annual coupon rate and a guaranteed loss of 1% per year, the bond yield, at $105.00, is ± 4%. When the 5-year and 10-year bond yields are nearly the same as the short-term, 90 days yields, the yield curve is called flat (Chart 2) similar to what it is today compared to 6 months ago.

To say the least, it is not a great vote of confidence for the stock market when you find huge numbers of investors buying 10-year government bonds with a 1.7% yield!

Chart 2

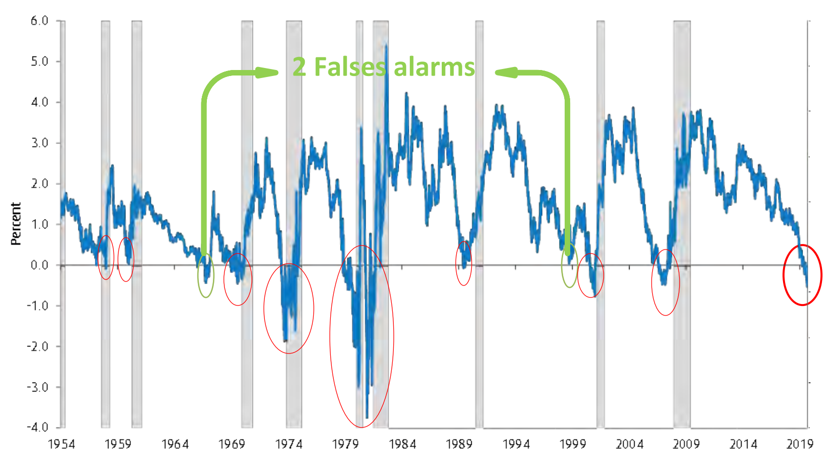


It may also tell you that when “smart” money prefers 10-year bonds at 1.7% over 1-year bonds offering the same rate, they probably expect short-term rates to come down.

The next question is, where will the short-term money go if, as and when, short-term rates fall? Given that such action by the Central Bank acts as a stimulus to the economy, and given that the average dividend yield of American equity indexes is higher than 10-year bond yields, we could witness a tsunami of cash coming from both the short-term money market and overpriced long-term bonds flowing back into equities.

Another argument for this possibility is that the “negative yield curve” that occurred temporarily in August can be a global symptom rather than a domestic one.

Chart 3: U.S. 10-Year *minus* 3-Month Treasury Yield Curve (January 04, 1954 – September 10, 2019)



Source: FactSet

As shown in the graph above, every time the blue line hits the zero level, it means the yield curve is flat. Below zero means a negative yield curve. The grey vertical bars indicate past recessions. With the exception of 1966 and 1998, flat or negative yield curve correctly forecasted a recession within 16 months, that is 8 times out of 10.

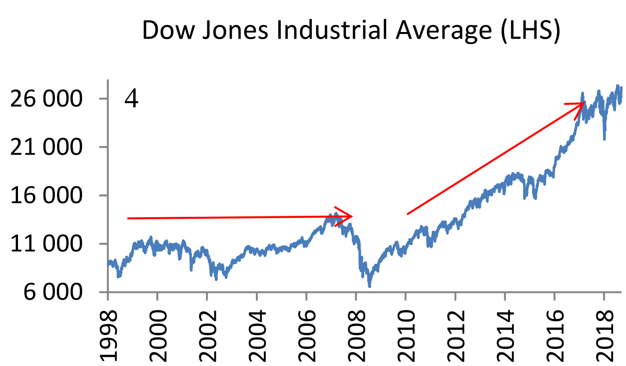
This past August's occurrence was not driven by a sharp rise in interest rates by the Central Bank in order to slow an overheating economy, but rather the result of a huge foreign demand in long-term U.S. treasuries whose yield was much more attractive than elsewhere in the G20 countries and beyond. In mid-August, an unexpected series of rate cuts, beginning with New Zealand, which lowered its rate by 0.5%, followed by India with a 0.35% cut, then by Thailand and Mexico with a 0.25% drop, drove demand for U.S. treasuries. It seemed like a race to the bottom to protect their currency against the falling yuan. Over thirty countries have cut rates so far this year.

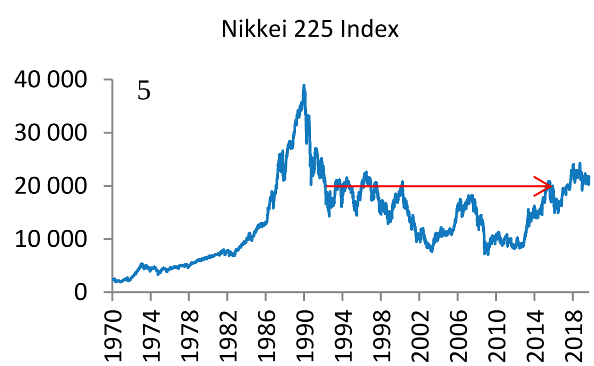
By lowering short-term rates, the Central Bank (the Fed) could help the yield curve to return to a positive slope and support a slowing economy with weak commodity prices and no sign of inflation. There is no doubt that the negative yield curve is a consequence of foreign demand for higher credit quality U.S. treasuries at higher rates (which is paradoxical), thus creating a bond market bubble.

But the money will remain in bonds until there is a reason to believe that world growth will resume. But what could be the catalyst?

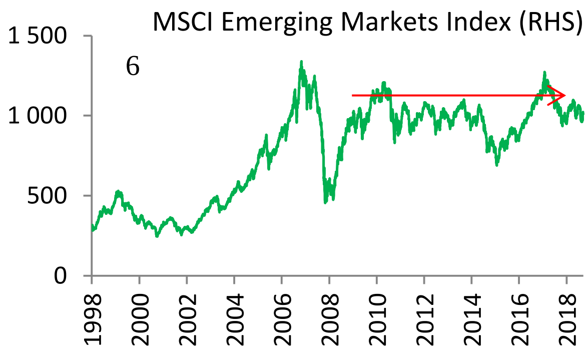
U.S. equity markets have outperformed the world throughout this decade. People forget that from January 1, 2000 to January 1, 2010, the Dow Jones was up a mere 2.8%, compared to a whopping 260% this decade to date! (Chart 4). One could say the lost decade was recovered. But what about the rest of the world? Japan has been in decline for 30 years; its market having peaked at 39,000 in 1989 and is standing at ±21,000 today (Chart 5). Meanwhile, emerging markets have been in the doldrums for the past decade (Chart 6) and the Eurozone is still fighting to maintain its identity, having been stagnant for the last five years (re: Brexit) (Chart 7).

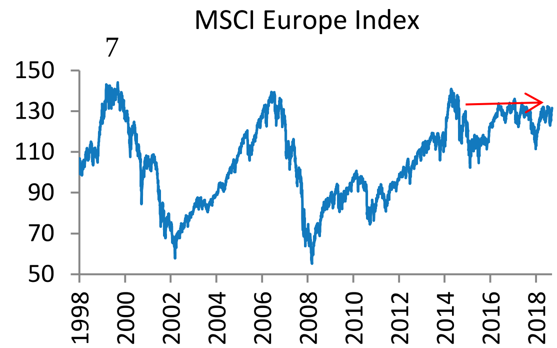
Charts 4, 5, 6, 7





Source: BMO Capital Markets





Source: BMO Capital Markets

Around the world, we have reached the limits of monetary policy as we now have $17 trillion or nearly 26% of all outstanding sovereign debt paying a negative return. No fewer than 10 of the G20 countries carry negative yields on their bonds (19 countries overall), which explains such a strong demand for U.S. treasuries (Table 1).

Table 1

The Negative Bond Complex

Country	6-Mo	1-Year	2-Year	5-Year	7-Year	10-Year	15-Year	30-Year
Switzerland	-0.87	-0.91	-0.97	-0.88	-0.83	-0.69	-0.49	-0.26
Denmark	-0.77	-0.63	-0.77	-0.73	-0.67	-0.49	-0.29	-0.17
Germany	-0.62	-0.70	-0.73	-0.72	-0.67	-0.47	-0.25	0.07
Netherland	-0.89	-0.60	-0.74	-0.64	-0.53	-0.33	-0.08	0.07
Finland	-0.67	-0.67	-0.67	-0.58	-0.45	-0.24	0.00	0.31
Austria	-0.65	-0.65	-0.65	-0.56	-0.43	-0.20	0.04	0.42
Sweden	-0.47	-0.58	-0.66	-0.49	-0.37	-0.15	0.13	0.56
France	-0.60	-0.68	-0.70	-0.56	-0.41	-0.18	0.12	0.71
Japan	-0.27	-0.24	-0.25	-0.26	-0.27	-0.15	0.08	0.35
Belgium	-0.99	-0.65	-0.66	-0.50	-0.37	-0.13	0.21	0.79
Ireland	-0.55	-0.56	-0.57	-0.39	-0.21	0.07	0.42	0.98
Spain	-0.38	-0.02	-0.49	-0.19	0.01	0.26	0.57	1.28
Portugal	-0.67	-0.62	-0.50	-0.14	0.06	0.29	0.69	1.26
Italy	-0.27	-0.30	-0.22	0.31	0.57	0.88	1.35	2.11
Canada	1.67	1.71	1.60	1.48	1.47	1.47	1.58	1.68
United States	1.93	1.87	1.75	1.70	1.78	1.85	1.95	2.42

Source: Factset

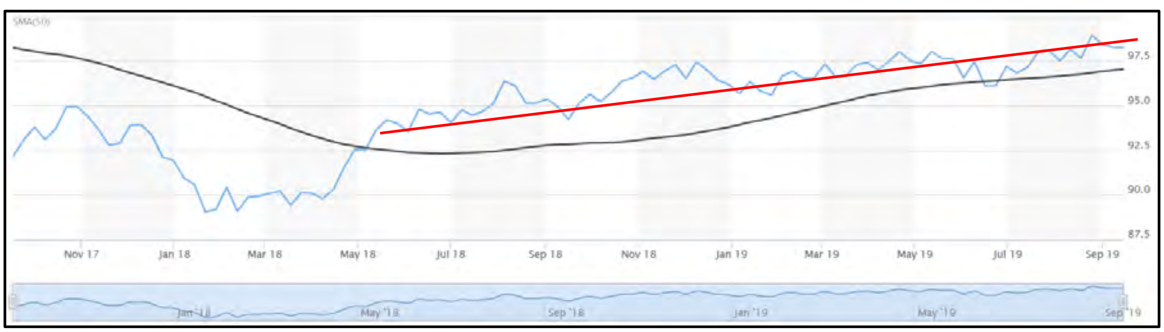
I have mentioned many times that monetary policy alone cannot drive an economy out of a deep recession. Other stimuli such as government spending and tax cuts are necessary companions to a softening of monetary policy. We are now witnessing such actions, namely from France, who led the way earlier this year with corporate and individual tax cuts totaling some $15 billion euros. More recently, Germany proposed to lower corporate tax rates from 33% to 25% for small and mid-sized businesses as its economy enters a technical recession.

But Brexit remains Europe's biggest stumbling block. Although the U.K. represents only 2% of global GDP, its close ties with the Eurozone, which represents 11% of global GDP, make it a significant concern. At the time of writing these lines, the parliament was heading to recess after a hard (no deal) Brexit seemed avoided. Obviously, a no deal Brexit would have severe counter effects on the U.K. economy. The pound would be crushed, boosting inflation and eroding consumers purchasing power. Consumer and business confidence would be shattered, so would capital expenditure programs. A rise in unemployment and a contracting GDP would be the result. This unlikely event is yet another brick in the wall of uncertainty.

Last but not the least: China. The world's second-largest economy is in a trade war with the largest economy, the U.S. China is under enormous pressure and is trying to accelerate its economic growth by using traditional means of stimulus i.e. lower interest rates, tax cuts and government spending. Yet their growth is reflected in commodity prices which remain low. Given their dependence on imports, China's demand for commodities remains modest, indicating slow growth. The falling yuan is also a way for China to offset U.S. tariffs, but it also means a higher cost for non-tariff imported goods. Consequently, Chinese consumption power is eroded and it does not help economic expansion. Mainland China is also trying to impose their strong centralized government's controls on Hong Kong, breaching the 10-year-old independence agreement when they took control from the U.K. It is known that the Chinese try to secure their assets in other countries, and many succeed through Hong Kong banks. Hong Kong is now pressing for more independence and freedom which creates yet another area of uncertainty for investors.

The world is exposed to very large conflicts, almost as if globalization is reaching puberty. So the world turns towards safe havens such as U.S. treasuries, which in turn strengthens the U.S. dollar.

Chart 8



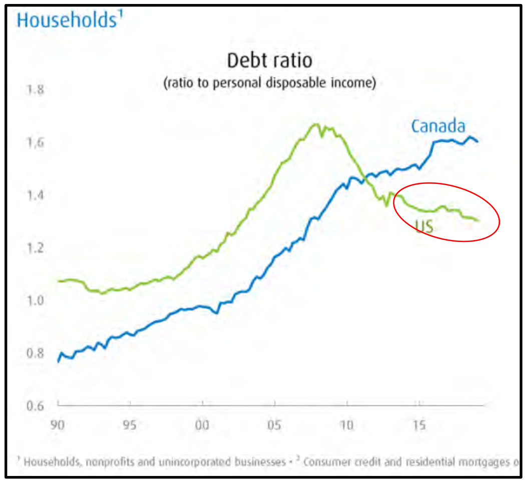
Source: https://www.marketwatch.com/investing/index/dxy/charts

Unfortunately, as the U.S. dollar strengthens (Chart 8, USD), commodities priced in U.S. dollars become out of reach for emerging market countries, which doesn't help their economic growth either. Furthermore, the lower the yields on U.S. treasuries, the more attractive gold becomes as the cost of carry falls.

Upside scenario

Trade concerns worldwide are the single biggest weight on world economic growth. It is my belief that as these trade issues are resolved, starting with the USMCA, then Brexit and eventually China, the world's capital currently over weighted in the U.S. would be redistributed (resulting in a lower U.S. dollar), uncertainty would slowly fade, yield curves would slowly normalize and global synchronized growth would resume. Over time, commodity prices would firm up and inflation would pick up, providing pricing power to companies. As long as there is a financially strong enough and willing consumer, economic growth will prevail. Fortunately, the U.S. consumer has lots of room to manoeuver in a low interest rate environment (Chart 9). In due course, central bankers would raise interest rates and induce a recession to maintain control over inflation.

Chart 9



Source: BMO Capital Markets

Downside scenario

Tariffs and retaliation prevail as the U.S. and China enter a full-fledged trade war with all its negative implications. Recession becomes self-induced, stock markets plummet and U.S. bond yields head to zero, perhaps even joining the rest of the G20 with negative yields. Gold becomes the ultimate safe haven as the world economy could fall in a depression.

This scenario is not unknown to humanity as it is exactly the one that brought the Great Depression upon us in the 1930s. Protectionism and trade wars were the source of the conflicts in the late 1920s, a century ago. After the First World War, a decade of expansion and prosperity that brought greed and defiance, like today, ended in the Great Depression. To make the same mistake twice would be unthinkable and improbable, but not impossible.

Investment strategy.

As mentioned in the previous newsletter, volatility is here to stay until trade wars subside and deals are reached. We cannot let fear and emotion dominate our investment decisions. The unpredictability of the geopolitical landscape forces us to be cautious and focus on facts and fundamentals. There are investment opportunities that are common to both scenarios, i.e. solid dividend yields in mature businesses and oligopolies, and gold. Regardless of the outcome, fiat currencies, the repetitious use of quantitative easing in many economies (printing of money) and the ever-climbing wall of debt are all good reasons to own gold. Recognized as a poor investment choice, gold's popularity shines from time to time, especially if there is little cost to holding it. It is also a great hedge on the rest of the market. The real question is, can we afford not having an insurance policy on our portfolio at nearly no cost?

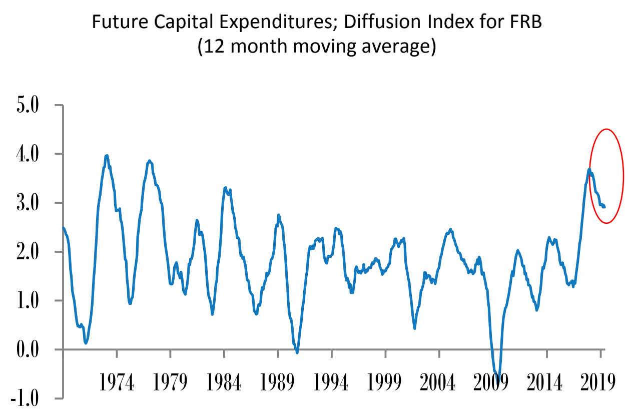
There are sectors that will benefit of lower interest rates and bond yields such as utilities telecom services and Real Estate which are well represented in our portfolio.

Consumer staples and healthcare are also perceived to be good defensive stocks in a more volatile environment. The more cyclical industries, namely consumer discretionary, base metals, industrials and to a lesser extent financials and technology, would get hurt the most in a downside scenario. Meanwhile, the energy sector is questionable as it can turn on a dime given geopolitical confrontations. Notwithstanding that risk, energy is closely tied to world economic growth, and so is highly cyclical.

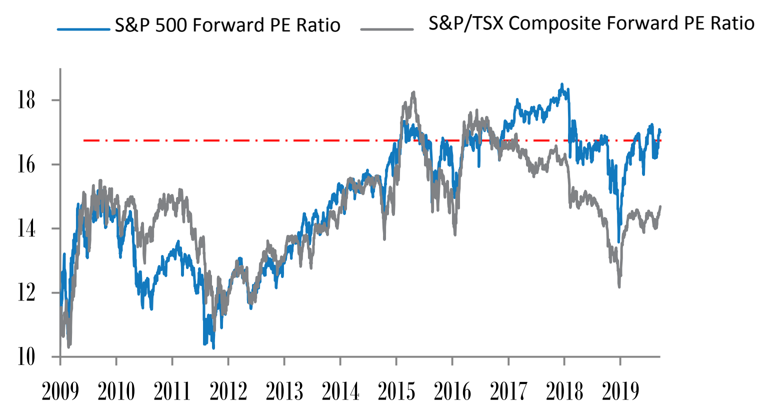
Conclusion

We are clearly facing a slowing economy as demonstrated by a slowdown in Capex (capital expenditures programs) and consumer spending.

Charts 10, 11



Source: FRED



Source: Bloomberg

Forward corporate earnings could be challenged and US equity markets are 2% away from all-time highs, trading roughly at 17x earnings. Given that there is not much room for disappointment, we would tend to revert to your original equity exposure target by taking some gains, offsetting underperforming stocks. Your asset mix should be reviewed to take into account volatility and unpredictable times. The BMO Nesbitt Burns recession risk model has risen to 33% within the next year and 52% in two years. We also know that we are one tweet away from a sharp adjustment on the yield curve in either direction. In early October, the scheduled U.S.- China trade meeting could boost expectations for a possible agreement between the two superpowers that control 40% of the world economy.

By the time you read these lines perhaps President Xi and President Trump will “drive” on the “fairway” to recovery, avoid a recession and enjoy recess…

Sectors	Recommended Weighting October 2019	Trend
Communication Services	3.5%	
Consumer Discretionary	2%	
Consumer Staples	5.5%	
Energy	4%	
Financials	14%	↓
Health	4.5%	
Industrials	7.5%	↓
Information Technology	7.5%	
Materials	2%	↑
Real Estate	5%	
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	
Apr 2019	Oct 2019		Apr 2019	Oct 2019
7.5%	10%	CASH (maturities ≤ 12 months)	7.5%	10%
47.5%	47.5%	Fixed income (Bonds & GICs)	32.5%	35%
15%	15%	Convertible Debs. And, Income, Generating, Securities	10%	10%
20%	20%	Equities	35%	35%
10%	7.5%	Foreign	15%	10%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Sources:

• Bank of Canada website
• Bloomberg (Germany to cut corp. tax rate to 25%)
• BMO Capital Markets Equity Research Reports
• BMO Capital Markets North American outlook
• BMO Financial Group Economic Outlook
• BMO Nesbit Burns
• BMO Nesbit Burns Part Team, portfolio advisory team
• BMO NB Canadian Equities Guided Portfolio – march 2019
• BMO NB US Equities Guided Portfolio – march 2019
• BMO NB North American Equities Guided Portfolio – march 2019
• Cornerstone Macro
• CNBC
• Dow Jones Newswires
• Globe and Mail
• New York Times
• Phases and Cycles
• RBC Capital markets
• Standard & Poor's Capital IQ Equity Research
• The Economist
• The Guardian World News (Brexit)
• The High-tech Strategist
• The Local (fifteen million people in France will benefit from Macron tax cuts)
• The Wall Street Journal
• Thompson One (Reuters)
• Ycharts.com

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

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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%	16.31%	19.11%	**21.30%**
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) ………………………………..				**12.42%**

* (YTD): Year To Date (september 30th, 2019)

$100,00 invested on June 1st 1990

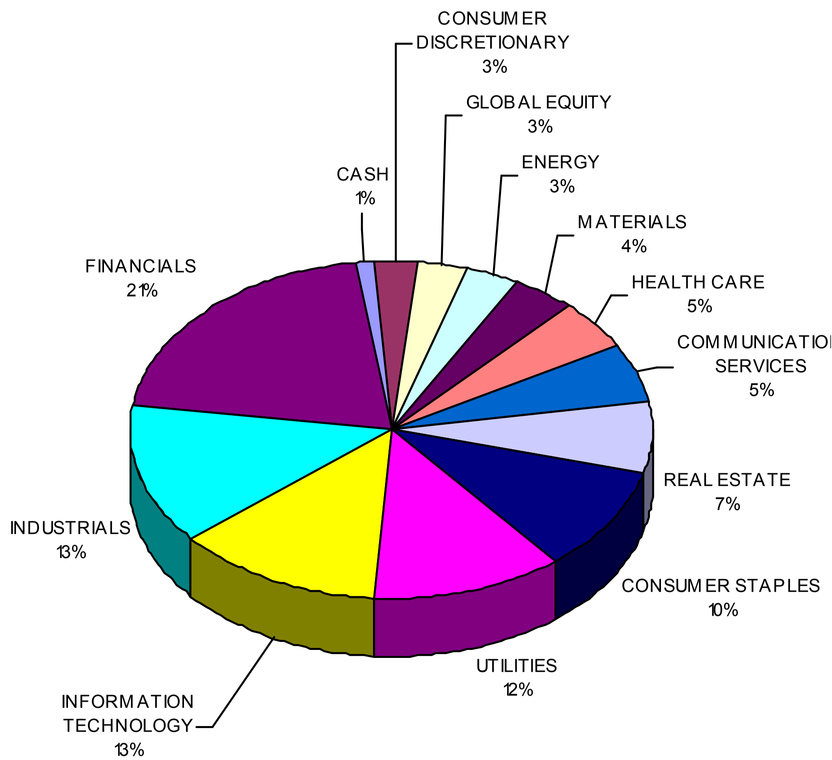
The returns are compounded monthly and revenues are reinvested.

1: Does not include income or dividend

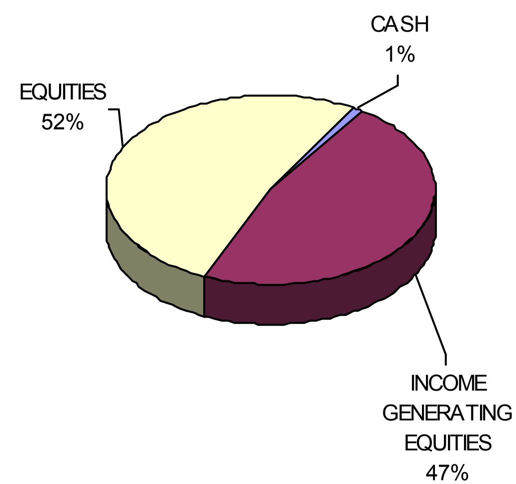
2: Includes income and dividend

September 2019

REFERENCE PORTFOLIO HOLDINGS AND ASSET MIX



By Sub-Index %



By Category %

BMO Wealth Management
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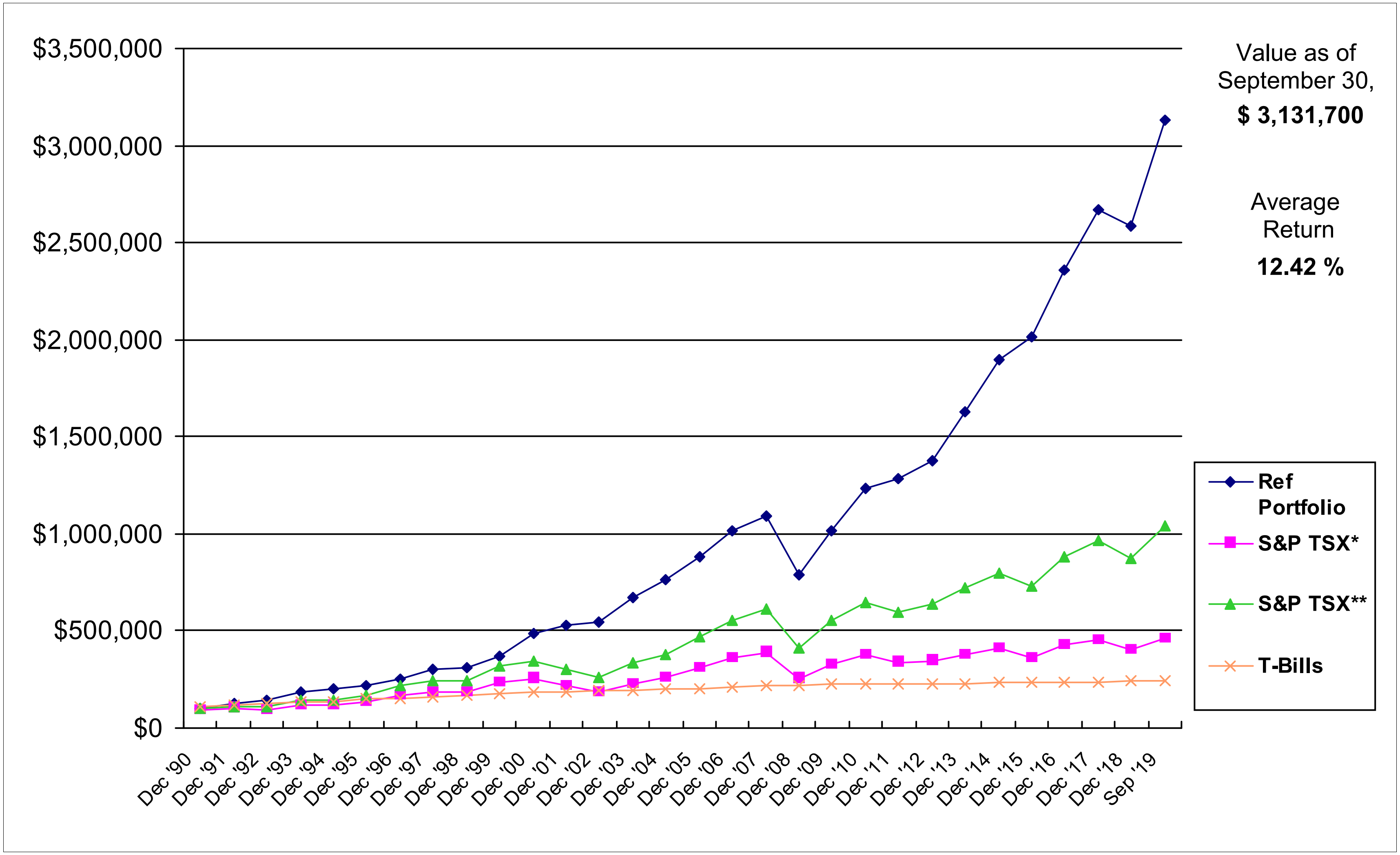
Reference Portfolio Return



$100,000 invested on June 1st 1990

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**Does not include income or div*

***Includes income and div*

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