Clearing the **hurdles**

BMO Wealth Management
BMO Nesbitt Burns

The COSGROVE-BROCK Group

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Philip's Comments

Sometimes the numbers can mask the real story: since the publication of the winter 2018 edition of our Newsletter, the S&P500 has barely moved at all: it posted a value of 2,821.98 points on February 1st, only 5.69 points higher than where markets closed on July 31st.[1] US markets have been flat over the last six months.

The Canadian story is not so different, with the S&P/TSX Composite index increasing by 573.09 points to close at 16,434.01 on July 31st – an increase of 3.6% over the same period – much of which can be attributed to the rising price of oil (up 4.5%).[2]

Flat markets in the US and modestly positive markets in Canada: surely, an uneventful half year! Not exactly…

The period since our last newsletter has seen the return of equity market volatility, against the backdrop of rising political noise and a marked increase in global trade tensions. Canada has not been immune to this, with our dollar dropping by 5.7% since February.[3] A falling Canadian dollar in a period of rising oil prices – now that is a rare occurrence.

In this commentary we reaffirm our stance, first expressed in our winter 2018 newsletter, that our approach to money management in this environment should be characterised by a good measure of caution. We lay out the case that the fundamental economic picture remains strong in most of the world, but that we find ourselves late enough in the economic cycle, and surrounded by enough new sources of uncertainty to justify a strategy of caution. This is not the time for the sprinters, but rather the more technical hurdlers, who know how to navigate the obstacles before them.

First Hurdle: Uncertainty, Personified

We can all be forgiven for having trouble remembering the world as it was, prior to November 8th, 2016. It feels as if the news cycle has been sped up, with every day delivering increasingly astonishing headlines, interspersed with a flurry of presidential tweets.

Following President Trump's election, markets seemed to rejoice. Between elections night in 2016 and December 22nd 2017, when the US tax reform bill was signed into law, the S&P500 climbed by a staggering 25.4%.[4] Over this first year of the Trump mandate there was no shortage of tweets, Justice Department investigations, or turnover in White House staff. What markets relied on was the renewed trend towards federal agency de-regulation, spearheaded by the White House, and the impending passage of the tax reform bill itself, which provided much needed tax relief to US Corporations (prior to this US corporate tax rates were some of the highest in the world). Basically, this policy cocktail allowed the markets to forgive the President's less conventional characteristics. From the standpoint of equity markets, the US administration was working with a net.

From December 23rd 2017 to July 31st, 2018 US equity markets have been positive (up by 5.1%)[5], but the path has been much choppier, with far higher rates of market volatility (see Figure 1).

*Figure 1: S&P500 since Election Night 2016 (**before** and **after** passage of Tax Reform)*

Source: Thomson One

While Donald Trump's protectionist leanings have been well known since the 1980's, he's been particularly prolific in his commentary on the topic since the start of this year. His words, tweets, and actions have been noticed by market participants. If in 2017 his questionable utterances were forgiven on the basis of the pending tax legislation, that pot has been removed from the end of the rainbow in 2018. This helps explain the increase in volatility that we have seen, and further justifies our more cautious stance.

So what is real, and what is bluster? And what would be the impact of the anti-free-trade policies that have been or could be put into place?

It should be noted that most members of the US Congress oppose the imposition of tariffs (taxes on imported goods) – including the majority of Republicans in both houses of Congress. It should also be noted that the US Constitution entrusts the legislative branch (Congress), not the executive branch (the White House) with these types of measures. However, the President has sweeping authority in matters of national security. Under section 232 of the *Trade Expansion Act of 1962*, the President can direct the Commerce Department to investigate and produce a report on the national security impact of specific imported goods, and can unilaterally impose tariffs on goods deemed to pose a threat to national security.[6] This means that as far as tariffs are concerned, the President is empowered to act with or without the consent of Congress, but must do so under the often questionable auspices of national security.

As for the economic impact of "tit-for-tat" tariffs, it could be serious though it would not be certain to cause the recession that many fear. BMO Capital Markets' Economics group has done some work to assess the economic impact of the tariffs that have been put into place to date, and has projected the impact of tariffs that have been put forward but have not yet been implemented.

- The US Picture: The estimated effect of both the imposed tariffs and the proposed tariffs on US gross domestic product (GDP) could be a reduction of about 1.25% in annual economic growth. US GDP growth had been estimated at 2.9% over 2018, though recent numbers have pointed to faster growth.[7]

- The Canadian Picture: As a trading nation, the impact on Canada could be quite serious. The estimated effect of the tariffs that have been announced and measures already in place on Canadian GDP could be a reduction of about 1.50% in annual growth. Canadian GDP growth stands at about 2.1% based on latest numbers.[8]

- The Chinese Picture: The more closed and faster growing Chinese economy dulls the impact of these measures – with the projected GDP cut estimated at 0.75% in annual economic growth. The Chinese economy was projected to grow in 2018 by about 6.6%.[9]

We know that tariffs are a matter of conviction for President Trump, and we know that that he has the authority to act unilaterally in this area, and has a track record of doing so. We also know that the consequences to global economic growth, while not necessarily dire, would certainly be serious. It is far from certain, however, that the scenario laid out above is inevitable. In late July President Trump met with Jean-Claude Juncker, President of the European Commission. Together, they agreed to move towards a zero-tariff policy on non-auto industrial goods. This was not an expected outcome to Juncker's Washington visit, but it shows that there is still scope for negotiated arrangements.[10]

A trade war is the escalation of a series of retributive tariffs applied between countries, and represents the most obvious source of significant short-term market risk. We can expect this part of the story to move forward significantly between now and the end of the year – with a particular eye on the continuation of NAFTA negotiations and the US mid-term elections.

The concerns about trade are short-term in nature. There is no doubt that restrictive trade policies will slow economic growth in the long-run, but the impact to markets is likely to be more sudden and linked to new policy announcements by governments around the world.

Second Hurdle: *Im*balance Sheets

The longer-term concerns we have are linked to the unwinding of the extraordinary financial measures put in place by central banks around the world in response to the financial crisis of 2008. The US Federal reserve initially led the way, lowering interest

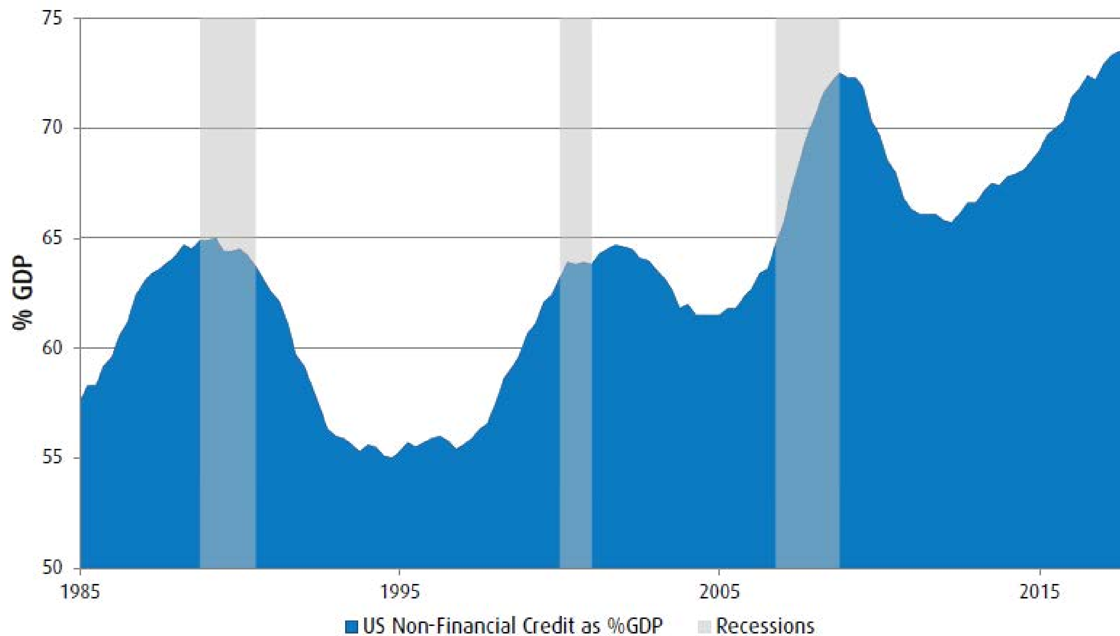
rates to zero, and actually going out into financial markets and purchasing assets using the central bank's balance sheet. Central banks from around the world worked in tandem at this effort. These measures were done with the intention of adding liquidity to a financial system that desperately needed it, and the result was a general increase in asset prices. From stocks, to bonds, to real estate – prices and valuations climbed.[11]

With the economy now in much better health, these measures have begun to reverse. Interest rates have been climbing in some parts of the world (Canada, the US, the UK) and central banks have begun slowing their rate of asset purchases, or selling off assets altogether. Some of these efforts have been ongoing for a few years and some of these efforts are quite recent. We are still at the beginning of this global process.

Just as the emergency measures lasted a very long time and caused growth in asset values over a long period of time, we can expect the reversal of these measures to have consequences that play out over years.

As a result of consistently low interest rates, the corporate sector has financed a greater and greater share of its activities through the issuance of debt. As a share of US GDP, corporate debt levels are currently higher than at any point in the last 30 years.[12] Furthermore, prior instances of similar spikes in the levels of corporate debt have had a tendency of coinciding with the onset of a recession (see Figure 2).

Figure 2: U.S. Corporate Debt-to-GDP



Source: Fixed Income Strategy, Portfolio Advisory Team, July 2018

As the graph above shows, high corporate debt levels are not constant – they occur on a cyclical basis. These measures are also a function of GDP, so even without widespread corporate debt reduction, a growing economy would help address these levels. Furthermore, companies could decide to pay down debt by issuing more shares, and this would not necessarily lead to a negative economic outcome.

We have discussed in some detail short term hurdles around trade policy, and long term challenges regarding the end of central bank asset purchase programs, as well as current high levels of corporate debt. These hurdles constitute the basis for our recommendation to steer portfolios towards more conservative asset allocations.

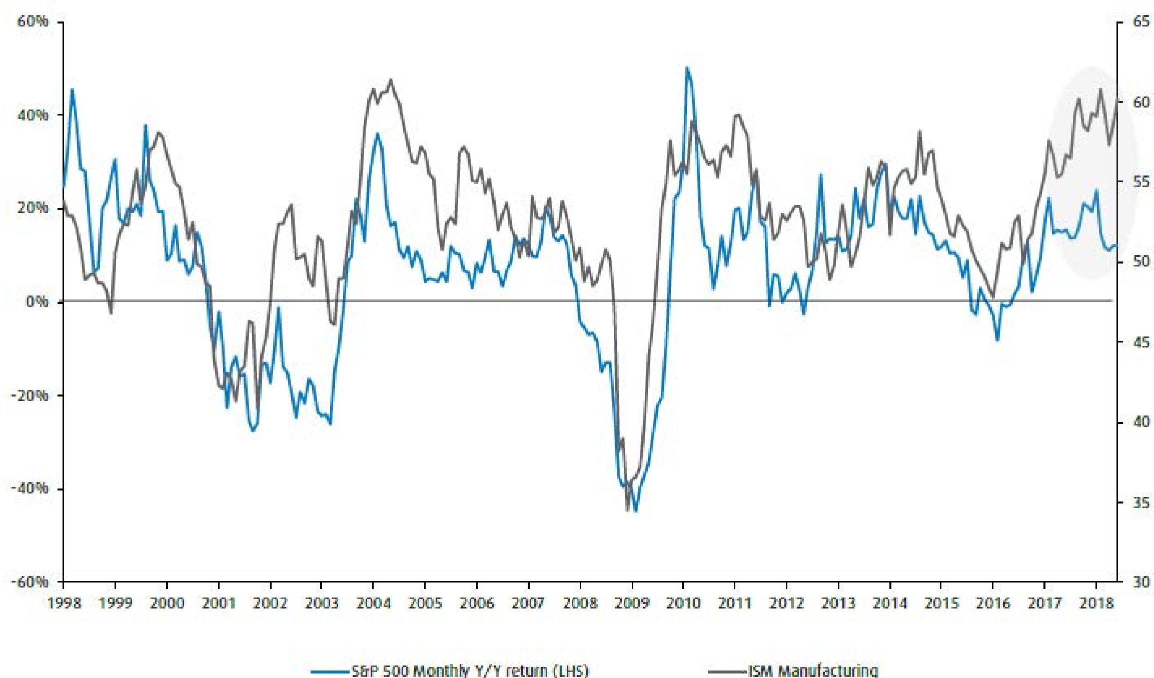
A Wind at our Backs

While we are viewing portfolios through an increasingly prudent lens, there are many indicators that point to continued economic growth. We will touch on some of these with the intention of underlining the reasons why investors can take a prudent stance, but should do so while taking a long term view regarding the core of their investment portfolio.

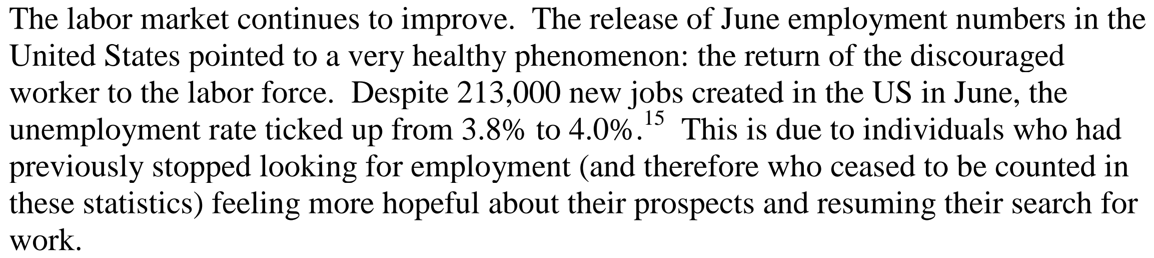
Despite the concerns described above, we are witnessing a period of synchronized global growth, where economies all over the word, be it Canada, the US, Europe, China, India, and most emerging markets, are expanding. The IMF estimates global GDP growth for 2018 at 3.9% - the highest rate of growth the world has seen since 2011.[13]

Survey-based data points are showing that market participants still feel very good about the economy overall. Consumer sentiment is as high as it's been since January of 2004, and business sentiment as measured by the ISM Manufacturing Index is well into expansionary territory and has been trending positively since late 2016 (see Figure 3).[14] It would be difficult to envision a recession in the context of these measures. The producers' survey in particular is considered a strong leading indicator for market growth.

Figure 3: S&P 500 Monthly Returns versus the ISM Manufacturing Index



Source: Equity Strategy, Portfolio Advisory Team, July 2018



The labor market continues to improve. The release of June employment numbers in the United States pointed to a very healthy phenomenon: the return of the discouraged worker to the labor force. Despite 213,000 new jobs created in the US in June, the unemployment rate ticked up from 3.8% to 4.0%.[15] This is due to individuals who had previously stopped looking for employment (and therefore who ceased to be counted in these statistics) feeling more hopeful about their prospects and resuming their search for work.

Strong economic growth, strong consumer and producer confidence, and a strong labour market underpin today's market conditions. It is true that we face serious hurdles in the short and long run, but the market is very well positioned to provide a pushing wind at our backs.

Conclusion

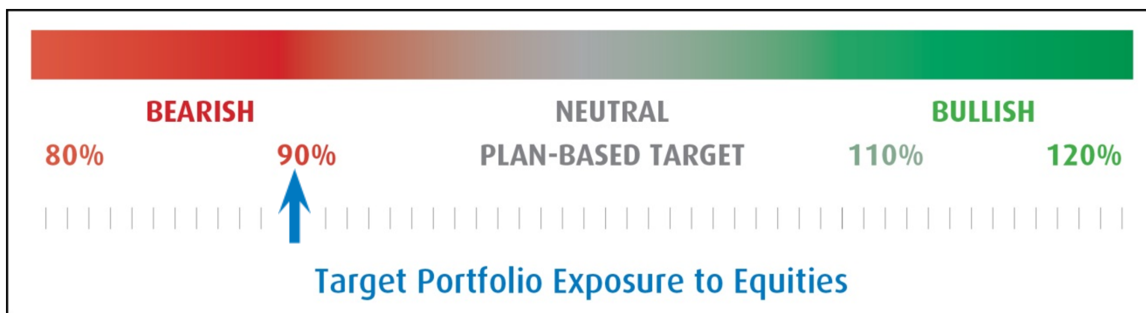
Despite some increasingly concerning headwinds, we are experiencing a period of simultaneous economic growth in most areas of the world. Investors should continue to be the beneficiaries of this growth, but we continue to believe that some caution is required.

- Short term, the most significant risk to markets and to economic growth is likely the emerging trade disputes that seem to be centred on this White House.
- Longer term, the currently high rate of corporate debt, as well as the gradual removal of central-bank-provided stimulus may pose a steady headwind to market growth.
- These risks must be weighed against the generally positive broader economic situation. Robust rates of global economic growth, low unemployment, consumer confidence and strong producer sentiment all continue to support the current economic expansion.
- We continue to recommend that clients maintain a slightly more defensive position than their long term target asset allocation would normally dictate.

Asset Allocation

Every investor's asset allocation target should be determined through a financial planning process. The portfolio's equity allocation should be in line with this target when our view on the markets is "neutral". At times, financial markets will present us with possibilities for greater growth or greater risks. Modifying the asset allocation of the portfolio to account for these factors is appropriate, so long as the investor's actual asset allocation does not deviate too severely from their plan and remains within their investor profile and risk tolerance boundaries.

At this time our view is that portfolios should be tilted as follows (deviations are a percentage of equity exposure, not a percentage of the total portfolio):



For example, a portfolio with a long term strategic target of 60% equity should currently be targeting a 54% equity weight, which represents 90% of the long term equity target.

Please note that our Model Portfolio is meant to be a guide as to the equity portion of our clients' portfolios – not their entire portfolio. Clients who have *Balanced* or *Income* investor profiles will require significant assets in fixed income securities in addition to the equities they hold.

Model Portfolio Metrics

	Model Portfolio	MSCI World Index[16]
Yield*	3.19%	2.41%
Portfolio Beta*	0.86	1.00
Number of Holdings	28	1643
Sector Allocation (Core Portfolio)		
Financial Services	25.0%	16.8%
Telecom. Services	7.5%	2.6%
Real Estate	5.0%	5.0%
Utilities	7.5%	3.0%
Consumer Staples	11.0%	8.3%
Consumer Discretionary	11.0%	12.7%
Healthcare	6.0%	12.2%
Information Tech.	6.0%	18.5%
Industrials	11.0%	11.2%
Energy	5.0%	6.8%
Materials	5.0%	4.9%

*As at 2018-07-31; source: Thomson ONE

Meet Our Team

Elizabeth I. Cosgrove, CFP
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Elizabeth became an Investment Advisor in 1983 after spending her first 8 years in the business working as an assistant. She received her securities license in 1980 by successfully completing the Canadian Securities Course and the Canadian Options Course. Elizabeth achieved her Vice President status in 2004. She has been practicing financial planning as a CFP® certificant since 1998 after successfully completing all six courses offered by the Financial Planners Standards Council. Elizabeth is fluently bilingual and offers her services in either French or English.

Elizabeth was born and raised in Ottawa in a family of eight. She currently resides in Manotick with her husband David. They enjoy golfing, gardening, bird watching and playing music.

Philip Brock, CFA, CFP, F.Pl., B.Com
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Since his entry in the financial industry in 2004, Philip has advised many families on retirement planning, personal credit, and investment management. He holds a Bachelor's degree in Commerce from the University of Ottawa and holds the Chartered Financial Analyst (CFA) designation. In addition, he has been practicing financial planning as a CFP® certificant since 2007, and has held the *Institut Québécois de planification financière*'s F.Pl. designation since 2015. Philip is happy to offer his services in French, English or Spanish.

Born in Montreal, Philip has lived in the National Capital Region since 1987. He calls Orléans home along with his wife Kathleen and their young sons, David, Jonathan and Nicolas. When he's not providing financial advice to his clients, he can usually be found on the ski hill, the curling rink or off in the woods on a canoe trip.

Patricia Butler, B.A.
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Patricia has been in the financial services industry since 1985. She received a B.A. from Concordia University in 1987 and has completed the Canadian Securities Course and the Professional Financial Planning Course. She joined BMO Nesbitt Burns in March 2004. As Associate Investment Advisor, she engages with our clients around issues of financial planning and portfolio maintenance among others. Patricia is fluently bilingual and is happy to assist you in either French or English.

Patricia enjoys reading, playing soccer and golf and spending time with her husband and two children.

Clara Augustine
Administrative Assistant
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Clara has over 13 years of experience in Business Administration and Sales Management. She received her BBA from the University of New Brunswick in 2009, subsequently beginning her career in the financial services industry. Clara worked with several BMO Bank of Montreal branches in a management capacity, joining BMO Nesbitt Burns in 2018. She works closely with each member of the Cosgrove-Brock Group to ensure your administrative needs are met seamlessly in the pursuit of your investment goals, and is pleased to offer her assistance in either English or French.

Clara was raised on the East Coast, but now calls Rockland home, where she lives with her husband and their young children. In her spare time, she is passionate about fitness, and enjoys cooking, writing, playing music and travelling with her family.

[1, 2, 3, 4, 5] Thomson One

[6] Gillespie, Patrick, *President Trump can levy tariffs without Congress*, CNN Money, January 23 2017

[7, 8, 9] Guatieri, Sal, *Tallying Trump's Tariff Tantrum Trauma*, BMO Capital Markets Economics, July 13 2018

[10] Thomson Reuters, *Trump, EU leader agree to talks on lowering trade barriers – will hold off on further tariffs, for now*, CBC News, July 25 2018

[7, 8, 9, 11,13] Capital Group, *Long-term perspective on markets and economies – Outlook – Midyear issue 2018*, June 2018

[12] Belley, Richard, *Sentimental Shift?*, Portfolio Strategy – Fixed Income Strategy, BMO Nesbitt Burns Portfolio Advisory Team, July 2018

[14] Rochon, Stéphane, *Happy Canada Day from Minnesota and Trade Disputes*, Portfolio Strategy – Equity Strategy, BMO Nesbitt Burns Portfolio Advisory Team, July 2018

[15] Kavcic, Robert, *Fed Eyes Return to Normal*, Global Equity Weekly, BMO Capital Markets Economics, July 6 2018

[16] MSCI World Index, MSCI Inc, www.msci.com

[17] Profiles for BNS, BCE, CHE.UN, INE, JNJ, MCD, MSFT, SU, TD, and TRP replicated from the BMO Capital Markets RED Sheet, July 31 2018

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