October 2019 Newsletter

Stagnation & Volatility

I thought I would try and explain the recent market stagnation and volatility of the last couple of months in this newsletter, which may be easier said than done. To try and encapsulate it in two words: 'Trade Deal', is about all you really have to know. However, the ongoing affects and the repercussions that have flowed out of these contentious negotiations have impacted all manner of things globally, led to great uncertainty and consequently a very volatile stock market. The stock market absolutely loathes uncertainty and in general will react badly with the higher the level of uncertainty. This translates into erratic stock movements that we have witnessed over the last quarter, and as the numbers below show going back over a year.

To put it into numbers and try and give you a better explanation of it all, I will use the North American main stock indices as our starting point. Most people are familiar with the **DOW JONES INDUSTRIAL AVERAGE**, often the most widely quoted US equity index, which is somewhat ironical as it comprises of only 30 stocks offering a fairly narrow interpretation of the US market or economy. The other index which is less widely known and quoted is the **NYSE** (New York Stock Exchange Composite Index) which comprises of 1200 different US stocks. This is a much wider view of the US economy and stock market as it includes many different industries and companies. The Third index we will look at is the **S&P 500** which comprises of 500 different stocks and is widely seen as the best indicator of the US economy as it includes the 500 largest companies in the US. When we look at these three indices going back over a year, they all tell a similar story. Look closely at the dates as we are going back to **October 2018**.

Index	Oct 8th, 2018	Oct 28th, 2018	Point Change	% Change
DOW Jones Index	26,486	27,090	604	2.20%
NYSE	13,000	13186	186	1.40%
S&P 500	2884	3039	155	5.37%

In the case of the NYSE which is the broadest index it actually peaked on **January 31st 2018 at 13,524** points. Today it stands at **13,186** points! So going over **20 months,** the largest index in the US is still underwater from where it was in January of 2018.

What of course is less evident to these index numbers above is the volatility that the markets have undergone during this very same period. **At the end of December 2018** the Indices were all in serious negative territory.

Index	Jan 1st, 2018 to Dec 31st, 2018
DOW Jones Index	-5.63%
NYSE	-11.80%
S&P 500	-6.24%
TSX CAD	-11.64%

In January of this year the markets staged a decent recovery which ran through the end of April 2019, only to see the S&P500 peel of -4.5%, and then rally back into the end of July and then pull back -4.3%, and then rally into September and then pullback another -4%, and so you get the story…

It really has been a rollercoaster and I wanted to point out the numbers to you as it is important to realize where things are and have been over the course of the last year. Basically the market has been flat over a longer period of time, yet with these large swings in a very short period of time. Almost all of these swings and spikes in volatility have revolved around the US / China Trade war and the imposition of tariffs or the delay of the tariffs or new meetings or the breakdown of dialogue between the two countries.

Yes, this has made life very difficult for your investment team here! I think we all have a little less hair and looking a little greyer as of late. Our job has also been made somewhat more difficult by the media saying the market has made 'New Highs' but fail to say from when or what point. Yes it is higher than December last year but barely over a year and more in some cases.

Our Strategy

We were fortunate in 2018 in that we managed to navigate around the severe downturn in the markets and because we were not negative for the 2018 year our starting point was higher. We captured some of the rally coming into early 2019 and then as things became increasingly volatile we decided to opt-out and try and spare our clients exposure to the volatility that was becoming all to frequent in the markets.

What this meant was that we sold equity and moved a larger portion into the bond markets in order to find some safety and stability. This strategy worked in terms of stability however by nature the bond market is a slow moving beast and a place to park money when times are uncertain. It is a difficult market to make capital gains in, as bond prices generally move slowly. With the increasing uncertainty we suddenly saw bond prices move higher as investors sought out safety and we saw some bond prices move up over 11% in a short period of time, which is very unusual for the bond market.

In most cases the bonds were break even in our portfolios or showing a slight capital gain. Though this protected us from the spikes in volatility it did not help with performance in your accounts. Our feeling was that the Risk and Reward ratios were too skewed to risk capital in such an uncertain environment.

Yes we missed out on some of the gains in the market in Utility stocks, Gold and the like, however we kept on looking at the major Indies and they were not exactly moving in the right direction.

Fast-forward to the end of October. What we are now seeing is that there appears to be some honest negotiation and discussion between China and the US and at least the promise of a partial agreement on some of the issues. The stock market has started to take this to heart and is now just finally starting to move past where it was in Sept of 2018.

What we are starting to see is the unwinding of the 'Fear Trade', where investors hid out in utilities, cash and bonds, they are now starting to cash in those bonds and move the money back into the stock market. What many investors forget is that bond prices move both and up and down and when you see a lift of 11% in the long bond market you can just as easily see a retracement when the stock market starts to take off. Investors do not want their own bonds paying 2.5% interest when they can buy a dividend paying stock paying 3% with the potential of making a 10% + capital gain. This is the rotation that we are starting to see in the market coming into the end of October and likely to run into the latter part of the year.

We are starting to see a 'Break Out' in many stock prices where we have seen stock prices stagnate and trade in a narrow price band going back several months, we are finally starting to see the prices break through these level as the money begins to flow back into financial stocks, Industrials and Technology names.

As you all know we have been strong believers in Technology over the years and this has stood us in very good stead over the long run. However in the last couple of months the volatility in some of our core holdings like AMAZON, VISA, MASTERCARD, CISCO, Broadcom and others has hurt us. We have seen Amazon trade down over 13%, CISCO over 17% as the volatility spiked. These movements all occurred in the space of about 2 months and highlighted the volatility in the markets. VISA and MasterCard traded down over 7% in 2 days for no good reason. We did our best to sit tight and hold onto these great companies as we look for the turn in the cycle which inevitably comes. As we pointed out above we are starting to see signs of a recovery in the market already as optimism increases.

Global Recession?

What you may ask of the global recession which has been so widely discussed in the media? "It depends" is probably the best answer. Our interpretation is that whether we have a recession in 2020 or not depends entirely on the outcome of the trade negotiations between the US and China. Any agreement including a limited agreement between the two sides should be enough to stave off a recession and drive these markets higher. A complete breakdown or failure to come to any agreement would greatly raise the risk of a recession some time in 2020.

The stock markets of late; and I speak to the last couple of weeks; seem to be indicating that they believe a deal of some sort is likely and therefore have started to move upwards once again, shaking off some of the extreme volatility of the previous months.

Another reason that the stock markets of this world are feeling a bit more positive is also largely due to the Central Banks of this world. At the time of writing 50 of the world's Central Banks have cut interest rates. The European Central Bank is even contemplating putting 'Quantitative Easing' back in place to boost the European Economy. The belief here is the action of the Central Banks is enough to stimulate the economy and stave off a recession in the coming year. Think back to 2008 and how the actions of the Central Banks around the world managed to get the global economy back on track after the 'Great Recession' of 2008.

Just look at Germany for example. Their economy has been in a 'Technical Recession' for the last 6 months as GDP shrunk, largely due to the drop in car exports. However when you look at German Stock Index the 'DAX', it has started to rally upwards. The same can be seen in the Japanese index and some of the other emerging markets.

So in spite of all of the negative media and sentiment the markets are finally starting to show some life after a year or more of stagnation and gut lurching volatility. One of our economic research providers, Cornerstone Macro, has been arguing for a number of months that we are already at the bottom of the economic cycle and that 'green shoots' are already evident in global manufacturing. They argue that the global economy has been in a cyclical slowdown for 21 months and that now the leading economic indicators are all starting to show signs of a recovery. What is slowly becoming evident is that the stock markets are starting to recognize and see the beginning of the turn in the cycle.

One of the main sectors that felt this downturn is the Industrial Sector which has lagged for almost 2 years. Obviously in downturns the Industrials feel it the most, as they are the most economically sensitive when companies are not buying new heavy equipment in times of uncertainty. Yet here we go as our Technical Analyst points out in his Daily Action Report Oct 30th: " Late last week the S&P 500 Equal Weight Industrials index broke out of a **massive two year trading range and simultaneously reversed a 20-month trend of underperformance vs the S&P 500."**

This ties in perfectly with what 'Cornerstone Macro' was stating in their September 31st report. So a month later the market starts to react and move to the positive. The more we look, the more we see signs that there is indeed light at the end of the tunnel for the global economy and consequently the markets.

Some people have commented however that this market has been moving up for too long a period and that this 'Bull Market' is long in the tooth. When we look at the pure data as presented by Russ Visch, our technical analyst, quotes: "Secular bull markets tend to last about 16 years and the most recent one began when the S&P 500 broke out in 2014 so we are still in the early/mid innings."

Russ continues to point out that this most recent period of stagnation has been what is called a 'cyclical bear market' within a longer term 'bull market' that started in 2014. He goes on to state:

The average **12-month gain** in the S&P 500 following a cyclical bear market is **36.4%.**

The average **24-month gain** in the S&P 500 following a cyclical bear market is **57.81%**

Trough-to-peak, the average total gain in the S&P 500 during cyclical bull markets of the past 70 years is **87%.** (Russ Visch, BMO Capital Markets, Daily Action Report Oct 17th)

If Russ is correct then we have some runway ahead of us in terms of the longer term cycle. Yes for sure there is going to continue to be some volatility as we have experienced until we get some definitive action on the Trade negotiations. Bottom line though is that the market and economy seem to be indicating that we are through the worst of it.

Currency and Portfolios

As you are all aware our portfolios have not been immune from the volatility and stagnation that has been evident in the markets the last 3 months or so. We have done our best to shield portfolios from some of the volatility by holding a larger percentage in bonds in both US $ and CAD $. The bonds have lessened the impact of the volatility however have not done much to grow the capital and the bottom line value.

The risk of course with bonds, is that as the stock markets start to improve, investors start to rotate money out of bonds and back into the equity market. When this occurs the bond prices come under pressure and so something that was providing stability in the portfolio can now start to impact it negatively.

As pointed out above we have started to see the rotation in the market the last couple of weeks and so we have acted accordingly by reducing our bond holdings in the portfolio and started putting more of the money back into the equity market. We have bought a number of great companies with very nice dividend yields at fairly inexpensive prices.

You will see new names like: CitiGroup, State Street, Rio Tinto, Brookfield Asset Management, PNC Financial, CN Rail and Waste Connections to name a few.

The risk of course is that we are a little early in the cycle and as always we expect some volatility in the weeks and months to come. However we are investing for the longer term and it is increasingly pointing towards an improving economy and strengthening stock market coming into the latter part of this year and into 2020.

CDN $

We hold a high percentage of investments in all accounts in US $. In some accounts we hold as much as 80% in US $ and only 20% in CAD $. We do this as the US markets have outperformed the Canadian TSX index for over 25 years and for the basic fact that we cannot get exposure to the world's leading companies by trading on the Canadian market.

The downside of this is that we are exposed to fluctuations in the CAD $ to US $ exchange rate on a daily basis. As much as the markets have been volatile so has the US/CAD $ exchange rate with the CAD $ rallying over 3.3% from March through October. This increase in the CAD$ of course has a negative impact on paper, of the US stocks that we own in the portfolio.

So when 50% to 80% of the portfolio is in US $, that of course has an impact on the monthly portfolio valuations that you see, as we report everything back to you in CAD $. We have to report in CAD $ due to the reporting requirements to CRA for taxes.

The bottom line is that we do not convert US $ back to CAD $ and once funds are converted we keep the US $ in US $ and do not transfer back and forwards as we always want to keep our US $ exposure and are not willing to play the currency game.

One reason for the CAD $ strength the last month in particular, is the fact that the Bank of Canada was one of the lone standouts of the Global Central Banks in not cutting interest rates (50 Central Banks have cut interest rates). This made our Canadian Interest Rates some of the highest in the developed world providing some support to our Loonie. However in the Bank of Canada's latest report the pointed to a weakening economy and global uncertainty as factors that might make them cut rates in the coming months. These comments alone were enough to move the CAD $ down by almost 1% in the space of minutes. So yes the volatility that has evident in the stock markets has also applied to the currency markets.

Longer term I remain of the belief that the CAD $ will trade lower once again versus the US $ in the coming years. Our fading Energy Sector, lack of foreign capital and growing Federal deficit are likely to weigh negatively on the currency. (Encana is one of the latest energy companies to cut their CDN affiliation, dropping the 'cana' from their name and moving headquarters south of the border. TransCanada, now TC Energy, did the same thing last year). The main driver of GDP in Canada this year has been 'Government'. I for one find this a little depressing as the only thing growing is the size of Government and their expenditures, which is not the sign of a healthy, well diversified economy. Enough said.

Bottom Line

We have come through the last couple of months a little battered and bruised by the market volatility and currency fluctuations, yet in general survived fairly well in uncertain times. We continue to see an improving longer term picture for the markets and the economy and so have positioned ourselves for that next leg in the recovery. So yes we see light at the end of the tunnel.

New Staff Members: We welcome Lili Hao as Investment Advisor and Sophie Xiong in Administration to our team and you will see communications from both of them in the coming months and years.

Regards,

From our Team: Jed, Greg, Marion, Dave, Kenzy, Samantha, Lili and Sophie.

I thought this little piece an interesting comment and some things that we do not always consider when reading the headlines:

Why is Beijing potentially embracing a truce? One answer is Hong Kong, which accounts for the bulk of FDI into China ($90b in 2018, versus roughly $20b for Asia ex HK, and less than $5b from the U.S.). And China uses HK as a way for Chinese companies to access foreign capital. As a *WSJ* article highlighted last Wednesday, "Since 1997, mainly Chinese companies have raised $335b by floating in HK, tapping a broader range of shareholders than they could onshore." In addition, "HK is by far the largest offshore center for bond sales by Chinese firms…" So, a HK shutdown would tighten financial conditions for the mainland – a headwind on the improving Chinese economy (e.g., mfg PMIs bottomed in January 2019, and have since been zig-zagging higher). HK turmoil threatens to offset some effects of Beijing's massive stimulus. The sooner a trade truce is signed, the better. (Cornerstone Macro Oct 29th)

This third party publication is not prepared or approved by BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltee/Ltd. ("BMO Nesbitt Burns") and therefore does not meet Canadian research disclosure requirements applicable to BMO Nesbitt Burns. The opinions, estimates and projections contained in the publication are those of the author as of the date indicated and are subject to change without notice. BMO Nesbitt Burns makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors or omissions which may be contained therein and accepts no liability whatsoever for any loss arising from any use of or reliance on the report or its contents. The provision of this publication is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities. BMO Nesbitt Burns or its affiliates may buy from or sell to customers the securities of issuers mentioned in this publication on a principal basis. BMO Nesbitt Burns, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities of issuers mentioned in the publication, related securities, or options, futures or other derivative instruments based thereon. BMO Nesbitt Burns may act as financial advisor and/or underwriter for certain of the issuers mentioned therein and may receive remuneration for same. BMO Nesbitt Burns is a wholly owned subsidiary of BMO Nesbitt Burns Corporation Limited, which is an indirect wholly-owned subsidiary of Bank of Montreal. Bank of Montreal or its affiliates may have lending arrangements with, or provide other remunerated services to, the issuers mentioned herein. The reader should assume that BMO Nesbitt Burns or its affiliates may have a conflict of interest and should not rely solely on this publication in evaluating whether or not to buy or sell securities of issuers discussed herein.

® "BMO (M-bar roundel symbol)" is a registered trade-mark of Bank of Montreal, used under licence. ® "Nesbitt Burns" is a registered trade-mark of BMO Nesbitt Burns Corporation Limited, used under licence. BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltée are indirect subsidiaries of Bank of Montreal.

The opinions, estimates and projections contained herein are those of the author as of the date hereof and are subject to change without notice and may not reflect those of BMO Nesbitt Burns Inc. {"BMO NBI"). Every effort has been made to ensure that the contents have been compiled or derived from sources believed to be reliable and contain information and opinions that are accurate and complete. Information may be available to BMO Nesbitt Burns or its affiliates that is not reflected herein. However, neither the author nor BMO NBI makes any representation or warranty, express or implied, in respect thereof, takes any responsibility for any errors or omissions which may be contained herein or accepts any liability whatsoever for any loss arising from any use of or reliance on this report or its contents. This report is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities. BMO NBI, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities mentioned herein as principal or agent. BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltee/Ltd. {"BMO Nesbitt Burns") will buy from or sell to customers securities of issuers mentioned herein on a principal basis. BMO Nesbitt Burns, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO Nesbitt Burns or its affiliates may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same. A significant lending relationship may exist between Bank of Montreal, or its affiliates, and certain of the issuers mentioned herein. BMO NBI is a wholly owned subsidiary of BMO Nesbitt Burns Corporation Limited which is a majority-owned subsidiary of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Nesbitt Burns Corp. and/or BMO Nesbitt Burns Securities Ltd. Member-Canadian Investor Protection Fund.

Member-Canadian Investor Protection Fund

If you are already a client of BMO Nesbitt Burns, please contact your Investment Advisor for more information.

BMO Wealth Management is the brand name for a business group consisting of Bank of Montreal and certain of its affiliates, including BMO Nesbitt Burns Inc., in providing wealth management products and services.

BMO Nesbitt Burns is a member-Canadian investor protection fund and member of the Investment Industry Regulatory Organizations of Canada.