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Year Ahead Outlook

A year ago when we wrote our outlook for 2018, we discussed the following areas of potential concern:

1. A U.S. stock market that looked “pricey” from a valuation standpoint, particularly technology-oriented stocks.

2. That investors may be lulled into a false sense of security due to an extended period of lower-than-normal volatility in terms of stock price movement.

3. Speculative investments such as ‘Bitcoin’ and its related investments trading way too high which indicated too much investor appetite for ‘risk’.

4. Challenges in all areas of the bond market with safe bonds paying very little and riskier bonds not paying enough to justify the added risk. Given ultra-low interest rates and the inverse relationship between interest rates and bond prices, we did not feel comfortable doing the traditional ‘sell down stocks somewhat and buy bonds’, as we anticipated weak bond market performance in 2018.

5. Concern as to how stock markets and companies in general may fare in a rising interest environment and how markets would respond when central banks finally stop using quantitative easing (QE) -- their ‘term’ for printing money electronically and using same to buy back publically-traded fixed income investments, in order to make interest rates low.

Our overall stance was to ‘play some defense’. We did this by underweighting U.S. stocks (particularly technology stocks) and avoiding individual stock and bond related investments that we deemed ‘too aggressive’; and concentrate instead on companies selling goods and services that are ‘needed’ instead of ‘wanted’. We also ensured our fixed income assets were tilted towards good quality.

Overall, the themes we were concerned about have materialized and we experienced a decent sized market sell-off towards the end of 2018.

So how did portfolios do? This past year was our first down year in many years. A typical client was down about 2% to 3% for the year. Relative to markets, we held in ‘ok’.

What we expect going forward

In general, we feel better heading into 2019 than we did into 2018, but let's look at some key metrics to try to get a handle on risk and return potential in financial markets:

Bond (fixed income related investments):

We are still challenged by (below normal) nominal and real interest rates, thus the risk of lower bond prices (in a rising rate environment) remains. Real interest rates (using 10-year U.S. treasuries minus U.S. core inflation as a proxy) remain well below average at 0.45% versus a historical average of 2.36%.[i] The U.S. Federal Reserve has ended its bond buying frenzy (QE) and is now starting to slowly reverse QE by selling bonds back into the market place. The 'Fed' seeks to get rid of about 2.6 trillion dollars of bonds over the years ahead. This will occur at the same time that 'debt-comfortable President Trump' and his Republican colleagues cut taxes to the extent that they will run a one trillion dollar deficit in 2019, with no sign of big deficit financing ending. Significant deficit financing means the U.S. federal debt-to-GDP ratio is set to increase from 78% of GDP to a projected 98% of GDP in 10 years' time.[ii]

The combination of both Federal Reserve and federal government bond selling will far exceed record levels going forward, so the possibility that higher medium- and long-term interest will be needed to incent these bond purchases remains. In addition, the Fed is still signaling higher short-term interest rates in 2019.

Fortunately, the rest of the developed world has lower interest rates than the U.S. so that will incent foreign buying of U.S. treasuries, although the European Central Bank plans to stop its bond buying (QE) program shortly. Thus, European interest rates will likely increase at some point making European bonds more attractive than today (e.g.10-year German government bonds pay a paltry 0.28%).

Our strategy of staying with short- to medium-term bond maturities (to mitigate the risk of lower bond prices) and above average bond issuer quality will remain as we go through 2019.

One area of fixed income that we use, 'preferred shares' typically issued by banks, pipeline and utility companies, has seen lower prices of late due largely to the overall sell-off in financial markets. With attractive company guaranteed dividend yields of about 5.5% right now, and increasing dividend yields in future (if interest rates go up), preferred shares look quite attractive at current trading levels.

The stock market: Let's look at the pros and cons

<u>Pros:</u>

1. A combination of lower share prices this past year and good corporate earnings growth means even the more expensive U.S. stock market is trading now at a reasonable 14.4 price to earnings multiple on forward expected earnings. This compares with a historical (1955 to 2018) average of 16.5 time earnings. The world stock market (outside the U.S.)

trades at an even more reasonable 11.5 times forward earnings and has a well above average dividend yield of 3.8%.

2. Sentiment (investor confidence) is more bearish than bullish, which is actually a positive indicator. Conversely, when investors feel good about returns and future prospects, it's time to start worrying. With aggressively priced investments such as bitcoin/block chain, cannabis companies and 'The FAANGs' (Facebook, Apple, Amazon, Netflix, and Google) falling significantly, we no longer worry about excessive 'investor enthusiasm'.

3. Unemployment in the U.S. and Canada is at record lows with no obvious threat to same for the next year or so.

4. Stocks certainly look better than low yielding bonds on a longer-term basis; and dividend yields on banks, pipeline, and utility and consumer staple stocks are quite good at present with many yielding in the 4% to 5% area.

Cons:

1. As said, the current price-to-earnings ratio (P/E ratio) is lower than average. While a low P/E ratio is more of a positive than negative, we still need to focus on where the "E" part of P/E is headed, namely 'corporate earnings'. The past four years has seen a strong increase in company profit margins due to productivity enhancements (technology and automation), low interest rates and globalization – all of which brings costs down and profit margins up. The rise in 'populism' as evident by the elections of Donald Trump and others (including a fellow who traded in his job as a comedian to become the current leader of Italy) tends to threaten economic and political cohesion which in turn can negatively affect corporate earnings – as the benefits of globalization to corporations sees setbacks and uncertainty. Brexit is further evidence of how populism can negatively affect financial markets. Higher interest rates will also challenge corporate profit margins.

2. The trade war between China and the U.S. is currently front and center in investors' minds. We have seen huge daily swings in the stock market of late as a result of investor focus on any positive or negative White House statements relating to this issue. We are already seeing lower earnings expectations being announced by many U.S. companies as a result of tariffs and uncertainty around their global organization of 'supply chain management'. China has now equaled the U.S. in GDP (adjusting for purchasing parity which factors in their lower valued currency) and on a projected basis will match the U.S. (in U.S. dollar terms) in a little over ten years. This has many geopolitical ramifications, almost all involving economic and military supremacy. World history is full of examples of things going wrong when power changes hands. China's growing military power, its ambitions in the South China Sea and wish to unify with Taiwan are among many potential flash points over years ahead. Regarding current trade tensions, our guess is that due to economic interdependence and mutual benefit, they will likely come to some form of trade agreement, but in the meantime, hold on to your hats as investors are very focused on this issue.

3. We are nine and a half years into a long period of economic expansion and that brings to light ‘recession risk’. While we see little risk of this in the short term, some are calling for a recession in 2020. The stock market may not fare badly if it is a mild recession, but market history includes examples of a quick reversal from low to high unemployment, which in turn can cause an economic downturn.

4. Lastly, we wonder how investor emotions will fare in future down market conditions when investors can now see their account values in real time with the click of a few buttons on their phones. It may lead to enhanced volatility? P.S. Pope Team Health Canada Warning “frequent checking of account values can be hazardous to one’s health”

Stock market conclusions given all of above

Fundamentally we are quite comfortable with the companies we own and the highly diversified portfolio management method we employ will take care of buying the odd company that may surprise us on the downside; and valuations, as said earlier, are quite reasonably. Over the long haul, as long as the consumers and businesses continue to need goods and services, companies will on average make money selling them.

We will keep risk and quality very much in mind, and it never hurts to take the proverbial ‘long-term mindset’ which in all previous times has proved to be a successful way to invest.

Dalbar is a U.S. company that has tracked actual investor returns for decades now and their latest published numbers show a return of just 2.7% per year (long-term) for U.S. investors (from 1998 to Dec 2017). The main reasons for underperformance they continue to identify are:

1. Putting too much money into stock markets and particular stocks/mutual funds when they are priced ‘too high’ and selling when they are low.

2. Incurring too high money management costs.

We are very cognizant of both these issues and do what we can to help mitigate this.

Bits and Bites

We continue to use a portion of client fees towards funding the ‘Scientist in Residence Program’ https://scientistinresidence.ca at inner city schools through CIBC Miracle Day. This past year, we, along with the other advisor team in our office, funded the program at two schools, namely Brock and Strathcona Elementary. For 2019, we plan to double the program to four schools. Thanks very much for your support for this great program where a scientist from UBC works with teachers and students doing hands-on science lessons. The lesson plans are then put ‘online’ for free access and are used by teachers to help kids (as far away as Africa) learn and enjoy science.

For clients who check account values online within the month, occasionally a particular investment will show as ‘no value’ for a day or two. This is due to our firm having to re-register some aspect of the security within the month. Thus, if your online account value seems down by an amount that is not explained by market conditions, this could be the reason why. Scan your account holdings to check or feel free of course to call in.

The TFSA limit for 2019 has increased to $6,000*. Many clients have asked us to fund their TFSA by re-registering funds or investments from their non-registered accounts. We are working on this now and anticipate being all done by early February. For those who have never contributed to a TFSA, the maximum catch up room is $63,500.

It’s RRSP time. The 2018 maximum is $26,230** and for 2019 it increases to $26,500. Your limit is 18% of last year’s income (minus pension income adjustment for those with company pensions). You can check your CRA notice of assessment for your RRSP limit (and see any unused contribution room from previous years). The deadline is the end of February.

For non-retired clients, consider monthly or bi-weekly automatic savings contributions. It’s by far the easiest way to save.

As we head towards tax season, we wanted to let clients know that for the first time, our firm is now in position to forward all clients a report showing any ‘sells’ that need to be declared, with corresponding tax costs.

We want to thank all clients who mentioned our services to friends and family members. Our minimum account size is currently $500,000 but as always, we are pleased to work with all children or grandchildren of existing clients regardless of account size.

We hope you had a nice Christmas and New Year and we very much appreciate you entrusting your financial affairs with our team. All the best in 2019!

Cheers,
CIBC Wood Gundy

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 * The annual dollar limit between 2009 and 2012 was $5,000. In 2013 and 2014 the annual dollar limit was $5,500. In 2015 it increased to $10,000, and reduced back to $5,500 2016 to 2018. $6,000 in 2019. **Less any Pension Adjustments.

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[i] Source: BLS Fact Set, Federal Reserve, JP Morgan Asset Management, as of Dec 31, 2018.

[ii] Source: Congressional Budget Office, Economic Outlook, August 2018.