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# Should we have sold in May and gone away?

As we were thinking about a title for this letter, we first thought about non-exciting titles like ‘Market Update’ or ‘Summer Update’.  Instead, we pondered about the pullback experienced in May, so borrowed our title from the old adage; that over previous market history, stock markets have tended to underperform from May to about mid-October. We have never believed that this theory can be used to any real advantage on go forward basis, but hopefully we came up with a more catchy title than ‘Market Summer Update’.

Let’s try and put some perspective to how and why stock and bond markets are doing what they’re doing, since we sent out our last ‘coveted’ Pope Team newsletter in early 2019.

As we closed out 2018, stock prices dipped into bear market territory - led by a twenty percent downward move in U.S. stock prices. What caused this? In a sense, we were due for some kind of pullback after some pretty strong equity performance. Also, worries about the U.S. Federal Reserve increasing interest rates, combined with concern that the global economy was due for a recession were the main reasons for the market’s decline.

This brings to mind another old adage namely “when just about everyone thinks something will happen, the opposite is more likely to occur”. Regarding interest rate direction, this proved to be the case as the U.S. Federal Reserve surprisingly changed strategy and signaled that interest rate increases were ‘on hold’.

Today everyone seems to think interest rates will stay the same or even go down a bit. Our best guess is that in the short-term, interest rates stay even (or go slightly lower) until central banks (such as the Fed) have a better understanding of the impact of current trade tensions and how the economy is doing; thus the future direction of rates will depend mostly on global economic news and results.

In the longer term, while this low interest rate environment appears to be a long-term secular trend for the foreseeable future, we still have to be prepared for higher interest rates just in case they do materialize. Thus, we are avoiding long-term bonds and continue to like fixed-reset preferred shares which pay a good yield and should do very well price-wise in any increasing interest rate environment.

The U.S. Fed reversal on future rate direction not only gave the economy a reprieve from higher interest rates, but also caused medium- and long-term bonds to rally prices wise – and higher bond prices means of course lower interest rates - which in turn incents money back into potentially higher earning stocks. Thus, until this just past month of May, we had a strong start to 2019.

Well, ‘that was then, this is now’, as during the month of May, optimism about financial markets turned sour due to today's Trump-tweet-sensitive financial market, worries about the U.S. failing (for now) to make a trade agreement with China, plus the ongoing dysfunctional Brexit.

As one may gleam from the above commentary, trying to guess where we are headed from here (in the short-term) is ‘pure coin-tossing guesswork’. Will the U.S. sign trade deal with China? In longer term, yes, but in the shorter term, who knows? And right now, the market is trading off of news related to this event.

Instead of trying to ‘guesstimate’ short-term market movements, let’s stand back and look at the many big picture issues that historically have given us a bit of a clue as to where things may be headed over the medium- to longer-term:

1. By far ‘number one’ on our list of key things to be thinking about is how high or low are stock prices? Whether it’s stock prices, real estate or any other asset class, it has been very predictive that ‘too high prices’ mean higher risk and lower expected returns -on go forward basis. Some investors feel that share prices are so high these days that they have to fall from here. The data does not back this up though as you see below. Here are a few key long-term returns taken from the attached Monthly markets report:

| | 5 years | 10 years | 20 years |
|---|---|---|---|
| CDN Stocks (TSX) | 5.0% | 7.6% | 7.0% |
| US Stocks (S&P 500) | 4.7% | 13.9% | 5.8% |
| Europe/Asia Stocks (EAFE) | 1.8% | 6.7% | 4.4% |

Source: CIBC PWM, Monthly World Markets Report, June 2019

As you see, longer-term returns seem ‘pretty normal’, not excessively high, so comparing stocks (which generate about a 6.5% earnings yield) vs. today's low yielding bonds, one can make the argument that share prices do not seem overvalued.

2. U.S. share prices seem a bit too high though and this is a legitimate concern that we have to factor in. Our well-diversified portfolio (geographically) helps mitigate part of this risk.

3. When one looks at the U.S. market, technology stocks have been responsible for most of the outperformance so a further way to mitigate risk is simply underweight tech stocks (which we are doing). We are prepared to lag a bit if markets do well from here (as tech stocks usually outperform in up market) but prefer to err on the safe side as tech stocks seem richly valued at the moment, and typically fall more than average during market downturns. Having said this, we are currently reviewing a possible buy of Apple, one of the few tech stock's that is valued reasonably in terms of valuation metrics. Its share price has fallen enough from its previous high to warrant a good look. Longer term, Apple is a company that despite its amazing success, has a degree of uncertainty, but shorter term, we believe there may be a trading opportunity as the market seems to be underestimating the massive amount of phone replacement that we believe will come, to allow for 5G. P.S. suggest holding off on new phone purchases until 5G comes. Personally I still have an

Apple 4S (most clients under 50, and some older, are laughing). My previous phone was a Nokia flip phone. (I hear more laughter).

4. Overall, we are able to find many companies and areas of the world to invest in that have normal (not high or low, but normal) valuations; thus we feel that longer-term, equities look ‘ok’. As always is the case though, events (good or bad) in today's fast changing connected world will drive short-term market performance.

So let’s now look at some of the main risks that investors are paying attention to:

## ECONOMIC RISKS

1. We have yet to experience any negative fallout from the grand economic experiment still going on named ‘quantitative easing (QE)’. In fact, asset prices (stocks and bonds) and the global economy in general, have very much benefited from the past ten years of below normal interest rates. Germany for example has a *negative* 0.2% interest rate on its ten-year government bonds, France pays zero interest on its ten-year bonds and Japan’s interest rates are about zero across its whole yield curve. Low interest rates do not incent prudent fiscal policy- with the most dramatic example being Japan’s massive debt load (250% of GDP!).

2. The U.S. Fed had planned to decrease its huge (close to five trillion dollar balance sheet) with the goal of mitigating some of its previous fixed income buying spree (done using electronically printed money); however the Fed seems to have changed its tune as it now plans to simply shift its buying away from mortgage back securities, to long dated U.S. federal treasury bonds.

3. The U.S. federal government is running a massive annual one-trillion-dollar deficit (that’s 1,000 Billion, with a B!). To put this in perspective, Canada’s ‘not so small’ annual federal deficit is currently about 20 billion dollars. As we are about 10% of the size of the U.S. (GDP-wise), a U.S. level deficit here would be a whopping 100 billion dollar deficit. Thus, the U.S. is likely stimulating its economy too much given record low unemployment levels. Simply put, the U.S does not need such massive fiscal stimulus to support its economy. Most economists would agree that large deficit spending should be saved for recessionary environments. The Fed must think it better step up and buy some of the massive U.S federal government bond supply with its ‘electronically printed money’, thus the decision to buy about 30% of bonds being issued to finance the U.S. deficit. This is not a sign of strength. These aggressive monetary and fiscal policies have helped stock and bond markets and the economy in general in the past ten years, but we need to be cognizant of the potential resulting risk of an ‘asset bubble’. Thus we prefer to not ‘swing for the fences’ and ensure we have very high quality in terms of stock and bond positions. This month’s Monthly World Market Report (attached) discusses the longer-term advantage of owning lower-risk high-quality stocks vs less predictable companies/industries. It also discusses

one of our high quality companies, Nutrien (a Pope Team model portfolio pick), the world's largest crop nutrient company.

4. Demographics, namely an ageing population in most of the developed world and China, means the global economy must get used to lower economic growth going forward, than what we have seen in the past.

5. Trade protectionism risk, which is a clear negative in terms of GDP growth, is clearly elevated at the moment.

## GEOPOLITICAL RISKS

Our world always has many of the above, and it's often not the event that is currently seen or predicted that affects markets. Here though is list of the main geopolitical risks we can think of:

1. Cyber-attacks, be they financial or military, which can have severe consequences in our increasingly connected world.

2. China's growing influence and military power and possibility of conflict with the U.S. as China takes over global economic leadership in the next ten years or so.

3. The risk of conflict between the U.S. and Iran.  U.S. ally Saudi Arabia (Sunni religion) is fighting a proxy war with its age old Shiite rival (Iran) in Yemen; meanwhile, the Trump administration has brought punishing sanctions on Iran in an attempt to renegotiate the Iranian nuclear deal, plus in retaliation for Iran's support of Hezbollah in Lebanon and Hamas in Gaza. Conflict could come from an accidental or planned confrontation in the strategically key shipping route of the Strait of Hormuz. Iran's recent shooting down of a U.S drone almost led to military confrontation. Israel's bombing of Iranian military operations in Syria also exemplifies the ongoing tension between Israel and Iran that could result in the U.S. being drawn into conflict between these two countries.

4. Populism- which has a nasty side in terms of drumming up conflicts, racism and uncertainty. While most of the developing world has made major strides in improving living standards, this is not happening in the developed world where the rich are indeed getting richer while poor and middle class see no growth in terms of real income. In the U.S. for example, the top 1% now control 39% of U.S. wealth while the bottom 90% own only 26% of wealth. Without policies to address this imbalance, populism looks like it's here to stay.

5. Having returned recently from a CIBC conference in Washington where we heard from many interesting speakers (such as James Comey and Ex CIA head, John Brennan), it's even more clear to us how unpredictable the White House is under its current leadership.

## Our stance and portfolio positioning

Our objective for clients, portfolio wise, is to have a Plan A for good markets and a Plan B for bad markets.

Maybe today's stock prices will prove to be somewhat too low given the low rate alternatives in the bond market, low levels of unemployment and the fact that many companies are buying back their own shares (a record 1.1 trillion in the U.S). Throw in productivity enhancements due to increased use of technology, the coming use of artificial intelligence and the massive increase in bandwidth and speed coming with 5G, and maybe we have a nice run upwards in share prices; or perhaps instead some of the aforementioned risks come to roost, causing markets to sell off. Thus the need for a Plan A and Plan B.

Our average client is a bit over 60% equity with the balance in fixed income (bond) related investments. This allows for reasonable long-term growth taking without excessive risk and our fixed income investments provide us the opportunity to take advantage of buying opportunities in the event of any large drop in stock prices.

Our fixed-income quality is good, as there continues to be not enough ‘incremental yield’ on riskier bonds to justify much exposure to same.  We are taking just enough risk on fixed- income to get our yield up to about 4%. As said earlier, we are also maintaining our short to medium term bond maturity date strategy to help mitigate the risk of lower bond prices -in case interest rates increase.

We continue as well to emphasize lower risk (defensive) type equities and will always have a significant amount of geographical, industry and individual investment diversification.

We are nearly complete in terms of converting the majority of the 650 families we work with to our discretionary trading process called ‘AMA’ (Advisor Managed Account). We feel this will benefit all clients (whether they are set up discretionary or not), as we can now do some of our trading (about 50,000 trades per year) more efficiently and effectively on a bulk basis and we can make adjustments to the portfolios in a more timely manner. This also allows our practice more time for our money management role, plus estate, financial and tax planning.

The paperwork for our AMA account allows us to utilize up to 10% in privately valued investments in order to emulate what Canada’s leading pension funds have been doing. Thus, we can now add an additional asset class that typically is not sensitive (price wise) to public market risk and generate what we expect will be healthy longer-term returns. We are prepared to add exposure (up to 10%) to these privately valued pools of assets (bonds, mortgages and commercial real estate) should public markets do well from here- and we thus see further need to dampen risk.

Please call with any questions or needs whatsoever. The more complex, the better. As we have done this job ‘for a while now’ and we enjoy delving into complexities if need be.

Have a great summer!

Cheers,
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