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# 2020: Year Ahead Outlook (Cautiously Un-pessimistic)

As portfolio managers, anytime we have a good run upwards in account values, we do our best to prepare in case markets reverse course. Our title above describes how we are positioning portfolios for both further upside potential, while being very cognizant of our industry's proverbial four-letter word, 'risk'.

This past year's return performance was strong, with most of our diverse asset classes (in fixed income, REITs and equities) performing well.

A combination of lower (therefore better) valued stocks due to market declines in late 2018 and the resulting surprise move downwards in central bank interest rates were likely the main drivers of strong returns in 2019. Across the globe, there were 90 interest rate cuts among 45 global central banks; with notable exception of the Bank of Canada - which kept its managed short-term interest rate 'as is'.

If interest rates were anywhere near 'normal', we would be preparing for downside risk by re-balancing a bit out of stocks and into bonds. The problem with doing this traditional 'risk off' trade is that real inflation adjusted interest rates are very low on safe bonds. In addition, any future increase in interest rates will result in lower bond prices.  Consequently, we could earn next to nothing (or even a negative total return on bonds) over the next couple of years. Regarding riskier 'high yield bonds', we also don't see this asset class as a place to go as an alternative to stocks. In fact, we have cut our high yield bond exposure significantly over the past few years as these bonds don't pay enough extra yield to justify the risk.

Interest rates are close to record lows (and even negative on over 15 trillion dollars' worth of European and Japanese government debt). This is likely the single biggest risk we need to be aware of.  It is inevitable that more money than usual will be incented into riskier but better paying investments (namely stocks, real-estate and higher-yielding-lesser-quality bonds). More money than usual flowing into these asset classes can cause overvaluation. Thus, despite several legitimate 'positives' (to be discussed below), we must be very cognizant of risk management and focus on ensuring that each investment we put your hard-earned money into has a high degree of quality – at a reasonable valuation.

Heading into the next year, it looks probable that the global economy will add one more year (at least) to the longest economic expansion in modern history. While global trade tensions (U.S./China and Brexit) has resulted in less corporate capital spending, low unemployment levels and now low interest rates have more than offset same.

On the home front, the last time the Canadian economy had a recession without one occurring in our largest trading partner, the U.S., was way back in 1951. The good news is it looks very unlikely that the U.S. will fall into recession this year, despite trade tensions, as a whopping 70% of U.S. GDP is based on non-trade-related consumer spending. The average U.S. consumer is in good shape due to reasonable real income growth, rising home prices and moderate household debt, thus consumer spending is relatively strong. With record low U.S. unemployment, low interest rates and a massive one trillion-dollar federal deficit -creating a big 'sugar effect'- most economists predict about 2% U.S. real GDP growth in 2020-despite largely self-inflicted trade dispute wounds.

Overall real global GDP growth in 2020 is estimated to be about 3%, as once again, emerging economies around the world outgrow developed economies-a trend that had been in place for many years now. If consensus growth estimates materialize in 2020, stock markets may enjoy another decent year, given stock valuations, while not cheap, are reasonable and may attract more buying demand than low yielding bond and GIC alternatives.

What can go wrong? Trade tensions can worsen, geopolitical risk can increase (e.g. U.S./Iran as just experienced, or U.S./North Korea); and in the longer term, excessive levels of borrowing by major countries such as the US and Japan creates an eventual debt burden- that these demographically aging countries have yet to reckon with. In addition, while there are very few signs of a recession in the shorter term, we must remain cautious, as we are well into record economic expansion territory and inevitably a recession will come.

Regardless of what risks we think may occur, oftentimes it's not the risk we can identify but some other risk that comes from 'out of the blue' that derails markets. Thus, we have the need to try and decrease downside risk while recognizing the return challenge (as discussed above) that paltry returns in the bond market mean.

Regarding Canada, we have mixed bag of pros and cons. The pros, however, seem to outnumber the cons. On the positive side, excessive levels of provincial government debt are finally being dealt with. Five provinces are in a fiscal surplus and four are projected to be in balance by 2023 (and even fiscally challenged Ontario by 2024). While the federal deficit will be about $26 billion in 2020, the key overall 'debt to GDP ratio' is declining at the federal level.

Record levels of Canadian household debt are a concern. However, balancing this concern is a likely rebound in resource exports as prices of oil, natural gas, lumber and gold improve. Our analysts at CIBC Wood Gundy think the improvement will continue in 2020.

A record low level of Canadian worker unemployment is another positive along with the fact that unlike the U.S, Europe and Japan, Canada never engaged in the monetary policy experiment of "quantitative easing" (printing money to buy bonds). Perhaps our previously underperforming Canadian stock market has turned the corner-which was the case in 2019.

## How are we trying to decrease risk?
## without decreasing stocks and increasing bonds

Firstly, keep doing what we have always done namely:

1. Ensure low individual stock risk (by keeping position sizes low) and through use of low cost and well diversified equity Exchange Traded Funds

2. Utilize significant industry, geographical and currency diversification in terms of equity exposure.

3. Ensure the use of numerous equity and fixed income asset classes that are not highly correlated return wise to each other.

4. Think more contrarian and value oriented in investment selection than 'follow the pack momentum investing' (thus now underweight both high priced U.S stock market and high-priced U.S tech stocks).

5. While we have tilted portfolios towards defensiveness by using mostly reasonably valued defensive individual equities, our broad-based ETFs give clients ownership in over 6,000 companies around the world; and thus, ensure ownership in all diverse industries in the global economy- including technology. Some of these tech companies will do very well as many industries deal with disruptive change due to technological advancements.

6. Avoid individual stocks in new and unproven industries that may seem exciting to jump into on the ground floor (e.g. cannabis and cryptocurrency stocks) but always seem to eventually disappoint.

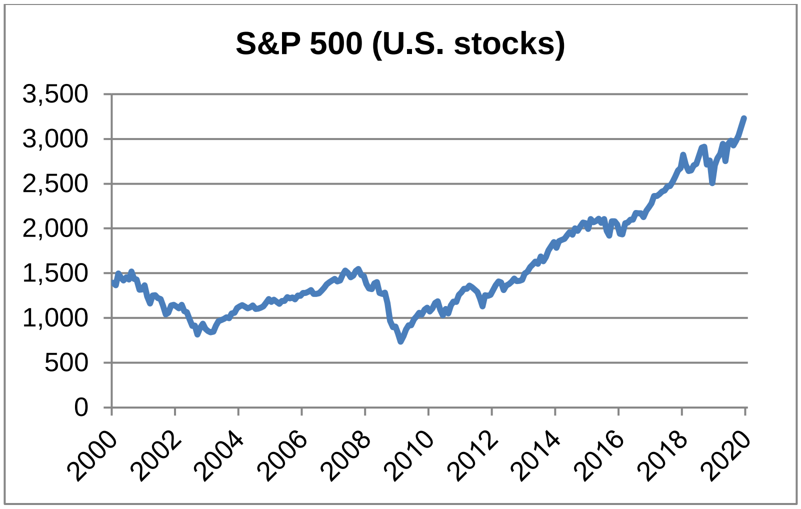
7. Continue to use our 'buy low sell high' and contrarian 'Dogs of Dow strategy'. This strategy has worked very well for clients since we began using it 20 years back (don't worry, I'm touching wood!).

8. Despite low returns on bonds, we still have reasonable exposure to some for safety, liquidity and income generation. Also, this keeps some 'powder dry' to add to stocks if a market decline results in a good buying opportunity.

9. Keep client money management costs below industry average and eliminate and/or minimize any outside money management cost as much as possible.

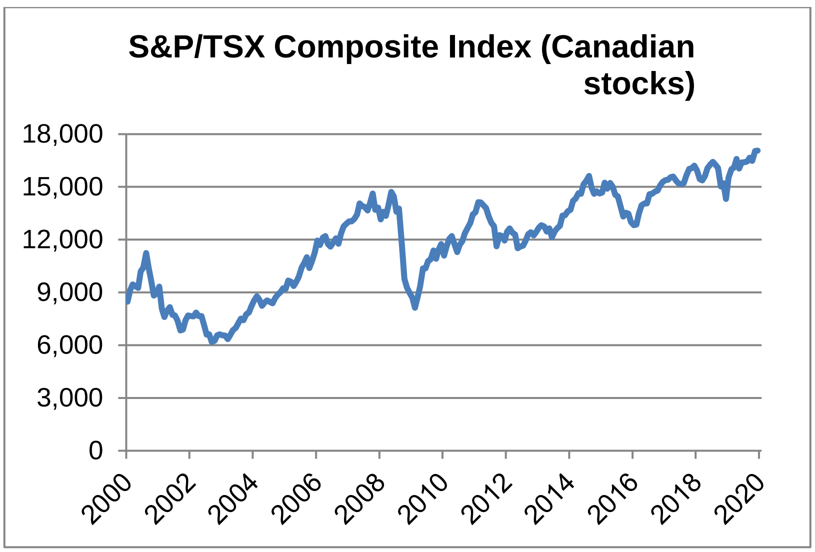
## Stock Market Performance Charts

How have markets performed over the longer term? Let's looks at the charts.



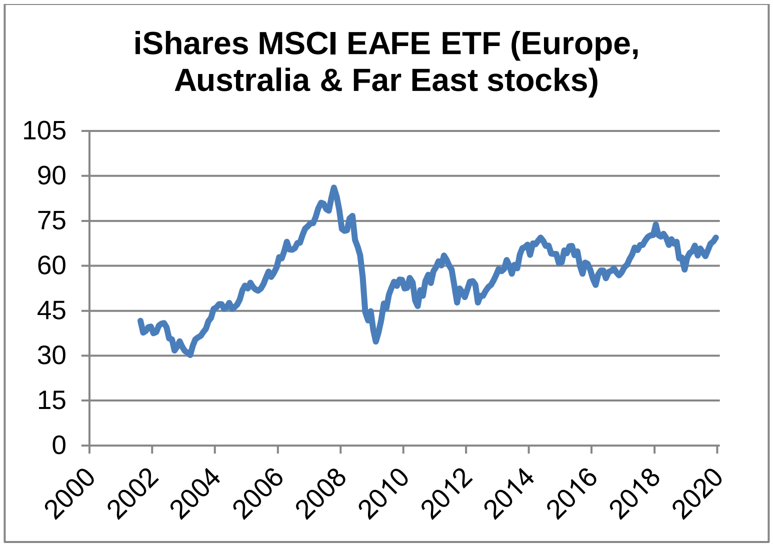

Source: Thomson One

As you see the U.S. stock market looks quite high. That is why we cut back U.S. exposure and are also underweight exposure to the industry that caused a lot of the outsized gains (technology).



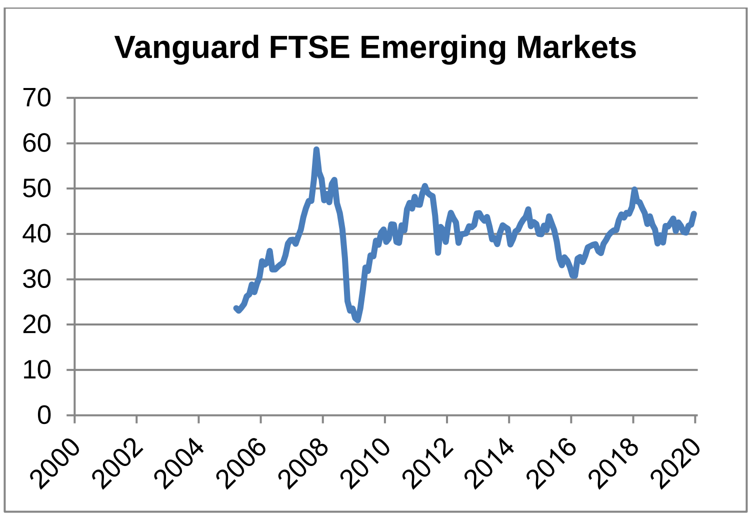

Source: Thomson One

Canadian stock prices, while up a reasonable amount from lows in March 2009 are just a bit higher than previous highs set in early 2008. Valuations, while not cheap, are ‘reasonable’.




Source: Thomson One

European and Asian stocks trade about 20% lower than previous highs (set in early 2007) and valuations (price to earnings and price to book value) are also a fair degree lower than U.S. equities. We have good exposure to this area through an ETF and one stock (Diageo which owns Guinness, Johnny Walker etc. Cheers!)




Source: Thomson One

Emerging Markets, (China, India, Taiwan, Brazil etc.) are another area we invest in via an ETF. Valuations are very reasonable, and this area looks low in price.

## What are we doing to adapt to changing financial market risk/return expectations?

1. At this later stage of the economic cycle, ensure virtually all our individual stocks have defensive nature to them (e.g. utilities, pipelines, banks, insurance companies, low cost retailers that are adapting well to online shopping, and rail companies). These industries traditionally weather economic downturns quite well.

2. Include areas that have lagged performance wise (thus likely have better risk/return going forward), such as developed market Europe and Asia, emerging markets and even Canada to an extent.

3. Fixed income wise, maintain or add exposure to high yielding tax-efficient preferred shares (paying dividends of about 5.5%, which is an interest income equivalent return of close to 8%).

## How can we use new (but proven) ways to dampen risk with the further goal of adding to return potential?

1. Emulate what Canada's largest pension funds have been doing- in terms of investing in pools of non-publicly traded privately valued bonds, mortgages, loans and commercial real-estate. This is just being done in discretionary 'Advisor Managed Accounts' due to regulatory paper work requirements.

2. Going forward, given that for most accounts we can now trade on a discretionary basis (thus no trade commissions), take a bit more active approach to trading particularly with resource-oriented stocks, real estate investment trusts and preferred shares. Risk mitigation and return enhancement are our goals.

3. Devote more time in our practice to the important roles of tax, financial and estate planning. We have made good progress in these areas and will continue to keep up to date by ensuring we devote time to continuous training. We have also added a new checklist on these matters to go through as we prepare for your annual review meetings. Please do not hesitate to ask for assistance in any of these areas any time throughout the year.

## Bits and Bites

This year's TFSA limit remains at $6,000. For most client situations, we will be investing in one of our model portfolio stocks, Royal Bank.

The 2019 RRSP maximum is $26,500 (deadline end of February) and the 2020 Maximum is $27,230. Please check your CRA notice of assessment for your RRSP limit.

As always in our year ahead letter, we want to very much thank all clients for entrusting us with your portfolio and financial affairs. We also want to thank clients who have mentioned our practice to friends, family or work colleagues. That is much appreciated. Our minimum new account size remains at $500,000. As always though, we are very happy to work with any direct family member regardless of account size, including getting the children started with investing (some kids chose to invest in Apple stock quite a while back -we wish we had too!).

We are pleased to announce that together with the other team in our branch, the Hasker Financial Group, we have added a third school, to our support of the "Scientist in Residence program". Through our firm's "CIBC Miracle Day fund", we devote a portion of earnings from clients to fund a UBC scientist to work with an elementary school for the school year. The scientist leads classes and develops lesson plans (that are also posted online -for use all over the world). Our three schools this year are Lord Strathcona (at Main and Hastings), Admiral Seymour (at Clark and Hastings) and Southlands- (in South Vancouver). Thank-you very much for your support!

We will also again support “Pathways”, a Richmond based organization that does great work helping people with mental health challenges develop life skills and find quality employment and housing.

All the best in 2020!

Cheers,
CIBC Wood Gundy

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