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The world continues post Brexit; so now we go back to hearing about Trump all the time

The British electorate's somewhat surprising decision to leave the EU was perhaps market event number 50 or so, that I have seen since joining this industry 28 years ago (not as surprising though as Iceland beating England at the Euro soccer championships days later). We follow event risk as part of our job, but from an investment process or philosophy standpoint our best advice is either "do nothing", or if you like, "take advantage of short-term weakness by adding a bit to stocks."

There is of course curiosity, more than enabled by today's instantaneously connected world, to follow major world events. A quarter of our 30-member cycling group evidenced this following the British election results in real-time on their phones during our group's 20th anniversary ride, beer and burger celebration at Sharkey's restaurant in Ladner. Yours truly left his so-called 'smartphone' in his manly spandex jersey's riding pouch, but I listened to the constant chatter shift from "they are going to stay in the EU" to eventually, "wow, they aren't going to stay and how about that crashing pound eh?" Maybe I can tax-deduct my burger/beer cost as a few people asked me about the impact to the stock market, Euro, British pound, etc.

Returning to work the next day meant reading all the usual market information on this topic, of which we get an abundance. The general conclusion though per usual, was that

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the world would continue. U.K. residents will keep shopping. Some U.K. companies such as exporters or those in tourism love this decision because the resulting lower U.K. currency gives them an advantage. U.K. banks are not happy campers though as some financial business will shift towards Germany and France. The next two years will see a lot of important negotiations, and there is good incentive on both sides to negotiate reasonably ‘free trade type’ deals.

In all likelihood, this is not the end of the EU as none of the pro-independence parties in other EU countries seem to have a chance at winning anytime soon. Fortunately, England never adopted the Euro, so that will make this transition a bit easier. Maybe pro-EU Scotland leaves the U.K. though (without the need for any modern-day William Wallace, Robert the Bruce, or Bonnie Prince Charlie), but that won’t shake the world economy to any extent.

Regarding the impact of the U.K.’s decision to leave on client accounts, those who check accounts daily online (you know who you are) saw lots of volatility. At first up (market predicts ‘remain side’ to win), then down (market surprised as ‘leave side’ wins, so big drop) then up (low-yielding cash comes off sidelines to buy now cheaper stocks.) Since then, markets have been trending upwards and headlines moved on to the Olympics and the latest head shaking Donald Trump statement.

How will the U.S. election affect markets? Our guess is very little. We give Trump at best a 1-in-4 chance of winning. And if he wins, we guess there is a similar 1-in-4 chance that he messes things up enough to damage capital markets. Keep in mind he has very few friends in either the Senate or House of Representatives, so in the ‘checks and balances U.S. system’, he likely won’t be able to carry out too much of his agenda anyway.

The world also seems to like Vancouver. What, if anything, should clients who own single family homes do?

In recent months, we all can’t help but chat about the incredibly high real estate prices in Vancouver. We are not going to enter the real estate prediction businesses too much but let’s look at the pros and cons going forward.

On the plus side, we have land constraints, incredibly low mortgage rates, and positive numbers in terms of immigration and inter- provincial migration, combined with foreign investment buying driven by a desire to diversify assets.

On the negative side going forward, we see high prices as a barrier to new buyers and the risk of higher interest rates (even most foreign buyers and recent immigrants are financing purchases with today's cheap mortgage rates). Add in the old adage 'what goes up can go down,' plus the potential for China to clamp down on out-of-country currency transfers and one must be at least somewhat cautious about local real estate prices— which are incredibly high relative to local incomes. Throw in the new 15% foreign land transfer tax, and at minimum we can expect a pause in rising prices.

What to do? Very little for most clients, but here are a few things we are seeing in our practice that we support:

1. If you're thinking about downsizing into a condo, timing looks fine to proceed either now or in the near future.
2. If you're thinking about moving to Vancouver Island or the Okanagan, timing looks good.
3. If you're in your late 70s or older and choose to sell, consider renting.
4. Feel free to take advantage of almost free interest rates by deferring your property taxes. The current interest rate is only 0.7% (prime minus 2.0%). If you are 55 to 65, your home must be assessed at $1.2 million or lower. At 65 plus, that does not matter. Call us if you have any questions as to how to apply for this deferral.

How can interest rates be negative, and what is the risk to financial markets if this experiment goes wrong?

In studying finance and economics many moons back, there was no mention about 'negative interest rates'. Today, if an investor buys a 10-year German government bond for 100 Euros, it pays back about 99 Euros in ten years. Thus, the investment is guaranteed to lose money if held to maturity.

Interest rates on sovereign bonds are negative on half of European government bonds and one third of government bonds around the world. If we think our interest rates are low (10-year Canada bonds pay around 1%), they are even lower in many other countries.

This highly aggressive and very much 'experimental' monetary policy engineered by central banks has unknown outcomes that we have to be concerned about. Personally, we think this is the single biggest risk and economic phenomenon out there today. Brexit or U.S. election type issues pale in comparison.

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First of all, how can interest rates be negative? We can trace this back to incredible central bank monetary stimulus used to rescue the financial markets in early 2009. Back then, we thought this would be a temporary measure and eventually interest rates would go back up at least somewhat, after the economy improved. Well, we are still waiting and waiting for higher rates and today's global bond market now discounts many years of low interest rates going forward; plus economic growth remains muted despite the lowest interest environment we have ever seen.

How do central banks pull off such low rates? Central banks (part of government but reasonably independent in decision making) control short-term interest rates by setting the borrowing rate in terms of what they pay or charge commercial banks to deposit or borrow. Some central banks currently pay negative interest rates on commercial bank deposits and charge next to nothing for them to borrow, with the hope that commercial banks will lend money out - instead of leaving funds on deposit with the central bank. This keeps interest rates low. In addition, European and Japanese central banks are mimicking what the U.S. Federal Reserve did; namely print money and use same to buy bonds and pools of mortgages, thereby forcing bond and mortgage prices up (which in turn pushes interest rates down).

On the positive side, low interest rates are good for the economy, good for asset prices (real estate and stocks) and very importantly decrease government and corporate and personal debt financing costs. With government debt as high as it is globally (40 trillion, which is close to double what it was ten years back), central banks have to be concerned about governments' capacity to pay interest costs. The last thing central banks want is default risk to be priced into government bond yields thereby driving rates up (e.g. the Greek situation). Thus, they keep interest rates very low (which in turn decreases government debt servicing costs) and attempt to spur some economic growth in today's slow growth world economy.

Aging populations in the developed world combined with a lower requirement for hard good consumption means a secular decrease in demand. No government or central bank out there seems willing to accept this reality.

One would hope that politicians would take advantage of lower debt servicing costs to decrease excessive government debt; however, of late, the U.S. Democrats are promising a big fiscal stimulus, Japan is doing just that, Britain is headed that way; and Canada has also returned to running a fiscal deficit federally, while many of our provinces carry far too much debt. Low interest rates clearly do not incent fiscal responsibility.

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Fortunately, inflation in today's incredibly competitive global trade environment remains low, thus central banks don't have to worry about combating inflation with higher interest rates.

So who is buying all these bonds with negatives yields? Recently I had a chance to ask that question to two individuals. One is a European money manager and the other is a Canadian investment banker who does business in Japan. The answer is pension funds (who are mandated to buy a certain percentage of government bonds), insurance companies who have to invest a portion of assets in guaranteed investments, conservative investors (stock market returns in Japan and Europe over many years now are poor, which has sapped local investor confidence)….and don't forget all that central bank buying I mentioned earlier. Can this continue? Our best guess is that it will over the short to medium-term, and it looks like we are also returning to global fiscal stimulus which will in turn restart growth in total government outstanding debt.

To return to theme of this letter, we are not concerned with typical 'on again off again event risk', but we have to be concerned about the ramifications of this incredibly aggressive experiment in monetary policy that has no history to learn from in terms of how this situation will play out, combined with government debt levels that would be hard to service in any normal interest rate world.

Japan is in the worst situation of any large country as its government now owes about 200% of GDP and its central bank has been by far the most aggressive in terms of bond, mortgage and even stock buying. Combine this with no population growth and it is clear that Japan is stuck between the proverbial rock and hard place.

Many years back, we used government bonds successfully in client portfolios. Today, we buy none. That won't change anytime soon.

Fortunately stock market valuations, while not cheap, are not too expensive in historical terms so it is possible that the next year or two could see excessive demand for stocks from yield-starved fixed income investors. We could also see good investment demand for preferred shares with yields over 5%, REITs with 6.5% distributions, and even medium-term corporate bonds with 3% yields. If demand for these types of investments is good, performance should also be able to meet objectives; but we will need to evolve accounts more defensively as the potential for an 'asset bubble' on stocks and parts of the bond market will become very real if valuations get too stretched as a result of artificially low interest rates.

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Thus, while market attention jumps from one 'event risk' to the next, this ongoing phenomenon of low and even negative interest rates (and its effect on stock and bond prices) will be the main issue we will focus our attention on. Needless to say, we will continue to have a high 'bar of quality' in terms of fixed income and equity names we use.

How we are trying to simplify your tax reporting, and what's behind how we select and use stock exchange traded funds (ETFs).

We are making some adjustments in the ETFs we use. With the tremendous growth in use of ETFs and many new ones being listed, certain ETFs that we purchased years back are no longer on our current pick list. At the moment, we are not changing what we invest in, but are changing some of the ETF providers used to get exposure to a given asset class.

Our objectives are to:

1. Simplify tax reporting by using Canadian-listed (not U.S.) ETFs that are therefore not subject to CRA's foreign income reporting rules.
2. Prevent those clients who have high net worth from being exposed to U.S. estate tax on their U.S. investments.
3. Improve tax efficiency as one of our ETFs in place today is subject to a bit of non-refundable withholding tax.
4. Utilize Vanguard now as our main ETF provider as this investor-friendly not-for-profit company (registered as a "co-op") has become the industry's lowest cost provider.
5. Decreasing usage of ETFs that engage in security lending. This is where an ETF lends out its certificates in return for a security lending fee. There is very little risk to this practice but we wish to eliminate the small (but theoretically possible) risk that could result from a default in the bank or brokerage firm that borrows the certificate.

There is no timing rush here, due to the fact that we are not changing asset classes we are investing in. We also have to take tax ramifications in consideration, as most of our ETFs are in non-registered accounts. In some cases, we can offset part of the capital gain through tax trading preferred shares and in other cases we are holding off selling certain ETFs (such as our two U.S. ones) in order to avoid triggering too much capital gains. We are reviewing this with clients at all annual review meetings and sometimes by telephone. There are no transaction costs involved.

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An evolution in our investment practice that we believe will help us do the best possible job.

Rick, Susan and I have all now completed our Certified Investment Manager (CIM) designation through taking additional industry courses. This made us eligible to apply for an industry designation called 'Portfolio Manager' which in turn allows us for the first time to offer discretionary money management advice. A small but growing number of investment managers have this designation. We did this with the following objectives in mind:

1. To be able to move quicker in terms of executing trades or changes in our asset allocation. An example as to how this can help occurred earlier this year, when we evaluated an opportunity to reduce U.S. stock/currency exposure, in favor of the then beaten up Canadian dollar/stock market. As we need to get approval for each and every trade, we were just able to get about fifteen percent of our trades done before the Canadian dollar/market 'turned back up on a dime'. Thus, now we are back in a holding pattern on this trade for the majority of our clientele. I recall once speaking with a mutual fund portfolio manager who did not understand how we on the 'retail' side of the business could effectively manage portfolios when we have to call each and every client in advance of doing trades. I said at the time that we were used it, and that overall, it generally does not hurt performance. Today, I would still say that this does not hinder us too much but I do feel we can improve things by making trades faster, and also by doing bulk trades, just like pension fund and mutual fund managers do.
2. As a discretionary portfolio manager, we can use our firms block trade desk to move out say five million dollars of an investment rather than doing trades one by one. This will result in better pricing through minimizing 'bid/offer spreads'.
3. Some clients have asked us to take care of any necessary investment changes for them either 'all the time' or perhaps just when they are traveling. In the past, we could not do trades without getting their approval each and every time. As a discretionary portfolio manager, we can now do this.
4. Our team spends a lot of time making phone calls to make trade recommendations or sweeping cash positions into an investment. In future, we will have more time for financial, tax and estate planning. In addition, we will have more time for doing the important job of monitoring financial markets; and doing stock and fixed income investment research. We understand though that ongoing client communication is very important, so we will be very cognizant to maintain good client contact.

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In order to be permitted to trade on a discretionary basis for given clients, we need to be fully 'fee-based' so that we can execute all trades without charging any trading commission. At the moment, we use a 'hybrid method' whereby we are fee-based on our 'index and stock strategy' and 'commission-based' on all other assets. Thus, we will have to be fee-based on all of the accounts that are deemed to be discretionary. This caused us some concern as our intention is not to increase what clients are paying. Standard industry pricing for fee-based accounts with discretionary ability is generally between 1.0% and 1.5% per year. Our clients typically pay much less than that and we promise to continue our below industry average pricing. After discussing this issue with our firm, we are pleased to have been given permission to discount our pricing enough where we feel we can achieve the above objectives without materially changing what clients pay.

Whether we do this or not is entirely your choice for all existing clients. So if you wish to keep things as they are, we can do so; and there is no rush whatsoever in implementing this. New clients though that choose to join our practice will be set up in this manner. In terms of implementation, we can discuss this in our annual reviews or on the phone anytime you wish.

On behalf of the team, we all hope you are having a great summer. As always, call or email us if we can be of any service.

Regards,
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