Chairman's Council

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Back To School Edition

Over many years now, we have noticed clients focus more on their finances as we move from summer vacation time into the fall months.

Our outlook going into 2017 was cautious regarding returns due to a combination of increased stock valuations and low interest rates. We also felt that below average volatility in financial markets was bound to change at some point. We stated we were not prepared to do what many investors have done and that is jettison low yielding bonds in favor of equities. Simply put, we felt we needed to maintain the capital preservation and the risk-minimizing attributes of our fixed income investments. We plan on continuing with this approach and will do so going forward unless stock markets fall enough to create a meaningful buying opportunity.

So far 2017 has been a somewhat 'off year' for Canadian equities with the TSX index down about 900 points from where it peaked in early 2017. European and Asian markets have been a bit weak as well; and while the U.S. stock market is trading near its all-time high, most gains on U.S. stocks this year have been eliminated by the increasing Canadian dollar.

Regarding the bond market, returns have been somewhat lackluster due to low yields combined with slightly lower bond prices (due to a small increase in interest rates that has pushed down bond prices a bit). This was expected, so we avoided long-term bonds where material declines in bond prices can occur in any rising interest rate environment.

Our preferred shares have had a good year thus far (most of the ones we own are the type that perform well when interest rates increase). Our real estate investment trusts (REITs), while flat price wise, continue to generate good cash flow of about 7% on average.

Put it all together and 2017 has been a 'so-so' year after a solid 2016, with strong returns in general from the lows of early 2009.

Regarding the situation with North Korea, markets are not pricing in very much risk as yet, but this 'tricky and risky situation' is likely to be in the headlines for a while. There is a lot of brinkmanship going on, not just between the U.S. and North Korea, but also between the U.S. and China. China has the power to stop North Korea's nuclear weapons program in that it is by far North Korea's largest trading partner, and is its sole supplier of oil and weaponry. One way or another, China wants to ensure it does not lose North Korea's 'buffer state' position. How China, the U.S. (and of course North Korea) play things from here will determine how much risk, if any, financial markets build into this latest geopolitical risk.

In our view, there are a variety of potential outcomes here and each poses a degree of potential short-term market risk:

1. The U.S. imposes trade sanctions on China if China does not play ball. That's a negative from a global growth standpoint.

2. The U.S. simply continues to build up its extensive missile defense capability in South Korea. This is not too bad an outcome as it minimizes any material nuclear threat from North Korea, avoids war and ensures China and Russia pay a price for not supporting enough Security Council trade sanctions against North Korea. Neither China nor Russia wants to see an increased missile defense system so close to their borders.

3. War – a bad and risky outcome. North Korea has extensive chemical and biological weapons so forget 'boots on the ground,' thus possibly an extensive and devastating air campaign where we hope their young and unpredictable leader does not launch nuclear weapons, and hope the leader is deposed internally.

4. North Korea gives in. That looks very unlikely without a lot more pressure than we have seen so far from China.

While we follow these situations closely as they can affect markets in the short term, we don't try and 'invest around them.' This is because one geopolitical risk follows another, which follows another. Not that long ago, the fear of ISIS was driving markets. Today, it's North Korea, and eventually we will move on to another one. In the longer run, it's not these events but the economy and corporate earnings that determine share prices.

We have not had a recession in over eight years and statistically that means we are due for one at some time in the near future. However, if central bank 'ultra-accommodative monetary policy' is maintained (i.e. 'low-ish' interest rates), we can go a while yet before the dreaded 'R' word hits the headlines. While interest rates are increasing somewhat, our outlook is that interest rates will still stay on the low side for the foreseeable future.

To control for risk as much as we can, we continue to emphasize a significant amount of diversification (geographically, industry and currency wise) and have tilted our equity (and bond issuer) exposure more towards defense instead of offense.

As said earlier, our typical client (age 67) also has a good degree of fixed income investments. Regardless, anytime markets get a bit weak, as has been the case over the summer months, we expect some statement weakness and also expect some clients to ask about same.

As we now head into the 'pay more attention to one's finances' fall season, please don't hesitate to call in to discuss any concern with respect to your accounts. While we are comfortable with what we own from a return and risk standpoint, short-term market weakness can and will occur at any point in time, so if for any reason you wish to discuss decreasing risk by emphasizing more bonds and less stocks, we are here to help.

We want to say this now when things are still reasonably calm with the understating that today, many clients check account values online on a very regular basis, and thus experience volatility more compared to the old days of waiting for monthly statements. While our job as your investment adviser is to take a calm and measured long-term view, we recognize that at times, markets will not be anything close to calm and measured in the short term.

We hope you enjoyed a nice 'not too smoky' summer, and for once, we look forward to rain to put out the remaining forest fires.

All the best!

Kind regards,
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