Manulife Securities

Mid- Quarter Newsletter – August 2019

INVITATION

On Sat Sept 14, Jordan and I are hosting an informal seminar on documenting all the information your heirs would want to know if you passed on. We invite you to register, and to bring your executor/heirs if you want to. Please call the office to register. We have over 50 items to go through that you might want to think about and communicate to your heirs and executors. We will guide you through recording your wishes and the location of important documents etc, so that you can then share this information with your family/executor etc.

INTERESTING MARKETS

Markets sure have been more volatile recently with the escalation of the U.S. trade war with China. Bond yields have dropped in many countries to the point where there is $15 Trillion invested in bonds with negative returns. That's right, the investor will get less money back that he/she bought the bonds for and they purchased the bonds knowing this. The bondholders must be so scared, that they just want a place to park their money where they know it's a limited amount they will lose. On Civic Holiday Monday when Canadian markets were closed, the S&P 500 (the major U.S. index) fell more than it has any single day since 2007. And all this came after the U.S. had the longest expansion (period of economic growth) in history, over 120 months. Does this mean anything to us?

There is an old saying that expansions don't die of old age. They usually end because of a policy decision that changed the course of the economy, like too great a rise in interest rates (or, like a trade war?). This time the next recession could be triggered by geo-political events. For the last 40 yrs world trade has gotten more and more global and more countries have come in line with global trade rules and standards. The clever strategists at CI Investments (at their last due diligence conference) said that what we are seeing is NOT the US trying to get new trade deals, but the US trying to derail China so that China does not supplant the US as the biggest economy in the world. For example, when the US claimed that equipment from Huawei, the largest telecom company in the world, posed a security risk, the US was really signalling to US semi-conductor companies that they couldn't sell to Huawei. Huawei can't manage without US semiconductors. So the US is essentially trying to cripple Huawei. China isn't going to tolerate this and is fighting back. What happened with Mexico lends credence to this. No sooner had Mexico ratified the new trade agreement that the US had just negotiated with them, than the US announced new tariffs on Mexico. This reaffirmed to the world that the US could not be trusted to stand by any agreements they negotiated. The strategists at CI predict that global trade will weaken as a result of US actions and equity profits will decline because of it. They also think the US didn't fix their banking problems properly and this is extending the fall-out from the financial crisis of 2007/2008, such that we could see another 15 yrs of recovery. This is what is preventing the US Federal Reserve from being able to raise interest rates, which is necessary to give them ammunition to fight future recessions.

Based on the above, you may think that it would be wise to get out of equities (stocks or stock funds). We can't sit in cash for the next 15 years. Inflation would erode that cash's purchasing power and that cash wouldn't be able to support retirement for nearly as long as previously expected. Gold is another option people look at. I remember a boyfriend around 1980 who had just made a lot of money buying gold around $300 and then selling it near $2,000 in 1979. Then gold went out of favour again and fell under $400 by 2001 before soaring to almost $$1,900. Then gold dropped to just over $1000 and now it's up around $1,500. That is a heck of a rollercoaster ride. Imagine if you had bought in 1979 at the peak and were holding gold now. You wouldn't have made a penny and might have had storage and insurance costs. We agree with Buffett that gold is not a real investment. It's betting on investor emotion. Then there's real estate. Most of us have some of our wealth tied up in real estate to live in. Do we want all out wealth tied up in a single asset class that also has a history of big swings? You've probably heard me say how the house I bought in 1985 in Ancaster really appreciated till 1992 (that followed 1982 when housing prices in Toronto fell by almost half). But then the price people were offering to buy my house in 1992 declined and was not seen again until 2003!!. If I had bought in 1992 and then needed to sell in the next 11 years, I could not have gotten my money back out. Immigration and super low interest rates have fueled housing prices for the last decade. What we expect to face in the next 15 years is rising interest rates and the leading edge of the large demographic group called the Baby Boomers largely ceasing to own homes because many will have passed on or moved into retirement homes. This may cause a glut in the housing market that will not support high real estate prices. That leaves bonds. Currently over $15 TRILLION of bonds are yielding negative returns. For example, someone might pay $101,000 to buy a US Treasury Bill that will return $100,000 plus $250 to the buyer at the end of three months when the T-Bill matures. Those buyers paid $750 for the privilege of having their money safely help by the US government. Even if they weren't losing money in nominal terms, they would be losing buying power because of inflation, which is exactly the problem with GICs. So the only place to invest seems to be defensive equities. This could be in infrastructure (renewable energy producers, water purification technology, toll bridges etc). This could be in undervalued essential businesses (funeral homes, nursing home chains, companies that supply equipment to all the pharmaceutical companies or supply parts essential to the burgeoning electric car industry, etc). It could be in dull companies if undervalued, like paint companies, socks and underwear manufacturers, fertilizer companies etc.

At the moment our favourite managers are getting more defensive. More and more infrastructure equities are becoming available, that we may be interested in at some time. And emerging market stocks have stayed cheap. US trade policies are keeping them that way at the moment. But, there could be quite a future in emerging markets.

So there is a ton of uncertainty in markets today. Returns in the future may not measure up to returns of the past. We are recommending defensive and low volatility equity strategies and we are keeping our eyes open and doing lots of research to keep trying to figure out if there comes a time when a change in strategy might be warranted. The Raptors reminded us recently that Defense can sometimes be the best Offense. You can't win in the long-term if you can't play defense and right now that's where we think investors need to concentrate.

Predicting the end of expansions and the move to recessions is not an exact science, but there are some leading indicators that are fairly reliable and are a big help.

- Employment Rate – When employment rates are trending up (and unemployment rates are trending down), it's not signalling a recession. According to the Brookings Institution analysis, using observations from the U.S. Federal Reserve, there is less than a 10% chance of a recession within a year right now, because unemployment is still trending down.
- Yield Curve – When long-term interest rates on government bonds are cheaper than the interest rates on short-term government bonds (creating an inverted yield curve), there is a one in three chance of a recession within the next 12 months. The yield curve has inverted for short periods recently. Most analysts feel it has to stay inverted for 6 months to be meaningful, and even after an inversion, a recession might not come for up to 2 yrs. So the risk of a recession is rising, but there is no imminent indication of one.
- Purchasing Managers' Index – An index over 50 means the economy should still be expanding and under 50 that the economy is going to retract. The U.S.'s PMI just fell from 50.6 to 50.2 (after being around 53 a year ago). This is close to signalling trouble. This indicator may not be as important as in the past since manufacturing is an increasingly small part of the economy as the service sector expands. A steep drop in the index from here would point to trouble, but the PMI isn't pointing there yet.
- Consumer Confidence – When this metric falls, people don't spend and that's a sign a recession is coming. This indicator is not as early an indicator as the other ones. So far, consumer confidence has remained relatively flat, so it's not pointing to trouble yet.

So all in all, it doesn't appear that a recession is too close. Keep in mind though that the stock market usually falls before a recession hits. Still it doesn't appear than anything bad for the markets is too imminent, but the brewing trade war could tip the apple cart. The main thing, as always, is to be prepared at all time for the unexpected. That means, if you are withdrawing income, to have your income matching strategy up to date. Call us if you aren't sure you have enough low and low-medium volatility holdings to protect your income stream or if you think we haven't topped up your income matching holdings (buckets 1 and 2) recently. Here are some other tips on being prepared.

- Make sure your holdings match your risk tolerance. If a drop in your account value of 10 or 20% is going to make you lose sleep, then don't chase balanced fund rates of return, because you can't get much growth in your portfolio without some rollercoaster markets. If you can't stand periodic drops of 30-40%, then you shouldn't be trying for the strong long-term returns of the stock market. Get out now and be content to have your investments just keep up with inflation.
- Set goals and understand your time horizons till you need to take money out. If you have a long time horizon, don't let short term volatility bother you.
- Diversify across funds investing in different size companies, in different parts of the world, in companies in different sectors of the economy etc, but stick with conservative equity strategies. Be fearful enough in exciting markets that you don't get greedy and start chasing risky strategies. Growth focused strategies may rise faster at times, but they also fall harder on average than our investment styles (value, dividend focused, growth at a reasonable price (GARP), low volatility).
- Remove Emotion From Your Decision-Making – This is hard to do. You have to remember that you have an investment process and strategy and that you need to stick with it during the rough times of the market. And at some time when others are fearful, you may have an opportunity to buy bargains. Get prepared to get greedy when the market is on sale (that is, when others are fearful). Don't be like the crowd who panic and sell their holdings at the worst prices and then

sit scared, on the sidelines in cash, for too long, missing a good deal of the recovery. And don't use what has happened in the recent past as a prediction for what the future will be. History shows that nothing ever goes up forever, and markets don't fall forever either.

Do you wish you had been an early investor in Royal Bank, Microsoft, Bell Canada, Manulife Financial, Boeing, TD Bank, Air Canada, Ford, Shoppers Drug Mart etc.? If you had been, would you have been able to hold onto your share emotionally until now to enjoy the huge long-term gains these companies have enjoyed? Microsoft fell from about $60 to $30 in 2001, Manulife from $25 to $8 after 2009, Royal Bank from $72 to $39 in 1998, TD from $77 to $34 after 2007 and BMO from over $70 to less than $30 after 2007. All of these companies had high volatility at some point and yet over the long-term, you could have made good money holding onto them through thick and thin. They are all profitable, quality businesses with some competitive advantages. So why would people sell them when they hit low prices? Emotions, rather than rational thinking. And when other people let their emotions make their investment decisions in a market downturn, that's when we may have the opportunity to buy into companies like those mentioned above at bargain prices again.

Your funds are full of profitable quality companies with competitive advantages and strong management. So don't get tempted to sell them cheap at any time in the future. Be ready to buy more if they go on sale.

That's it for this mid-quarter newsletter. Hope you can come to the seminar in Sept. Let us know.

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