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Article Compliments of,

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Keep Calm & Carry On

NOVEMBER 2018

INSIDE THIS ISSUE:

Market Complexity

Hard to understand

'Keep Calm and Carry On' was a motivational campaign produced by the British government in 1939 in preparation for World War II. The poster was intended to raise the morale of the British public, threatened with widely predicted mass air attacks on major cities. Although what we're experiencing in the financial world is minuscule in comparison, I've titled this newsletter Keep Calm and Carry On in the hopes that the information I lay out summarized on Figure 1 will help alleviate some of the fears that are so common at times like these. For those not interested in every detail, I have provided a synopsis on the first page and a half for a quick read.

In early October I communicated that the sudden market selloff was more of a typical short-term correction and unlikely the start of something more serious. October was actually the worst calendar month for stocks markets since 2011 so we ask ourselves, has anything changed to make our prognosis different? Lots of things have changed, but the underlying fundamentals of the economy remain healthy and therefore we do not believe this will be anything like a 2008 prolonged scenario. When we see market corrections like this, we always immediately revisit our models and review our individual investments to make sure we are making the best decisions possible, with the most relevant information available. In this year-end Wise Investor, I will discuss again the 7 economic indicators that we monitor that have in conjunction helped predict every recession since World War II. <u>In summary, all of these indicators are still exhibiting positive signs confirming our views that we are comfortable owning equities resulting in no significant changes to our overall investment strategy, page 4.</u>

Figure 1: Recessionary Dashboard

Start of Recession	Yield Curve	Inflation Trends	Labour Market	Credit Perform.	ISM Mfg.	Earnings Quality	Housing Market
Nov. 1973	Recessionary	Recessionary	Recessionary	Recessionary	Recessionary	--	Recessionary
Jan. 1980	Recessionary	Recessionary	Recessionary	Recessionary	Recessionary	--	Recessionary
July 1981	Recessionary	Expansionary	Expansionary	Recessionary	Recessionary	--	Recessionary
July 1990	Recessionary	Recessionary	Recessionary	Recessionary	Recessionary	Recessionary	Recessionary
Mar. 2001	Recessionary	Recessionary	Recessionary	Recessionary	Recessionary	Recessionary	Neutral
Dec. 2007	Recessionary	Recessionary	Neutral	Recessionary	Recessionary	Recessionary	Recessionary
Present	Expansionary	Neutral	Expansionary	Expansionary	Expansionary	Expansionary	Neutral

Recessionary Expansionary Neutral

Source: Marley Snow, for illustration purposes, November 2018

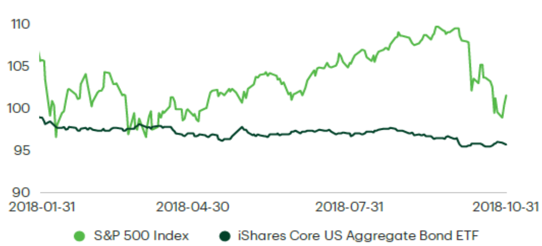
What's Going On?

Let's address the elephant in the room: Global stock markets declined through October and November taking both the Canadian S&P TSX Composite Index and the U.S. S&P 500 index down 9% and 10.1% from their 2018 record highs. Unfortunately, there has been little place to hide as bonds have also declined with the rise in interest rates this year, see figure 2. We think the causes of this temporary correction are many, most notably tariff wars, specifically with China, coupled with a lower earnings growth outlook for a number of U.S. corporations, specifically technology. Stock markets are as simple as supply and demand and if there are less buyers for a stock or the stock markets than there are sellers on any particular day or week or month, then the stock markets will go down. At current, the sellers have been winning but as stocks continue to go on sale, buyers might inevitably return which will drive the recovery.

What Does This Mean?

Firstly, the North American economy has become more global over the past decades, with the largest companies having built extensive international relationships as they rely on worldwide sources for lower-cost production of their goods. Higher input costs due to taxes and tariffs will potentially get passed along to the end buyer, like you and I, resulting in less money in our pockets to spend which lowers economic growth. The uncertainty that the trade negotiations bring, specifically with China as a huge input provider, is causing unrest in the markets for fear of lower profits and higher costs in the future.

Figure 2: New normal? Returns of S&P 500 Index and iShares Core US Aggregate Bond ETF



Source: Bloomberg Finance L.P. as at November 6, 2018.
Price was rebased to 100 and in USD.

Secondly, the pullback has been the deepest in the technology sector. This has hurt overall market performance year-to-date because technology also accounted for the majority of the gains over the past few years, see figures 8 & 9 page 4. Even with amazing 3rd quarter earnings their steep sell-off was mainly due to their lowered expectations for growth over the coming quarters which puts into question their high/expensive stock prices.

I believe these two main factors have caused angst among investors limiting the number of buyers in the market and increasing the number of sellers resulting in a challenging, October and November, to say the least.

Why Should You Care

Firstly, I believe that it's highly unlikely that we are in the early stages of an equity bear market as it's hard to find any evidence of an imminent economic downturn. In fact, market and economic fundamentals remain solid and it's far more likely that we are in the middle of a common correction in what could continue to be a positive market for a number of years. Corrections like this are very common with the most recent being the start of 2018, see Figure 3. It's always painful looking at your portfolio values in the midst of a pullback. Although downturns are always disconcerting, occasional periods of turbulence are to be expected. On average, we see a correction of this magnitude every 7 months, see Figure 4. As I outline in great detail on the following pages, despite the sell-off and the pickup in volatility, the backdrop for equity markets remains generally favorable. In my opinion, Stock market exposure is still the best choice for investors seeking higher long-term returns than that of GICs.

Figure 3: Market Corrections

S&P 500 Index Recent Corrections

Start Date	End Date	Correction	Calendar Return
4/29/2011	8/8/2011	-17.45%	
8/31/2011	10/3/2011	-9.67%	
10/28/2011	11/25/2011	-9.64%	0%
4/2/2012	6/1/2012	-9.58%	
9/14/2012	11/14/2012	-7.17%	13%
5/21/2013	6/24/2013	-5.58%	30%
1/15/2014	2/3/2014	-5.72%	
9/18/2014	10/15/2014	-7.28%	11%
7/20/2015	8/25/2015	-12.04%	
9/16/2015	9/28/2015	-5.64%	
11/3/2015	2/11/2016	-12.71%	-1%
6/8/2016	6/27/2016	-5.52%	10%
3/1/2017	5/17/2017	-2.40%	19%
1/26/2018	2/8/2018	-10.10%	
3/9/2018	4/2/2018	-7.27%	
9/20/2018	11/24/2018	-10.10%	TBD?

Source: Bloomberg Finance L.P. as at November 25, 2018

Summary

In summary, I believe we will look back on the fall of 2018 as we look back on the past 15 similar pullbacks over the past 7 years with a grain of salt in a longer-term uptrend for equities. For those that want the economic particulates that have gone into my analysis please continue reading.

Figure 4: Correction Frequency

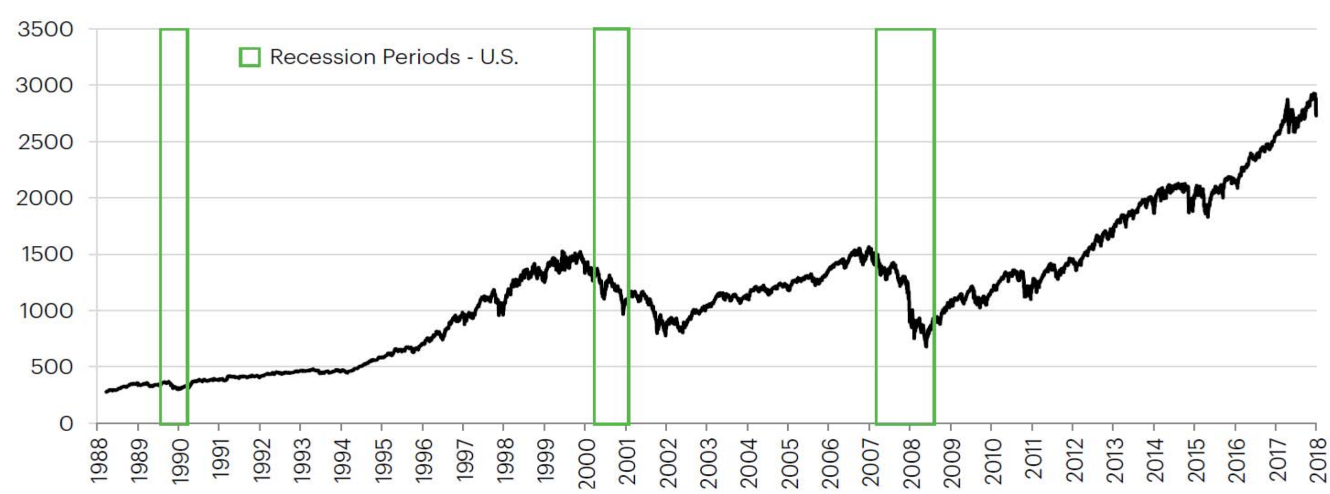
Type of Decline	Average Frequency*	Average Length*	Last Occurrence
S&P 500 Index 1928 - 2018 (YTD)			
-5% or more	About 4 times a year	24 days	Nov-18
-10% or more	About every 7 months	64 days	Feb-18
-15% or more	About every 1.5 years	110 days	Aug-11
-20% or more	About every 2.5 years	183 days	Mar-09

Source: Bloomberg Finance L.P. as at November 25, 2018
*Measures from the date of the market high to the date of the market low.

Recessionary Indicators

Over the past 30 years, there have been three major recessionary periods. A look at the S&P 500 index over that period of time shows a pretty evident correlation between economic contractions and long-term market corrections, see Figure 5. It's apparent that the market responds to economic pressure. Predicting stock markets in the short-term is impossible, so we analyze 7 economic factors that, in combination, have predicted every recession since World War II. When we anticipate that a recession is coming, we start to adjust our investment strategy to get defensive. I will outline on the following pages why I believe the likelihood of a U.S. recession in the next 12 months is very low as referenced on my Recession Dashboard.

Figure 5: How the Market Responds (S&P500 Index)



Source: Bloomberg Finance L.P. As at October 15, 2018.

Yield Curve

The yield curve, specifically the 'inverted yield curve', is one of the more reliable indicators of an impending recession. The yield curve is a graph of the yield of government bonds typically ranging from 3 months to 10 years. Because of the fact that short term bonds usually pay a lower interest rate than long-term bonds, the shape of the graph is usually upward sloping from the bottom left to the top right. An inverted yield curve is a result of the opposite where short term bonds actually pay a higher interest rate than long. This is associated with an economy showing signs of diminishing growth. Investors become pessimistic about the future and purchase long-term bonds to help protect themselves which drives up prices and drives down yields resulting in inverting the yield curve. As you can see below, the last 7 major recessions have been preceded by a yield curve inversion giving investors, on average, 11 months to prepare for the following stock market collapse.

At current, the gap between 3 month and 10 year bond yields is 0.60% and 0.68% for Canada and the U.S. respectively. This is something that needs to be monitored closely as short term rates continue to rise next year but the current upward sloping yield curve is ***positive*** and indicates **no problem here**.

Yield Curve Inversions and Bear Markets (2 & 10s/90-day & 10s)

Inversion Date		S&P 500				TSX				
2s & 10s	90-day & 10s	S&P 500 Peak	Lead Months	Lead Gain	Decline from Peak	TSX Peak	Lead Months	Lead Gain	Decline from Peak	Econ Peak
Aug 1967	Dec 1968	Nov 1968	15.4	15.6%	-36.1%	May 1969	21.4	25.0%	-28.3%	Dec 1969
Feb 1973	Jun 1973	Jan 1973	-1.3	-4.6%	-48.2%	Oct 1973	8.3	5.5%	-38.2%	Nov 1973
Aug 1978	Nov 1978	Feb 1980	17.9	13.1%	-17.1%	Feb 1980	18.5	77.1%	-22.4%	Jan 1980
Sep 1980	Oct 1980	Nov 1980	2.5	11.9%	-27.1%	Nov 1980	2.5	2.8%	-44.0%	Jul 1981
Dec 1988	May 1989	Jul 1990	19.1	33.5%	-19.9%	Oct 1989	9.8	22.5%	-25.5%	Jul 1990
Feb 2000	Jul 2000	Mar 2000	1.8	8.4%	-36.8%	Sep 2000	7.1	29.9%	-42.8%	Mar 2001
Dec 2005	Jul 2006	Oct 2007	21.5	24.6%	-56.8%	Jun 2008	30.1	34.0%	-49.8%	Dec 2007
		Average	11	14.6%	-34.6%	Average	14	28.1%	-35.9%	

Source: TD Securities

Yields prior to 1976 is 3s10s rather than 2s10s, based on daily Federal Reserve H15 release

Lead months measures time from first inversion to stock market peak, lead gain measures stock market price gain from first inversion peak

Peak decline measures stock market price gain from first inversion peak

S&P 500 calculations based on daily close, TSX calculations based on daily close (76 to present), weekly close (71 to 75), monthly close (56 to 100)

Econ Peak is the peak month of US economy as determined by the NBER

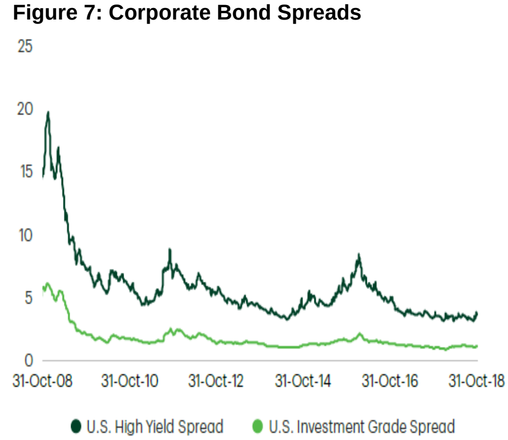
Inflation Trends & the Labour Market

Inflation is one of the key factors underlying the future health of financial markets and future path of interest rates. The most important factors that make up an inflation outlook come from within the labour market, specifically employment and wages. Employment has been the biggest success story of the United States currently sitting at historical unemployment lows of 3.7%. Sub 4% unemployment has become such a commonplace that I believe investors are overlooking the fact that such readings are far from common. This level has not been seen in nearly 50 years since Neil Armstrong walked on the moon in 1969. With so many people employed, corporations are forced to incentivize employees with higher wages which add to expenses which increases costs and in turn, inflation. Despite strong wage growth, inflation remains low, sitting at 2.40 in Canada and 2.50 in the U.S. in October which is below the highs closer to 3.00% seen in July. We need to keep an eye on this as I expect wages to continue to increase which will likely lead to future inflation, but in my opinion, **no problem here yet** as inflation is ***neutral*** and the labour market remains ***positive***.

Credit Performance & Interest Rates

We also monitor interest rates to gauge credit performance because high levels of debt can slow the economy if borrowing costs rise for businesses. One way of monitoring this is through the difference (spread) of investment grade and non-investment grade bonds. This spread will potentially widen as lenders become concerned with the future and demand a higher interest rate to lend out their money. This spread currently sits at 2.65% compared to 2008 where the spread widened to over 5.00%. Another key determinant of where spreads go is the path of central bank interest rate changes. Central banks raise rates to combat inflation. The U.S. Federal Reserve Bank intends on raising rates up to around 3.00% over the next year with Canada expected 2 to 3 hikes of 0.25% in 2019. When central banks tighten too far, too fast, lenders begin to restrict lending to consumers and businesses again slowing the economy. With the low inflation noted above I believe the current interest rate path of central banks is sustainable for the economy. Recessions have never started when interest rates are as close to zero as they are now and with low bond spreads, both indicators are still considered ***positive*** with **no cautionary signs here**.

Figure 7: Corporate Bond Spreads



Source: Bloomberg Finance L.P as at October 11, 2018

ISM Manufacturing

ISM Manufacturing stands for the Institute for Supply Management's U.S. manufacturing index which surveys more than 300 manufacturing firms monitoring production, inventories, new orders, deliveries and much more. This is important as a lot of economic activity is a direct result of manufacturing which then trickles down to the rest of the economy. As a result, ISM manufacturing can be a good leading indicator and a reading above 50% indicates expansion and anything below suggests contraction. The latest October reading was 57.7% which fell from 59.8% the previous month but remains well in ***positive*** territory. Although this indicates a slight seasonal slowing month over month, we see **no problem here**.

Earnings Quality

As of writing, we are wrapping up the third straight quarter of 25%+ earnings growth with an exceptional 3rd quarter report of over 28% year-over-year growth. Of that, 80% of companies beat earnings expectations by an average of over 14%. This encouraging trend was overshadowed by some high profile multinational companies reporting subdued profits due to rising input costs related to tariffs and warned of further pressure if trade disputes worsen. This in conjunction with the Trump's corporate tax cut boost dropping off in 2019 has raised the possibility that earnings growth will potentially slow in coming quarters. When looking at the price of a stock we pay some multiple of future earnings. If those earnings are expected to be less, then the stock price should follow. The earnings outlook has moderated, but still points to double digit growth. We trust the market can absorb a modest pullback in earnings to more sustainable levels but also remain mindful that the inherently fragile investor psychology can oversell stocks even in the absence of tangible negative data. Although there are **no problems evident,** due to the uncertainty around trade we have moved this indicator to ***neutral*** which could turn back positive if the U.S. and China could come to some sort of an agreement.

Housing Market

A person's home is typically their largest asset with the mortgage their largest liability. This factors greatly into consumer confidence therefore the housing market can be a good leading indicator of where the economy is headed. Homebuilder confidence and sales expectations fell in November impacted by rising mortgage rates. Key indicators that we monitor here are buildings permits and housing supply which have both trended slightly in the wrong direction over the quarter but remain far from where they reached last recession, as outlined below. Again, this needs to be monitored going forward as consumers digest higher mortgage rates and supply possibly continues to increase. At this point **we see no problems**, but have moved this as our 2nd indicator to a ***neutral*** rating until we see the impact of rising interest rates and the path of central banks.

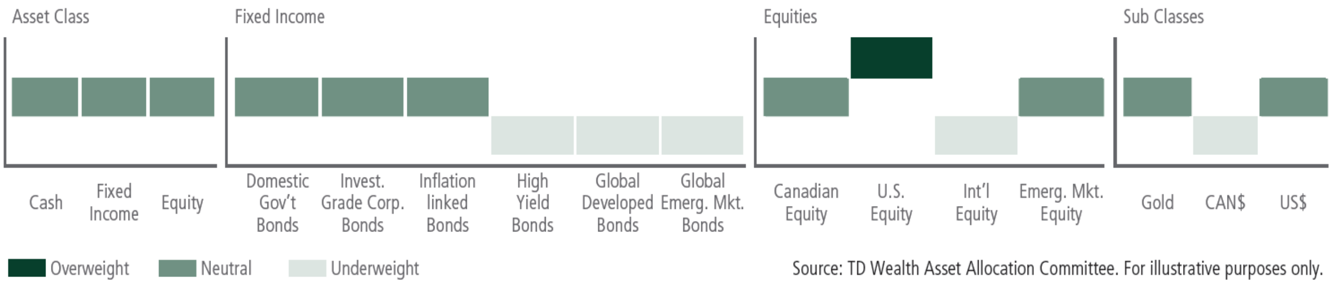
Figure 7: U.S. Monthly Houseing Supply

Source: U.S. Bureau of the Census – *shaded areas indicate U.S. recessions*

Conclusion

What stands out form our analysis is that equity market fears are not supported by any drastic deterioration in our fundamental indicators as none are showing signs of recession. Outside of unforeseen events, I believe the biggest risk to the investment environment remains the ongoing dispute with China and the path of interest rate increases. As we live in an ever-changing environment, we need to continue to monitor for any economic weakness which would prompt us to move to a more defensive stance but for the time being we recommend keeping calm and carrying on. In the next section I will discuss some elements of our investment strategy going forward.

Asset Allocation Summary



Source: TD Wealth Asset Allocation Committee. For illustrative purposes only.

Investment Strategy

If I believed a recession was around the corner, I would be pairing back risk significantly. As you can see from our Asset Allocation Summary on the following page, we remain positive and overweight on U.S. equities, neutral on Canadian Equities and just increased Emerging Markets to neutral from underweight. We maintain limited exposure internationally as well as in global and high yield bonds.

Geographically we are neutral on Canada because of our elevated household debt which we believe is unsustainable as interest rates rise and could very well push Canada into a recession before the U.S. in years to come. The only caveat to Canada would be some sort of a solution to our limited energy infrastructure and in turn, oil prices. The U.S. remains our overweight because they continue to be the strongest economy running at full throttle although I would say the gas tank is below half. We have limited exposure to international equities which look cheaper than North America but may have more limited upside due to high debt levels, tariffs and political angst. Emerging markets look extremely cheap on a valuation basis but may remain under pressure with high levels of debt denominated in U.S. dollars if the currency continues to rise.

There is a sale going on in the stock market so we are reevaluating each position and making adjustments to the strongest companies to help make sure we are positioned positively when things ultimately recover. Within Canada, the recent sell-off makes bank stocks more reasonably priced and balance sheets are the strongest in many decades. Historically, banks have been positively correlated with increased inflation. As we expect inflation to slowly rise, an overweight position here should benefit portfolios. Depending on how earnings reports go at the beginning of December, there may be an opportunity to Increase exposure.

From a U.S. standpoint the majority of the major internet companies have experience a large decline. The press would have you believe we are in a tech wreck like 2000 but I just don't see it. The six U.S. tech giants known as the FAANG+M (Facebook, Amazon, Apple, Netflix, Google, and Microsoft) had contributed over 51% of the S&P 500's performance this year and were due for a little backing and filling (see Figures 8 & 9). Amazon and Google for instance were down 19% and 25% from their highs through the latest bout of volatility. The tech sector is far better positioned with real earnings, cash flow and limited debt. One of the most exciting areas for growth is cloud computing with the huge wave of IT spending we're witnessing. The largest player in this space happens to be Amazon followed by Microsoft and Google. It's an enormous area for potential growth that I don't see slowing down and don't believe has been factored into stock prices.

Figure 8: Year-To-Date Returns

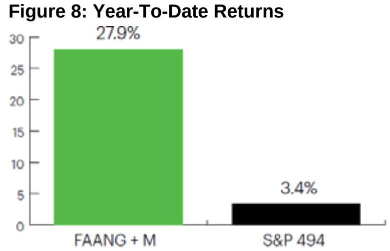
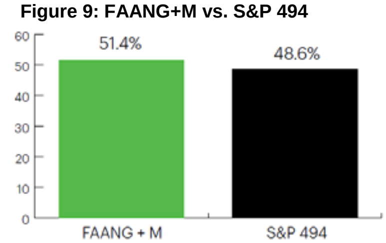


Figure 9: FAANG+M vs. S&P 494



Source: Bloomberg Finance L.P.
As at Aug 31, 2018, pre-pull back

As we prepare for the later business cycle and when we see more cautionary signs in the economy we intend to shift some of our pure growth focus into hedged strategies. These types of strategies usually come in the form of a hedge fund soon to be rebranded as 'Liquid Alternatives'. They typically have a little less upside but can benefit as stock markets go up as well as down because they will take negative positions in lower quality stocks. The idea here is that if all stocks are going down, the lower quality ones will go down further and the portfolio can still make money in negative markets. I hesitate to delve into too much detail here but will share some further thoughts in future publications when more relevant.

We continue to watch the risks but overall remain cautiously optimistic therefore I reiterate my belief that equities are a quintessential component for long-term investors targeting returns above a 3.00% GIC. While market averages may bounce around for a while, markets stand at a lower-risk, higher-reward juncture. Short-term market volatility is considered healthy and normal market behavior, although uncomfortable while in the midst of it. We encourage investors to consider on investing for the long-term as timing short-term corrections is impossible. We have confidence that the companies we own in portfolios will right themselves with the markets in the coming months and are not suffering from anything more than a broad sell-off and short-term repricing.

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How It Works

100 Friends, 3 Charities, 4 times per year.

We're just a group of people looking to make a greater impact together than we could do on our own. We get together once every three months, bringing along $100 each. Three local charities pitch, we all vote, and one amazing charity walks away with $10k+.

We've raised over $190,000 for local charities so far.

Snow
Wealth Management Group

Personal Note

When things get chaotic in the world I always make sure to take some time to be grateful, especially around the holidays. What helps me remember to be appreciative of what we have is by giving back to those less fortunate. As my avid readers know, I have been active with a group named ***Give a Damn Vancouver***, formerly 100 Men Who Give A Damn. We started as a handful of young business professionals from around the city and have grown to over 150 individuals from all walks of life. Every quarter we get together and each bring $100. We invite three charities and they each give us their pitch for our donation. We all anonymously vote, and one amazing charity walks away with $10K+. With the matched donation of some incredible local professional hockey players we have been able to raise over $190,000 in the last three years!

Our October event winner was the Stigma-Free Zone. They started as a support group for bipolar women suffering in silence in Victoria. They have grown to working with numerous schools, organizations and businesses to help create a Stigma-Free agenda for a number of mental illnesses with all age groups and sexes. We implore their ongoing work and efforts.

It's been remarkable how much interest we have had from charities and our waitlist for a nomination has grown to over a year. A good way to get on our radar is to get involved at one of our events. If you have any interest or would like to participate in one of our events don't hesitate to reach out to me.

Before I sign off, I just wanted to reiterate that helping people reach their financial goals is the most professionally satisfying thing I do. So if you come across anyone who might want some help with their goals, retirement plan or investment strategy, let me know. I'd love to see if we can help!

Happy Holidays!!

Marley

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