Capital Markets Overview

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Compliments of:

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Let us repeat what we stated in our 'Winter' edition:

***"Market Correction Update**: We finalized the writing of this newsletter just as the market correction started in early February. It may still be ongoing as we write this but this was expected after such a long run without a correction. We remind all of our readers that equity market corrections (downward moves ranging from 2%-10%) are very healthy and usually quite common over an economic expansion. This one is quite frankly desirable as market technicals were well into overbought territory and need to moderate for the market to move higher. We anticipate some sideways action in most global equity markets over the short-term with renewed strength to the upside along with increased volatility in the months ahead."*

We are of a similar opinion presently. The high for the Toronto Stock Exchange (TSX) occurred on Jan 23rd, 2018 at 16,357 (Bloomberg). The low occurred on April 4th, 2018 at 14,991 – a 1,366 decline from top to bottom or 8.4%. Today (April 13th, 2018), the market closed at 15,273 – up from the April 4 low but still down from the high. We feel this correction could be over *but entering at this stage would be a 'higher risk' entry point.* Markets will likely remain volatile. That said, risk or no risk, we remind everyone our target – in this business cycle – for the TSX is 17,000. We established this new target shortly after the market hit 16,000 (our previous target) and you may all wish to review previous Capital Markets Overviews (CMOs) to see how we arrived at these targets. If we hit our new 17,000 target, such would be a 1,727 future point advance or an 11.4% gain. Interest rates, while rising, remain at very low unappealing rates. Furthermore, as long as they are rising, the outlook for Fixed Income is 'very cautious' because bonds decline in market price and value as rates rise. We still believe there is more risk in the Fixed Income asset class than in the Equity asset class. It is most unfortunate that there is no place to 'run-and-hide' and, if one is 'risk averse' we continue to advocate the acceptance of low rates of return (1% - maybe 2%) until better value emerges in either the Fixed Income and/or the Equity asset class.

The benchmark returns for the 1st quarter of 2018 were not great either. The Canadian equity market was down 4.5% while the U.S. S&P 500 was also down .8% (but up 1.7% in Cdn $$ terms). 3 month T-Bills generated just a .3% return while the Cdn broad bond composite got just a .1% return. Net most returns were very low to negative. As we stated above we still favour the equity markets if you want better returns but we are also one of the first to suggest that both the Equity and Fixed Income asset classes have elevated risks. Patience please.

As a Reminder there are really only 2 Asset Classes

The 2 assets classes are: (1) Equity, and/or (2) Fixed Income. Some might suggest there is a 3rd asset class – called Cash Reserves. This is true but Cash Reserves could also be considered a subset of Fixed Income since it involves fixed income products that mature in less than a year (such as a treasury bill or money market fund). Technically those that mature over a year are called Fixed Income. For this purpose we group both together.

The truth is Arnaud Wealth Management Group (AWMG) is not wild about either asset class because both asset classes now have a fair amount of risk. But given we only have 2 to choose from, we favour Equities over Fixed Income. The reason for this is because we do NOT see a recession on the horizon and we believe that earnings should be quite solid this quarter and next. It appears, for the first time in a long time, this is also global in nature as reasonable economic growth patterns are synchronized globally.

This will likely lead to rising inflation and this, of course, will likely lead to rising interest rates. And rising interest rates puts a great deal of pressure on bond prices (bond prices decline if yields rise – this is a mathematical fact and the only guarantee we can give – if bond yields rise, bond prices ***WILL*** decline) and this applies to other fixed income products. AWMG feels that equity prices have 'corrected' in the past 2 months and should be in the position where they yield future positive results.

Economy

The economy is NOT robust but it is fine. There are currently very few signs of a recession on the horizon. The last recession we had was in 2008 – so this means this business expansion is getting long 'in-the-tooth' at 9 years – among the longer ones we have experienced. This is likely due to the historically low interest rates in the past 9 years. And while these rates are now rising, we do not forecast a period of rapidly rising rates but rather a more subdued outlook – at least for awhile yet. Inflation must be watched carefully because all bets are off if it gathers a head-of-steam. We feel that some cyclical exposure is important to have in your portfolio for the near to medium term. We have positions in mining and oil and gas in our model portfolios.

Our investment philosophy is to reduce (but ***NOT*** eliminate) Equity exposure during periods of time just prior to a recession and during the first few months of one. Most recessions last 6 to 9 months. Hence, since a recession is not on our radar screen presently we prefer to weight portfolios with 'some' Equity exposure. However, given that this cycle is getting 'long-in-the-tooth' and that many selections, in our opinion, are fairly valued – as stated above - such conditions prevent us from being overly bullish on equities and we remain with a conservative bias. We are more in the mood to 'preserve capital' than to 'generate returns'.

Model Portfolios

Canadian Equity Model – as at April 16, 2018, with the TSX down 5.6% this model is holding its own. We have 17 selections in this portfolio with a 13.8% position in Cash Reserves. We have been very inactive in the quarter – selling **Trans Canada Pipe** and **Lundin** while adding **Teck Resources** and **Tricon Capital**. Our positions with weightings in parentheses are as of April 27, 2018: **Brookfield Asset Management** (3.6%), **Tricon Capital** (4.3**%), Real Matters** (3.3%), **T D Bank** (4.1%), **Parklawn Corp** (6.6%), **Maple Leaf Foods** (5.9%), **K Bro Linen** (3.5%), **Air Canada** (9.2%), **Cargojet** (3.6%), **Evertz** (4.3%), **Maxar Technologies** (3.1%), **Chorus Aviation** (6.1%), **Parex Resources** (9.6%), **Altagas** (2.5%), **I Shares Gold** (3.4%), **Teck Resources** (8.5%), and **Vermillion Energy** (4.7%).

U.S. Equity Model – as at April 16, 2018 with the S&P 500 up 0.1% we were very active in the first quarter of 2018 – so will we give you our current positions as of April 27, 2018 and their weightings: **Synchrony Financial** (3.9%), **Charles Schwab** (5.3%), **Berkshire Hathaway** (4.2%), **AIG Wts** (5.1%), **Electronic Arts** (5.7%), **Disney Corp** (5.1%), **Alexion Pharma** (4.0%), **Broadcom** (4.0%), **Google Inc** (5.1%), **Dow Dupont** (5.8%), **Alibaba** (4.5%), **I Pay Prime Mobile** (2.7%), **Tencent Holdings** (5.4%), **Microsoft** (12.1%), **Lennar Corp** (9.0%), and **Centennial Resource Dev** (8.0%). The Cash weighting in the portfolio is 10.3%.

Fixed Income Update

Not only are interest rates continuing higher to start the year, but credit spreads widened through much of February and March before tightening slightly in April so all areas of the fixed income markets have been under pressure of late. The market is clearly somewhat concerned about rising interest rates as we are finally seeing signs of inflation which suggests the U.S. Federal Reserve (and to some extent the Bank of Canada), may be forced to raise interest rates, rather than taking a more passive data dependent approach. While the headlines suggest stocks don't like rising interest rates, historical data suggests otherwise. It's quite common for stocks to rise in value as central banks raise interest rates. It's not until the yield curve flattens or inverts that equity and other risky asset markets usually start to price in the chance of a recession and exhibit weakness. Currently, the short-end of the yield curve – 6mth to 2yrs – remains fairly steep which bodes well for banks and other financials, as well as overall economic activity. While the mid/long term yield curves as measured by the spread between 2 or 5yr bonds and 10yr bonds, and 2y or 5yr bonds and 30yr bonds are flattening, they remain steep enough to foster solid economic activity. On an absolute basis, many other long-term studies show that equity markets can easily rise while interest rates are not only rising, but they don't show signs of weakness until interest rates get to the 4.50% level, as measured by the 10yr U.S. Treasury yield. We're still well below that with the current 10yr TSY yield only flirting with the 3% level. At 4.50%, history suggests bonds become an attractive substitute for equities, especially if equities are priced towards the high end of their historic range.

The new U.S. Federal Reserve (the Fed) Governor Jerome Powell has also caused the market to pause and take note. While he appears to be less hawkish over the short term following his initial official comments in his new role, he still appears to be hawkish over the long run, suggesting the path for interest rates remains higher. This should be the balance that equity markets should strike as P/E multiples tend not to rise too much as central banks are raising interest rates. This suggests all of the heavy lifting in stock prices will have to come from increasing corporate earnings. Changes in the corporate tax code in the U.S. are certainly helping earnings so far, and are actually well-timed given the Fed's desired path for interest rates, however it remains to be seen if this pace of improvement can be sustained over a multi-year period.

Inflation is rising and while commodities are not our favourite asset class in general, they do serve as an effective way to help safeguard equity portfolios against the risks associated with rising interest rates. While general stock prices can move higher, it's harder for utilities, telecoms and other bond proxy type equities to rise during these periods unless they're exhibiting healthy earnings growth – which is not often the case for these sectors. We've positioned our portfolios in the hopes to take advantage of these trends.

On the U.S. Primary Election

With a Democrat recently winning in Pennsylvania - a state where President Donald Trump saw massive success during his Presidential campaign - it's safe to conclude the winds are shifting again for the U.S. political landscape. Many are now forecasting the Democrats will take back the House of Representatives with the Republicans likely holding onto the Senate. This suggests uncertainty in Washington is set to rise. The stock market may react negatively to this should the push to impeach President Trump become more pronounced. If the Republicans hold onto the Senate however, it's unlikely the simulative tax bill, President Trump's only major policy win to date, will suffer from a repeal. Given its positive impact on corporate earnings, this bodes well for risky asset prices. After factoring in current valuation levels and this balance of political risks in Washington, we continue to believe the risks point to a neutral or semi-conservative risk weighting as it relates to your investment policy statement.

On the 2018 Budget

A lot of the early Liberal government rhetoric concerning individual corporations did not make it into the most recent budget. As such, we can avoid discussing the previous scenario and focus on the changes that matter most:

The bottom line regarding the most impactful changes really only impact incorporated individuals with corporation investment accounts. Going forward, the government will only allow $50,000 of passive income generated within the corporation to be taxed at the lower corporate tax rate. Any dollar earned more than this level will result in the small business tax deduction being reduced by a factor of 5:1. As such, it becomes very punitive to generate income inside corporations going forward. The logic behind the $50,000 threshold is an expected 5% return on a $1,000,000 deposit. These monies are still subject to lower taxes to better support small business working capital demands including expenses, payroll, etc. The other major change is a stricter means test for any employees receiving dividends or income from the corporation for tax purposes. Going forward, if you're splitting income with family members, you will have to prove they are actively invested or participating in the business. The logic here is that many incorporated individuals were unfairly splitting income with family members that had nothing to do with their business to lower their tax bill. If neither of these scenarios apply to you, you have little to worry about regarding this year's budget but please feel free to contact us with any questions or concerns so that we can connect you with a TD specialist that can address your tax related questions.

On President Donald Trump

It is getting very difficult to ignore his antics but given all that he has done and said, we feel that it is amazing the equity markets have stayed where they have. President Trump is fixated on addressing the manufacturing trade deficit of the United States, even though he seems to ignore most economists who say it doesn't matter as well as the service surplus that the U.S. finds itself in with most countries. They're hiding behind the excuse that Steel and Aluminum industries are crucial to the Nation's security, however, in my opinion this just doesn't hold up. Not only do these industries currently exist just fine, and simply run at a lower capacity which could easily be ramped up during war times, targeted subsidies to support these industries would make a lot more sense and have far less negative economic impact across the economy. As such, we believe this Chinese tariff talk won't result in a full blown trade war as that is not in anyone's best interest. The NAFTA and other trade negotiations do carry negative economic consequences over the short-term however should common sense not prevail so we continue to watch this very closely.

Spousal and Synthetic Loan Updates

Spousal loans – a 'spousal loan' is an income splitting loan to help you save on taxes. With the recent rise in Canadian interest rates, the Canada Revenue Agency (CRA) is taking this opportunity to increases its posted prescribed rate interest rate from 1% to 2% on March 31, 2018. This is the interest rate used to implement a spousal loan strategy, a favourite of ours. All existing spousal loans are permanent for life and locked in at 1% providing you continue to service the loan, **so there is nothing to do if you already have a spousal loan;** however if you're interested in this strategy because you and your spouse are currently in significantly different tax brackets, please contact us as soon as possible so we can look into implementing this strategy. Spousal loans can save you thousands of dollars depending on your tax bracket. They often make sense for spouses in different marginal tax brackets with significant non-registered assets.

Synthetic loans -*a* synthetic loan is another means of obtaining affordable capital. As long as you have non-registered assets that can be used as collateral, we can raise inexpensive forms of debt in the market by borrowing/short selling Government of Canada Bonds. We then provide you the funds with the proceeds raised from borrowing and shorting the bonds. The rate of the loan is based on the bond's yield to maturity. Short selling does involve some risk. It also involves the potential for capital gains if yields rise. Please contact us to learn more about Synthetic Loans so that we can discuss in detail the potential benefits and risk of this strategy to determine if this could be suitable for you.

TFSA Contributions

Just another reminder that your TFSA contribution is $5,500 for this year; funds you should consider looking to shelter as soon as possible. Please contact us as soon as possible if you have not already done so as we cannot contribute to your TFSA without confirming with you first.

- Limit is $5,500 for the 2018 calendar year
- Total cumulative contribution room is $57,500

If you are unsure if you have maximized your lifetime TFSA contribution, contact the CRA at 1-800-959-8281, then press * to speak to an agent. They can provide you with your cumulative contribution total, which you can pass along to us so we can best manage this going forward. Unfortunately, we cannot contact the CRA on your behalf due to privacy reasons (otherwise we would!).

Specialized Wealth Management Resources

In addition to the core portfolio management services we offer, our colleagues at TD Wealth can also offer a wide array of additional wealth management resources. They include:

- Insurance – help protect the value of your estate. Call us to discuss further if this is a wealth priority for you so that we can connect you with a TD specialist that can provide you with more information.
- Will and Estate Planning – make it easier on the executor of your estate and your beneficiaries by ensuring good standing of your legal documentations - this includes powers of attorney for both financial and health related matters, wills, permanent executor and trustee services.
- Business Succession Planning – if you're the owner of a small business, there are unique tax-efficient ways to transition and sell your business when the time comes. Call us to discuss your options further.
- Financial Planning – we have simple and sophisticated options for financial and tax planning depending on your individual scenario.

If any of these wealth management services offer any interest, please don't hesitate to call us to discuss how they can be applied to your individual situation.

Summary

We believe there are currently elevated risks in both the Fixed Income (due to outlook for rising interest yields) and Equity (due to length of current economic cycle) assets classes and that the more conservative investment approach is to lower your investment profile and accept the lower investment returns that accompany this strategy. However, if you wish higher returns, we favour Equities and have a higher target for both the Canadian and U.S. equity markets.

Have a great Spring!!! See you in the Summer.

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