RICHARDSON GMP

Spring
2018

## Opportunity or Worry – Which to Choose?

**The underlying economic reasons for owning equities are compelling:**

- Global economic growth is solid. Leading indicators are strong.
- Earnings growth is fantastic. Lower taxes in the U.S. drive further earnings gains and fuel consumer spending.
- Interest rates are moving upward globally. Why? Because economic growth and inflation are both rising. When interest rates are low and rising, bond returns are low and possibly negative. Real assets, property, and businesses grow faster as demand for products and price inflation allows profits to rise. Equities post their best gains when rates and inflation are in their early stages of rising.
- Valuation is reasonable, although not inexpensive.

**When should equities be reduced?** As the following objectively quantifiable conditions *start* to occur, portfolios should shift *portions* of equities into cash, bonds, and alternative investments:

- The yield curve becomes flat or inverted. (Short rates higher than long)
- GDP revisions become negative.
- Earnings and/or revenue revisions become negative.
- Capital spending and investment starts reducing.
- Central banks are no longer raising rates or talking about reducing them.
- Volatility is low and starts rising.
- Market breadth narrows (few stocks and sectors are hitting highs).
- Relative strength shifts away from equity to fixed income.
- Relative strength shifts away from economically sensitive sectors to defensive sectors.
- Market neutral hedge funds start to outperform momentum and growth strategies.

**The only condition present is that volatility was low and increased. Investors should hold close to maximum levels of equity according to their Investment Policy Statement and minimum levels in fixed income.**

OUR PARTNERS

Brad A. Hunter

**Richardson GMP**
Suite 4700, 525 8th Avenue SW
Calgary, Alberta
T2P 1G1

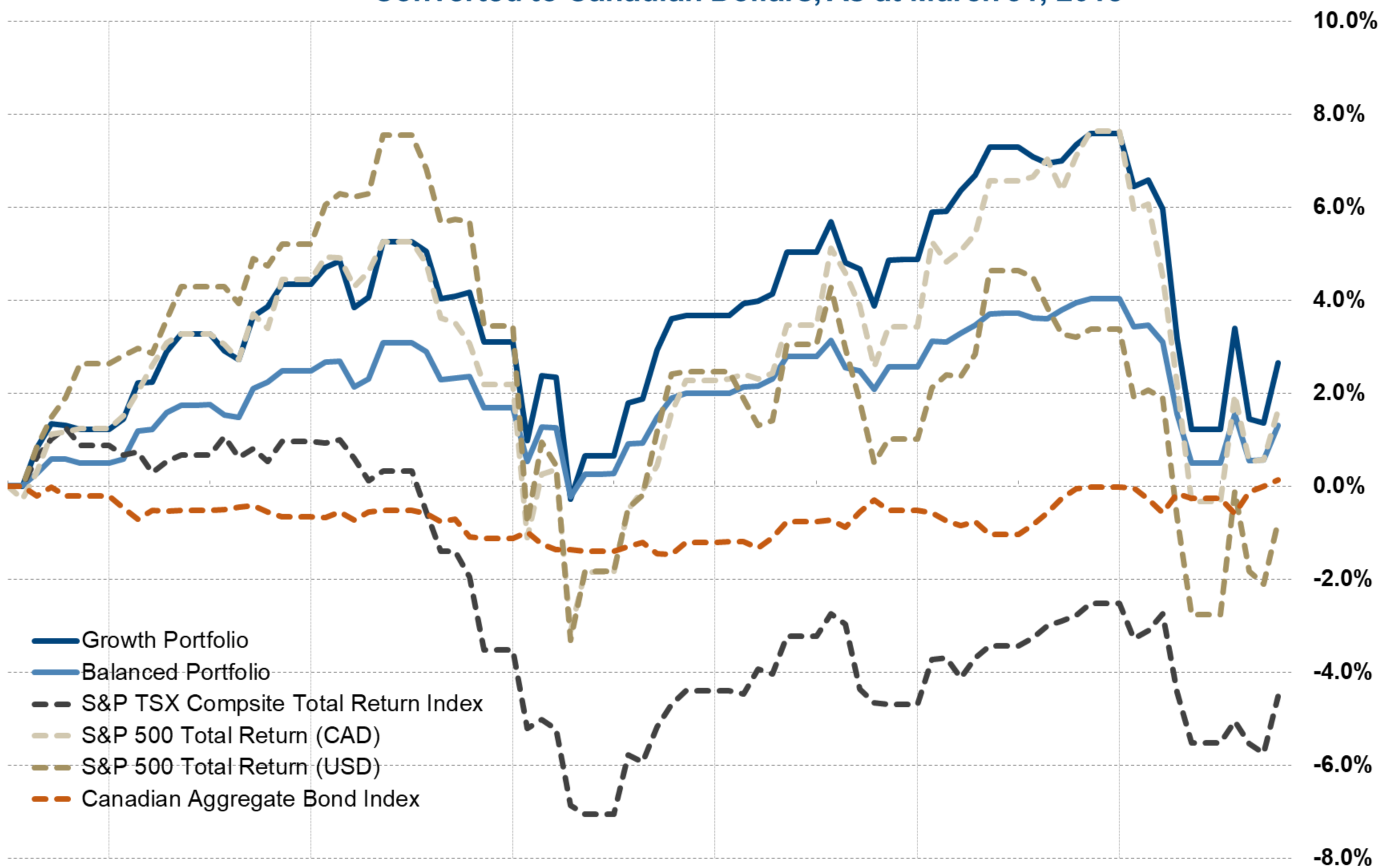
**Tel.** 1.866.867.7735
**Fax** 403.355.6109

**Brad Hunter, CA, CFP®, CIM®**
Director, Wealth Management
Portfolio Manager
**Tel.** 403.355.6033
**www.BradHunter.ca**

Connect with me on LinkedIn

**Rita Penno**
Associate
**Tel.** 403.355.6034

**Chris Mitchell, PFP®**
Associate
**Tel.** 403.355.6066




Source: Richardson GMP, net of fees, unaudited

**Growth Portfolio** is one specific growth-oriented managed account. The asset mix was approximately 80% equity, 5% fixed income and 15% alternative investments.

**Balanced Portfolio** is one specific balanced managed account. The asset mix was approximately 47% equity, 35% fixed income, 15% alternatives, and 3% cash.

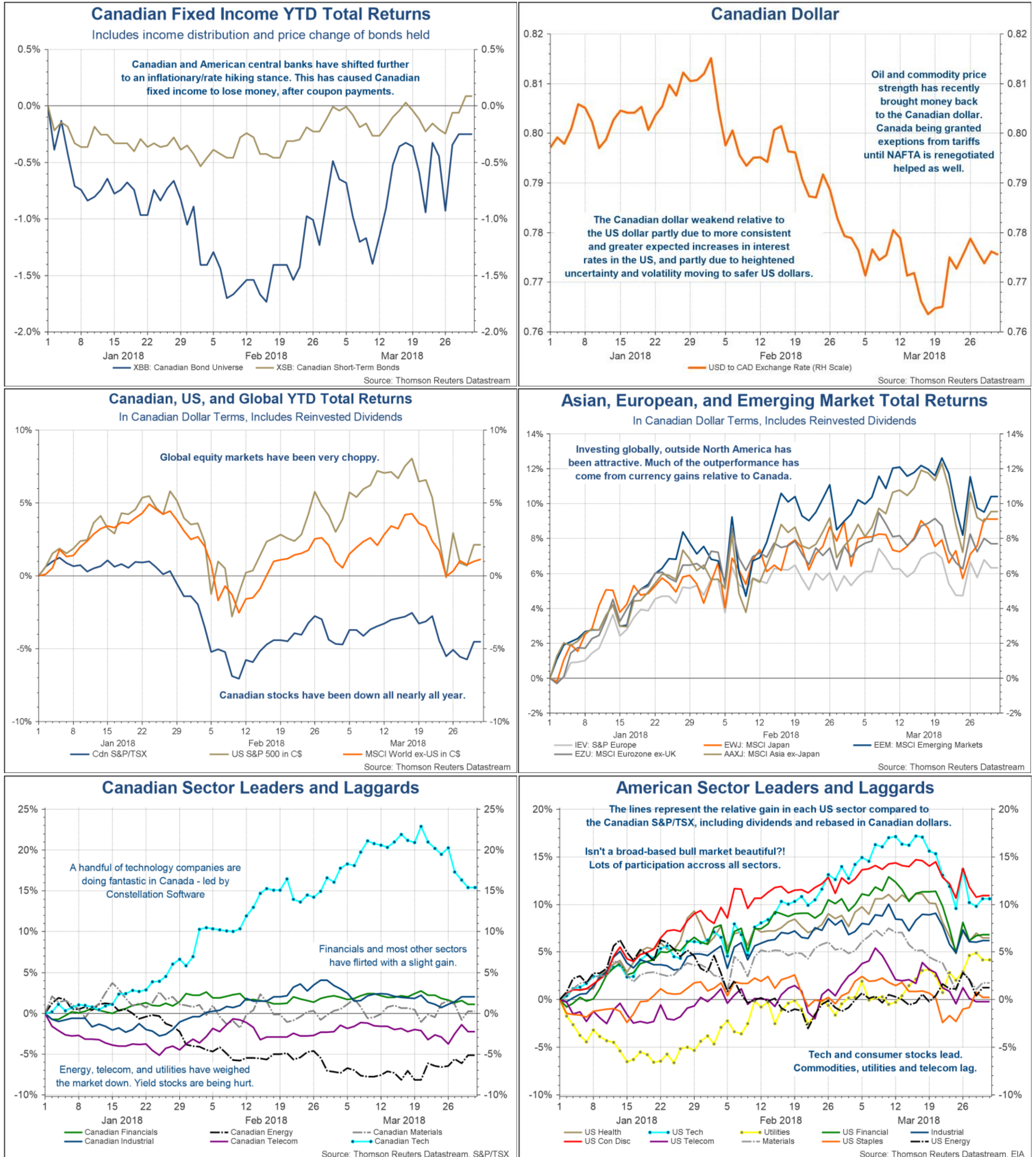
Selected accounts are considered representative of growth and balanced portfolios across most managed client accounts. The level of cash varied throughout the quarter. Individual managed accounts vary in results due to customization. Deposits or withdrawals to portfolios, and the resulting implementation of changes in securities held represents the largest cause for differences in accounts. Client-directed and non-model securities held in managed accounts can also result in a significant performance difference from the average experience.

**A great start to the year for managed accounts!**

- Growth investors are doing better than if they had all of their money at risk in the best benchmark – U.S. equity.
- The Canadian equity market is doing poorly; yet most clients are **beating this index by 5-7%** over one quarter**.**
- The Canadian bond index is flat year-to-date as yields move upward. Safety isn't so safe.
- Managed clients are making money in a negative environment, holding less risk and less volatility, while still making more money than if they risked their full portfolio in equity. It won't always be this good, but lets enjoy a great quarter!

  Thanks to those who emailed me encouragement – very much appreciated.

## 2018 First Quarter Key Market Perfomance



## Opportunities

**The underlying fundamentals in the U.S. economy and stock market are extremely positive.** The Purchasing Manager's Index created by the Institute for Supply Management and the Leading Economic Index developed by The Conference Board are two of the best leading economic indicators developed. They both include a grouping of economic indexes. Currently both indexes are as positive as they could be. When they have indicated economic strength, that has commonly been the case.

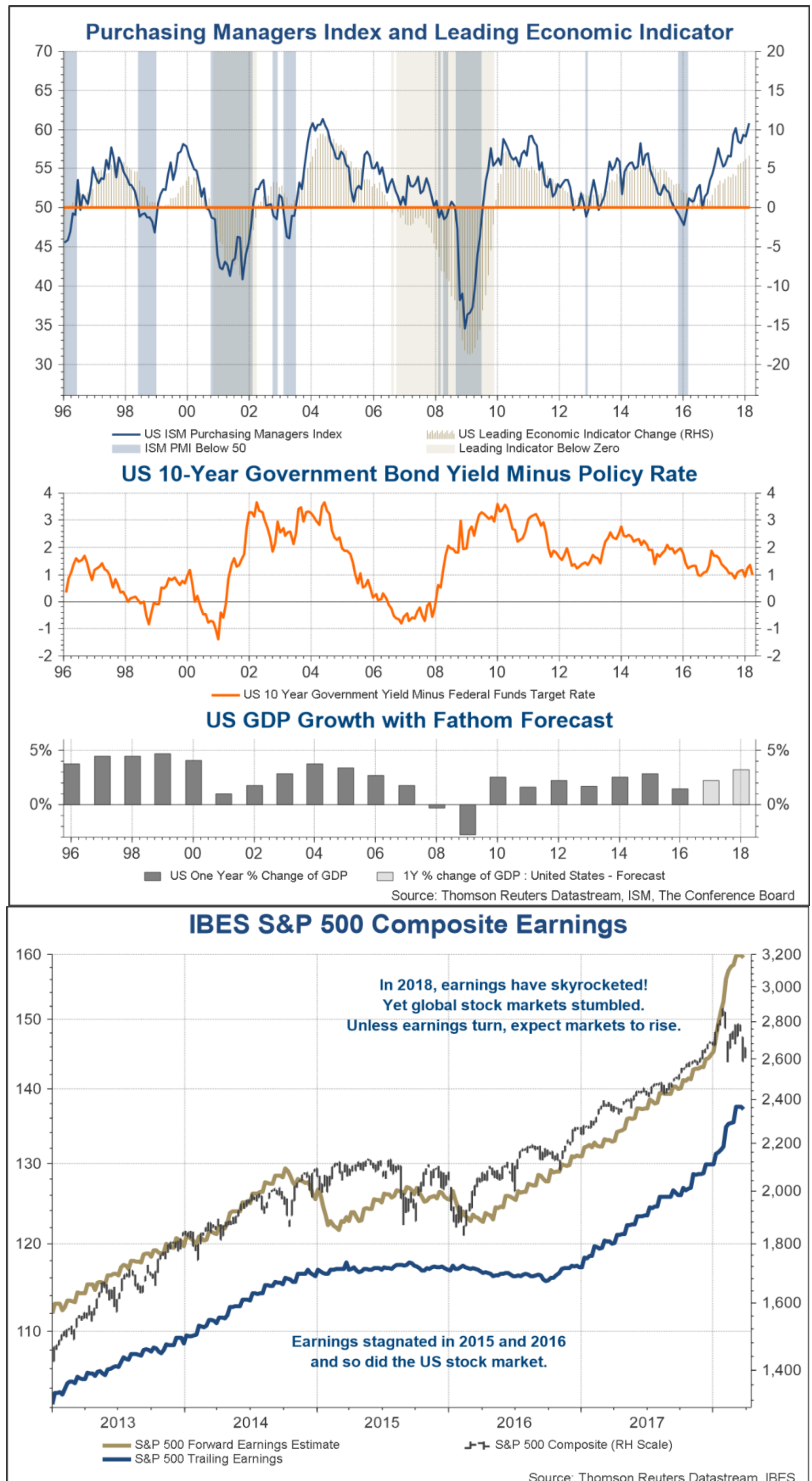
**Monetary policy**, enacted by changes in interest rates, has also been predictive of economic and market weakness. When short-term rates exceed long-term rates, the economy slows. Typically, within months of this condition, equities fall.

In investment jargon, when the yield curve becomes flat or inverted, the market is at heightened risk of falling. When it is normal or positively sloped, as shown by a positive number on the graph to the right, the economy typically experiences growth.

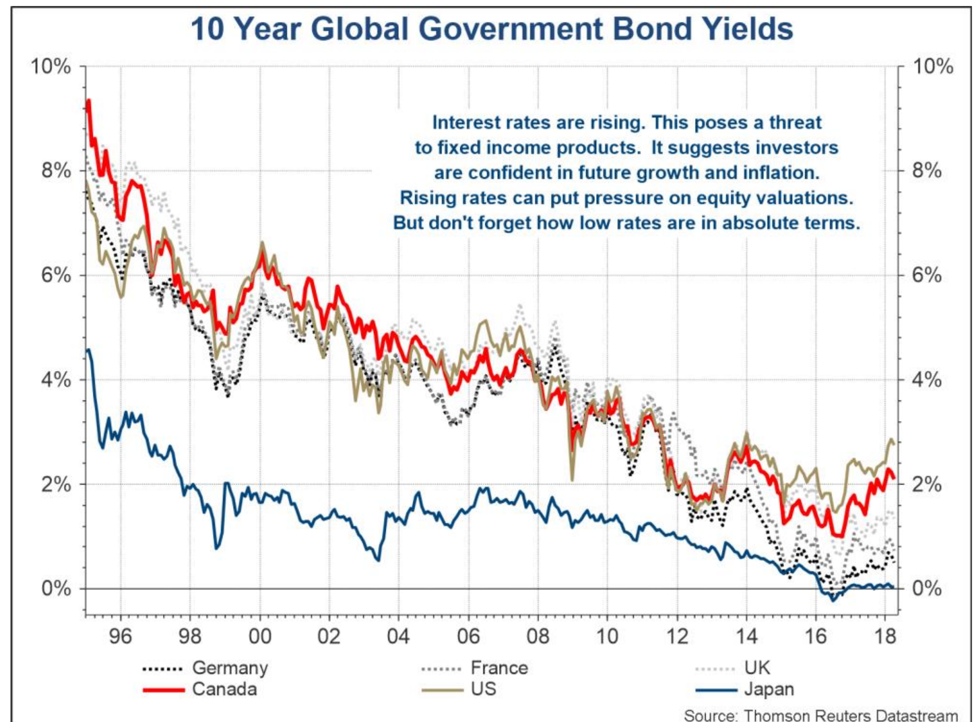
The interest rate environment appears to be several rate hikes away from even beginning to meaningfully slow the economy.

**Underlying earnings growth in the U.S. market has been spectacular**. Lower tax rates in effect for 2018 provide a boost.

**Companies that earn more money are worth more.** If this statement weren't true, then capital markets would be no different than a casino. Currently investors in the American broad market are discounting the reality of how much earnings are growing and have been revised upward. It is possible that current fears in the market will turn this trend. Until the trend *actually* changes, I'd believe it will continue.



## Worries




**Investing in global equities has been challenging this year.** Investors worry over the pace of interest rate hikes, renegotiation of global trade, currency volatility, and negative headlines about leading technology giants and political actions.

**1) Higher bond yields.** As interest rates rise, growth can slow and the discounted value of future earnings of businesses can decline. Investors have been surprised at how strong inflation, employment, and earnings have been. Central banks globally are confirming a trend of higher interest rates.

Rates moving upward does warrant caution, particularly after multiple years of it. But higher rates are also a byproduct of growth, inflation, employment, and greater demand for goods. These things benefit equities. Keep in mind that rates are still low in absolute terms and that they have not been rising for very long.

**2) Global Trade.** Let's quit acting like we work for the media and want to sell headlines by calling the renegotiation of trade terms a "trade war". Sure, it gets better readership to call it that. But there is no war going on. Trump has a clearly stated mandate to revitalize jobs, particularly manufacturing ones, in the United States. The vote for Brexit as well as many elections around the globe have highlighted the need for terms of trade to change everywhere. NAFTA is being rewritten. It's no big deal. Globalization has benefited the world for three decades. Today the global electorate cares more about having work and working where they currently live than getting the cheapest goods, in many cases.

There may be more protectionism in new trade deals. We are learning how interconnected economically the globe is and how complicated it can be to track a product through its various stages of creation. Don't fall into zealot ideals on how international flows and taxation should work, without knowing anything about how they currently do work. As political leaders and economists better understand exactly how goods flow around the world, there is potential they uncover a better system to manage, tax, and compensate businesses and employees fairly.

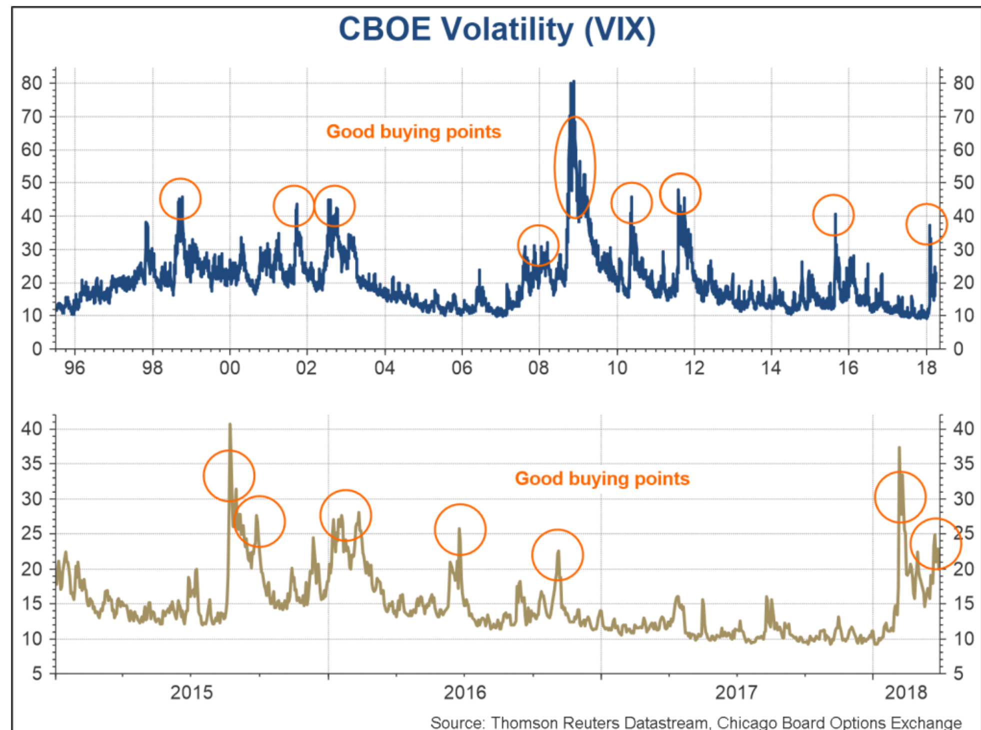
Brexit was about the renegotiation of trade terms. Markets sank for two days. Nearly two years later, they are substantially higher in Europe and around the world. The test of renegotiating trade terms for investors will be whether the underlying companies earn more or not. A likely outcome of trade renegotiation is continued upward pressure on rates and inflation.

**3) Technology stocks have also been hurt of late.** Investors worry about Trump attacking Amazon and additional regulation for Facebook. Analysts thought Amazon would earn U$8.08 per share this fiscal year two months ago, and now they think it will earn U$8.36 per share. They thought Facebook would earn U$7.16 per share this fiscal year three months ago and increased that now to U$7.26 per share. The direction of the earnings revisions tells you all you need to know. Facebook potentially being regulated in its editing and review of posted comments seems to have improved the potential earnings of the company forcing Facebook to adopt better standards on data management and privacy probably drives away potential competition and pushes them towards being the de facto standard in the social media space.

## Greater Volatility

Uncertainties like those described on the prior page has led to an increase in volatility. **Historically speaking, a spike in volatility has been a great opportunity to purchase equities for the long-term.** Within days to weeks of most "crises", markets rebound.

**The problem with using volatility is that it provides a pretty good buy signal but doesn't give much guidance on when to sell.** Low volatility can persist for months or years.



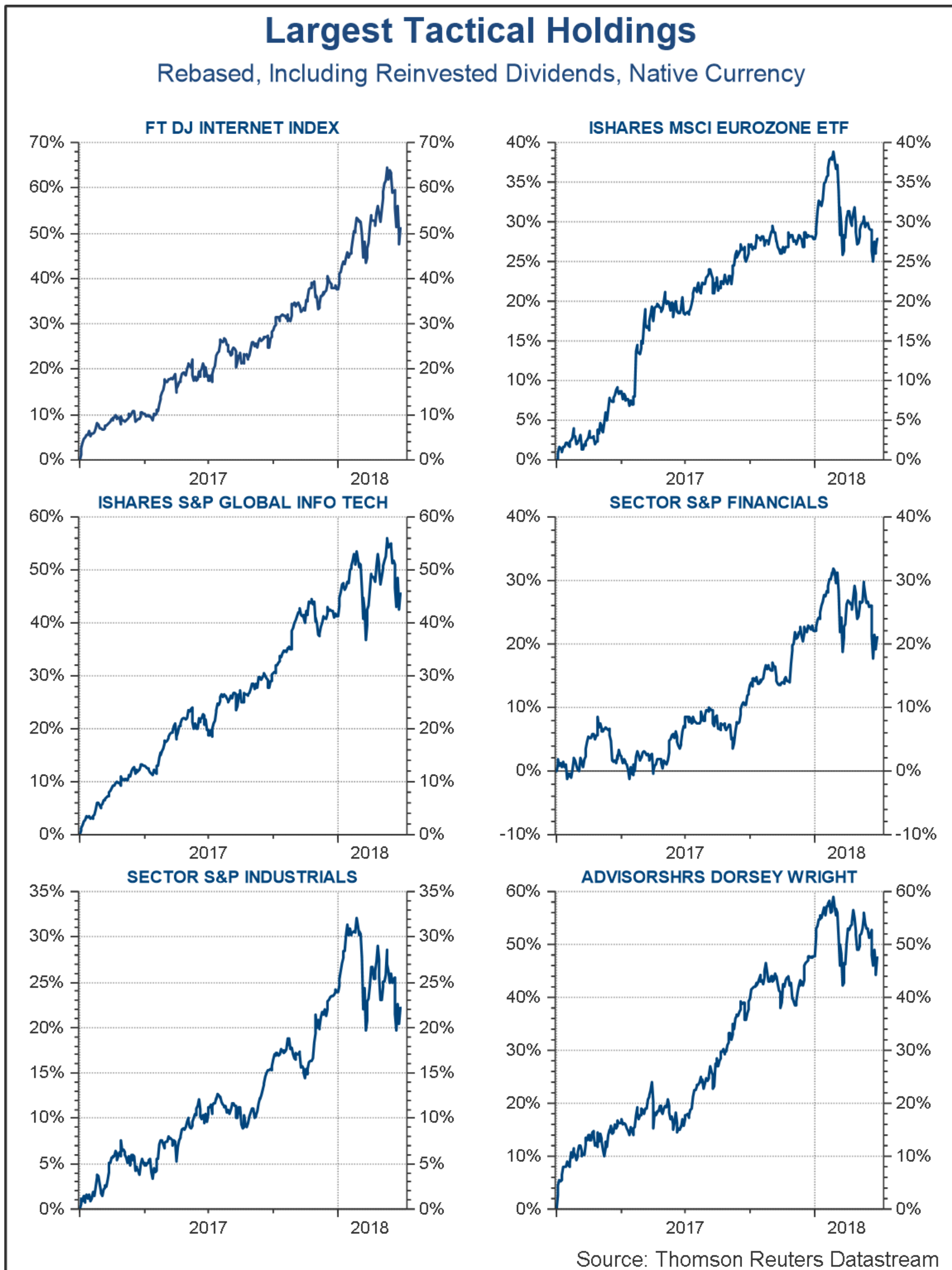

## What To Do

**Portfolios should firmly own significant amounts of equity and lower amounts of fixed** income because of stimulative monetary policy, robust GDP growth, leading indicators close to their most positive historic levels, robust capital spending, fantastic underlying corporate earnings growth, positive earnings revisions, wide market breadth, and interest rates lower than inflation.

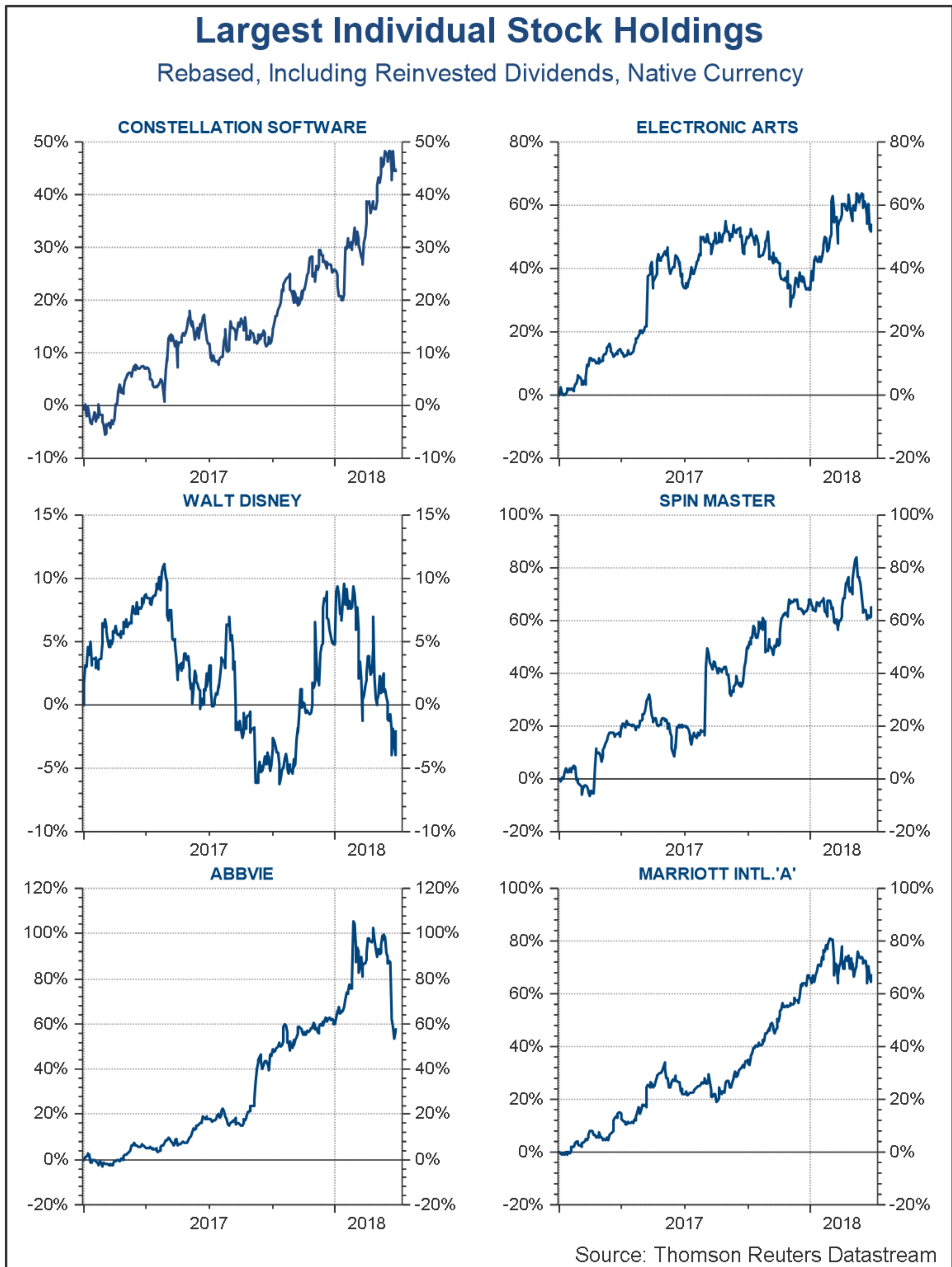
**Owning defensive stocks that often have high yield and low growth is going to be of little help.** These securities may suffer as interest rates rise their yields become less attractive. Without being able to participate very much in the current growth that is driving inflation and rising rates, defensive securities are less attractive.

**Hedge funds (particularly market neutral ones) show their greatest outperformance during the later stages of the economic cycle** and well into the ensuing recession. Investors thinking that the bull market may be coming to an end should consider increasing their exposure to alternatives. As market breadth narrows, hedge funds have the best chance of performing well. That is, as fewer securities contribute to a rising stock market (and more of them start to have negative returns), hedge funds become ideally positioned to potentially win on both their long and short positions simultaneously. Currently, with so many securities participating in the rally, their short book tends to hinder performance (it's harder to find securities not going up). Last year many hedge funds struggled. So far this year, they are performing closer to equity markets, sometimes better. This is also an indicator to watch providing insight into when the bull market might be over.

**Start raising cash when the VIX becomes low and securities hit new highs again.** This may cause the portfolio to potentially underperform as markets continue to rise. Unless there are many other signals suggesting a major market downturn, only 5-10% of equities might be trimmed towards market highs. By using a smaller cash buffer, the overall long-term strategy will be kept intact and allow significant participation in the primary upward trend. The increase in volatility may continue, particularly as an effect from rising interest rates. A small amount of funds that can capitalize on greater uncertainty and volatility that doesn't jeopardize the long-term investment strategy may allow more opportunistic moves.




Represents the six largest tactical positions held in managed accounts. They are all exchange traded funds.




Represents the six largest individual stocks held in managed accounts.

## Call Me for a Discussion

Want a partner to help you with managing your financial decisions?

Have enough to do at work?

Wish you could spend more time with your family?

Is watching Netflix more appealing than reviewing charts and financial statements?

When do you get time to develop your hobbies and personal interests?

Not sure how to structure a portfolio to optimize tax reduction?

Can't keep up with all the changes in taxation, technology, and financial markets?

Please give me a call. Let's find out if we can save you some time, improve your results, and give you a greater sense of confidence in your financial strategy.

**I sincerely appreciate your business. I strive to earn your trust. I appreciate introductions you could make for me to any family or friends that might benefit from our services.**

Regards,

Connect with me on LinkedIn

**Brad A. Hunter, CA, CFP®, CIM®**
Portfolio Manager, Director, Wealth Management | **Richardson GMP Limited**
Suite 4700 • 525 8th Avenue SW • Calgary, AB • T2P 1G1

**Direct** 403.355.6033
**Email** Brad.Hunter@RichardsonGMP.com
**Web** **www.BradHunter.ca**

The opinions expressed in this report are the opinions of the author and readers should not assume they reflect the opinions or recommendations of Richardson GMP Limited or its affiliates. Assumptions, opinions and estimates constitute the author's judgment as of the date of this material and are subject to change without notice. We do not warrant the completeness or accuracy of this material, and it should not be relied upon as such. Before acting on any recommendation, you should consider whether it is suitable for your particular circumstances and, if necessary, seek professional advice. Past performance is not indicative of future results. The comments contained herein are general in nature and are not intended to be, nor should be construed to be, legal or tax advice to any particular individual. Accordingly, individuals should consult their own legal or tax advisors for advice with respect to the tax consequences to them, having regard to their own particular circumstances. Insurance services are offered through Richardson GMP Insurance Services Limited in BC, AB, SK, MB, NWT, ON, QC,NB,NS,PEI and NL. Additional administrative support and policy management are provided by PPI Partners. Richardson GMP Limited is a member of Canadian Investor Protection Fund. Richardson is a trade-mark of James Richardson & Sons Limited. GMP is a registered trade-mark of GMP Securities L.P. Both used under license by Richardson GMP Limited.