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RICHARDSON GMP

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Peaks, Valleys, and Strategy

Global stock markets were weak during September through November 2018. Then fell heavily in December. Reasons include:

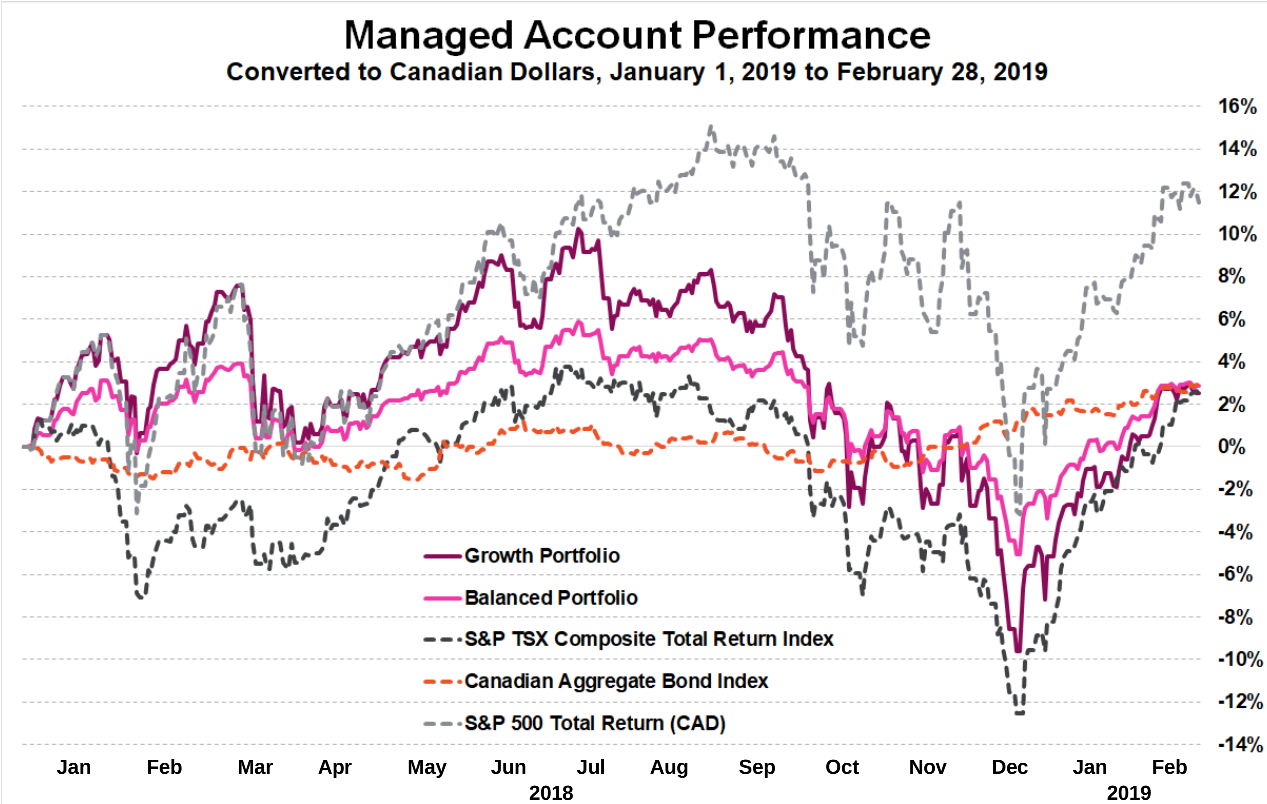
- The Fed's desire to raise interest rates three or four times in 2019, communicated early in December.
- Suspicion that global economic slowdown would spread to the US.
- Apprehension that tariffs and trade hostilities with China would cause further weakness.
- Government shutdown into Christmas season as well as heightened political tensions around immigration issues.

The subsequent rally from January through March 2019 was swift and substantial. Factors assisting the recovery include:

- The Fed reversed their previous stance of anticipating several interest rate hikes to not hiking at all or possibly once over the next two years.
- Actual earnings announcements were good, often beating recently reduced expectations. The economy was growing at a slower pace. But it is still growing. The panic was overdone.
- Progress seemed to be made on Chinese trade negotiations, potentially delaying or eliminating proposed tariffs. There has been increasing agreement that global trade issues need to be addressed. Businesses and consumers also seem to be adapting.
- The government shutdown ended without significantly affecting the US economy.

Portfolio strategy going forward:

- **Buying fixed income is attractive.** Interest rates went up steadily over the past two years. With Fed policy on hold and slowing economic growth, fixed income investments are more desirable.
- **Alternative investments have started to show consistently higher gains**. Risk management used in products that don't rely on the market to go up or on interest rates add to stability and consistency to portfolios. Average returns for the group have been fairly good.
- **Equities will be reduced from overweight, likely between now and June.** From the end of 2016 to the summer of 2018, US equities have been the <u>best</u> asset class. Equities have been owned heavily in portfolios, and exposure was increased during market weakness during the fourth quarter of 2018. Slowing earnings, heightened volatility, and uncertainty over sector leadership, suggests reducing the overweight equity stance to individual client portfolio average target levels. However, we don't want to exit the current rally too early.



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, 13% alternatives, and 2% cash.

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.

Managed Accounts

Both growth and balanced clients significantly beat Canadian equity and Canadian bond indexes for the first three-quarters of 2018. Growth managed portfolios nearly kept pace with the absolute best index in the world – the US stock market in Canadian terms – while typically only owning around half their portfolio in securities from that market. A fantastic run for much of the year.

However, portfolios were hurt by the market correction last Fall into December. By the end of the year, managed performance was slightly negative, but still several percent better than the Canadian index. Recovery in early 2019 strangely put fourteen month performance at around a 2-3% gain no matter what strategy was used, with the exception of results from a 100% US stock strategy.

Buying more equities during the market correction ended up hurting managed portfolios, as the correction ended up being longer and deeper than originally thought. However, this overweight equity position was maintained past December facilitating a rapid recovery in 2019. **Many portfolios are now close to their previous all-time highs typically set around August 2018.** The next challenge is selling some equity into market strength over the next few months.

The Fed

Before Christmas, why did the Fed see reasons to consistently increase interest rates over 2019, while instead investors, economists, and some politicians seemed to demand the opposite?

The Federal Open Market Committee is the monetary policymaking body in the US. It sets the interest rates banks get when they lend to each other, and broadly has an impact on the direction of US interest rates.

The Federal Reserve's job is to achieve maximum US employment with stable prices. Looking at jobs and inflation data helps us better understand the Fed's position, since that is their focus.

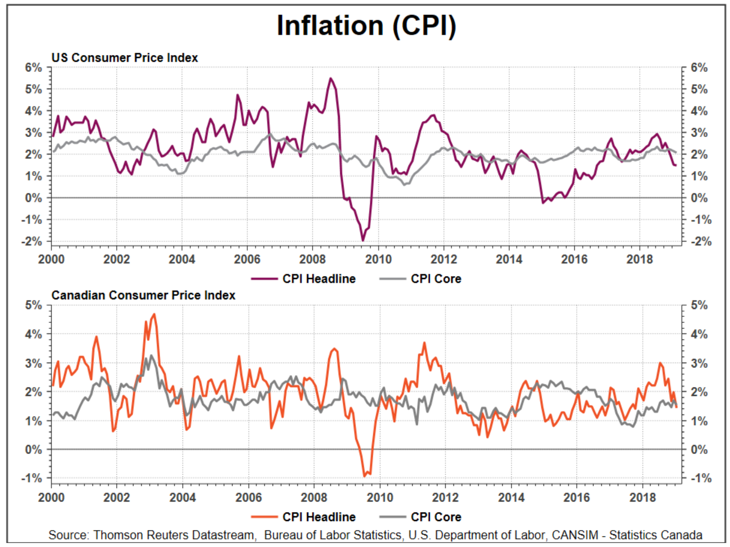
Inflation has been steadily rising since the last slowdown in the earnings cycle three years ago. Last summer, core inflation was well over 2% and when more variable items were included in inflation such as energy and food prices, it was nearing 3%.

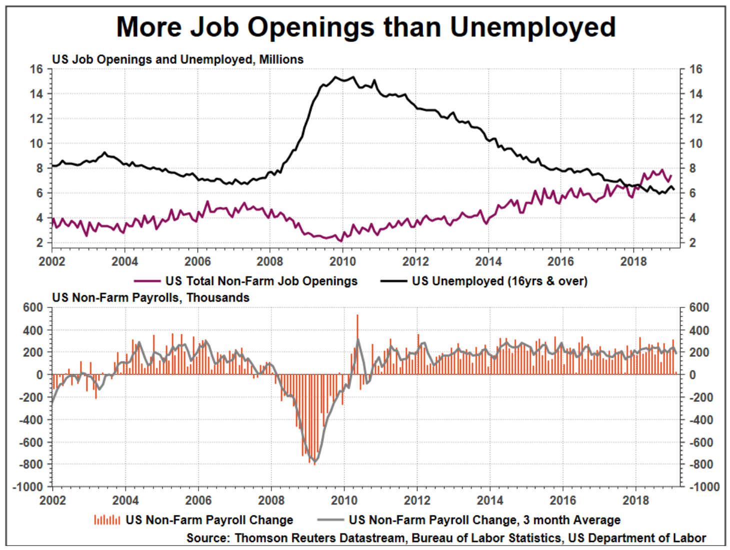
Work is plentiful in the US. Unemployment has dropped to its lowest rate in decades. For the first time since the data on job openings has been followed, there are more jobs available in the US than there are unemployed individuals. With strong labour conditions, it shouldn't be a surprise that average wages are rising.

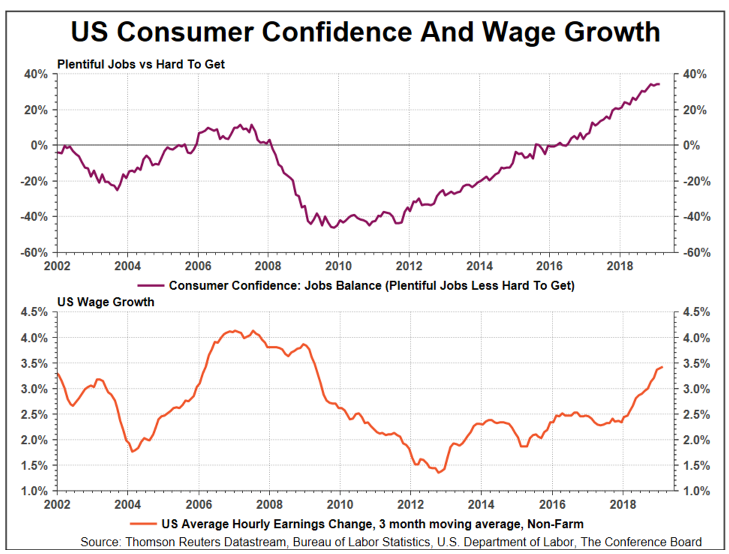
Wages have the strongest impact on overall inflation. When people are working, they are comfortable spending. With inflation moving to the high end of the Fed's comfortable range, and a strong labour market with wage pressures, one can understand the Fed's stance on wanting to increase interest rates to slow inflation growth.

Investors saw a policy of raising rates as making an already slowing global economy slow faster. So in December, they sold out furiously.

In its February 2019 testimony, the Fed reversed course, and explained that interest rate hikes were now off the table – maybe one at most and not for some time. Inflation had subsided, but it is hard to say how much the drop in stock markets and other factors played into this decision. This change in policy bodes well for both equities and fixed income.

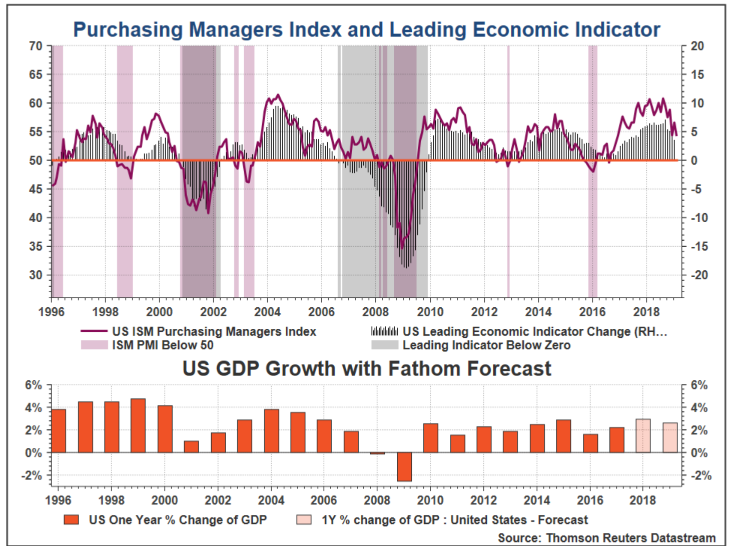






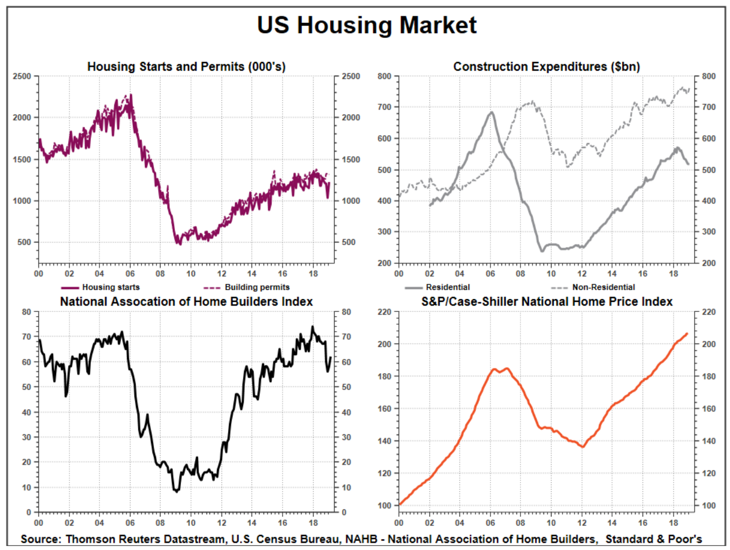
Is the US Economy Strong or Not?

Yes. But it peaked and is slowing.



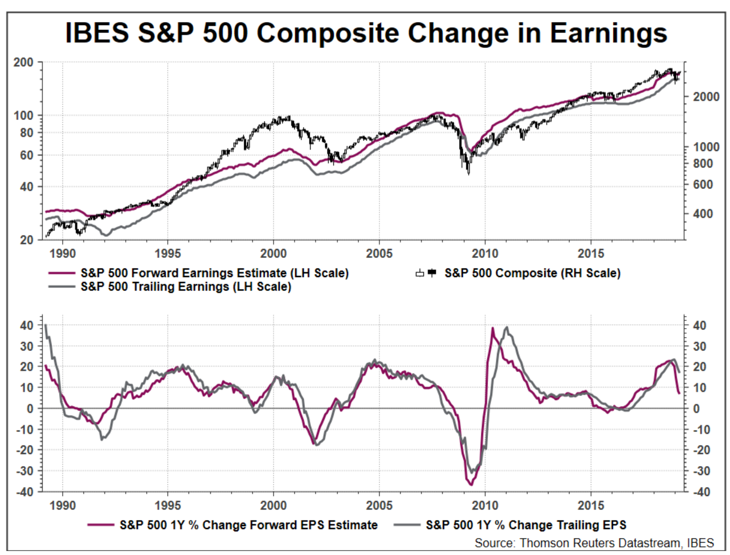
Some investors focus on leading economic indicators showing economic growth, GDP being solid, and corporate US earnings being strong. **Others** point to the rapid reduction in earnings from a recent peak and the slowdown in leading indicators, especially housing. **Everyone** seems confused on exactly how trade negotiations with China will ultimately affect the world economy.

The excessive panic in stock markets in December followed by a rapid rebound in early 2019 summarizes how these two popular opinions are rapidly adopted and then discarded by investors.



The strongest boost financial markets experienced in 2019 was a result of Fed Chairman Jerome Powell's testimony in February. He explained that the Fed saw several economic indicators had slowed, and recognized that the weak economies of Europe and abroad had a negative impact on US growth. Guidance changed from raising rates four times in 2019, to zero to one increase maybe later this year or next. Stock markets roared ahead. A month later, they still haven't stopped.

Fixed income has become more attractive. Over the past two years, investors received interest payments, but the value of their marketable bonds fell as rates went up. Rates were very low in absolute terms in the first place. The addition of inflation and taxes usually created an overall negative real return.



Today rates are higher, providing a better yield to maturity to start from. Interest rates appear more stable, or at least are no longer increasing. This allows investors to earn interest payments without seeing much change in the marketable underlying bond value.

There is still earnings growth in companies that make up the market. The US tax change in 2018 caused extraordinary growth that year, but distorts what is happening in 2019. Are earnings really slowing this year, or does the lower earnings growth rate just represent a reduction by the amount of the prior year's tax gain? **I don't think enough analysis has been done to separate tax policy effects in 2018 from recurring earnings**. I wouldn't be surprised if underlying earnings growth has been largely positive and consistent after removing the effects of the one-time tax benefit. With the Fed on the sidelines, keeping target levels of equity exposure makes sense.

Chinese Trade

The US buys five times as much as it sells to China. Therefore, tariffs and the current trade dispute hurts China far more than the US.

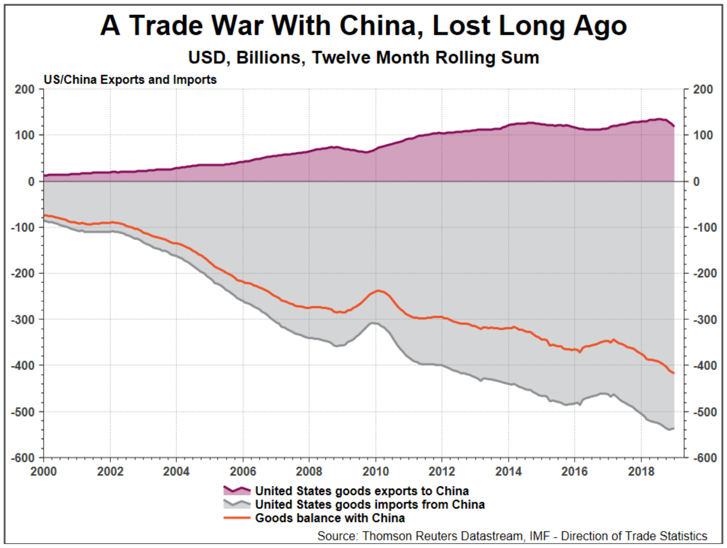
The trade relationship many countries have with China doesn't seem that healthy. Developed countries build manufacturing sites in China and direct input raw materials there. Products are assembled using cheap labour and then sold around the world. Having goods manufactured in China using cheap labour eliminates jobs in developed countries. How then do those in developed countries earn the income to pay for Chinese manufactured goods when their jobs are gone? How long can this model last for?

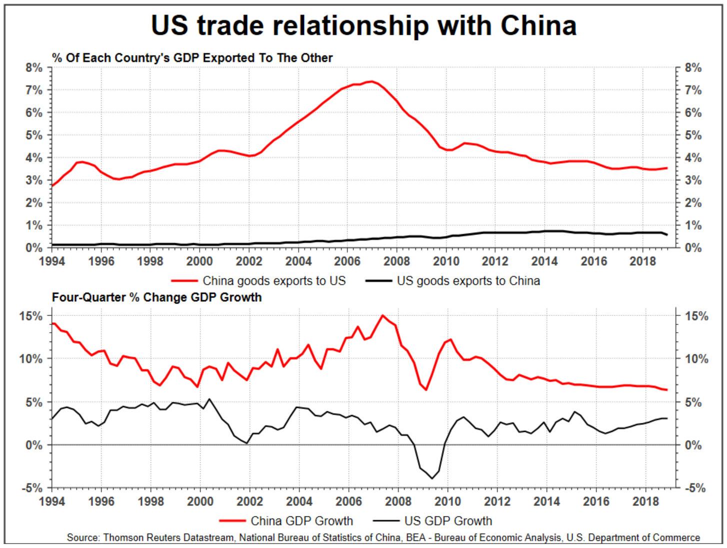
Intellectual property and worker rights are two increasingly significant issues that need to be addressed in trade with China. Chinese manufacturers have enjoyed significant cost benefits in labour by simply not providing many of the benefits and rights other industrialized economies offer. Copyright infringement and the requirement to share proprietary technology with the Chinese government has kept many US companies from selling their goods in China.

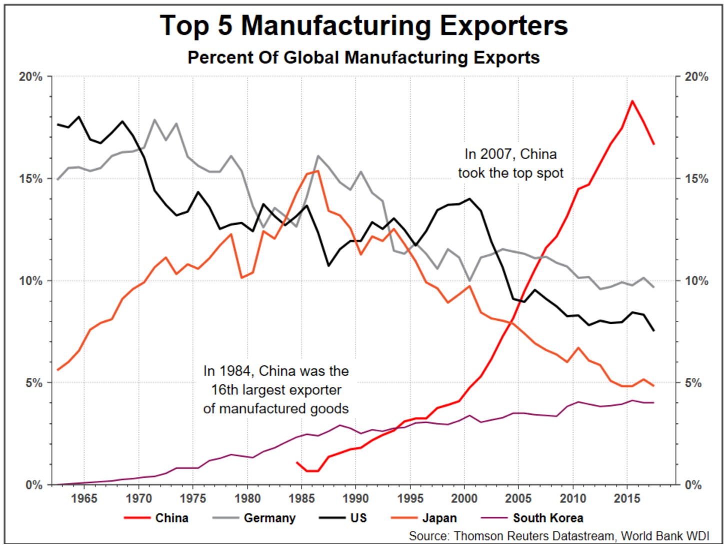
The US is a consumer economy that imports much more than it exports. It soaks up goods produced around the world. This buying power makes foreign companies dependent on American consumption, while American companies, broadly speaking, are far less reliant on foreign countries.

The current opportunity for investment portfolios is to focus on **owning smaller US public companies** that sell a greater number of goods and services within the US compared to exporting them. This strategy takes advantage of current trade disputes and negotiations. Putting tariffs, quotas, or other constraints on foreign companies selling in the US, will help domestic ones compete more efficiently.

Managed accounts own US small/mid cap baskets of stocks through the tactical model to take advantage of this trend.







Fixed Income

Yield represents what fixed income holders expect to earn per year over the life of the security. The average yields for the various credit risk categories to the right are based on typically 5-7 year terms to maturity. An index or average never actually has a maturity as the portfolio is constantly re-invested.

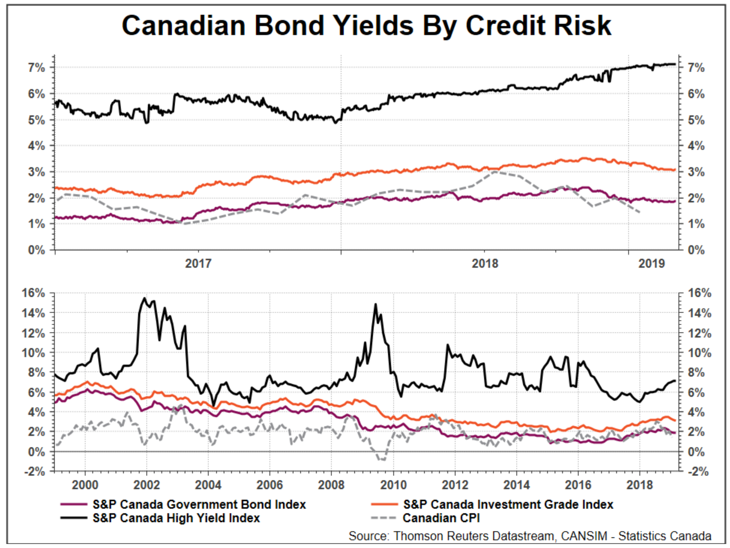
The total return is what fixed income investors actually get in a specific period, usually annually. Although fixed income investors pocket interest payments over the year, the marketable value of the bond changes over the bond's life. **The market value and total return move inverse to the change in interest rates.** The longer the term to maturity, the greater the change in market value will be for a given interest rate change.

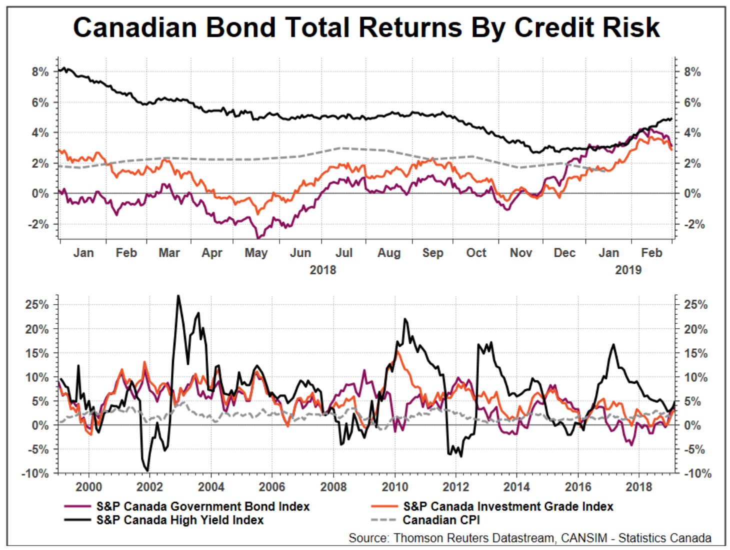
Total twelve-month rolling returns were negative for government and investment grade bond holders during most of 2018. This is because rates moved up significantly. By 2019, as expectations for rate increases evaporated, total returns went upward (as interest rates mildly subsided).

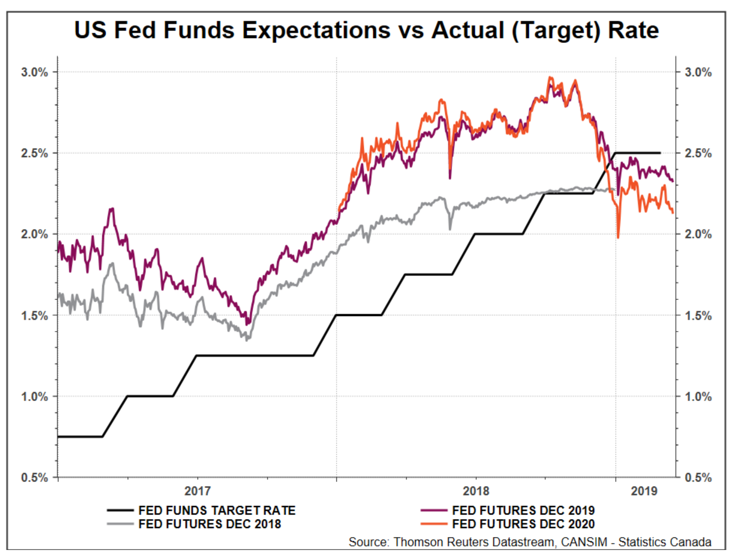
Fed minutes and testimony still seem to suggest potentially one more rate hike over sometime in the future. But on average, fed funds forecasters are actually forecasting a rate decrease sometime over the next two years. Will strong employment and wage pressures keep the Fed potentially raising rates when global economic slowdown suggests a more accommodative strategy?

Fixed income as an investment has become more attractive for a Canadian. Roughly speaking, government credit provides a 2% yield. Moving to investment grade corporate bonds yields 3%. Sprinkling in a portion of high yield securities (which have higher risks of something going wrong) might improve some of the portfolio yielding 7%. Currently in managed portfolios, a combined portfolio of these elements yields between 4-5% (selections are made by individual client risk tolerance).

Fixed income forms a foundation for returns in a balanced portfolio.







Technology

Tech stocks continue to lead the US stock market. The underlying reason is simple: earnings growth.

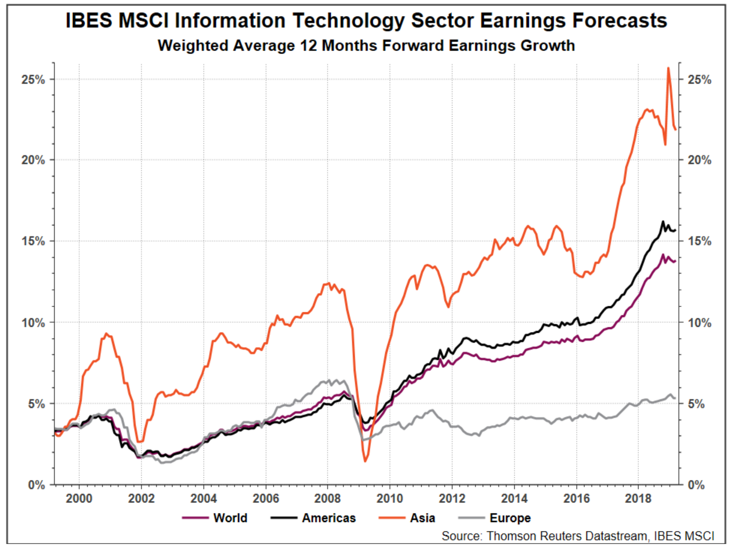
The decline in global markets during the fourth quarter of 2018 hit technology stocks extensively. Major market corrections often coincide with leadership ending in some sectors and rotating to new leadership in other ones. Tech stocks have been favourites and leaders for several years, many having higher than average valuations. There was a significant risk that tech leadership may have come to an end in the fourth quarter of 2018.

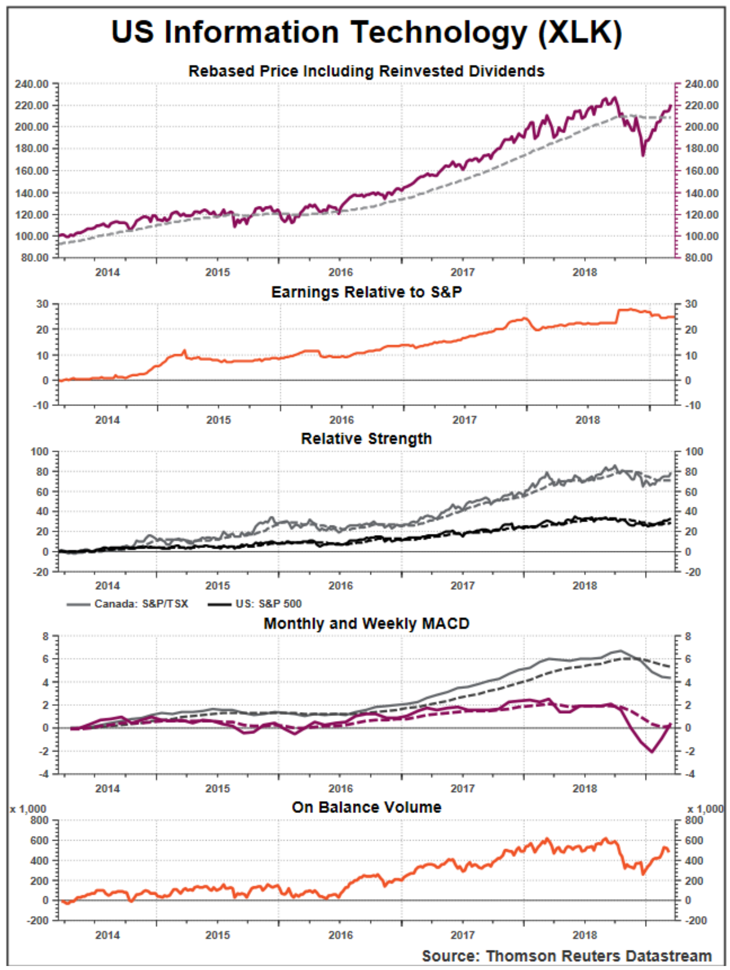
However, technology bounced back in 2019 to re-establish itself. In fact it is one of the few sectors that has shown consistent leadership the entire 2019 recovery. Energy stocks, industrials, consumer, and even financials had inconsistent spurts of leadership. But in all of these cases, it has been spotty and difficult to really be sure if the relative strength will last.

As a group, the technology sector is above its forty-week moving averge price and regained relative strength against both the Canadian and US markets. This upward move has been confirmed on significant volume buying. The weekly moving average convergence/divergence (MACD) has just posted a buy signal, although the longer term monthly MACD signal has not yet confirmed a longer term uptrend.

One cause for concern is that earnings growth seems to have peaked. Earnings growth is still high, but slowing growth adds some risk to expensively valued technology stocks. On a relative basis, underlying earnings growth has weakened the last few months to compared other sectors.

Technology continues to be held overweight in managed portfolios. Stocks such as Constellation Software, Cisco, and Genpact are directly held. Larger portfolios also hold Paypal, Mastercard, Nvidia and Square.





The largest holding in portfolios is the First Trust DJ Internet Index. This basket holds sizable proportions of Amazon, Google, Netflix, Facebook, Paypal, and Ebay. Another basket held in managed accounts contains broader technology companies such as Apple, Microsoft, Intel, Oracle, and Samsung. A cybersecurity exchange traded fund is also owned in the tactical model to take advantage of the growing importance to protect information.

Discretionary Management

Money is fuel. It allows you to either do the things you want to do, or prevents you from doing them when you don't have enough.

Financial management is matching your current investments and future earnings to the things you want to spend it on over your lifetime. A financial plan maps this out. It helps you confidently live your life, knowing you have planned out the "fuel" to do it.

A rate of return on the investments in the plan is key to making it work. Having a written Investment Policy Statement sets out the rules and strategies used to manage investments. Reporting allows comparison of portfolio results to the plan, giving you confidence you are on track.

With discretionary management, each family is placed into multiple securities models uniquely based on their goals and risk tolerance. When a security in a model changes, management software aggregates all the individual client purchases into one bulk trade. All clients get their proportionate share of the fill in any transactions that affect their portfolio. Fair and efficient. Non-discretionary Investment Advisors must call dozens or hundreds of clients to facilitate each transaction. Their time is spent simply calling clients for authority to transact.

Having the discretionary ability to enact trades proactively has significant benefits. It frees clients from having to make constant and numerous decisions. The relationship and communications between the Portfolio Manager and his or her clients focus on understanding the client's situation, designing solutions, and finding appropriate securities. It allows for consistent and simultaneous management across all portfolios.

The person with authority to trade bears responsibility for results. If you want advice from an Investment Advisor because you want to be involved, that's great. But the returns are yours, and management occurs when you, the decision maker, communicate with the Advisor. If you want to delegate managing your money then you need to give a Portfolio Manager the discretionary authority to do so. The decision maker is the manager.

I sincerely appreciate your business. I strive to earn your trust. I appreciate introductions to any family or friends that might benefit from our services.

Regards,

Your Wealth Team

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