The Market in Review

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This week's articles and insights

1. *A View from the Heights*
2. *Follow the Money*
3. *Are You Surprised?*

"Nobody is afraid of the heights. They're just afraid of the fall."

- **Anonymous**

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	23,434	+4.95%	+18.58%
S&P 500	2,581	+0.23%	+15.29% (+9.95% in $CDN)
TSX	15,954	+0.61%	+ 4.36%

A View from the Heights

Most talking heads on TV are full of doom and gloom. We have an ingrown fear of heights and with the Dow Jones Industrial Average setting 69 new record closing highs since the 2016 presidential election, many are nervous. We may have come too far, too fast.

When trying to determine whether or not stocks are over-valued, the first thing we look at is earnings. The US market, as measured by the S&P 500 index, has a forward price/earnings ratio of 19x versus the 50-year average of 16x. On the surface, it is somewhat expensive.

However, earnings have been rising strongly, which is likely what the market is responding to. Normally, the period from November 1st through April 30th is the strongest part of the year for stocks. This year, the weakest months – May through October – have been very strong. September and October have the worst records historically, and yet they were among the strongest this year.

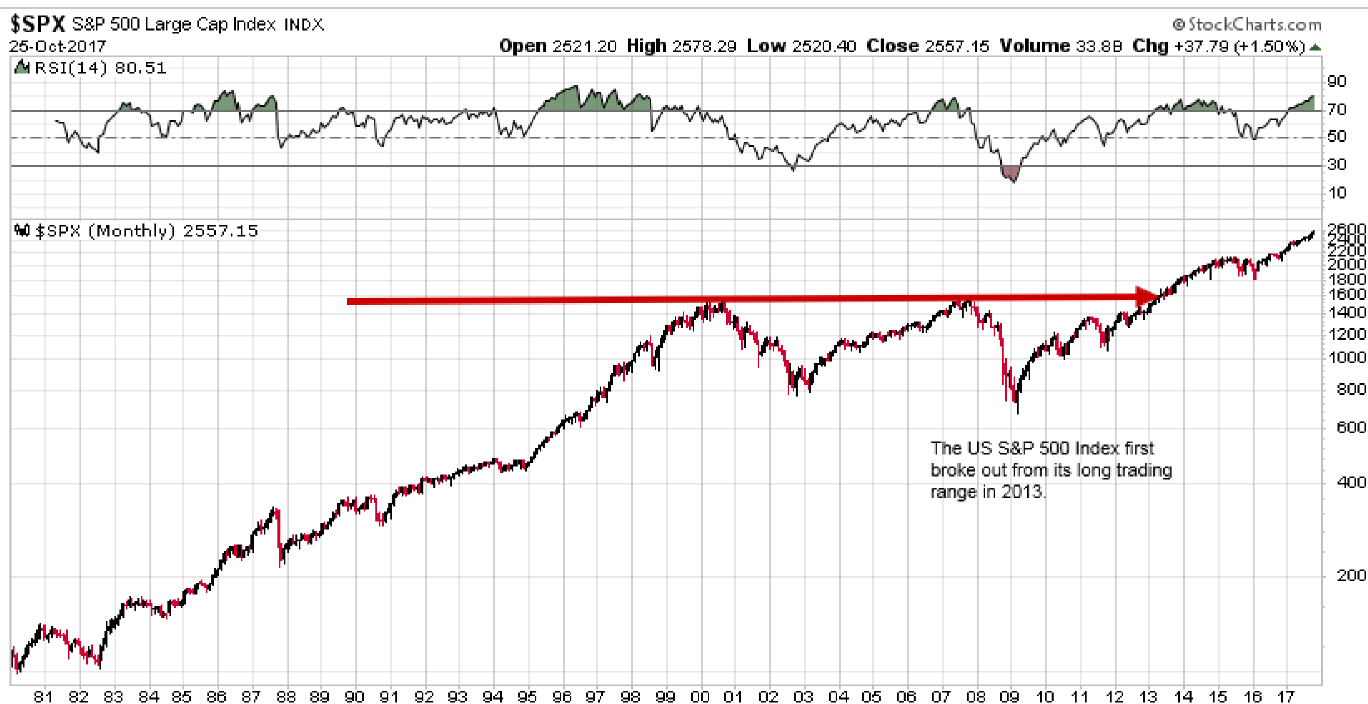
Perhaps November and December will also do the opposite, with stocks pausing, or even declining. We have said for months that we expect some sort of pullback and have been wrong. At some point, even a broken clock tells the right time, so we may yet get our decline.

Peter Mazzoni and I were in Montreal last week for the Raymond James national conference. Tom James, our former president and now Chairman Emeritus, spoke, and he is always a breath of fresh air. He was the longest-serving brokerage CEO in America and backed it up by investing his personal money in Raymond James shares. He kept the firm out of the sub-prime loan debacle that sunk most other firms in 2008 and we only took government support because they forced it on us. We paid it back within a few months. More financial advisors are joining Raymond James today than almost any other firm.

We also had a chance to hear from our chief strategist, Jeff Saut. Some of you heard Jeff a few years ago when we brought him to Victoria for a lunch. Jeff is often featured on BNN in Canada and on the US business shows. While he is cautious in the near-term, he is surprisingly optimistic about the years ahead.

Jeff Saut likes what he sees in the market.

Traditionally, bull markets can last 10-18 years. If you measure this one from the low in 2009, we are now approaching 9 years. Jeff maintains that we are making a mistake in measuring this bull market from 2009. He thinks we should measure it from 2013, when the market broke out of its long trading range, making it a much more youthful 4-year rally:



Jeff went on to ask the question "What kills this bull market?" and then answers each point:

- Global growth would have to decelerate. *It's not*.
- Wages and inflation would have to rise. *They aren't*.
- The Fed would have to tighten monetary policy significantly. *It's not.*
- The European Central Bank would have to tighten policy substantially. *It's not*.
- Credit growth would have had to be surging. *It's not*.
- Corporate anima spirits would have been taking off. *They're not*.
- Equities would have to be expensive relative to bonds. *They're not*.
- Investors would have had to be euphoric about equities. *They're not.*

He points out that corporate earnings have turned up. Rising earnings means the market may not be as expensive as many think. And there is also the prospect of the Trump tax cuts, which could boost earnings even further.

Jeff also thinks Mexico could be the new China. It has a growing neighbour in the U.S., falling energy prices which lower manufacturing costs, and a very skilled labour force that is now price-competitive with Chinese workers. He says we should ignore talk of “the Trump wall” and focus on the strong countries on both sides of it.

His conclusion is that the secular (long-term) bull market has years left to run.

While we are not as table-poundingly optimistic as Jeff Saut, it is refreshing to hear of a brighter future instead of a darker one for a change.

Follow the Money

Not everything is up this year. Long-term Canada bonds are -10% in the last 12 months (FTSE TMX Long Term Canada Total Return Index), for example. This is a result of the interest rate hikes and stronger growth in the economy. We may see growth levelling out, however, as the Bank of Canada’s expectations for Canadian GDP growth going forward are modest:

3.1% in 2017
2.1% in 2018
1.5% in 2019

Most of our bond managers have avoided this steep decline in government bonds by investing in corporate bonds and elsewhere in the world. Returns from bonds, however, are likely to be low in the years ahead.

Commercial real estate has also seen modest gains in the past year in Canada. The sector of real estate that most investors continue to be transfixed by is residential. The gains in Vancouver and Toronto have been eye-popping. The knock-on effects have also been immense, from how to house minimum wage workers to missing taxes on condo flipping. One major question is where all the money has come from to send prices so high.

New information has surfaced that may help answer this question.

A recent investigation by the Vancouver Sun into the River Rock casino in Richmond has revealed that hundreds of millions in drug money was laundered

through gambling chips into “clean” money. It may have then been invested in Vancouver real estate. It was a very sophisticated operation that saw sport bags containing $100,000 in $20 bills used to purchase gambling chips with no requirement as to the source of these funds, and then cashed out again into cashier’s cheques. The Sun reports that Silver International, the bank under investigation, “laundered $220 million in cash in B.C., and sent over $300 million offshore” in just one year. It was used as a conduit to funnel money out of China, with most of the cash likely ending up in Vancouver real estate.

All with little to no identification, determination of where the money came from, or taxes paid.

Meanwhile, at our level of the banking industry, we will not take more than $1,000 in cash and any cheque from a third-party requires copious forms, ID, and red tape. Why such a difference for Canadian citizens? Perhaps all we need to speed things up is a sport bag.

This story will either blow up into something much larger, or get quietly buried. Governments are now addicted to gambling revenue and would be reluctant to stem the flow.

We want to say thanks to our clients for introducing their friends and family members to us throughout the year. It’s a tremendous compliment and a huge responsibility, and something we never take lightly.

Are You Surprised?

I have been asked to appear on CHEK - our local TV station – this weekend for their current affairs segment called Sunday Spotlight. A much more attractive woman was unavailable, and so I was slotted in as their second choice. Hey, I may have a face more suited for radio, but I can still be entertaining.

The topic is a new survey that finds Canadians are nowhere near prepared for rising interest rates. I am to comment on this and ways people can prepare.

One of the questions will be *Are you surprised?*

It is hard to be surprised.

First, Canadians have now racked up a record amount of personal debt. And who can blame us? We have been tempted by the lowest interest rates since the 1930s, making it easier to carry a huge loan than ever before. The MLS benchmark value for a single family home in Victoria was an eye-popping $823,000 in September 2017. Canadians now owe a total of approximately $2.0 trillion in mortgage, auto, and home equity loans.

Second, short-term rates have doubled this year from by 0.5% to 1.0%, with the Bank Lending Rate (used to set mortgage rates) now sitting at about 3.20%. That's the highest in six years. On a $400,000 variable mortgage, the interest cost is up about $100 per month since June. Rates have only gone down for so many years. Many borrowers were caught off guard when rates went up.

Now, my personal opinion is that rates will stay low for a long time. The Canadian financial system (and the US, and Europe's, and Japan's) has so much debt now that there would be an avalanche of bankruptcies if the Bank Lending Rate rose back to 7% where it was in 2001. An over-indebted system cannot afford higher rates.

However, this is not to say that rates cannot spike for a period of time. From 1981 to today, the Bank Lending Rate fell from 23% to 2.70%. In 1989, my wife and I took out our first mortgage. Because I am "in the business" and was watching rates fall, I decided on a variable rate mortgage at 9%. Two years later, that same rate was over 13%. We sacrificed everything to pay our debt down. Of course, once we were debt-free, rates began their steady decline again, with the lending rate dropping to 5% by 1994.

Young people carrying large mortgages at variable rates are in a very vulnerable position today. The Bank of Canada would like to get back to "neutral" rates where they are no longer goosing the property markets. A neutral rate could be as much as 2% higher from here, which could add hundreds of dollars to the monthly mortgage bill.

Therefore, anyone in this situation should be looking at locking in a fixed mortgage rate now, for budgeting peace of mind, if for nothing else. They will pay more, but they will know their costs for years.

One of the other key points of the survey is how close to the edge so many people are. It says more than 42% of households are already within $200 of not being able to pay their bills.

How on Earth did we come to this?

Something every school should teach is basic budgeting. My wife and I used a three-envelope system when we were first married; one for rent and food, one for gasoline and utilities, and one for miscellaneous. We filled each envelope at the beginning of the month with cash and paid the bills from that cash. When the cash ran out, we stopped spending.

The hardest envelope? Miscellaneous. This was the one for those unknown bills that hit you in the side of the head when you are least prepared. We were far from perfect, but we lived like mice and managed to save enough for a down payment on a house.

I doubt I will be able to get into the finer points of budgeting in a 4-minute TV segment, but that would be my first message to people living on the edge of their incomes: learn to spend less.

If rates rise, your financial survival really will depend on it.

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