Wealth Matters – Spring 2017

Page and Associates Ltd.
95 Mural St., Suite 405,
Richmond Hill, ON. L4B 3G2
905-884-5563 ext. 243
www.askpage.com

In This Issue: Canadian Federal Budget, Investment Market Commentary, Outlook, Measuring Returns

Canadian Federal Budget

The Canadian Federal Budget was released March 22nd 2017, making no changes to personal tax rates and only minor changes to personal income taxes by eliminating a number of targeted credits. Some had expected an increase in the Capital Gains inclusion rate, but this was not even discussed in the budget - this would have made Canada one of the few developed countries not to use a 50% inclusion rate, discouraging capital investment. However, several business income tax measures were announced, including changes to prevent high income professionals from deferring tax on their partly completed Work in Progress. While no specific changes were announced for corporate taxation, the budget noted a number of tax reduction or deferral strategies involving investment holding companies that concern the government, such as:

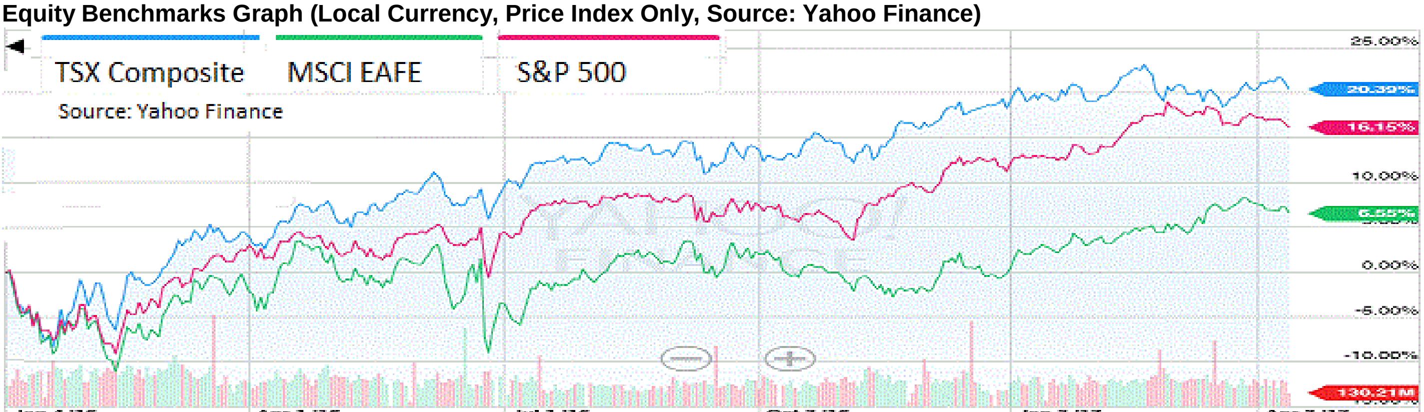
- Retaining business income taxed at the small business rate in a holding company to defer the additional personal tax, then investing in tax-deferred holdings within the corporation.
- Sprinkling corporate income to family members who are in lower tax brackets

Expect a consultation paper over the summer inviting comments from the accounting and business community, with new rules released this fall or in the Spring 2018 budget. Some accountants are advising clients not to rush to set up long term structures of this nature until the rules are clarified.

Investment Market Commentary

Equity markets worldwide had solid positive returns in the first quarter of 2017: despite setbacks in energy and healthcare sectors, the Canadian market (TSX Composite) returned almost 2.5%, while the US and international markets (S&P500 and MSCI EAFE) both posted over 5% for the quarter.

Equity Benchmarks Graph (Local Currency, Price Index Only, Source: Yahoo Finance)



Canadian January economic growth was particularly strong, and job creation remained steady, while the Consumer Confidence Index ended March at its highest level since 2010. The 2016 oil price recovery continued into the first quarter, with OPEC agreeing to constrain output growth, but the price was temporarily set back in late March, limiting growth of the commodity-heavy TSX. The Bank of Canada continues to hold interest rates steady after its small cuts in 2015, until the growth trend is confirmed by more data points. (continued on next page…)

Investment Market Commentary (…continued)

At its April 12th meeting, governor Stephen Poloz signaled that the bank now has more confidence that the economy will expand steadily toward capacity, seeming to rule out further cuts that had recently been deemed possible, and opening the door to reversing the 2015 cut if economic performance continues apace.

The Trump presidency will finish its first 100 days in the month of April, though the inauguration seems so long ago given so much news and unpredictability. It began in late January with a flurry of hastily drafted Executive Orders to confirm or underscore policy objectives, but lacking the policy details economists were looking for to better predict impacts on the economy and markets. US equities surged anyway on speculation that corporate tax cuts and deregulation would boost corporate profits, justifying higher stock prices. The Dow Jones Industrial Average index had been pushing against the psychological barrier at 20,000 for several months, and once it pushed past 20,000 it surged to over 21,000 before settling back to around 20,660 at the end of the quarter. Both the S&P 500 and Dow benchmarks gained over 5% for the quarter. US equities generally are trading at historically high multiples that likely presume the promised tax and regulatory changes as well as continued profit growth, just recently recovering after 18 months of decline

Profit margins are already high and some upward labour cost pressures may be on the horizon to constrain margin growth. A number of analysts and portfolio managers have expressed concern about these valuations, with some traders holding higher levels of cash and others being very selective about which companies they will buy and at what prices. Corporate earnings reporting for the first quarter will begin shortly and stock prices may be volatile.

The US Federal Reserve Bank closed off 2016 with the first rate hike in 12 months though it had signaled more moves for 2016. It hiked another 0.25% in March, and is widely expected to hike 2 or 3 more times in 2017 provided the US economy continues to add jobs and growth, both of which have been particularly strong and steady during the quarter. ADP reported strong March growth in private payrolls, though the US Bureau of Labour Statistics report showed a much smaller figure than expected. Some analysts note the latter report would have been negatively affected by weather and other factors, so the April numbers will be closely watched.

Several other central banks followed the Fed's moves, likely to support the value of their currencies against the US dollar (China, Japan, Switzerland, England, and a few of the gulf states). The Bank of Canada may be expected to follow the next increase there, based on its most recent signals.

These central bank hikes normally affect only the short term end of the bond yield curve, with longer bond yields determined by the market's appetite for risk vs safety. The equity surge of the past few months had generally reduced demand for safe bonds, and yields had increased while bond prices sagged. This began to reverse itself in late March and early April on the US government's failure to achieve promised changes to the Affordable Care Act and growing doubt that expected tax reforms and infrastructure spending plans will be clarified as soon as had been hoped: bond prices firmed and yields dropped once again, flattening the yield curve. The Federal Reserve Bank has some $4trillion of government bonds on its balance sheet, perhaps double what it would normally hold, and would be expected to unload some of that inventory over the coming years, and which could depress prices and push yields higher. This could either give the Fed a new lever to exert some control on mid- and long-term interest rates, or allow it to stabilize long-term rates by unloading opportunistically into bond rallies. Either way, this presents a headwind limiting expected returns on longer-dated bonds.

Emerging markets equities recovered more than 10% for the quarter after having been beaten up in 2015, and the 2016 recovery having had a setback in the fourth quarter, partly for fear of capital outflows seeking higher yields on US treasuries. It looks like that fear had been overblown. Valuations in the US are at the highest levels since 2000, causing investors to look elsewhere for opportunity. Many Emerging Markets are dependent on commodity prices which are continuing to firm after a dreadful 2015, though that recovery may now have run its course.

Trump's protectionist rhetoric and withdrawal from the Trans-Pacific Partnership trade negotiations, and his vow to renegotiate NAFTA, may signal trouble for continued globalization and free-trade. This could be a risk for Canada, as the US is still a destination for the majority of our exports, but Canada has a relatively small imbalance with the US, while Trump's targets appear to be those with whom the US has a substantial trade deficit i.e. Mexico and China. That trade deficit is a problem which is not sustainable and has needed a solution for over a decade, though the tariff or border tax solution is not one that is permissible under long-standing globally-negotiated trade rules, and would certainly cost American consumers. It is far from clear how this may play out. (continued on next page…)

Outside North America, one of the major developments was the UK finally invoking article 50 of the EU Lisbon Treaty in the last week of the quarter, beginning what most believe will be a challenging 2-year long negotiation to try to maintain some of the benefits of EU membership while not being bound by other rules. The EU is likely to take a tough stance with the UK partly as a warning to other members who may try to negotiate special treatment.

Far right parties in Holland, France and parts of Germany have been emboldened by some of the Trump rhetoric and have been polling with some strength. If successful in upcoming elections in those countries, they could de-stablize the EU. Dutch electors rejected the far right anti-immigrant party, but left a number of minority parties to work out a functional coalition. Several other important elections in the region are scheduled throughout the rest of 2017 and may cause some market volatility, though equity market multiples in Europe are only about 65% of those in the US and we may expect that some of this risk has been priced in.

Outlook

Geo-Political
- Elections in France, Germany, Turkey
- Conflicts in Syria, North Korea
- NAFTA and other US-international trade relations

Economic
- US Budget approval by end of April
- US tax reform and infrastructure plans, trade actions

Monetary
- Federal Reserve to raise rates 2 or 3 more times in 2017, other countries may follow
- Fed and eventually ECB sales of bond inventories

Benchmark Total Returns

Total Returns CAD$ to March 31 2017	**1M**	**3M**	**6M**	**12M**	**2Y**	**3Y**	**5Y**	**10Y**	**15Y**
Canadian Dollar ($US/$CA)	*-0.56%*	*0.78%*	*-1.55%*	*-2.65%*	*-2.43%*	*-6.03%*	*-5.59%*	*-1.44%*	*1.20%*
Canada									
Canadian Fixed Income									
91 Day T-Bills	0.03%	0.10%	0.25%	0.48%	0.50%	0.64%	0.79%	1.30%	
FTSE TMX Short Term Bond	0.13%	0.67%	0.67%	1.27%	1.20%	2.09%	2.21%	3.53%	
FTSE TMX Universe	0.40%	1.25%	-2.19%	1.53%	1.17%	4.09%	3.56%	4.78%	
FTSE TMX Long Term Bond	0.95%	1.88%	1.88%	1.72%	0.57%	6.59%	4.85%	6.40%	
FTSE TMX High Yield Bond	0.06%	3.20%	3.20%	19.56%	7.07%	4.65%	6.51%	6.64%	
Canadian Equity									
S&P/TSX Composite	1.34%	2.41%	7.06%	18.62%	5.27%	5.82%	7.84%	4.70%	7.43%
S&P/TSX SmallCap	1.00%	1.47%	4.64%	29.48%	10.51%	3.29%	3.38%	1.81%	4.61%
TSX Sectors									
Cdn. Energy	1.82%	-9.09%	1.01%	18.21%	-1.47%	-9.76%	-2.53%	-1.89%	5.56%
Cdn. Materials	0.86%	6.14%	-0.46%	24.88%	7.01%	1.68%	-5.11%	0.33%	5.13%
Cdn. Consumer Staples	5.11%	3.09%	1.85%	3.21%	10.12%	20.06%	21.26%	12.52%	9.70%
Cdn. Health Care	-5.66%	-2.81%	-15.80%	-23.79%	-26.91%	-7.94%	3.18%	6.20%	1.30%
Global Gold	0.15%	7.16%	-12.17%	14.64%	16.24%	5.70%	-8.09%	-2.85%	1.92%
U.S.A.									
S&P 500 (LargeCap)	0.68%	5.25%	11.85%	20.36%	11.93%	17.46%	20.01%	9.07%	5.82%
Russell 2000	0.69%	1.67%	13.27%	29.65%	9.38%	14.10%	19.01%	8.68%	7.09%
International									
MSCI EAFE (Net)	3.33%	6.42%	8.15%	14.71%	3.74%	6.95%	12.10%	2.52%	4.49%
MSCI Europe	4.73%	6.77%	8.91%	13.47%	3.35%	5.41%	12.55%	2.79%	4.81%
MSCI Japan	0.32%	3.83%	6.13%	17.94%	6.05%	13.19%	13.45%	2.31%	3.82%
MSCI EM (Emerging Markets)	3.12%	10.62%	8.61%	20.85%	4.47%	8.07%	7.16%	4.55%	8.55%

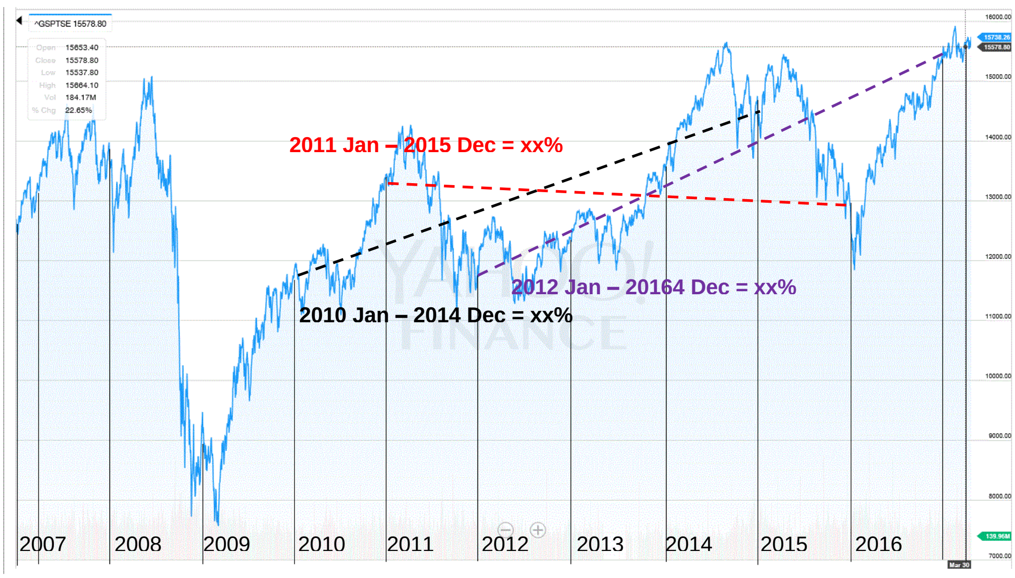
Measuring Returns

Equity markets are by nature volatile, and this causes a wide variance in the return measured in shorter periods. These measures are highly dependent on the start and end dates selected, even if the periods are the same length. This is especially notable in the 1-year and 10-year returns posted this quarter.

The 1-year returns are particularly high, given the strength of Q1 2017, and the rebound in Q2 2016 from an awful Q1 2016. Canadian, US and international benchmarks all show near 20% return over this 12 month period, while in the 12 months ending Dec 31 the US benchmark returned just under 9% and the international benchmark was negative 2%.

In contrast, the 10-year returns being measured in 2017 will start during the strong market conditions prevalent in 2007 just before the large negative impact of the 2008 global financial crisis. As a result, the Canadian and international benchmark returns are only about 4.7% and 5.7% annualized over this period, considerably lower than their long term averages closer to 10%.

The graph below shows the S&P TSX Canadian benchmark price since Jan. 1 2007, with the vertical lines pointing to each January 1st. The dashed lines show the price change over 3 consecutive 5-year periods, ending in December 2014 (black), 2015 (red) and 2016 (purple).



You would expect the period ending in December 2015 to show a lower return than the others, because it ended with a year that delivered a large loss.

But it did end higher than the start of the other two periods. Its 5-year return was as much affected by the fact that this period began in a much higher priced market than the other two periods shown.

Such volatility tends to average out with longer measurement periods, but strong gains or declines near the end points can still skew measured returns.

If equity markets remained flat for the next 12 months, the 10-year return measures we publish in April 2018 would start at the market peak in 2008 just before the crisis, and would look even worse than they do now. And by the end of 2018, the 10-year measures would start near the bottom of the crisis, and would show much higher than average returns.

Because of these mathematical effects, it is important to ensure start and end dates of any measurement period are consistent when making comparisons, or that the unique market conditions of the interval are taken into account before reaching conclusions based on the measured returns.

Feedback

We hope you've enjoyed this newsletter. Your comments are important, and they are very valuable to us. Please let us know any ideas you may have for improving the newsletter, or topics you'd like to see in future issues. Email us at contact@askpage.com. You can receive this newsletter by email – just ask!