Wealth Matters – Fall 2017

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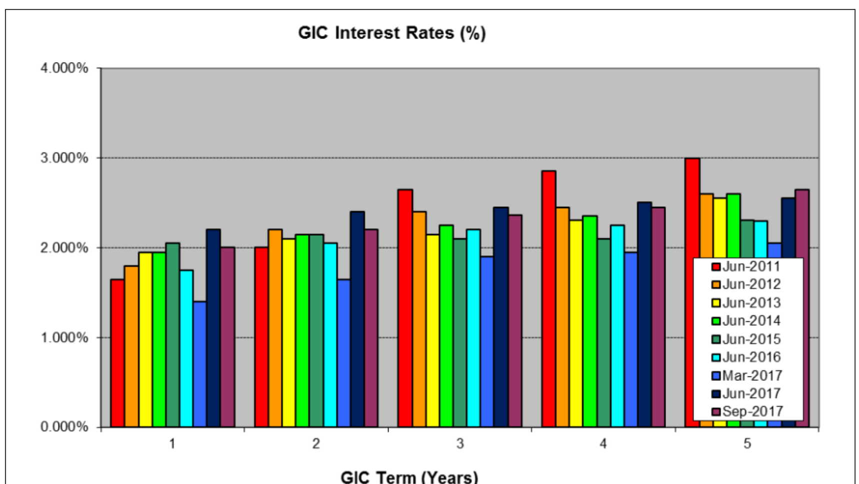
Interest Rate Outlook

The Bank of Canada (BoC) made a second rate hike this summer as we expected in our Q2 commentary, though this merely reverses the two ‘emergency’ cuts made in 2015 in response to the collapse in oil prices. Canada posted unusually strong GDP growth for the second quarter – the highest of the G7 countries – and though the latest readings for July were flat, overall employment growth continued in each month of the 3rd quarter. In fact, September marks the 10th straight month of employment gains, and over 230,000 net jobs have been added so far this year, prompting some to suggest a further hike may be in order to produce the first net increase since 2010.

Still, export growth may be limited by the considerable strengthening of the Canadian dollar (CAD) against the USD, which was kick-started by the first hike, with the second one helping push it over 82 cents US in mid-September. This is a huge 8% increase from the 76cents exchange rate at the beginning of 2017. Huge moves like this are disruptive, and make our exports more costly, so the BoC may prefer to wait for the US Federal reserve to hike before it makes its next move. The move in the exchange rate was certainly also impacted by a US currency weakening against other world currencies, and some of the factors contributing to that weakness may be abating, as the CAD retreated to about 80 cents by the end of September.

Some analysts have long feared losses in bond portfolios as a result of interest rates gradually rising toward their longer-term averages, and 2017 may be the year we see such an outcome. The 1-year return on the TMX Bond Universe index was 0.2% at the end of June, but the index had at that time gained over 2% for the year-to-date. The decline of almost 2% for the quarter left the year-to-date return at just under 0.5%, and the 1-year return is almost negative 3%. Longer-duration government bonds are most sensitive to rate changes, and the TMX Long Term Bond index was off by almost 4% for the quarter. Part of this could be attributed to the US Fed clarifying its plan to start reducing its inventory of government bonds purchased in the Quantitative Easing (QE) program between 2009 and 2014. The reduction is expected to begin in the 4th quarter, but the proposed pace of $6bln per month seems small compared with the $75bln per month purchases made during QE2 in 2010-2011. So the market impact may be much less than some fear, and may have priced this in already.



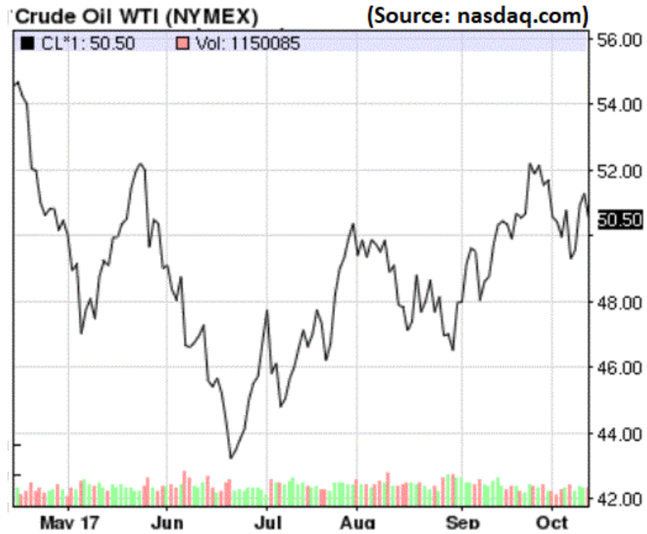
Source: Cannex Financial Exchanges

The top GIC rates for 5-year terms edged up slightly in the quarter, reflecting the higher long-term bond yields. The slight reduction in shorter terms is more likely due to competitive factors present in June, but aside from this, rates remain at least equal to 5-years-ago levels.

Investment Market Commentary

The left-for-dead Canadian stock market roared back to life in the last few weeks of September, after the TSX price index spent most of the quarter in the red for the year. US and international stocks continued their upward momentum from the first half of the year, with major US indices regularly hitting new all-time highs.

Crude oil started the year over US$55/barrel and by June had collapsed to under $44. By the latter half of September it had recovered to the $50-52 range as inventories were drawn down over the summer driving season. The TSX energy sector had been down 22% since the start of the year, but rebounded almost 12% in September. It is still off over 12% for the year to-date.



The broader TSX Composite index, with dividends reinvested, returned almost 4% for the quarter, with 3% of that in September. With the flat first half of the year, it is up almost 4.5% for the year, about its 3-year average, and a little better than its 10-year average. The oil price plunge and concerns about NAFTA have held our market back most of this year. While the oil price seems to have normalized, the NAFTA issue remains a concern.

US stocks continued their climb, with a string of political and international relations shocks seemingly unable to rattle markets for any length of time. The S&P500 index total return is over 14% to the end of the quarter, though the rise of the Canadian dollar has stolen over half of that gain for Canadian investors who realized just over 6%. The Trump administration seems unable to make progress on several key issues: health care reform and tax reform chief among them. It was expected the tax reforms may have added as much as 10% to some stock valuations, and the lack of progress on this file may have contributed to price retrenchment over the summer, though this file seems to be moving once again and some of the rebound may be related.

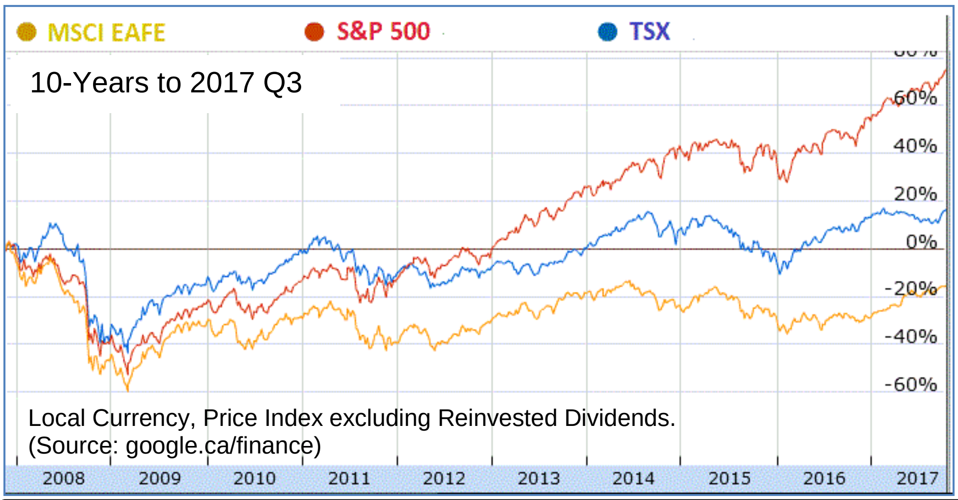
Although US stock valuations are historically high at about 20x prior year earnings, this is not an unreasonable multiple given the relatively low level of bond yields and inflation. In fact, since the Financial Crisis, the excess of 10-year bond yields over the dividend yield of the S&P500 has narrowed to almost zero. US corporate earnings have been rising again this year after a couple of years of retreat, and if this continues, today's price multiple may actually look like a bargain. Otherwise, the market is fully valued. Either way, there is risk.

Historically, geo-political shocks do impact markets but usually not as strongly or for as long as economic fundamentals. And while the expansion in the US is now over 90 months long, compared with a post-war average of 58 months, none of the usual signs of coming recession are yet present. In fact, the Conference Board's Composite Leading Indicator has actually been gaining strength in recent months. That does not rule out a significant downward correction in prices, especially given the high valuations on the US market. Some commentators believe we are overdue for such a correction, and some portfolio managers have been increasing cash levels to be able to take advantage if one comes.

Sign of Recession	Present today
Inverted Yield Curve	No
ISM Manufacturing PMI Below 45	No
Positive Inflationary Trends	No
Capacity Utilization above 80% and peaking	No
Housing Starts Declining	No
Labor Market Weakening	No
Leading Economic Indicators Negative	No

While the US expansion has been strong for a few years now, many international markets had been weakening until just recently, though that seems now to be changing. The International Monetary Fund (IMF) has generally been revising economic growth forecasts higher for many economies over the summer. Furthermore, the global manufacturing Purchasing Managers Index, which measures the expectations of corporations for future growth, has recently become positive across all major global economies, a pattern not seen for many years. This bodes well for equities around the globe, and could help sustain the US expansion as export opportunities grow.

Benchmark Returns



Total Returns CAD$ to September 30, 2017	1M	3M	9M	12M	2Y	3Y	5Y	10Y	15Y
Canadian Dollar ($US/$CAD)	*0.45%*	*3.98%*	*7.59%*	*5.10%*	*3.60%*	*-3.52%*	*-4.65%*	*-2.23%*	*1.61%*
Canada									
Canadian Fixed Income									
91 Day T-Bills	0.01%	0.13%	0.33%	0.47%	0.46%	0.57%	0.74%	1.09%	
FTSE TMX Short Term Bond	-0.45%	-0.45%	-0.20%	-0.70%	0.65%	1.44%	1.71%	3.29%	
FTSE TMX Universe	-1.32%	-1.84%	0.48%	-2.97%	1.56%	2.79%	2.66%	4.74%	
FTSE TMX Long Term Bond	-2.59%	-4.09%	1.73%	-5.95%	2.93%	4.43%	3.62%	6.59%	
FTSE TMX High Yield Bond	0.61%	2.30%	7.37%	11.30%	10.66%	4.92%	6.20%	7.06%	
Canadian Equity									
S&P/TSX Composite	3.06%	3.68%	4.45%	9.18%	11.67%	4.54%	8.06%	4.06%	9.23%
S&P/TSX SmallCap	2.06%	2.36%	-1.86%	1.21%	17.23%	2.45%	3.94%	1.41%	5.46%
TSX Sectors									
Cdn. Energy	11.89%	11.15%	-12.42%	-2.69%	9.55%	-10.84%	-3.24%	-2.98%	5.37%
Cdn. Materials	-3.81%	3.25%	2.54%	-3.83%	22.57%	2.04%	-5.92%	-2.00%	6.21%
Cdn. Consumer Staples	0.41%	-2.07%	2.44%	1.21%	6.25%	14.23%	20.03%	12.19%	10.24%
Cdn. Health Care	5.22%	-5.84%	-4.81%	-17.53%	-22.76%	-10.57%	2.39%	7.42%	3.83%
Global Gold	-6.58%	0.85%	1.59%	-16.73%	26.62%	6.55%	-9.89%	-3.38%	1.22%
U.S.A.									
S&P 500 (LargeCap)	1.60%	0.48%	6.19%	12.85%	12.94%	14.85%	19.79%	9.88%	8.30%
Russell 2000	5.76%	1.62%	3.12%	14.88%	13.97%	16.27%	19.34%	10.30%	9.60%
International									
MSCI EAFE (Net)	2.03%	1.37%	11.50%	13.32%	8.72%	8.87%	13.66%	3.65%	6.55%
MSCI Europe	2.85%	2.41%	14.74%	17.04%	8.72%	8.79%	14.29%	4.01%	7.50%
MSCI Japan	1.63%	0.11%	6.54%	8.91%	9.55%	12.04%	16.32%	4.23%	4.48%
MSCI EM (Emerging Markets)	-0.82%	3.90%	19.10%	16.94%	15.85%	9.12%	9.44%	3.97%	11.07%

(Source: Guardian Capital Advisors)

Corporate Tax Changes

Tax reform is a phrase we seem to hear more about in connection with the USA, but there is a version of it happening here in Canada too. The Federal Budget from March 2017 promised reforms aimed at eliminating tax advantages enjoyed by owners of private corporations, beginning with a consultation paper and comment period.

In July, Federal Finance Minister Bill Morneau published a policy paper proposing changes to private corporation tax rules that would discourage three main activities deemed to create unfair advantages for corporation owners with large profits:

- The accumulation of investments in corporations that are not related to the company's business activities,
- The 'sprinkling' of corporate profits to other family members who are in lower tax brackets, and
- The conversion of investment income into capital gains which are not fully taxable.

The corporate tax rules and the proposed changes are very complex. The 63-page paper explained the problems and spelled out the details of the proposals. It also called for comment from industry before this moves forward to become official policy. And it got a heap of comments by the October 2nd deadline: over 140 of them, mostly negative.

A CBC opinion piece by Colin Horgan notes that you would expect business and professional groups like Chambers of Commerce and the Ontario Medical Association to object – after all, they are the ones whose members will lose the tax advantages being targeted, and they have the resources to hire lobbyists. We could debate whether there is a social policy rationale for entrepreneurs or professionals to have some of these advantages to encourage their business activity, which creates jobs. However, there are some real concerns with the proposals that don't hinge on that debate.

On the social policy debate, Advocis (the professional association for financial planners) has presented examples showing that the self-employed person under the existing rules cannot even come close to the tax advantages enjoyed by a salaried civil servant earning similar income plus government pension and benefits. A survey of New Brunswick doctors by CTV suggests a reduction in hours worked could result from the removal of the targeted incentives. After all, doctors were only recently permitted to use the private corporation structure to put them on a level playing field with other business owners, and these benefits were expected to help retain their talents in Canada.

Of those who agree that the tax advantages should be addressed, many note several unfortunate impacts. Allan Lanthier in the Financial Post accepts the objectives, and even supports some of the proposals: "We should all take a deep breath. Some of the government's proposals actually make sense, and are long overdue. Others go too far and need to be reconsidered." In the 'go too far' basket are situations where the effective tax rate on passive investment income increases to over 70%, much higher than the top personal rate, and impacts on legitimate business transition strategies used by business owners to sell the business, which could make it less attractive to sell the business to their children than selling to strangers. Of particular concern to the accounting and financial planning professions is a change in tax rules that have been in place for decades, where that change may impact the tax treatment of transactions in the past, or call for costly changes to structures that were perfectly legitimate under the former rules but would be punitive under the new ones. Especially troublesome is the number of situations under the proposal that would be subject to interpretation or assessment by CRA, making it very difficult to plan one's financial strategy with confidence.

The Finance Minister did say in late September "We're out listening to people and haven't concluded on the fiscal measures" (CTV), so we expect revisions to the proposals that would address many of the concerns. Meanwhile, most accountants we work with are advising clients to hold off on finalizing any major business restructuring plans until the rules become clearer.

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. PS - You can receive this newsletter by email – just ask and we'll put you on our list!