Money Never Sleeps

The Newsletter for the Informed Investor

Wealth Management
Dominion Securities

Fall 2016

Vito Finucci, B.Comm, CIM, FCSI
Vice-President & Director,
Investment Advisor
Associate Portfolio Manager
519-675-2011
vito.finucci@rbc.com

Jodie Fuller
Associate Advisor
519-675-2511
jodie.fuller@rbc.com

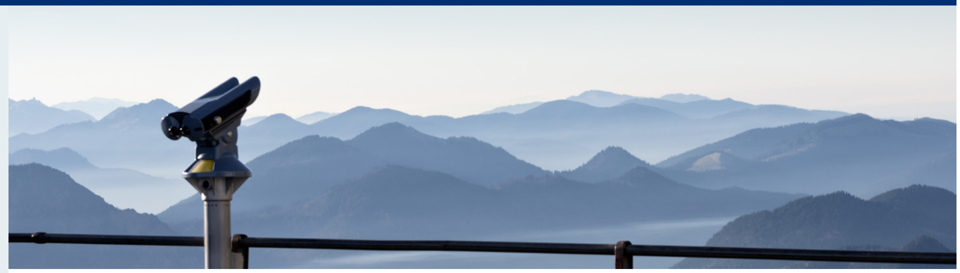
Gary Weatherup, CFP
Associate Advisor and
Financial Planner
519-675-2021
gary.weatherup@rbc.com

Sarah Smith, CIM, PFP
Associate Advisor
519-675-2505
sarah.e.smith@rbc.com

Jessica Basacco
Administrative Assistant
519-675-2021
jessica.bassaco@rbc.com

Fax: 519-675-2020
www.rbcds.com/vito.finucci

RBC Dominion Securities
148 Fullarton St., Suite 1900
London, Ontario N6A 5P3



Bonds aweigh!

Is there a bond bubble?

"I used to think that if there was reincarnation I wanted to come back as the President or the Pope or a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."

Democratic Political "Attack Dog" James Carville

We last talked about the bond market in June 2014 (Infomail: The Great Rotation Is Coming 6/30/14). I was under the belief that the economy was strong enough to stand on its own two legs and the U.S. Federal Reserve (the "Fed") would start to "normalize" interest rates and start raising them. In hindsight, I bet the Fed wished they had because they'd now be at 0.75%-1.00% and have something to work with in the tool box, rather than just being in the box they put themselves into.

What I also missed was how far European and Japanese central bankers would go with negative interest rates – perhaps one of the greatest economic policy abominations of all time. But hey, in December 1996, then Fed Chair Alan Greenspan made his famous "irrational exurberance" line about the stock markets, only to see the markets roll higher for another three plus years, but he was right, just early.

I wanted to revisit the bond market situation. It's an unusual year for bond investors. Bonds have risen alongside stocks, which is an atypical occurrence over any extended period of time. The extreme monetary policy actions around the world have created a relentless march towards zero (and even below) rates. In fact, at recent lows, about a third of all global soverign debt was trading at negative yields.

What has been confusing is that if bond yields are falling like they have, that would normally translate to a weak economy and deflationary forces, which normally would not be good for corporate profits, and by extension, the stock market. In Japan and Europe (with Brexit), one could argue growth is slow, but in the USA, where the 10-year Treasury hit a new low of 1.30% in sympathy after Brexit, one could argue the fundamentals are strong and don't seem to justify such low yields, especially with the Fed on the verge of raising.

Interest rates have been going down for so long, I think there are a lot of people who think they will never rise.

So given 10-year yields around the globe look something like this (as of Sept 30. 2016) ...

USA	1.59%	Switzerland	-0.55%
Germany	-0.12%	Japan	-0.09%
France	0.186%	China	2.75%

(source: www.tradingecomics.com)

... I would suspect what has been going on, given the U.S. economic fundamentals, is that U.S. Treasury yields are only declining due to global capital flows. In other words, they are a result of a global reach for yield, combined with being in the U.S. dollar.

That behaviour, by extention, has also led to strong flows to "bond proxies," such as high dividend-paying stocks like utilities, consumer staples and real estate. Ususally stock rallies are led by the aggressive sectors (like technology, consumer discretionary) and defensive names lag. The recent run (since Brexit) has been the exact oposite. Not normal action.

The scary part now comes because negative rates have not had much of an impact, so in their twisted thinking the bureaucrats will deduce they are not working because they have not done enough of it, so will push negative rates even more negative, which could push the valuations in that defensive part of the stock market even higher.

In my opinion, that substitute buying chasing yield is not what sustains bull markets, rather corporate earnings are, and that's what should be driving stock prices.

The last Fed meeting a week ago left rates unchanged in the target range of 0.25%-0.50%, but three Fed presidents cast dissenting votes in favour of a hike, so we know it's coming. However, at the same time, the Fed lowered its 2018 GDP projection from 2.0% to 1.8% which, again, adds to the confusion. There is a Fed meeting on Nov. 2, but the odds of acting six days before the election are slim to none, and slim left town.

We're getting closer to a genuine tightening of U.S. monetary policy, and it should signal a change in policy, especially if a change in the presidency (regardless of who wins) unleashes some ecomonic growth in the U.S. economy. Remember the "taper tantrum" in 2013? There was aggressive thinking the Fed was going to raise and the U.S. 10-year Treasury went from 1.60% to 3.00% in a hurry. The bond market was pounded.

Interest rates have been going down for so long, I think there are a lot of people who think they will never rise. In fact, the bond market trade of the last 35 years might be the longest-running winning trade in the history of any asset class.

10-year Treasury yields

Source: Federal Reserve

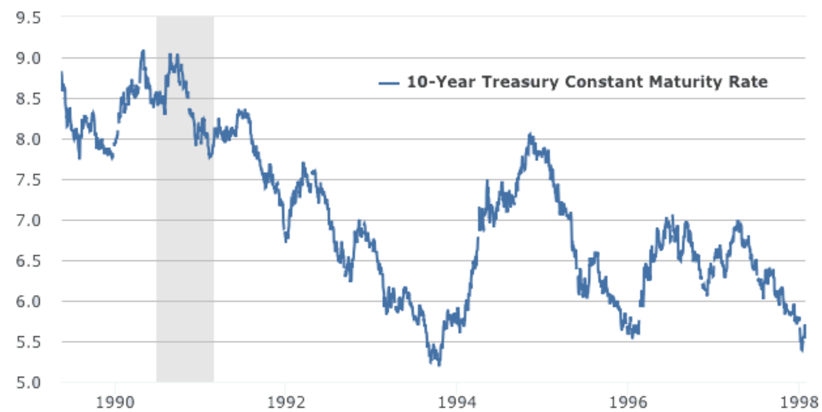
One thing about being around for some time is seeing more cycles. I was here in 1994 when rates went from about 5.50% to 8.00%. Fixed-income holdings were beat up pretty bad, and a government guranteed bond was down 20-25%... in a hurry.

While rates around the world might still go lower first (I would not be surprised if the U.S. 10-year hit 1.00%), there is little doubt the developed world's government bond markets are showing characteristics of a bubble. We have bond markets where mathematically, there is little room for profit. The risk/reward relationship for bonds is unfavourable. We have negative rates in many bond markets, which virtually gurantee... well… a negative nominal return.

What may be the catalyst that bursts the bubble? Who knows. Japan might hit a debt wall, the Chinese economy might grow faster than expected, changing fund flows, a less accomodative ECB in Europe or even the Bank of England reacting to the Brexit vote.

We could be at another Greenspan "irrational exurbance" movement, and bond markets still run for a while, but I have no doubt what the end result will be at some point.

U.S. Treasury 10-year yields
January 1990 – December 1998



Source: Federal Reserve Bank of St Louis (FRED)

Quotes

"When government subsidizes poverty and failure, you get more of both."
- James Dale Davidson

"Politics is not a bad profession. If you succeed, there are many rewards; if you disgrace yourself, you can always write a book."
- Ronald Reagan

"It's just a job. Grass grows, birds fly, waves pound the sand. I beat people up."
- Boxing Great Muhammad Ali

Notes

In its first 137 years of existence, the province of Ontario accumulated $139 billion in debt.

In the last 12 years, the Liberal provincial government has accumulated $191 billion in debt.

(Source: Wikipedia)

Millennials (those born between 1981 and 2000) now number 9,500,000 in Canada (or 27% of the population).

On average, 73% use social media daily, 51% buy online monthly, and they spend an average of 2.2 hours daily on their smartphones.

(Source: Manulife Solutions Magazine Spring 2016)

Will Trump Follow?
The last three losers of the Presidential elections and their net worth were as follows:

	Wealth	Source of Wealth
Mitt Romney	$250M	Self-made
John McCain	$100M	Marriage
John Kerry	$287M	Marriage

(Source: Wall Street Strategies, July 3, 2014)

Around the globe

Canada (Selective Buy)

- Continues to struggle with anemic growth
- Housing markets in Toronto and Vancouver remain a bubble concern
- Massive government debts everywhere raise long term questions
- Expect 2017 GDP of 1.75% (after 1.6% in 2016)

U.S.A. (Strong Buy)

- U.S. presidential election will dominate headlines over next 30 days
- Federal Reserve raises rates in December?
- 2017 GDP target 2.00% (2016 = 1.75% average)

Europe (Buy)

- Brexit realities now kicking in
- Negative rates will go more negative as ECB continues to stimulate
- If GDP is positive in 2016 and 2017 would be an achievement

Asia (Avoid)

- Too many questions with China (still); Japan sputters
- If China can reflate, can change entire global economy

Emerging Markets (Avoid)

- Have suffered the worst declines and may be stabilizing, some are great value, but negative rates, geopolitical concerns, and a strong U.S. dollar don't make risk/reward worthwhile
- Too much political risk and strong U.S. dollar plays havoc

A special welcome to all new clients who have joined us

Thank you especially to clients who have mentioned our name to people they know. As a sign of gratitude, four times a year we'll randomly select a client who has introduced our services to a friend for special acknowledgement via a nice dinner at one of the finer restaurants in London.

Congrats, Ron F., our winner this quarter!

Please don't keep us a secret!

We are very happy and proud of the clients we serve in our practice and we are always open to serve more clients just like you. Should you be talking to someone who is unhappy with their current advisor, or would like a second opinion, we would be grateful if you passed on our numbers: 519-675-2011 or 1-800-265-5911. Thanks for keeping us in mind.

Wealth Management
Dominion Securities