RBC Dominion Securities Inc.

MONEY NEVER SLEEPS

THE NEWSLETTER FOR THE INFORMED INVESTOR SUMMER 2015

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DAZED AND CONFUSED – THE GREAT ROTATION COMETH

Bonds: Good Buy or Goodbye?

"I think it's highly likely that the people who confidently think they know the consequences – none of whom predicted this – now they know what's going to happen next? Anybody who is intelligent who is not confused doesn't understand the situation very well. If you find it puzzling, your brain is working correctly."
Charlie Munger, Berkshire Hathaway, Warren Buffet's longtime partner

Uncertainty has been building in markets throughout 2015, as we move towards the first U.S. Federal Reserve interest rate hike since 2006. There are many who will argue that the only reason markets have recovered after the financial crisis of 2008-09 was because of all the Central Bank stimulus which flooded the world with cash, recapitalized banks and restored consumer confidence. So logically, would a reversal of that policy have the opposite results?

Despite a very good 2013 and 2014 in U.S. equity markets, the inflows into bond funds greatly outweighed equity inflows. As of the end of 2014, the longer-term flow into bonds was an enormous $1.2 trillion into fixed income funds since 2006, versus a negative $800 billion pulled from stock funds.

In other words, there is still a very long way to go to get the balance back to some form of equilibrium—and I believe that The Great Rotation is coming.

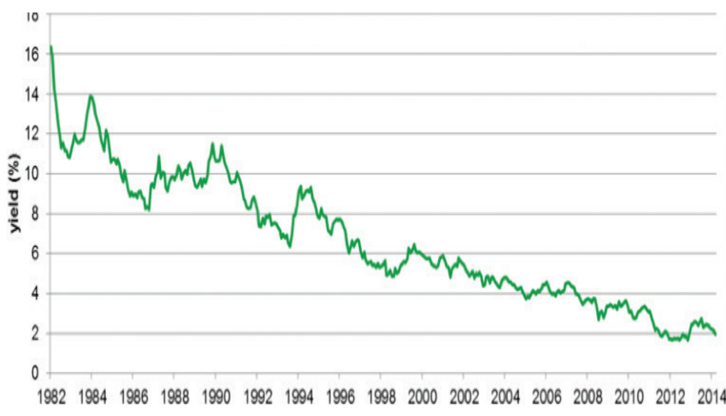
The bond rally which has taken place since the early 1980's (over 30 years) may have been the greatest run by any asset class—in history. One only needs to look at the long-term chart (at the top of page two) of Canadian 10-year bond yields and you will get the picture.

Now, I am just a simple boy from Niagara, but with interest rates at zero, I know the next major move is up (i.e. higher yields)... I just don't know when. But lately, there's been some things happening that makes one scratch their head and say "hmmm":

- In June of 2014, ECB head Mario Draghi set negative interest rates for money held in the European Central Bank, an unprecedented move.
- In the last 180 days, German 10-year Bund yields went from over 1% in early December to a yield of 0.16% on April 29, back to almost 1.0% as of June 26.

Continued on page 2

Government of Canada 10 Year Bond Yield



Source: Blackrock
http://www.blackrockblog.com/can/2014/10/14/dont-stop-believin-bonds

Greece Two-Year Bond Yield

Source: Investing.com

- In late May, Portugal sold 300 million euros worth of debt securities with a negative yield for the first time ever, at an average yield of minus 0.002%. That's right: an investor gets less than what they invested. The really strange part: The issue was 4.6 times oversubscribed.
- In Q2 2015, government bonds were heading towards the largest quarterly sell off in almost 30 years.
- Bill Gross, founder of the world's biggest bond manager, Pimco, leaves the firm in September 2014.

So one of our readers would ask, why would someone invest $100 in a low-risk investment only to have $99 at the end of the year? Two reasons:

1. They thought they would lose even more on something else.
2. They think they will make it up on capital appreciation (like the bond's price or currency gains).

So, a cynic might say, why not -1%, -3%, -6% on interest rates? Can the madness continue? Sure, I suppose, given endless funds by the ECB, but logic says, I doubt it, because of things like Greece, a risk premium gets added. The chart in the top right-hand corner shows what Greek bonds (two years) have done just in 2015.

In my 30 years, I've learned that crowded trades get unwound, and the bond markets are a crowded trade. So with the U.S. Fed raising rates while other global Central Banks like the ECB, Bank of Japan, China, and yes even Canada, are still easing, it will become a question of which punch bowl investors will choose.

Which brings me to liquidity... or perhaps the lack of it.

When The Great Rotation really starts gaining some steam, I worry about liquidity in the bond markets. Wall Street has essentially been regulated out of proprietary trading in fixed income (unintended consequence of Dodd Frank regulations). So when bids are needed, they won't be there. And I doubt the mutual funds, hedge funds, yes maybe even RBC, will want to take into their inventory 10-year investments yielding less than 2%. The massive inflows into ETF fixed income investments will reverse in a hurry, and where will the bid come from to support prices? Those people will dump assets because their competitors will be dumping theirs.

Here are some facts that support my thoughts. The U.S. corporate bond market has almost doubled to $4.5 trillion since the start of 2007, yet banks today hold just $50 billion of bonds compared to $300 billion pre-crisis. Trading volumes on the U.S. Treasury market have fallen 10% even as the market has tripled since 2005, while the portion of outstanding bonds held by dealers has plummeted to 4% from 15% (Source: Reuters May 20, 2015).

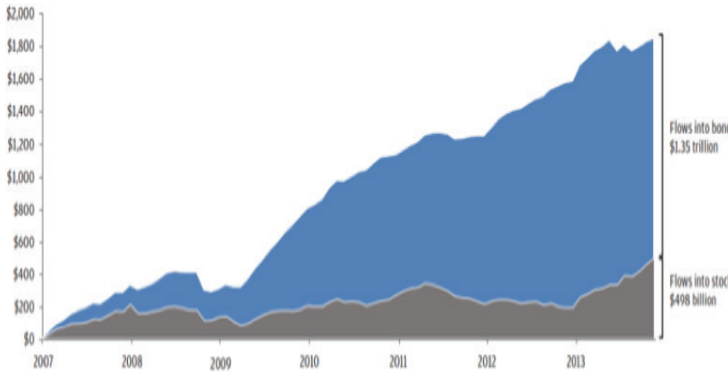
According to JP Morgan, a year ago, you could trade $280 million of U.S. Treasuries without moving markets; today it's closer to $80 million. What the higher regulations have done is push risk out of the banking system and on to its customers.

In my experience, central banks have traditionally bought high and sold low. Remember just a few years ago when they all dumped their gold reserves? Right before gold almost tripled. As mentioned earlier, the ECB is currently buying massive amounts of Euro bonds… at 700-year lows. There has been limitless demand for 30-year bonds from pension funds and insurance companies.

So what does a bond bear market look like?

Actually, for many investors out there, they really don't know, because it's been 30 years since we had one. I remember the 1994 cycle, when fixed income dropped 20-25% in a matter of months (and that was on instruments with face yields of 7-9%). The growth of passive holdings (like ETFs) and the unintended consequences of the Dodd-Frank regulation could have a big impact.

Flows Into Bonds vs. Stocks



Source: JP Morgan Asset Management

Right now, there are a lot of money managers who have never had to deal with their so-called conservative investments getting thrashed, and there won't be many places to hide.

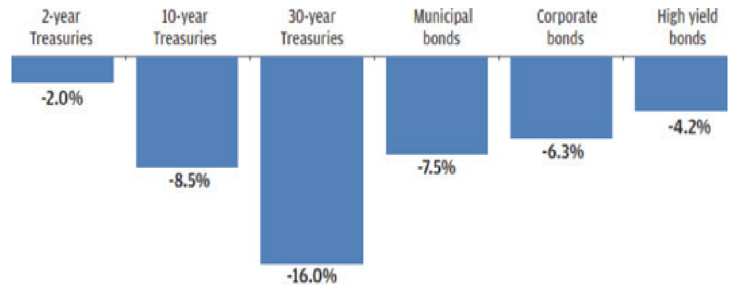
I read a lot about high-yield corporates, but remember—high-yield bonds were created in the mid-1980's by Michael Milken, and that was after the last bond bull market began, so really not a long history.

While I don't expect a big up-tick in rates, and as I've said here many times, I expect interest rates to remain historically lower and for a longer period of time. The chart above (top right) shows it will not take much of a rate increase to cause some panic.

So if what I think might happen actually happens, who's going to hurt the most? The Baby Boomers.

The Baby Boomers were the ones who got beat up in the equity markets in 2000-2002, and then again in 2008-2009, at which point many swore off stocks and went ALL into bonds, because "bonds are safe." So now the biggest funds in the world are bond and fixed income funds. After being hammered twice in a decade in stocks, many investors threw in the towel on equities. Now at or in retirement, none of these people think their bond funds can get beat up. Surprise!

Percentage Decline in Bond Value if Interest Rates Rise by 1%



Source: JP Morgan Asset Management

So we have made strategic and tactical moves in anticipation of The Great Rotation. I still believe equities will greatly outperform bonds over the next decade and, for the next while anyway, equities in the U.S. and Europe over Canada.

The Little Picture… But Really, the Big Picture

On July 8, we hosted our 26th annual Children's Golf Classic at Sunningdale. We raised an incredible $230,000 at this year's event. The event has raised approximately $3.5 million (net) over the years, 100% of which goes to our local Children's Hospital. A special thank you to all of our clients and friends who have been supporters of this great cause for many years.

Notes

The underfunding of American pension plans by cities and states. According to Morningstar, the worst for underfunding are:

Cities	**States**
Chicago 37% Funded	Puerto Rico 10% Funded
Philadelphia 49%	Illinois 40%
Jacksonville 57%	Kentucky 45%
NYC 60%	Connecticut 47%
Pheonix 61%	Louisiana 55%

Emerging?
During the week ending June 6, investors withdrew $8 billion from the Asian equity markets and a total of $9.3 billion from emerging markets – the largest outflow since 2008. The heavy outflows were spurred by weakening currencies.
(RBC Morning Insight June 12, 2015)

Around the GLOBE

Canada (Reduce)

- Alberta election results have changed my outlook on Canada
- The collapse in energy prices (which will hurt Federal coffers), the provincial fiscal disasters in Ontario and Quebec, the pending PQ sovereignty debate, the pending Federal election, and now Alberta, lead me to believe Canada may have a tough time over the next little while

U.S.A. (Strong Buy)

- Growth seems to be accelerating at times, but not at others
- Strong U.S. dollar having an impact on multinational earnings
- U.S. Presidential election rhetoric beginning to heat up
- Federal Reserve expected to start raising interest rates later this year

Europe (Buy)

- Is still a mess, but getting better; optimism creeping in
- Massive stimulus by ECB showing signs of working
- Greatly reduced euro helping export nations
- Greek distraction will be resolved one way or another soon

Asia (Hold)

- Japan seems to be improving, but China remains a question mark as it has stumbled the last few months due to persistent challenges from deteriorating competitiveness and the aftermath of credit excesses

Emerging Markets (Hold)

- As a group have decelerated the last few years, despite best global demographics
- Slowing globalization, external debt and structural challenges all keeping a cap on growth
- The political risk on top of it all doesn't make it worthwhile – for now – despite perhaps being among the cheapest priced assets on the globe

Quotes

"Most economic fallacies derive from the tendency to assume that there is a fixed pie that one party can gain only at the expense of another."
- Economist Milton Friedman

"Wealth is not about having a lot of money; it's about having a lot of options."
- Comedian Chris Rock

"Apparently, the only people who are supposed to be responsible are the taxpayers... and they are increasingly made to be responsible for other people's irresponsibility."
- U.S. Economist Thomas Sowell

"There is nothing we receive with so much reluctance as advice."
- Poet Joseph Addison

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.

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.

Congrats, Mary B., our winner this quarter!

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