Wealth Management
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High Anxiety?

With 2017 heading into its final leg, investors are increasingly anxious about the heights to which the stock market indices have climbed. Despite these concerns, in reality, while the Canadian TSX has hit all-time highs, in 2017 it has lagged its American and most European counterparts by significant margins. Canadian investors who avoided the U.S. markets may be tempted to jump in but reasons to be cautious abound. Valuations of stocks, in particular in the U.S., are high, investor margin (borrowing) levels are high, and investor greed is again at a frenzy, with underinvested investors showing signs of wanting to "get in" from, as my teenage daughter would say, feelings of "FOMO" ("fear of missing out" for those of us in the "over-40" crowd…).

So when is "high" too high? That, as we used to say, is the $64,000 question! Part of the answer has to come from where these heights derived. By all accounts, low interest rates and accommodative fiscal policies of Central Banks globally have played the major part in driving stock market valuations higher. Just like housing markets rose dramatically starting in the mid-90s as interest rates plummeted, stock markets too have enjoyed low borrowing rates to propel prices higher. Businesses can borrow to invest in infrastructure as well as in stock buybacks, and mergers and acquisitions are easier to finance. Low rates mean that investors can afford to borrow against their own assets, such as their homes or against their existing stock portfolios, in order to invest, as the "spread" in what they can earn versus the borrowing costs are in their favour. Therefore, higher interest rates are certainly one potential catalyst to "crash" this party. While the U.S. is threatening to raise interest rates again, which could put a damper on this "party", and Canada has surprisingly raised rates twice in 2017, only to see levels of economic activity recently showing signs of slowing down, European authorities have recently reconfirmed their commitment to extend this party into the "wee hours". The ECB – Europe's "Central" Bank - has decided, due to moribund growth and potential political risk (most recently in Spain), to keep the fiscal wheels greased with easy fiscal and monetary policy for the foreseeable future.

What "alternatives" should an investor consider? No doubt, part of the drive for buying stocks is the definite lack of attractive alternative investments. Consider that real estate investing also suffers from high valuations in most locations and from overleveraged consumers, and that the same factor (higher rates) which could threaten stock valuations would likely also threaten high real estate prices. In addition, the past few years have seen government bodies tinkering with mortgage requirements which has put additional pressure on housing prices with more than enough anecdotal evidence to suggest a slow-down in that area is already occurring. Short-term savings accounts, or so-called "high-interest" savings accounts are an oxymoron, with rates still below 2%. The so-called "risk-free" rate of 10-year Government bonds in Canada and in the U.S. are hovering below and just above 2% respectively, as are bank-issued GICs. Investment-grade bonds are yielding on average about 3%, and even high-yielding, below-investment grade, bonds are on average yielding in the 5% range, which according to many is insufficient for the risk being assumed in owning them. Private mortgages can offer yields in the 7%+ range, but they generally lack liquidity, they have capital risk in particular for the highest-yielding ones, they offer no capital growth, and they pay interest-only, so they are not right for all investors. In short, investors face tough choices.

Should investors be preparing for a big "crash" or worse, in light of the apparent asset bubbles being created by low interest rates? Andy Xie, a Shanghai based investment analyst and economist recently posted an essay in the *South China Morning Post* in which he stated that "The bubble economy is set to burst." He notes that "American household net worth is at an all-time high of five times GDP, significantly higher than the bubble peaks of 4.1 times in 2000 and 4.7 in 2007, and far higher than the historical norm of three times GDP. He notes further that many central bankers have been puzzled by the breakdown of the "Phillips curve" which normally suggests that falling unemployment rates will lead to wage inflation and then consumer price inflation, when in fact that has not been the result. Mark Grant, Chief Strategist and Managing Director of Hilltop Securities points out that the "total size of the assets of the world's central banks is now at $US 21.7 trillion, and they are growing by approximately $300 billion per month." This puts the actions of the Central Banks in the spotlight, ahead of normal ways to measure markets such as P/E ratios, earnings and profits, and which are the stimuli behind a lot of the market action, which may put many at unease. He references *Yardeni Research* which shows that the Bank of Japan's assets are 92.2% of their nominal GDP, the ECB's assets at 37.7% of theirs, and the U.S. Fed's assets at 23% of its nominal GDP. These assets have a force of their own and he believes, while bizarre and incomprehensible, at the same time it means there is no massive "crash" in sight as "it is the money [from the Central Banks] that is driving equity prices higher [and] yields lower…", and which is unlikely to stop soon, "as the world's economies could not withstand the pressure."

Bottom line

Investing or choosing not to invest are both choices. Before one invests**,** whether we are in a "brave new world" or just a variation of previous worlds, we are in the reality we find ourselves. Trying to outguess the Central Bankers of the world seems rather futile. The old adage in stock market investing was, "Don't fight the Fed", so to the extent that rule still applies, at *Krygier Wealth Management*, it's business as usual.

Global benchmarks
As at October 31, 2017 (Canadian $ Returns)

Asset class	1 year	3 years	5 years
S&P/TSX Composite T/R (Canada)	11.5%	6.2%	8.4%
S&P 500 TR - US$	23.6%	10.8%	15.2%
NASDAQ Composite - US$	29.6%	13.3%	17.7%
MSCI Europe Index Price Return	18.8%	7.3%	10.7%
MSCI Emerging Markets	18.8%	8.0%	7.7%
China S.E Shanghai A Price Return	7.4%	13.9%	14.7%
MSCI World Index Price Return	15.7%	10.9%	15.1%

Asset class	1 year	3 years	5 years
30-year U.S. T-Bond - US$	-3.3%	3.7%	2.7%
10-year U.S. T-Bond - US$	-2.7%	1.9%	0.9%
Long GOC Bond (2048)	-7.7%	3.7%	2.7%
10-year GOC Bond	-4.1%	2.8%	2.4%
5-year GOC Bond	-2.4%	1.6%	1.7%
3-month CDN T-bill	0.5%	0.6%	0.7%
US$/CDN$ (1.2888)	-3.9%	4.6%	5.2%

Source: RBC Capital Markets Quantitative Research

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