The O'Neill Wealth Management Group

Wealth Management
Dominion Securities

Q2 Executive Summary

The O'Neill Wealth Management Group

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We believe everyone should feel confident about their future.

Confidence builds as we acknowledge the things beyond our control and focus on those we can influence. We can't control the level of inflation, central banks decisions on interest rates, the outcome of NAFTA negotiations, Chinese/U.S. trade tariffs or Presidential Tweets. We can however have control over our goals for saving and spending, time horizons, investment discipline, guidelines for Asset Allocation, quality metrics, and setting appropriate limits and boundaries.

We also have more control over our own reactions than we sometimes think. Rather than fear an economic or financial market downturn is coming, we can accept recessions are inevitable, natural occurrences that follow a business cycle. Confidence comes when we consistently prepare, so when downturns happen, rather than shock and surprise, we know how we will manage through it.

To be clear, the signs of the next recession are still scarce for now. We do know that financial markets have been more volatile in the first half of 2018, economic growth has slowed, and the enthusiasm over the U.S. tax cuts is now facing increasing tension and apprehension about protectionism. Inflation and interest rates are no longer at rock-bottom levels and are trending higher, and the U.S. dollar has resumed its escalation. At the mid-point of the year, equities have been struggling to make sustained headway.

Before looking forward it is important to recognize how unusually good, and therefore unsustainable, 2017 was. Despite the "volatility pendulum" swinging far in the other direction, 2018 has been more "normal" in many ways, and the outlook is far from all bad. While slower, economic growth is still relatively good. Higher interest rates, oil prices, inflation and a U.S. dollar have not had a materially negative impact so far, and may have a way to go before they do.

The key macro risks we have identified for the U.S. have been an ongoing topic of discussion in our quarterly review commentaries, and meetings for some time. Namely, the age or "late-stage" of the business cycle, combined with the risk of protectionism and trade. At the same time, the Canadian economy faces the unique challenges of diminishing relative competitiveness, and concerning levels of household and consumer debt. While we talked about these issues throughout 2017, for the most part equity markets essentially shrugged off concerns, and rewarded investors with a very decent all-in return, and surprisingly low equity-market volatility. Contrast that to 2018, when volatility is back, and financial markets are in a state of "high alert" responding to an onslaught of macro and company level shocks. With the Tax Reform Bill passed, the republicans have shifted focus in a big way towards issues of trade. Investors are now seemingly realizing there are in fact risks to protectionism. It is not just rhetoric, but could result in a real economic drag.

The long, drawn-out, often gloomy NAFTA negotiations have oscillated between optimistic and shocking. There is no question, the unpredictable nature of President Trump contributes to the uncertainty, and this issue will remain an overhang and key risk until it is resolved.

Corporate earnings, which drove equity returns in 2017, will be critical to sustaining the expansion. They have been growing rapidly due in part to the passage of the U.S. tax cuts. Stocks continue to offer upside potential from current levels but, valuations are demanding, and therefore prices are more vulnerable to a negative shift in risk appetite and/or deterioration in the outlook for earnings. We must acknowledge that another recession is inevitable *eventually.*

RBC GAM remains positive on the macroeconomic backdrop, believing it is likely to support further gradual increases in interest rates and rising corporate profits. Overall stocks continue to outperform bonds (in our base case), but recognize the cycle is maturing and therefore we need to proactively dial back risk in our portfolios.

As we know however, we should prepare not only for our “base-case” but for a range of possible outcomes. Chief Economist Eric Lascelles said “my best guess is that protectionism will merely act as a pesky drag on global growth avoiding outright economic carnage. But alternate scenarios abound, and one must acknowledge something like a 20 percent chance of a rather uglier outcome: a full-blown trade war. This might not be full-on recessionary, but it could certainly suck all of the juice out of the recent U.S. tax cuts”.

While we were pleased to have participated, in “better-than-expected” equity market returns last year, we also got pro-actively more defensive, and took several opportunities to dial-back risk in our portfolios. This quarter we felt it was important to reiterate what our strategy has been and continues to be in light of the variety of risks to our more positive base-case view:

- **Regular Profit Taking**. Part of our more *cautiously* optimistic approach over the last 18 months is evidenced by frequent profit-taking. We have accomplished this in three primary ways; (1) *Frequent Rebalancing.* Extra diligence in maintaining the asset allocation targets defined in each client’s Investment Policy; (2) *Small Reduction in U.S. Equities.* While the U.S. market has proven to be the best positive contributor to performance over the last several years, with valuations stretched, we did take our U.S. position down slightly. To be clear, we still have an “overweight” position in U.S. (as compared to a standard *balanced* portfolio), it is just slightly less-overweight. The difference was added to a small position in continental Europe and Canadian equities; (3) *Carefully watching Valuations.* Our individual trades have overwhelmingly been motivated by profit-taking and searching for more reasonable valuations.

- **Defensive Positioning**. Despite the challenges facing the Canadian economy, and by extension the Canadian market, we like the defensive properties offered many of our core Canadian positions, namely the dividend growth and share buy-back opportunities, combined with the preferential tax treatment of income from Canadian companies. Sector-rotation decisions to tilt away from ‘trade-sensitive’ companies mean that we have an emphasis on stocks that are less economically focused. Combining these with U.S. companies in sectors that are under-represented in the Canadian market, and we have a diversified and defensively positioned portfolio overall. We would not go so far as to say that we are recession-proof, but we would say it is recession-resilient.

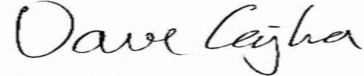
- **Taking Advantage of Higher-Interest Rates**. Higher rates have allowed us to rotate out of some corporate debt, and into higher quality government-back fixed income. CDIC covered GICs with yields of over 3% mean we don’t need to stretch for yield by taking more risk with corporate bonds, whose prices will be more sensitive to interest rate increases. We will continue to take steps to ensure our fixed income allocations represent a solid foundation for potentially more volatile and turbulent times ahead.

- **Built in Flexibility.** We have maintained flexibility with our “swing” positions. Liquid positions (pools, ETFs etc) that can be used as a source of cash will allow us to rebalance and/or take advantage of opportunities quickly. Right now the market is in “reaction-mode”. However when we are in the beginning of a more pronounced and perhaps prolonged downturn, that is truly when it makes sense to add to our core positions that we are confident will come out the other side with less volatility.

Ongoing reviews of your priorities and circumstances used in your Financial Plan, along with portfolio guidelines defined in your Investment Policy are essential to the ultimate success of your investment strategy. Knowing your investment plan is always aligned with your immediate needs, and your vision for the future allows you to maintain clarity and confidence at every stage of the cycle.

We hope you enjoy all that the summer season has to offer, and we look forward to seeing you soon.

Sincerely,



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