The O'Neill Wealth Management Group

Wealth Management
Dominion Securities

Q3 Executive Summary

The O'Neill Wealth Management Group

RBC Dominion Securities Inc.

Maureen O'Neill
Vice-President & Portfolio Manager
maureen.oneill@rbc.com
613-566-7562

Jennifer Shone
Investment Advisor
jennifer.shone@rbc.com

Dave Cajka
Wealth Advisor
dave.cajka@rbc.com

Agnieszka Wasiluk
Associate
agnieszka.wasiluk@rbc.com

Edward Lis
Associate
edward.lis@rbc.com

45 O'Connor St
Suite 900
Ottawa ON K1P 1A4
1-800-461-1958
www.theoneillwealthmanagementgroup.com

We do comprehensive portfolio updates every ninety days, not to torture ourselves by reliving the latest headlines in the news, or to propose big sweeping changes to our strategy, but rather to check-in to make sure we remain on track. Most of our portfolio changes seem subtle as they happen, minor adjustments that add value incrementally over time. Yes we need to be informed, and adapt to the macroeconomic environment as it evolves, but always from the perspective of aligning our personal needs in the short-term, and our long-term goals. Are the decisions we make each week, month and quarter helping us stay on track with our long-term Financial Plans? This is why we believe having a system for regular reporting and communication is important, and why it is one of our core commitments to you.

We are in the late stage of this business cycle, and it is advancing. The current economic expansion is mature and is now officially the longest on record. The risk of a recession is substantial, but it is not happening yet. Eric Lascelles, Chief Economist for RBC Global Asset Management (RBC GAM) has increased the odds of a recession to approximately 40% within the next year. This is high by any standard, but is still not viewed as the central outcome.

Global growth has slowed, as manufacturing has started to falter, while the service sector is helping to offset this somewhat. Consumer spending is proving resilient, though no longer at peak levels. The extent to which consumers stay engaged is a key factor. With the U.S. saving rate high, reasonably good wage growth, and declining household leverage, it is realistic. Though this can change quickly should businesses stop hiring.

Central bankers have pivoted to monetary stimulus almost simultaneously, with some having already delivered rate cuts, including the U.S. Federal Reserve, while others are hinting they are coming. This helped the mood of global equity markets to take a turn for the better over the past quarter. The monetary stimulus is supportive for economies and for stocks, however the capacity for further rate cuts is limited. The market is expecting the Federal Reserve to cut interest rates up to four times over the next year, while RBC GAM believes they will cut three times. This is important at a time when fiscal stimulus in the U.S. is fading.

The Yield Curve (relationship between short and long term interest rates) remains inverted, and is therefore a warning of the increased risks of an economic downturn within the next six months to two years. At the same time bond yields are once again extraordinarily low. While yields remain positive in many economies, real yields (adjusted for inflation) on government bonds have fallen below zero indicating investors are accepting a guaranteed loss in their future purchasing power should they hold to maturity.

Ongoing concerns regarding trade, protectionism, and a Saudi-Iran confrontation triggering an oil price surge, topped the list of worries over the past quarter. Global equities rallied in July, and then stumbled in August as trade tensions escalated *again* between the U.S. and China. Just as quickly, upcoming talks gained a firmer footing, though a breakthrough is far from assured. The Brexit situation is baffling. Three years after the initial vote, seemingly all options were still on the table. By the end of the quarter, the prospect of a no-deal Brexit seemed to have receded, though not vanished altogether, and the price of oil was close to the pre-attack level, but RBC Capital Markets (RBC CM) suggests the crisis is not over.

Adding to this already long list, House Speaker Nancy Pelosi, recently announced that the U.S. House of Representatives will move forward with a formal impeachment inquiry into President Trump. At this point it seems very unlikely that Trump will be removed from office, given the removal requires a two-thirds majority in the Republican controlled Senate. RBC GAM believes the U.S. election remains "up in the air", and so far no "great" outcome on the horizon from an economic perspective. Should the Senate remain republican and the house remain democratic, whoever the President is, they will have limited ability to govern. The market does not love this scenario. The U.S. becomes even less likely to deliver stimulus in 2020, and passage of the USMCA trade deal becomes even less certain.

We have been talking about the risk of a recession for so long (mentioned in each of the last 7 quarterly executive summaries). Naturally we want to know when is it coming, how long will it last, and how severe will it be? We would love to be able to provide precise answers to these questions. Instead we must weigh probabilities, as evidenced by economic models, evaluate the plausible scenarios based on the list of potential risks – both to the downside and the upside, make the most prudent decisions in a systematic and sustained way as the economic background develops, and leave some room for being wrong in the short-term.

For now RBC's base-case is for continued economic growth, at a slower rate in 2019 vs 2018, and further deceleration in 2020. If corporate profit growth remains solid, then U.S. stocks can move higher. An environment of moderate earnings growth, low interest rates and low inflation is good for stocks. Of course the risks to the downside are higher now than they were 3 months ago, and the longer the expansion lasts the more likely it is to stumble. A recession scenario damages profits and investor confidence and would send stock prices meaningfully lower. Though as pointed out by Eric Lascelles recently, expectations are for a milder and shallower recession than the previous one, but possibly one which lasts longer.

So what is our plan to prepare? Should we do anything differently? What if we're wrong? To a degree this is an exercise in evaluating our immediate or short-term needs, against our long-term goals. We all have some immediate need for protection. We need confidence in where our day-to-day cash flow is coming from, and how we expect to cover short-term expenses. The extent these need to be covered from our investment portfolios helps to dictate the need for liquidity, safety and income. The long-term objectives and goals center on the opportunity to accumulate capital, and/or enhance income in the future over time. While knowing there is adequate security to meet your requirements in the short-term is necessary and comforting, having access to liquidity, either through regular savings or through appropriate asset allocation, during downturns, allows for the opportunity to shorten recovery time, increase future recurring income by adding to those companies with solid and growing dividends, and create value and growth for future years.

Having an investment discipline is not about timing markets perfectly, rather it is an ongoing process of systematically making tactical, responsible decisions to either pare back risk, and/or be opportunistic, always within the guidelines and parameters of individual long-term Financial Plans, and Investment Policy Statements. In this way we can keep our Financial Plans on track, even when we are “bracing for impact” in the near term. While not easy, disproportionate fear is no more the answer than greed is during excessive bull markets.

This has been our central message over the last many quarterly reviews. As the outlook has progressed and risk premiums for equities and fixed income increased, our strategy to take risk off the table, and become more defensive, cautious and flexible also developed slowly, systematically, and carefully over time. It is true that equity risk premiums are higher today, however the low current level and declining outlook for interest rates creates the short-term tactical dilemma. Equities have provided meaningful returns this year, and recovery from the correction at the end of 2018. Being too cautious can lead to missed opportunities, and too aggressive means you lack the flexibility to act when warranted. We feel confident in the quality of the positions in our portfolios, and in their resiliency, not only during bouts of short-term volatility (that is expected in a late-stage cycle), but also should (when) we find ourselves inevitably in a longer downturn. We continue to expect stocks to outperform bonds over the long-term, and so will maintain the position deemed appropriate for each individual in their Investment Policy, however we don’t feel this is the time to hold substantial risk positions.

Corrections, pullbacks, and certainly longer-lasting downturns in equity markets, that are associated with recessions, are not fun to live through….and frankly neither is the anticipation of waiting for their arrival. Preparation, forward planning, and having a disciplined process to manage through it can, in our experience, calm the anxiety of “waiting” and provide the perspective, control, and confidence needed when we find ourselves (eventually) in the midst of it.

During this Thanksgiving season we have much to be grateful for. Thank you for your trust and confidence in our team. We wish you and your loved ones health and happiness.

Best regards,

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