The PFP Quarterly

Wealth Management
Dominion Securities

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Quarterly Update

A lot can change in 3 months. If we were to wind the clocks back a few months, we were in the midst of: trade discussions between China and the United States, lingering problems with the United Kingdom and Brexit and fears of slowing global growth. Fast forward; China and United States have the first phase of a new trade deal signed, the conservative party of Britain look to have made progress on developing a transition strategy from the European Union and with accommodative monetary policy globally, economic growth continues to chug along. As we described in our summer commentary, we believe the world economy is like a three propeller plane: United States, China and Europe. Until there are issues with two of the propellers, the plane while turbulent at times, will continue to push forward.

The American consumer

All of the gloom surrounding trade and recession talk is diminishing and a less fraught outlook for the economy in 2020 is rising. The engine behind this outlook is the United States and more importantly, the American consumer. The guiding force behind the American consumer is low unemployment and a tight labour market. The unemployment rate sits near a 50-year low (as seen in figure 1) and is below most estimates of "full employment." To drive the point home, presently there are 7.3 million jobs available versus 5.8 million unemployed. Think about that, there are significantly more job openings than the number of unemployed. This is something that has never happened in the history of the data. One of our highest-conviction calls for 2020 is for a further acceleration in wage growth. Average hourly earnings growth moved convincingly above the 3% mark (y/y) for the first time in a decade a little more than a year ago.

Figure 1

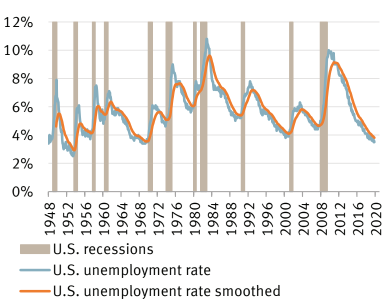

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Figure 2

Price-to-earnings (P/E) ratios of major equity indexes

	Forward P/E	10-yr Avg.
S&P 500	17.5x	15.1x
S&P Small Cap 600	18.5x	18.0x
S&P/TSX Comp	14.8x	14.7x
STOXX Europe 600	14.6x	13.2x
FTSE All-Share	12.9x	12.7x
Hang Seng	10.3x	11.1x
Shanghai Comp	10.7x	11.4x
TOPIX	13.7x	13.6x

Note: Data represents forward P/E ratios based on Bloomberg consensus earnings forecasts for the next 12 months.
Source – Bloomberg; data as of 11/12/19

But job creation and the unemployment rate only tell part of the story. The best way to gauge the consumer's ability to drive spending is through wages. Production (non-supervisory) workers comprise more than 80% of the U.S. workforce, and their real aggregate wages are growing at rates well above the long-term average (3% year over year). Given the tightness of the labor market, there is almost no reasonable argument to be made that casts doubt on the consumer's ability to drive spending in the coming year at a better than 2% pace.

Easy money

This tight labour market and strong wage growth is coupled with very accommodative monetary policy globally (i.e. interest rates). The US consumer's reaction to accommodative rates, extreme labor market tightness, job security, as well as to rising wages, has been to save more. Needless to say, this is an atypical reaction. In fact, our saving model suggests that given this feel-good backdrop the consumer should be drawing down savings. Instead, the saving rate remains elevated in the U.S. at about 8%. Households continue to de-lever despite extraordinarily low interest rates. Credit card delinquencies are running at a rate only slightly above the all-time low reading posted back in 2015. North of the border, Canadian household debt represented 177% of disposable income in 2019.

The American consumer has decided to use this opportunity to de-leverage but to be fair, where else would they park their money. Their options: an elevated real estate market, a rich equity market or a low-rate fixed income market. When it comes to their "safe money", the search for returns is much harder to find than in years prior. Investors are affected to the extent they have traditionally maintained low-risk, fixed-income-heavy portfolios and experienced stable stream of payouts. With 17 Trillion in negative yielding debt being traded globally in 2019, investors may have to turn to other buckets for historic returns or may have to accept lower rates for longer.

2020 Outlook

As we think about 2020, there is almost no getting around the fact that the consumer will again be the engine. On the face of it, calmer waters on the trade front would suggest businesses' capital expenditures could show some lift in the coming year, but we would caution against placing too much optimism here. Even if trade worries completely vanish, we still have the coming presidential elections that could add a dose of uncertainty to the backdrop. Thus we do not see business capital expenditures helping propel growth in any material way. Rather, the consumer will again shoulder the burden.

We have a constructive outlook for stocks in 2020. The economic expansion should have further to run, in our view, underpinned by accommodative credit conditions everywhere, the robust good health of the American consumer, easing U.S.-China trade tensions, and the likelihood most developed economies will deliver some fiscal stimulus. Corporate earnings will likely increase, as should dividends and stock buybacks, pushing share prices higher. Valuations are also on the market's side. They are above average, but not unreasonable considering the ultra-low interest rate environment and the more extreme valuation peaks reached in the two previous bull market cycles (as seen in figure 2). That being said, we are cautious about over-extending into equities and need to remind ourselves that we are still in the longest equity bull cycle in history.

Thank you for your continued trust and support.

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