The PFP Quarterly

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Wealth Management
Dominion Securities

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Quarterly update

It's remarkable how fast things can change. In our last quarterly report, we discussed: the rising tensions between China and the United States; the disagreement between the U.S. government and the U.S. Federal Reserve over the future path of monetary policy; and the extreme negative volatility in global markets in the fourth quarter. Fast forward three months: markets are back up near their all-time highs and those issues appear to be less significant. It goes to show that the markets tend to be irrational at times. We came out of 2018 confident that the lows of the fourth quarter weren't the end of the current economic cycle but rather a resetting of valuations. Our thesis remains the same: this current cycle is not over but we are facing the later stages of the cycle and remain cautious.

Yield curve

Unlike last year and years previous, there are now indicators signaling that the end of this current economic cycle is around the corner. Over the last couple of quarters, indicators like the slowing growth in the three largest economies (U.S., Europe and China) and the inversion of the yield curve have drawn investors' attention. Slowing growth in late cycles is common but the inversion of the yield curve is something that most investors look for as indication of our next recession.

On March 22, for the first time since 2007, long-term rates (10-year) had fallen below short-term rates (one-year). This was the first recessionary sign to peek its head for this current market cycle. The inversion of the yield curve grabbed investors' attention as this indicator typically forecasts the beginning of the next recession about 11 to 14 months later. The recent inversion makes it

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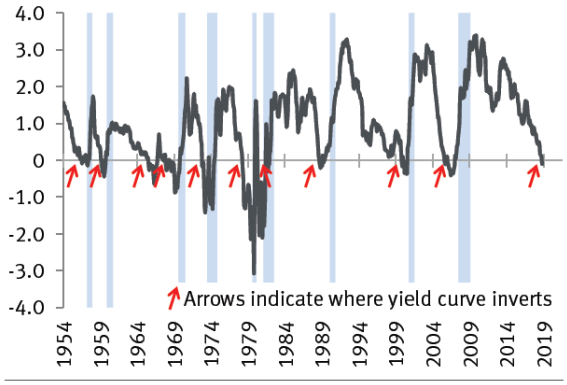
Yield differential between 10-year and one-year U.S. treasury note



Note: Shaded areas indicate recessions
Source - RBC Wealth Management, U.S. Federal Reserve, National Bureau of Economic Research

appropriate to start thinking about that eventual recession but we believe it will take some time for the U.S. to officially go into one. At the time of writing this, the yield curve has now normalized but it does show that we are nearing the end of the cycle. No matter how historically reliable the inversion of the yield curve may be, investors should be reluctant to bank on one signal. The last part of the expansion cycle could be very drawn out and we will need other indicators like unemployment claims and the conference board leading economic index to provide more validity on an impeding recession.

European course correction

The global economy is driven by three major players: the U.S., China and Europe. The global economy is like an airplane: if one propeller stops working, the airplane will continue to work but will begin to experience turbulence. If two propellers stop working, the plane is going down. At this point in time, the first market to watch is Europe. Over the past 12 months, there has been a lot of noise around the European markets. At the top of the list is the never-ending saga surrounding Brexit. Delays after delays have become normal due to the government's and businesses' lack of preparation for Brexit. While it appears a withdrawal agreement will eventually go through, Theresa May is under immense pressure to rule out a "no-deal", i.e. a separation from the EU without a transition period.

Europe as a whole is increasingly dependent on external demands with exports representing 28% of their GDP and 40% of the overall exports going to emerging markets. With the volatile times in Asia and the slowing growth in nations like China, this has caused a strain on European GDP. In addition to Brexit and the slowing European GDP, political tensions in Italy and France, as well as the automotive hurdles in Germany, have forced some of these countries to fall into a technical recession. With the rising risks that are surrounding the European economies, we are keeping a close eye on this part of the world as we believe this may be the first propeller to experience technical difficulties.

What are we doing?

As mentioned in our previous quarterly note, we believed that the fourth quarter of last year was simply a correction and not the end of the market cycle. That said, we thought that there would be a better time to reduce our overall equity exposure and develop a more defensive portfolio. In our last quarterly note, we mentioned that we were going to continue to prepare our portfolios for the next recession. We have been adamant on our message and our portfolio has shifted on all fronts. Over the last quarter, we have reduced our overall equity position (Canadian, U.S. and international equity) as global markets have once again hit all-time highs. We have transitioned more of the portfolio into high-quality, short-duration government and corporate bonds. We believe that adding a larger portion of high-quality bonds will add to our overall defensive stance and help the portfolio mitigate the volatility that will continue as we work through the end of this current economic cycle.

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