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of RBC Dominion Securities

Wealth Management
Dominion Securities

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Integrity, Trust and Experience
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Welcome and thank you

A warm welcome to the clients who have recently joined us, and a special thank you to the people who mentioned our name to them. We appreciate your trust and support.

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When the tide changes

Following the financial crisis some nine years ago, the major central banks acted in concert and lowered interest rates to offset the deflationary forces present at that time. Not only did they lower administered short interest rates to emergency and miniscule levels, but they embarked on a bold new monetary experiment called "quantitative easing." This process involved effectively printing money and buying bonds in the marketplace. The power of an enormous buyer of bonds with bottomless pockets pushed the price of bonds much higher and consequently yields and interest rates much lower. By doing this, central banks were not only able to manipulate short-term interest rates lower as they have done traditionally, but were able to push down interest rates for much longer-term bonds for the first time. This is truly a phenomenal and extraordinary economic manipulation that has, to date, worked.

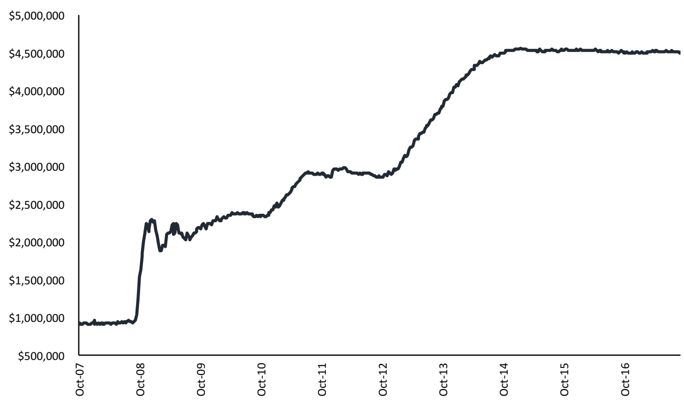
Today, almost exactly nine years since Lehman Brothers collapsed, the world continues to turn and most economies are in much better health. Economies are growing, the financial system is stronger, and unemployment is at healthy, low levels. After nine years of healing, the economies of the western developed world have recovered and are healthy enough that artificially low emergency-level interest rates are no longer warranted, and are perhaps imprudent. While official inflation measures remain low, the measurement remains suspect. There is certainly inflation in several asset classes such as real estate in some areas, and in some areas of the stock market. Abundant liquidity provided by quantitative easing and artificially low interest rates has caused this.

For some time the U.S. central bank has been signaling that the emergency level low interest rates are no longer warranted and they have been raising short-term administered interest rates. Some other central banks have followed suit or are signaling that they too will begin raising interest rates. Furthermore, the U.S. central bank has announced that starting in October, it will begin selling the $4.5 trillion of bonds it bought in its quantitative easing program. It seems to me that this is a tidal change and instead of the financial world being awash in a high tide of liquidity, the tide is beginning to go out. As the monetary tide recedes it will once again expose some swimmers that are naked.

The availability and cost of money is a common denominator of asset prices. I believe that like a tide going out, the availability of money will gradually be reduced and the cost will continue to rise. The bursting of the "high tech" stock market bubble in 2000 and the financial crisis in 2008 were both preceded by central banks tightening. Central bankers are well aware of this and intend on doing a better job this time, but I cannot rule out unintended consequences. The timing on when the markets react to monetary tightening is unpredictable. "Wile E Coyote" in the classic Warner Brothers "Looney Tunes" cartoon series repeatedly runs off the edge of a cliff in his enthusiasm but doesn't fall down to earth until he looks down. Markets are basically a crowd of people that is full of self-fulfilling "group think" that it so often ends in folly. "What were we thinking?" and "It's different this time" are terms we've heard before.

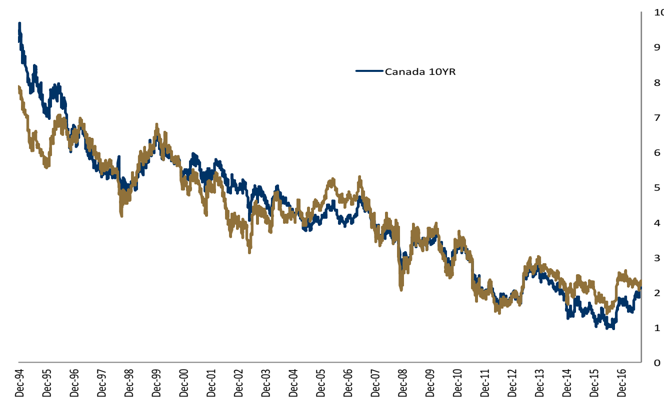
In spite of the short-term interest rate increases so far, and central banks warning that they will be turning into

Fed balance sheet



Source: RBC Dominion Securities Bloomberg

U.S. vs. Canada 10-year bond yield



Source: RBC Dominion Securities

sellers of bonds rather than buyers, there really hasn't been much of a rise in yields yet. Investors' appetite for bonds seems undiminished even though there are plenty of warnings that could be heeded. I suppose bond buyers are confident that central banks have finally figured out how to tighten without causing mayhem to pop up somewhere.

Although President Trump and North Korea continue threatening each other, the markets have not been too perturbed by this frightening situation. Similarly, instability in Venezuela, the Mideast and a few other places has not drawn much attention in spite of the real possibility of economic disruption and higher oil prices.

The major stock market indices in the U.S. have continued to reach new high levels buoyed by low interest rates, abundant liquidity and optimism that President Trump will be able to lower taxes. Although the economy and corporate earnings have increased, most of the gain in the markets since the financial crisis can be attributed to lower interest rates. More recent gains in the major U.S. indices have been fueled by a handful of technology companies that are over-bought, over-owned, and perhaps over-priced. Many good companies with less exciting stories languish. Markets with narrow leadership have historically proven unhealthy. Further, automated trading, computer-based stock-buying platforms and exchange-traded funds are said to represent over one third of market participation today, which could mean that when something causes the market to look down like Wile E. Coyote, the fall could be rapid.

In spite of my worries above, I am actually quite optimistic. The world economy has healed nicely in the nine years since the financial crisis, the banking system is much healthier, economies are growing and unemployment is falling in spite of automation replacing workers in many industries. These things are all good reasons for optimism. Good companies with sound business models, good financing, and trading at reasonable prices continue to remain attractive. They will weather the changing tide of interest rate increases as they climb back to normal levels. However, there are undoubtedly be some assets that have grown because of low interest rates or whose price is inflated by them that will not fare as well. We'll see when the tide eventually goes out. In the meantime, I will do my best to protect your interests, as always.

Tony Pringle, CFA
September 30, 2017