# PPM GROUP
## of RBC Dominion Securities

Wealth Management
Dominion Securities

June 2018

**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.

*Pringle*
PORTFOLIO MANAGEMENT GROUP

# Too much of a good thing

As humans, we are prone to mood swings and emotional extremes. Often, we over-indulge when things are good, like reaching for that third piece of pie. Crowds are prone to this as well, and the group mentality within them creates a self-fulfilling loop of confidence that can be described as a safety in numbers. Maybe it is a deep-rooted primal instinct to stick with the herd, but it can lead to disaster when conditions become extreme. Like a herd of buffaloes charging off a cliff to run away from a few hunters. The damage that the hunters could have done would be minimal compared to the devastation of losing most of the herd.

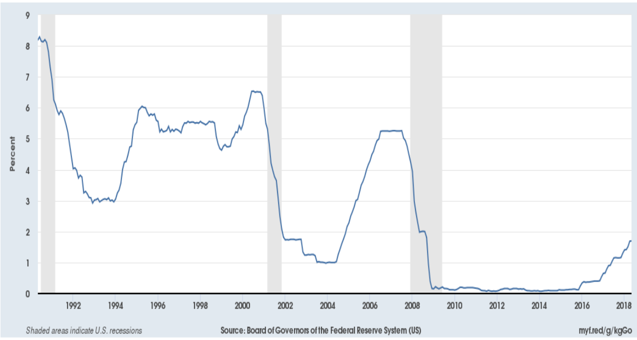
I use this analogy as the major central banks of the world have reduced interest rates to near zero for short-term borrowing since the financial crisis. By printing money and buying bonds, the central banks have effectively manipulated the interest rates down for all borrowing. Led by the U.S. and followed by the U.K., Japan and eventually the EU, this unprecedented bold scheme has finally begun to work. This reflation of the U.S. and world economies took some nine years since the financial crisis which in itself speaks volumes as to how bad things were.

The experimental and extraordinary monetary stimulus has worked, and the prudent thing to do is begin to remove the excess money and "normalize" interest rates and the cost of money. So, the U.S. central bank has been raising short-term rates steadily and has signaled that they will continue to do so over the next year. Further, they stopped printing money and buying bonds and have begun to wind down the $4.4 trillion portfolio of bonds they had purchased over the past nine years.

Both of these actions are extremely tricky in an economy that has become accustomed to ultra-cheap money. Markets had adjusted many asset prices up to reflect the low-interest-rate-environment and abundance of cheap credit. The growing realization that low inflation and interest rates was yesterday's story has caused repricing of some assets, leading to market turbulence since February.

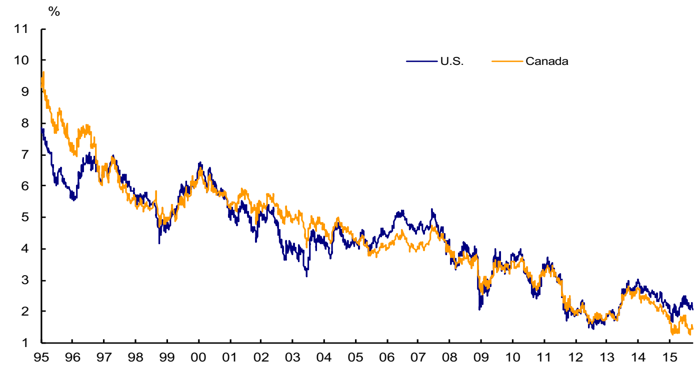
At this stage, the ultra-low-interest-rate environment might be too much of a good thing for many parts of the market. As usual, repricing of assets doesn't necessarily happen immediately as economic factors underlying the raising of rates usually come in intermittently. As well, the central bank is trying to raise rates and tighten very gently so as to not cause a crash or panic. As a result, their actions and language are full of finesse. Think of trying to land a fully loaded jumbo jet for the first time ever. Maybe at night too. Tightening by central banks used to be a common occurrence when business cycles were four years long. However, for the last 20 years or so, the U.S. central bank has allowed them to be longer – six years or so before the financial crisis, and nine since. The burst of the dot com bubble in 2000 was triggered by the U.S. central bank tightening, as was the housing and financial crisis in 2008. To fix these recessions, interest rates were lowered and lowered again, and for longer periods each time. An optimist might say this time is different. We're more sophisticated now and the causes of the financial crisis were repaired. The herd, of course, is blind to the fact that things are changing; each buffalo is just happy to be ahead of the one running behind it in the crowd.

Effective fed fund rates




Source: Board of Governors of the Federal Reserve System (U.S.)

Canada and U.S. 10-year bond yields




Source: Federal Reserve Board, Statistics Canada

While the U.S. has embarked on a tightening cycle of rates, most other major economies lagged it in the economic cycle and have not, although they are signaling their intent to do so. Beyond that, there have been further complications with President Trump's trade policies. While I think these are mainly positioning tactics to highlight his "America First" slogan before U.S. mid-term elections this fall (and negotiating tools in trade discussions), the tariffs he has announced are economically dangerous, disruptive, inflationary and precedent-setting. Most of us are hoping that level heads will prevail and that trade tariffs will prove largely temporary, but I wonder whether they will begin to take on a life of their own and be part of the future. If this happens, inflation will get a further lift, and interest rates too. That could really change the investing landscape.

The 10-year U.S. Treasury bond yielded 2.4% on January 1, and by February was yielding around 3.0%. Still peanuts, but the cost of borrowing for 10 years increased by 25%, so someone's feeling pain. Since then it has fallen back to about 2.9%, probably reflecting investors moving from the turbulent equity market to the relative safety of bonds. With the U.S. economy seemingly growing at 3.0%, perhaps closer to 4.0%, inflation at 2.8% or so and well above the 2.0% target, and unemployment below 4.0%, interest rates are bound to rise there. All of this is before any trade tariffs. I remain very wary of the bond market. The Canadian economy has not yet followed the U.S. economy upward. Consumers are stretched, housing is weakening, oil in Alberta cannot get to world markets and trade negotiations threaten manufacturing. All in all, I expect that short-term rates will remain lower than the U.S. for now.

We all know that most stock markets have performed very well since the financial crisis, but it seems overlooked that most of the gains were due to falling interest rates and the consequent repricing up of stock prices. It now appears that the movie is beginning to play in reverse, with higher interest rates weighing on stock valuations. This explains the choppy and sloppy markets this year. I sense that beyond the macro forces that underpin equity markets there is nonsensical crowding in a few consumer technology stocks. This reminds me of the period in the late 1990s, just before the dot com bubble burst. A group of good companies were so popular that their valuations became extreme, and it took their stock prices some 10 years to recover after the crash. Back then, the prudent thing to do was to sell or avoid the overpriced areas of the market, and buy and hold the unloved but quality companies.

It is an interesting time in the financial markets. The U.S. economy is doing very well at the moment which requires higher interest rates, which in turn will weigh on equity valuations. President Trump is implementing trade barriers which could threaten world trade and will add to inflation. The ultra-low interest rates over the past nine years have undoubtedly led to some investors "reaching for yield" and taking on extra risk, which will surface and not play out well as the cost of money rises. There are parts of the market that are "crowded trades" in good performing but overpriced stocks that create speculative herd behavior. Consequently, there are good companies that are trading at decent valuations but lack the excitement of the darling companies. While still constructive on the markets, I am growing increasingly wary of how things will play out, and concerned that a day of reckoning for speculators and those who reached for yield is approaching. As always, I will do my best to protect your interests.

**Tony Pringle, CFA**
June 30, 2018

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