Serber Speaking

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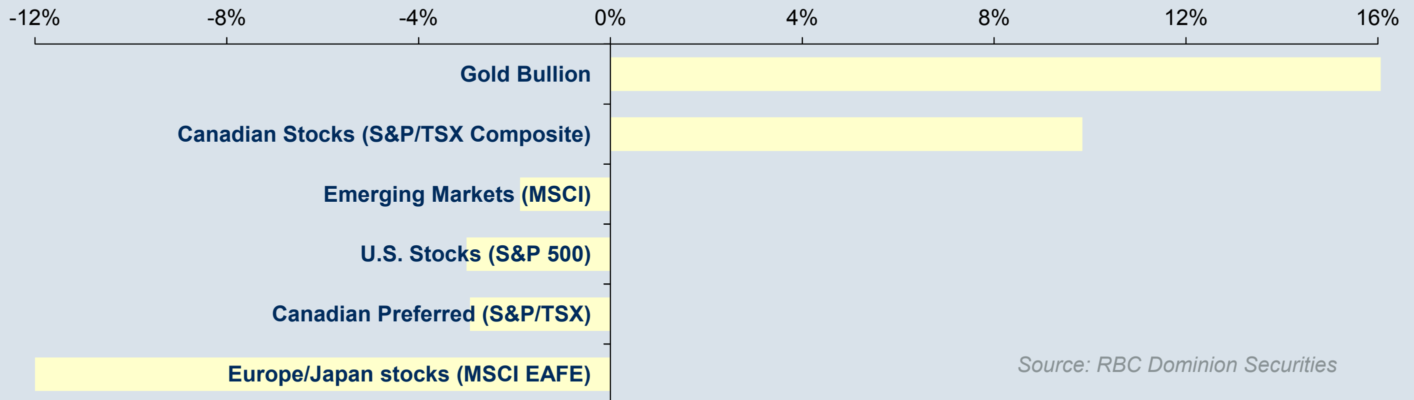
Commentary for the quarter ending June 30, 2016

Canadian Market Continues to Outperform

Last year, the more exposure one had *outside* Canada, the better. For the first half of 2016, the opposite was true. Positive trends established in Q1 continued into Q2, and Canada boasts one of the world's top-performing stock markets year-to-date, with the TSX total return index up almost 10 percent, as seen on the chart below. This is due to a strong rebound in the resource sector, which was severely beaten down last year. The TSX Energy index is up 18 percent year-to-date on a recovery in crude oil prices (from US$37 to US$48), while the TSX Gold Mining index has vaulted by more than 100 percent, propelled by a 16-percent gain in the price of gold. The bad news is that other asset classes have had negative returns so far this year, as also seen on the chart.



Our typical balanced portfolio, which includes some gold exposure, gained about two percent in the first half, or four percent annualized. Diversified portfolios without gold may have had a hard time generating more than break-even.

Why do returns seem so meagre these days, and what happens next?

Investment returns are tied to economic growth. In an economy that doesn't grow, there can be no investment returns. (True, individual investors could make returns through security selection and market timing, but I'm talking here about the aggregate investment returns of everybody, combined). As can be seen on the graph on Page Two, global GDP growth has been trending downward for the last 50 years and is now sitting at around two percent. A GDP growth-rate drop from three percent to two percent has a large impact and explains why portfolio returns have been lacklustre for some time. To wit: the MSCI World index of major stock markets is up only five percent over the past 16 years, excluding dividends, in CAD$ (Source: MSCI).

What returns should we expect going forward? The key, as mentioned, is economic growth. Economic theory says there are two ways to increase economic growth: 1) Increase the labour force and/or 2) increase labour force productivity. The first is achieved through procreation and immigration (one-third to half of Canadian labour force growth is attributable to immigration). The second is achieved mainly through innovation - cars replacing horses, electricity and hydrocarbons replacing steam, computers replacing filing cabinets, etc.

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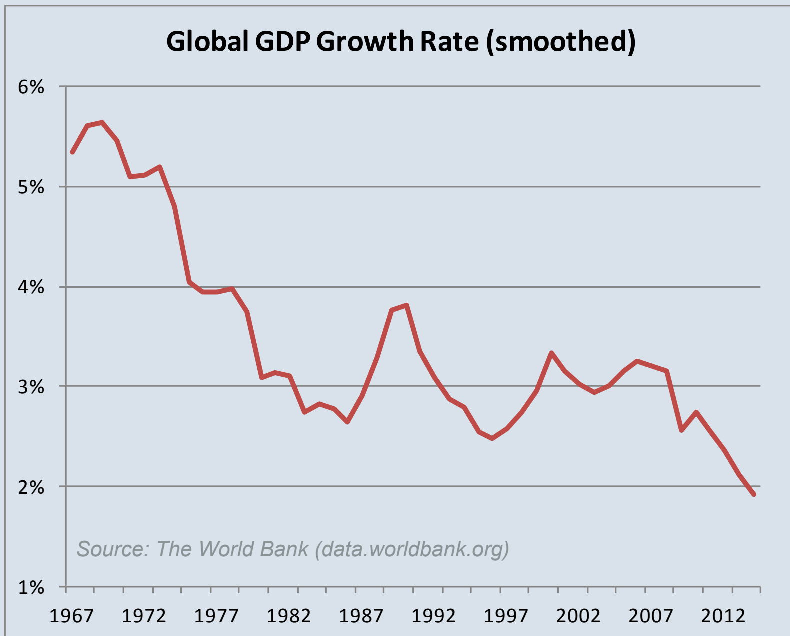
These innovative revolutions constantly occur and are necessary for economic growth. That said, while the aggregate economy is always better off for it, most productivity-increasing innovations create pockets of winners and losers. Innovation also entails risk - most innovations don't catch on and lose money, while some do catch on, creating whole new industries and fortunes for the innovators who were instrumental in creating them (ask Bill Gates).



Meanwhile, global labour force growth is slowing, currently expanding at about 1.2 percent per year, down from 1.7 percent 20 years ago. Productivity growth has fallen even more dramatically: since the early 2000s, U.S. growth rates have plunged from 2.4 percent annually to 0.3 percent, in Europe it has fallen from 1.8 percent to 0.5 percent, and in other mature economies, including Canada, the average has fallen from 2.9 percent to 1.4 percent per year. These data explain why economic growth is down from the three-percent-range of the 1990s to the current two percent. (Source: The World Bank).

As a result, today's dominant theme in the global economy is uncomfortably slow growth. Clearly, policymakers would love to see a revival in the global GDP growth rate. Their main resuscitation tools are monetary and fiscal policy. The monetary policy approach involves making money more available to encourage people to spend more, hopefully providing the economy with a "demand-side" kick-start. Central bankers around the world have been aggressively pursuing this policy since 2008, and they will likely become even more aggressive over the next couple of years, especially in Europe and Japan.

Fiscal policy in this context refers to governments increasing debt to stimulate their economies through tax cuts, social benefits or direct spending on projects such as infrastructure. Government debt-financed spending has been out of favour for some time, although it may make a comeback as policymakers and politicians (motivated by voters) are increasingly encouraged to do something to spur economic growth and "damn the torpedoes." Last year's election win by Canada's Liberal Party on just such a platform is potentially a sign of things to come in other countries.

Brexit in context

The recent Brexit vote was driven in no small part by years of slow economic growth. British voters, especially less-educated working-class voters, attribute their poor economic circumstances to a rapid rise in the immigration of unskilled labour. Slow growth has made it difficult to absorb them, and wages have suffered as a result of the influx. Globalization creates winners and losers, and unskilled workers in the West are in the latter category, a problem exacerbated by slow growth. This fact requires that policymakers deal thoughtfully with the question of how the negative effects of globalization on the "losers" should be mitigated. As far as the average Brexit voter could tell, the opposite is happening in Brussels. (Ditto with a large contingent of those who support Donald Trump.)

There are two opposite potential paths following the Brexit vote. In the first scenario, EU policymakers realize their "tough love" approach to struggling sectors is a mistake and become much more generous with fiscal and monetary support. In the second scenario, the EU digs in its tough-love heels, in which case the most likely outcome is severe economic pain in some countries leading to other "Brexits." This could cause the disintegration of the EU and would reverse the globalization trend in general.

In the present situation, it is less a matter of what is right vs. wrong but more a matter of choosing the lesser of two evils. I think a rapid backpedal on tough love, an increase in fiscal stimulus and a tightening of immigration policy (including a shift in the mix from unskilled toward skilled labour) is the better option, and is certainly the message the Brexit vote sent to the EU. Time will tell if the EU is interested in heeding it. Sometimes, I like to boil an issue down to a single indicator: In this case, keep an eye out for the possible ouster of Germany's intransigent and dogmatic finance

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minister, Wolfgang Schauble, which would be a clear sign that the EU (Germany) is changing its tune. If this happens, I would buy European bank stocks for significant gain potential.

Interestingly, either Brexit outcome is likely to eventually boost inflation. On the one hand, fiscal and monetary stimulus are clearly inflationary, while on the other hand a retreat from globalization is also inflationary. The spike in the gold and silver price since Brexit—plus seven percent and plus 17 percent, respectively—are perhaps telegraphing this message.

Pulling it together

Notwithstanding the recent rapid bounce back in many financial markets to pre-Brexit levels, risks still abound. There will be uncertainty in Britain (Will a second plebiscite ratify a new treaty with the EU? Will Scotland hold a second vote on secession?), and the EU's policy responses will be closely watched. Focus may soon shift to Italy and whether it may move toward "Itexit." A good indicator is the price action of European bank stocks, which reflect investor confidence in the EU financial system. Many large EU bank stocks have dropped precipitously over the past year, plummeting further after the Brexit vote. Indeed, over the past 12 months shares of Santander Bank (largest bank in Spain) are down 50 percent, shares of Deutsche Bank (largest bank in Germany) are down 60 percent, and shares of Unicredit (largest bank in Italy) are down almost 75 percent -- all hitting new 20-year lows. Since banks are the foundation upon which much of monetary policy's effectiveness relies, this sign of dysfunction is a concern. A sharp rebound in these shares, if it were to happen, would indicate the EU is relenting on austerity and would be good news for investors. The opposite would be, well, the opposite.

To acknowledge the heightened risks, I have reduced equity exposure to below-neutral levels and increased the cash allocation in my managed portfolios. If you have not already done so in your portfolio, the current "Brexit Bounce" should make you consider seriously the same strategy.

Wealth Management and Financial Planning

I recently attended a conference of the authoritative Society of Trust and Estate Planners. One presentation which got my attention covered the tax benefits of using life insurance for long-term wealth planning. The fact that growth in a life insurance policy is tax-free on death is one of its several important pluses. For high net-worth clients, insurance planning also allows them to:

1. fund estate tax liabilities;

2. provide for a family capital liquidity pool;

3. create an alternative investment strategy (high rate of return, low risk); and

4. fund a buyout or other requirement arising at time of death.

As a licensed Insurance Representative, with a top team of insurance and tax specialists behind me, I can help with these strategies and would welcome the opportunity to discuss them with you. Please call any time - my coordinates are at the top of the page.

Until next time, best regards,

David Serber

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