

Piazza Wealth Management Quarterly Newsletter



Wealth Management
Dominion Securities

Spring 2018

Welcome & Thank You

Welcome to all the new clients who have joined us since our last newsletter.

Thank you to the people who recommended our services.

Views and opinions
for the clients and friends of

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Wall Street West News

Dear Clients and Friends,

The markets began 2018 with a volatile Q1. The US markets ended their streak of positive months in February when fears of high interest rates and overheating brought back volatility not seen in 2017. The best performing sector in the US in Q1 was Information Technology, while the worst performer was Telecom.

This quarter was a busy one for Donald Trump's white house. Trump was not backing down in his trade talks with China and started a mini trade war by implementing tariffs on many Chinese products (over \$50 billion), which was then countered by China to a much lesser extent (\$3 billion). The administration saw a lot of restructuring with the prominent Gary Cohn quitting as Trump's top economic advisor over a dispute on tariffs.

The Federal Reserve increased interest rates by another 0.25% to 1.65%. This was the 6th rate hike since they began raising rates in December of 2015. The Bank of Canada also raised interest rates by 0.25% in January to reach 1.25%.

The Crypto world has taken a backseat and fallen out of favor dramatically with all of the renewed volatility. Bitcoin started January above \$17,000 and ended the quarter below \$7000.

On a personal note, Bobby and Jenny both went to Florida for spring break to spend time with their families, while Jason added a new member to his family, his new dog Harley.

All the best for spring!

Bobby, Jenny, Jason, Karen and Matthew

INDEX	2018
S&P/ TSX Composite	-5.20%
DJIA TR	-2.50%
S&P 500 TR	-1.20%
NASDAQ TR	2.30%

As at April 1st, 2018

An old risk waits offstage

Jim Allworth, RBC Investment Strategist

There are more than trade tensions to worry about. A surge in price pressures—not in anyone’s forecast, including our own or the Fed’s—could upset the economic/investment apple cart. Two conditions that could push inflation uncomfortably higher are present simultaneously for the first time in a decade. Lean against developing inflation risks.

Leaving politics and potential trade wars aside for the moment, an eerie calm has descended on the economic and investment backdrop:

- All the developed economies are growing at solid, if unspectacular rates, as is China and much of Asia. Russia and Brazil have pulled out of deep downturns.
- Purchasing Managers’ Indexes (measures of economic activity) are at elevated levels pretty well everywhere, except perhaps China. Forward-looking indicators suggest industrial output will continue to grow.
- Unemployment rates continue to fall everywhere. Businesses in the U.S., Canada, and Japan cite difficulty in attracting and retaining qualified employees as a challenging business constraint. Wages are growing and consumers are confident.
- Corporate profits are strong, while upbeat management guidance points to continued growth in revenues and earnings through 2019.
- Central banks remain mostly accommodative, while commercial banks are out looking for creditworthy businesses and individuals to whom to lend.

What could disturb this happy, constructive equilibrium? In our view, something that is least expected—a sustained surge in inflation rates—would substantially worsen the global economic and investment outlook.

On the policy front, this would force central banks to tighten faster than currently planned. Most central banks in the developed economies have a core inflation target of 2.0%. In all those countries inflation has been gradually picking up but remains below that threshold. After trying to avoid slipping into deflation for several years, most central bankers would breathe a sigh of relief if inflation were to move back up into a more “normal” zone.

But if it looked like inflation was headed toward 3%, asset markets might not wait for the Federal Reserve or the European Central Bank to make up their minds. The ultralow bond yields of the past several years have persisted because of the consistently low rate of inflation as well as the assurances of monetary policymakers that any move to “normalise” monetary conditions would be undertaken gradually and patiently. Unexpectedly strong inflation rates would call both presumptions into question.

Bond investors typically demand a coupon rate well above the prevailing rate of inflation to protect against higher-than-expected inflation over the life of the bond.

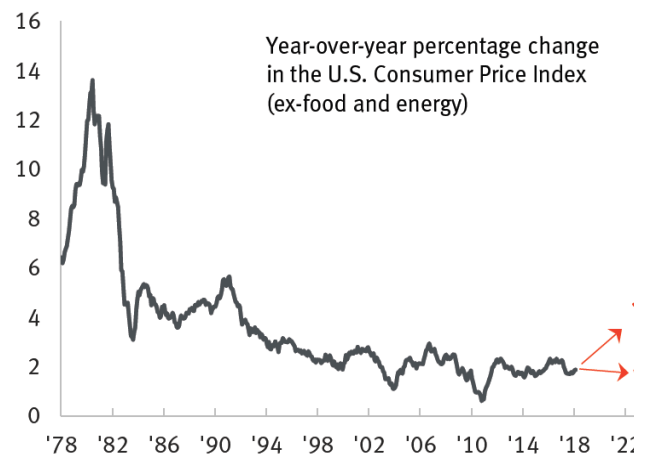
Conviction that inflation rates were going to stay low has persuaded bond investors in recent years to accept an unusually low cushion of such protection. Upsetting the apple cart of inflation expectations, were it to occur, might result in bond yields moving up by more than just the increase in the inflation rate.

Equity prices, for their part, would probably undergo some recalibration too. Rising corporate bond yields often act to bring price-to-earnings (P/E) multiples down, while a faster pace of monetary tightening raises risks of recession, bringing closer the prospect of an eventual decline in corporate profits and an accompanying bear market for equities.

Are there reasons to be concerned?

Let us say right here that a damaging surge in inflation is not in our forecasts for any of the developed economies or the emerging economies. We are looking for moderately higher inflation in 2018, with a little more to come in 2019.

Possible change of trend



Source - RBC Wealth Management, U.S. Federal Reserve; data through Feb. 2

That said, there is at least one leading indicator that leaves open the possibility this year's widely expected gradual increase in inflation rates could be somewhat greater than forecast, with possibly more to come in 2019. The Underlying Inflation Gauge (UIG) published monthly and calculated by the New York Federal Reserve (see chart on previous page) has done a good job of flagging changes in the rate of growth of the core Consumer Price Index in the U.S. 18 months or so ahead of time. The UIG has been in an uptrend for 22 months, suggesting the inflation rate should be moving higher through this year and well into next.

Two factors looked at together also suggest there is a risk of underestimating inflation over the next couple of years. The old monetarist dictum states inflation is the result of "too much money chasing too few goods." Arguably there is too much money and has been ever since central banks adopted aggressively accommodative policies in the wake of the Great Recession. In the intervening nine years money supply in the biggest economies has grown appreciably faster than GDP.

This rapid growth of money supply concerned many observers who expected an inevitably damaging bout of inflation. But that excessive inflation never arrived. Just the opposite: deflation has been a preoccupying worry of central banks until very recently. One explanation has it that the "too few goods" part has been missing. There has been a great deal of excess capacity available in the developed economies even as China and much of emerging Asia were adding substantial new productive capability. This has kept prices of many goods subdued or even declining despite the growth in the money supply.

But today, fixed asset investment in China has slowed considerably while the government actively tries to shutter excess capacity in several basic industries. Meanwhile, the so-called "output gap" has closed in the developed world, with "excess capacity" turning into "not enough capacity" in several countries, including the U.S. (see chart on following page). So, one has to acknowledge the combined conditions of *too much money chasing too few goods* may be increasingly operative over the next couple of years and for the first time in a decade.

Lean against risk

We think the appropriate stance for most investors is one that leans against developing inflation risks. We were already forecasting some increased inflation for the coming year. It's noteworthy that the Fed has recently pushed its own core inflation target to 2.1% for 2019, above its long-term target of 2.0% for the first time in years. Both our forecast and the Fed's fall a long way short of a damaging surge in price pressures.

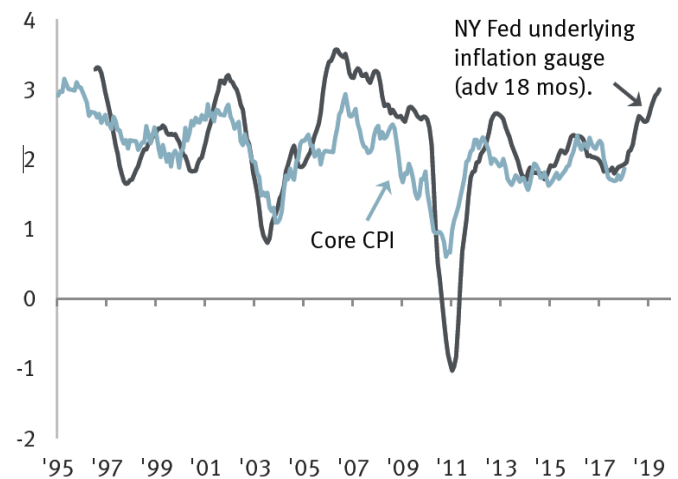
That said, higher inflation than anyone is expecting would pose a significant risk to an investment portfolio. In a world where the output gap is in danger of closing for the first time in a decade and where there will continue to be excess money sitting in global bank accounts for some time to come, there is a greater probability that inflation expectations could undergo an upward shift that markets have not yet factored in.

Such a shift would hold ramifications for:

- The pace and eventual extent of central bank tightening;
- The spread between market interest rates and the inflation rate;
- The spread between corporate bond yields and government yields;
- The valuation (P/E ratio) of the equity markets; and
- The appropriate sector composition of equity portfolios.

We have set out some thoughts on how to consider the potential impact of these developing risks within investment portfolios in the articles that follow.

Indications of higher inflation to come



Source - RBC Wealth Management, U.S. Federal Reserve Bank of New York

An equity playbook for rising rates

The prospect of moderately higher inflation and interest rates puts different sectors in the spotlight. Financials do well in such periods, Utilities do not. Among other favored sectors, we have found two in particular for which the time may be right.

Our forecast has U.S. inflation rising moderately this year to or above the Fed's long-term target of 2%, with more of the same expected for 2019. There is a possibility that the pace of inflation in both years could be somewhat brisker than our forecast.

In our view, this is not a question of revisiting the rip-roaring '70s or '80s, when inflation rates were often in the high single digits, if not higher. Rather, we see it as leaving behind the ultralow inflation of 1%–2%, and accompanying fears of deflation, of the past several years to arrive at today, where expectations are for sustained GDP growth with inflation running in the 2.0%–2.5% range, or perhaps somewhat higher. We believe this emerging new plateau in inflation has not yet been fully factored into financial markets.

The most certain outcome of any move higher in the inflation rate would be some accompanying increase in interest rates. From the perspective of an equity investor the pertinent question should be: "How do we want to position our equity portfolio in order to benefit from the prospect of higher inflation and interest rates?"

To answer this question, we reviewed the last 27 years to examine what happens in the equity market during periods of rising 10-year bond yields—a by-product of rising inflation. We looked at the data by quarter and identified 10 periods when bond yields climbed 59 basis points or more.

The best and the worst

Our analysis found two sectors where the business dynamics make changes in inflation and interest rates particularly important.

The first is Financials, especially banks. Rising interest rates are usually very good for bank profits. Interest costs on customer deposits rise slowly because demand deposits typically are paid nothing or very little, while term deposits and CDs are paid a fixed rate over a fixed term. So the total interest bill on a bank's deposit base rises more slowly than posted deposit rates as a large proportion of deposits gradually matures and rolls over into the higher rate.

By contrast, the interest rate on most bank loans floats higher with the prime rate almost instantly.

Banks also benefit from higher loan activity that comes with the stronger economy that has produced the higher inflation and interest rates. The resulting wider bank profit margins produce higher earnings and the prospect of higher dividends.

On average, Financials has been the best-performing sector in the periods of rising interest rates we looked at.

Just as consistently, the Utilities sector has been the worst performer. In periods of rising inflation, utilities' fuel and operating costs can rise quickly, while the rates they are able to charge customers usually rise more slowly, often held back by the regulatory process. Squeezed profit margins constrain dividend increases, especially since many utilities are already paying out an above-average proportion of their earnings.

Rising yields make bonds, with their comparative certainty of payout and promised repayment of principal, look more and more competitive against utility shares where dividend increases look to be on hold. Broadly speaking, sectors that had higher dividend payouts on average underperformed, according to our analysis.

Here are some of the other sectors of note. Technology was surprisingly strong with positive returns in every period of rising yields, the only sector to achieve this result. Many of the largest Tech stocks have very low levels of debt in their capital structure and trade much more on their growth prospects than their dividends, if they pay one at all.

In addition to Technology and Financials, we found Materials, Industrials, Consumer Discretionary, and Energy all outperformed the S&P 500. We believe the relative strength in more economically sensitive (cyclical) sectors such as these makes sense, as a rising interest rate environment is typically associated with a strengthening of the business activity levels for these groups.

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www.bobbypiazza.com



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