SECOND QUARTER REPORT – JUNE 20TH, 2019

In 1981, the 30-Year US Government Bond yielded 15%. In 2016, it yielded 2.30%. Today, it sits at around 2.60%.

WHERE TO INVEST?

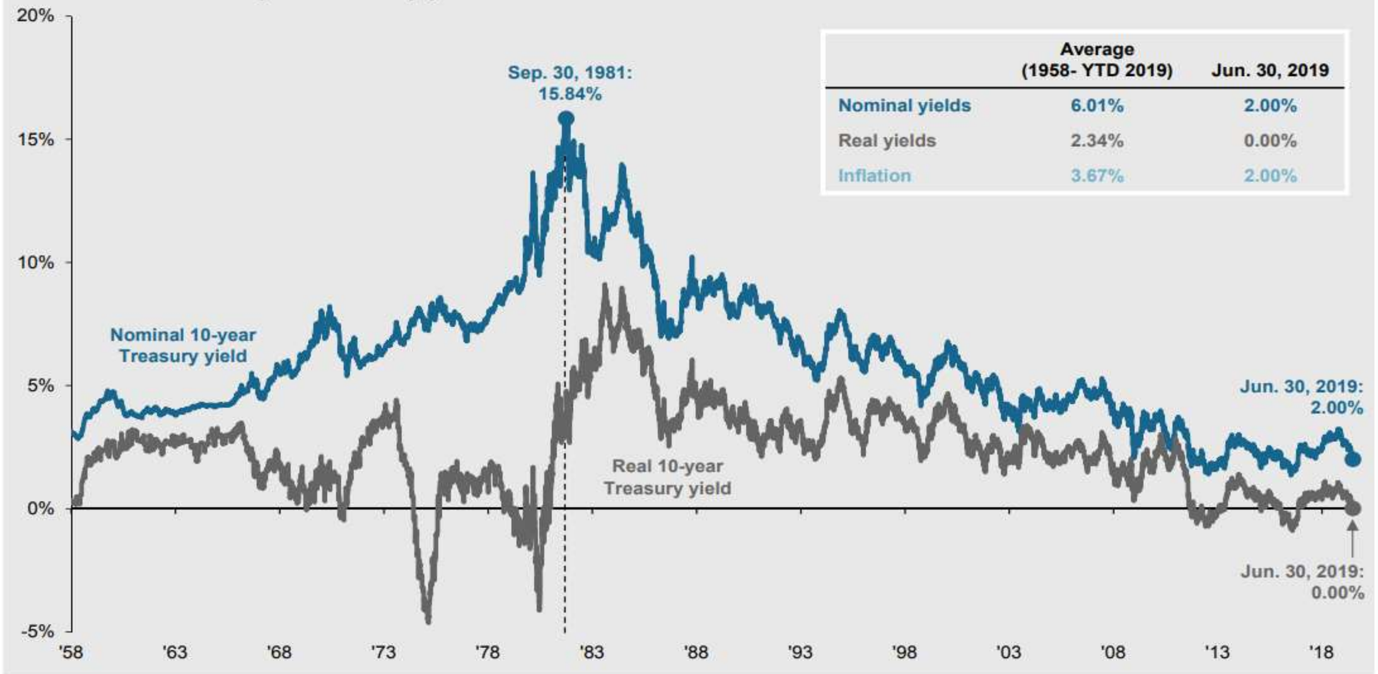
In the early 80's, my Mom, who was in her 20's, would take her paychecks to the bank to deposit them. She saved as much as she could, and took out as little as possible for living expenses. It didn't make any sense to spend more than she needed. The bank was paying her close to 15% in interest. Anything she saved would be worth 15% more next year. A few years later, my parents decided to buy their first home with the money they saved. They looked around for a while, and finally found the perfect lot to start a family and build the exact house they wanted. It was 1987, and they were thrilled to lock in an interest rate of 10%. For many of us, high rates are just part of history books. Something we won't see again. Like records, 8-tracks, cassettes and soon CD's, 15% interest rates are a distant memory. You can currently get a mortgage for less than 3%. Times have sure changed over the last 30 years.

1946–1981 was categorized as a period of rising interest rates. In 1981, the 30-Year US Treasury yield peaked at close to 15%. 1981 was the end of 35 years of rising interest rates.

1981–2016 was a new interest rate cycle. This cycle was characterized by falling rates. Rates fell from 15% in 1981, to a low of 2.11% in 2016 on a 30-Year US Treasury bond. My grandparents, who were born in the 40's had never experienced a period of falling interest rates until they were in their 40's. Just like Millennial's today have never experienced a period of rising rates. My parents' story would be much different today than it was 35 years ago.

Investors today have a decision to make on how to invest their money. You can no longer go to the bank like my Mom did and lock-in a 15% interest rate. Savings accounts are virtually paying nothing. With what little they do pay, the tax man takes away a good chunk of any interest earned.

On the next page you can see the history of 10-Year US Treasury Yields. They peaked at over 15% in 1981 and sit at 2.0% today.



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for June 2019, where real yields are calculated by subtracting out May 2019 year-over-year core inflation.
Guide to the Markets – U.S. Data are as of June 30, 2019.

Investors today, have two choices: invest in bonds or invest in stocks. Below are yields around the world as of June 28th, 2019. Note Germany yields are negative for 10-year bonds.

Bond [1]	Current Yield
10 Year Canadian Government Bond	1.46%
30 Year Canadian Government Bond	1.68%
10 Year United States Government Bond	2.00%
30 Year United States Government Bond	2.53%
10 Year Germany Government Bond	-0.32%
30 Year Germany Government Bond	0.26%

A common method to valuing stocks is called the Price to Earnings ratio (P/E ratio). If Coca Cola stock price is currently worth $70 a share, and their earnings are $3.50 a year per share, then it would have a P/E ratio of 20.

$$\text{P/E Ratio} = \frac{\text{Price per Share}}{\text{Earnings per Share}}$$

$$20 = \frac{\$70}{\$3.50}$$

We all like to go shopping at our favourite store when it has a ½ price sale. Who doesn’t want save money? It’s the same when buying stocks. The lower the P/E ratio, the cheaper the stock, and the less you’re paying for earnings. The higher the P/E ratio, the more expensive it is. A stock with a P/E Ratio of 10 is ½ as expensive as a stock trading at 20.

[1] Bond yields https://www.marketwatch.com/investing/bonds?mod=investing

Looking at bonds, your earnings are the interest you receive. For every $100 invested in a 30-Year Government of Canada bond, you will receive $1.68 in income (based on a 1.68% yield). Calculating the P/E ratio for bonds is 100/1.68 = 60. For a 30-Year Government of Germany bond, you would receive $0.26 in income each year, and the P/E Ratio is 385.

In the Canadian stock market, our index currently trades at P/E ratio of 15.28 forward earnings. For every $100 you invest, you are receiving $6.55 in earnings[2].

In the US, the S&P 500 currently trades at P/E ratio of 16.95 forward earnings. For every $100 you invest, you receive $5.90 in earnings.[3]

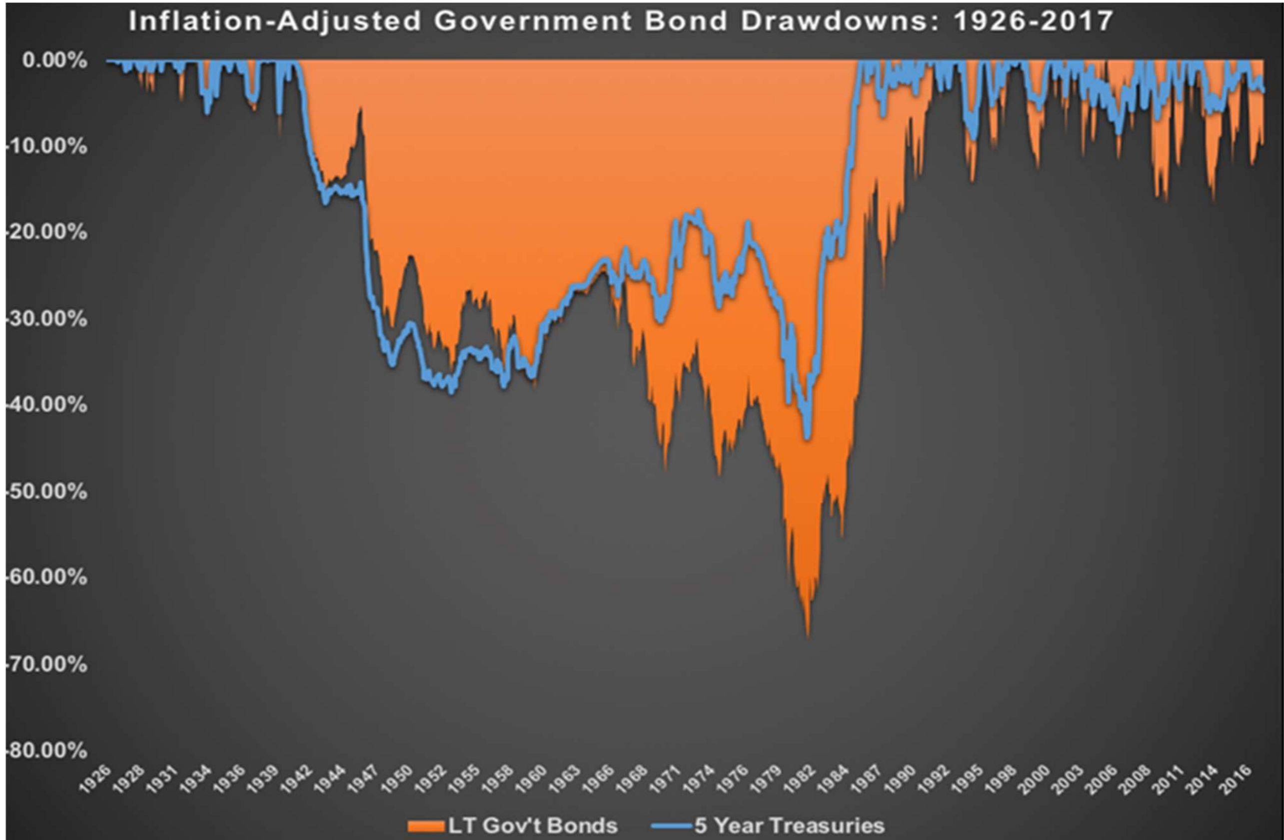
	P/ E Ratio	**Earnings Per $100 Invested**
30 Year Canadian Government Bond	60	$1.68
30 Year United States Government Bond	40	$2.53
30 Year Germany Government Bond	385	$0.26
S&P/TSX	15	$6.55
S&P 500	17	$5.90

At the top of the US tech bubble in 2000, which recorded the most expensive valuation ever recorded for US stocks, the S&P 500 was trading at a P/E ratio of 27. 30-Year Canadian bonds are trading at P/E 60.That means that Canadian bonds are 122% more expensive than US stocks have ever been! German 30-Year Bonds are 1326%, more expensive than US stocks have ever been! Government bonds are not on sale right now. US and Canadian Government Bonds are currently 2-3X more expensive than the Canadian and US stock markets.[4]

We've all seen more expensive gas prices, houses, rents, and groceries. When my parents grew up, gas prices were less than 10 cents a litre. When I was growing up they were less than 60 cents a litre. When I have kids, they will be lucky if it's less than $2.00 a litre. The annual inflation rate in Canada was 2.4% in May. A 30-Year Government of Canada bond today yields 1.68%. After inflation, an investor buying a 30-Year Government of Canada bond would lose money every year…for the next 30 years at current inflation rates. The real risk for investors today is the loss of purchasing power over the long-run due to inflation.

On the next page is a chart showing the real loss of purchasing power of 5-Year US Government Bonds and long-term bonds. In the 80's when inflation exploded, long-term bond investors lost close to 70% of their purchasing power. Even with 5-Year bonds, investors lost close to 50% of their purchasing power. If the yield on a 30-Year Government of Canada bond went from 1.70%, to 3.40%, investors would lose 32% of the bond value and if long-term rates went back to 5%, investors would lose over 50% of the bond value.[5]

[2] https://us.spindices.com/indices/equity/sp-tsx-composite-index
[3] https://us.spindices.com/indices/equity/sp-500
[4] https://am.jpmorgan.com/blob-gim/1383407651970/83456/MI-GTM_3Q19.pdf?segment=AMERICAS_US_ADV&locale=en_US
[5] https://tradingeconomics.com/canada/inflation-cpi



[6]

Over the life of a bond, interest payments are fixed. Investors buying 30-Year Canadian Government Bonds will receive $1.68 in interest for every $100 invested, every year for the next 30 years. Companies, on the other hand, have the ability to grow their earnings. In the last 30 years, the S&P 500 has grown its earnings by 4.1% per year. Paying $100 for $5.90 of earnings of the S&P 500 today will have grown to $19.70 in 30 years if earnings continue to grow at the same pace.

As an investor, what is the most attractive investment, bonds, or stocks?

Investors today are pessimistic. There are fears around a recession, trade wars, and slowing global growth. This has caused bonds to be sought after and has pushed interest rates to historic lows. Investors are less excited about stocks, despite the good opportunities they've presented for long-term investors. Compared to bonds, we see much better value in stocks, from both a valuation analysis and a long-term inflation hedge. Investors purchasing bonds today may be taking on a lot more risk than they think. Investors who bought long-term bonds in the 80's were surprised to have lost 70% of their purchasing power when inflation exploded.

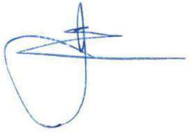
Having to choose between bonds and stocks, stocks are significantly more attractive. Successful long-term investors like to buy things on sale. Bonds are not on sale. This doesn't mean that bonds shouldn't be included in a portfolio. There are specific situations and circumstances where they fit. However, investors need to be careful with the types of bonds they do own.

As I've highlighted in the past, we've avoided specific sectors in the market. In my last newsletter, I described the overstretched indebted Canadian consumer. We see that as one of the biggest risks to investors in Canada as Financials are 1/3rd of our markets. We continue to find excellent opportunities in Canada, especially where investors have overlooked certain sectors and companies. We also continue to be tactical, using market volatility to our advantage. The end of 2018 brought us great opportunities. We took advantage of the fear and panic in the market and will watch for future opportunities.

[6] https://www.bloomberg.com/opinion/articles/2018-02-12/bond-bear-markets-aren-t-measured-in-losses-alone

I'm happy to discuss any questions you have about your portfolio.

-Kind regards,



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