Serber Speaking

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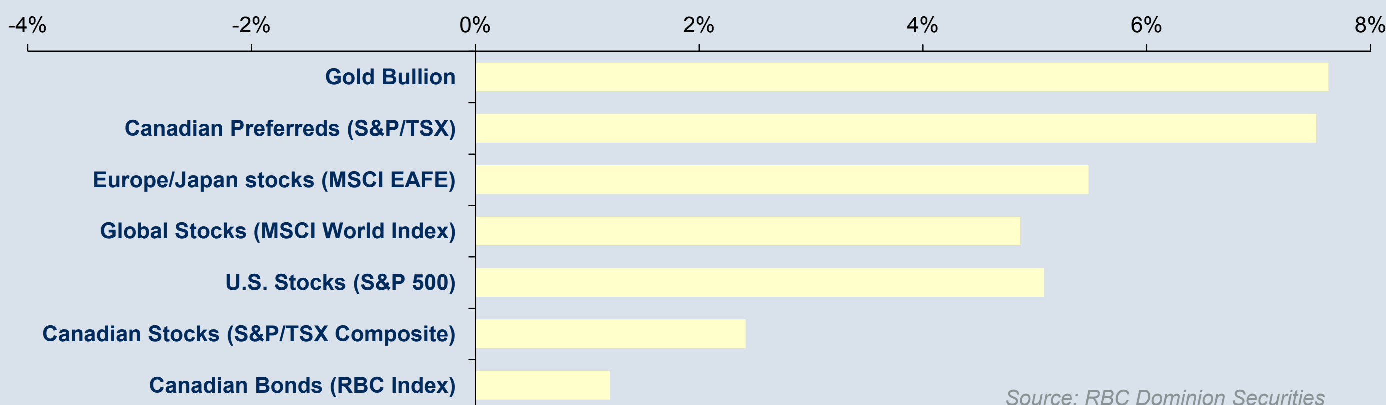
Commentary for the quarter ended March 31, 2017

2017 - Off to a Positive Start

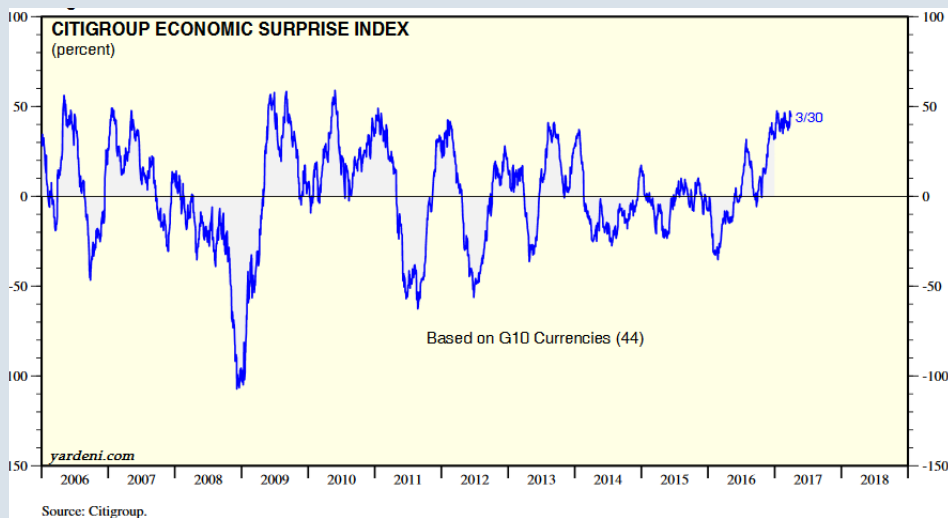
The first quarter of 2017 delivered positive investment returns across the board. Economic indicators and financial markets are signalling renewed health in the global economy with expected increased returns and decreased near-term risk for financial investments. In addition, optimism for business along with market-friendly policies emanating out of the U.S. over the coming months and years provided a further boost to the positive sentiment. Portfolios benefited as investors bid up the price of stocks, preferred shares, gold and higher-yielding bonds. As can be seen on the chart, all investment categories that we track generated positive results in Q1.

Performance by Asset Class: January 1 to March 31, 2017 (in Canadian $)



Improving Economy

When it comes to evaluating investments and the economy overall, I pay particular attention to so-called “surprise” indicators, which track the degree to which economic data surpass or fall below forecasts. For example, if the average forecast by economists for, say, Q1 GDP growth is one percent and the actual number the government announces is two percent, this is a positive surprise. Surprise indicators are valuable because they tell us when reality is deviating from expectations. This typically leads to a change in expectations -- and knowing where expectations are likely heading can be profitable.



As seen on the chart, for most of 2014, 2015 and 2016 Citigroup’s G10 Economic Surprise Index, representing an average of economic surprise for the developed world, was stuck below zero. In other words, for most of this period, the global economy was repeatedly performing below expectations.

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Since late 2016, however, the indicator has moved up strongly and now sits at a reading of plus 44, the highest level since 2010. (Yardeni Research: High Frequency Indicators, March 30, 2017). Many media and other observers attribute most of the recent market strength to the "Trump effect." While this is no doubt an important factor, it may be more a matter of coincidence that the global economy took a turn for the better, and started beating forecasts, starting last fall, around the same time as the U.S. election.

Outlook for 2017 and beyond

Positive economic momentum appears likely to carry through the remainder of 2017 and into 2018. According to the authoritative analysis by BCA Research, there are several key reasons for this:

1) **Inventory drawdowns were a drag on GDP growth for the past two years**. Inventories are cyclical, and an expected inventory rebuilding cycle will provide a tailwind to GDP growth.

2) **The era of government fiscal austerity is coming to an end**. We can see this close to home where the Liberal government has replaced fiscal restraint with deficit spending and in the political success of Trump's fiscal platform of tax cuts and infrastructure spending. Fiscal Thrust, a measure of the contribution to GDP growth from a change in government spending, turned positive in 2016 in the U.S. for the first time since 2010.

3) **Financial conditions are supportive**. Credit is easily available today at a moderate interest rate, while surging asset prices are fuelling increased consumer confidence.

While all of these factors can and will reverse themselves over time, they do not tend to change on a dime. This suggests portfolios over the next 12 months should emphasize higher risk/return vehicles such as stocks and higher-yield corporate bonds. That said, risk markets have had a big run over the past six months and a correction is possible or even likely in the near term. Given the above, a reasonable strategy is to remain slightly underweight equities at present and be prepared to buy and overweight equities on any correction of five percent or more over the next few months. In fact, this is my game plan.

Outlook for 2019 and beyond

Developments after 2018 look decidedly less positive. Stronger growth over the next 12 months, assuming it materializes, will inspire the U.S. Federal Reserve to continue to raise interest rates. The problem is that the Fed never knows how high they need to raise rates until after the fact, when they look back and see they may have precipitated a recession. This is indeed what occurred in the last cycle: Between 2004 and 2006, the Fed raised rates from one percent to 5.25 percent, contributing to the great recession and financial crisis which began in 2007.

If the monetary authorities follow a similar script, which BCA believes is likely, look for a mild recession to unfold by 2019 (mild because the excesses built up during this expansion appear to be moderate). If this forecast is correct, then at some point in 2018 it will be prudent to reduce risk (equity) exposure and shift toward safe-haven assets such as government bonds. By that point U.S. 10-year government bonds should yield around three percent, offering a reasonable place to park money while waiting for the gathering storm to pass.

Outlook for the 2020s

If the medium-term outlook is clouded by the possibility of recession in 2019, the major risk for the longer-term is stagflation. As noted above, the doctrine of Fiscal Discipline for government spending and deficits is losing favour as politicians take on more generous policies to woo so-called populist voters. Also, the generation of the inflation hawks, those central bankers who cut their teeth in the high-inflation 1970s, are slowly being replaced by a newer generation who are, if anything, more worried about defeating deflation than they are about inflation.

Expansive fiscal policy and lax monetary policy is a recipe for inflation. At the same time, productivity growth has slowed dramatically over the past decade. If the productivity trend does not improve, then economic growth will stagnate. While such developments are a long way off, and therefore highly uncertain, it is worth thinking ahead to what the financial world might look like in the 2020s. One strategy, appropriate in a scenario which includes higher inflation, would be to increase holdings in gold and precious metals equities -- perhaps sometime next year when the U.S. dollar peaks for this cycle.

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Most Canadians do not have an up to-date Will

As anyone who has been through the process will tell you, handling the affairs of a loved one who has passed away is not an easy task. Just at the time when family members are facing loss and grief, there is a bewildering array of technical, legal and financial issues that need to be considered and properly handled.

Most Canadians appoint family members as executors of their estates. This makes sense on a certain level. However, is it a good idea to saddle family members with all the increasingly complicated work involved in settling your estate? An alternative is to appoint a “Corporate Executor” such as RBC’s Estate and Trust Services Group. I will talk more about this next quarter.

In the meantime, the first step to protect your loved ones from unnecessary headache and heartache is to make sure your will is current. If you answer “yes” to any of the following questions, you should review your will with your legal adviser to determine if changes are necessary.

1. Since your will was created, have you been married, divorced, separated, or have you started a relationship with a new partner?

2. Have you had any additions to the family, such as a child or grandchild?

3. Has your net worth significantly increased (e.g., with an inheritance) or decreased (e.g., because of bankruptcy)?

4. Have you moved to a different province or territory?

5. Have you acquired significant new assets, such as a cottage, business or farm?

6. Are your chosen executors or trustees still appropriate?

7. Do you wish to add or remove any beneficiaries, or wish to change the terms of distribution to any of the beneficiaries?

8. Have there been any changes to relevant legislation since your will was created that would impact on your wishes (e.g., changes to the Income Tax Act or provincial Family Law legislation)?

9. Has a spouse or significant beneficiary died or become disabled since your current will was created?

As a Portfolio Manager and Wealth Advisor, it is clear to me that families who prepare properly for the future are better off than those who don’t. If you would like to discuss your estate plan, please feel free to contact me.

Until next time, best regards,

David Serber

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