Serber Speaking

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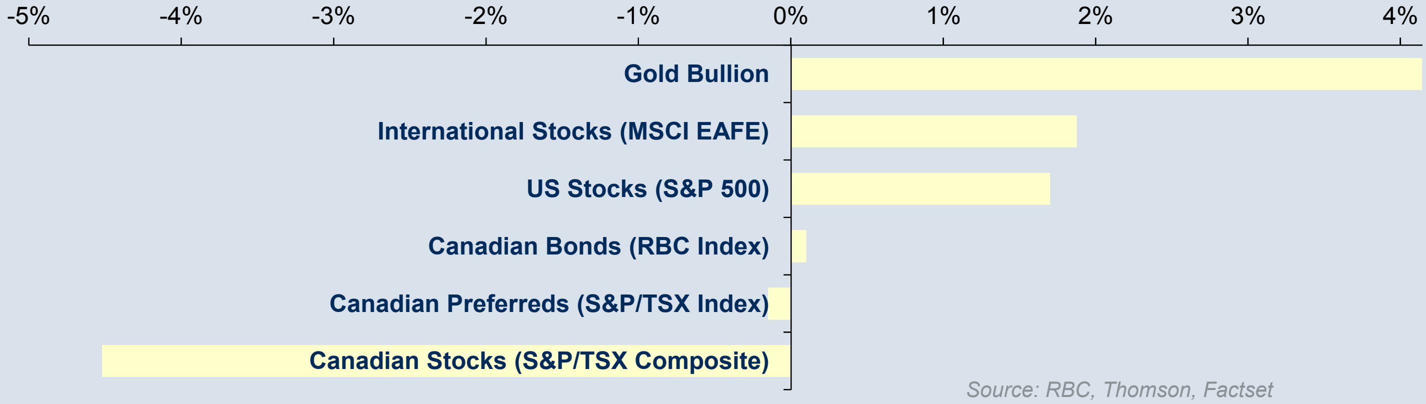
Commentary for the quarter ended March 31, 2018

...and then, things went sideways

Financial markets in the first quarter of 2018 certainly had their share of ups and downs. January was very strong, followed by weakness in both February and March. Despite the turmoil, our typical client's portfolio generated gains for the quarter thanks to diversification and a conservative approach. As can be seen on the chart below, the best performer last quarter was gold bullion, with a gain of more than four percent. Gold was helped by investors seeking a safe financial asset in the face of market volat ility. It also reflects an early sign that inflation may become an issue, longer term.

Performance by Asset Class: Jan. 1 to Mar. 31, 2018 (in Canadian $)



Source: RBC, Thomson, Factset

Meanwhile, stock markets were a mixed bag, as US and international markets posted modest gains of between one and two percent while, closer to home, the Canadian TSX Composite's total return index posted a 4.5-percent loss. Fixed income produced almost no returns for the quarter, with bonds producing a small gain and preferred shares a small loss.

This is what the late stage of an economic expansion looks like...

While no two economic cycles are the same, there are common themes and event sequences, which repeat themselves time and again. A simplified version of the sequence goes like this:

Recession > Recovery > Early Expansion > Late Expansion > Recession

Each stage has its own character, duration and proximal causes - all of which vary from cycle to cycle. Still, following the sequence of these phases can provide clues for financial market behaviour and investment strategies.

It has been 10 years since the last recession. Globally, now, we are clearly in the late expansion stage, characterized by solid economic momentum, above-average asset market returns, falling unemployment and central bank tightening of monetary policy (i.e., raising of interest rates).

How the top ETF holdings in my Managed Portfolios did in Q1

Total Return in CAD $

iShares China	5%
iShares MSCI EAFE - Small-Cap	4%
Vanguard FTSE Developed Mkts	2%
iShares Core S&P 500	2%
Hamilton Capital Global Banks	1%
Horizons Active Preferred	0%
iShares Strategic Fixed Income	0%
iShares Core U.S. Aggregate Bond	-1%
BMO MSCI EAFE Hedged to CAD	-3%

From an investment point of view, the late expansion phase is tricky. On the one hand, we are getting closer and closer to the point at which prices for assets like stocks, real estate, and higher-risk corporate bonds peak and begin to fall -- which argues in favour of starting to sell these assets now to "wait it out" in cash or GICs. On the other hand, the last year or two of the late expansion can see powerful upward moves for asset prices (sometimes known as the final blow-off phase). For example, the late 1990s saw two significant market sell-offs and volatility spikes in 1997 and 1998 as part of an increasingly risky late expansion phase. Those who sold out of the market, however, may have been sorely disappointed as they watched it gain another 50 percent from 1998 to its peak in the fall of 2000 (Basis: S&P500).

In other words, it is valid to be worried but it is also premature to run for cover. I expect positive stock market returns over the next year or so, based on the following:

1) **Global financial conditions are still stimulative**. This can change, however, and needs to be closely watched.

2) **Banks are in good shape**. Balance sheets are in a much healthier position than they were prior to the last recession.

3) **Fiscal stimulus provides a tailwind to demand**. Recent US tax cuts and spending intentions will add to US GDP growth in 2018 and 2019 before tapering off.

4) **Unemployment is on its way to multi-decade lows**. This supports consumer confidence and spending.

As the expected late-cycle market gains materialize, I will be slowly reducing exposure to riskier assets such as stocks, higher-yield corporate bonds and preferreds, and tilting toward safe-haven assets such as cash equivalents, GICs and government bonds.

What about longer term?

Work done by BCA Research, a leading global investment analyst, and others, including Robert Schiller, a US economics Nobelist, show that a strong correlation exists between a market's current valuation level and its subsequent 10-year average return—the higher the market's valuation, the lower the next decade's average return. This analysis suggests that the US market, based on its current high valuation, is expected to generate low average returns for the next 10 years.

The good news is that other geographic markets are more reasonably valued, which means their expected average returns look to be more rewarding over the next decade, as seen on the adjacent forecast table.

Forecast 10-year average annual returns

Japan	10%
China	9%
Canada	8%
Euro Area	7%
UK	6%
US	4%

Source: BCA Research

Of course, current valuation is not the only factor affecting future returns. There are numerous other developments, such as productivity trends, politics, war and technological change that will influence markets over the next decade. That said, at the very least the valuation analysis and chart make the point that portfolios should be well diversified geographically. The portfolios I manage hold about one-third of their equity exposure in Canada and two-thirds outside Canada.

What about interest rates?

It is likely that interest rates will grind higher over the coming year in the US and Canada. Indeed, interest rates have already increased quite a bit: the yield on the five-year Canada bond is up from the 0.75 percent area in 2015/16 to more than two percent currently. It is important to understand that increasing interest rates is a self-limiting process. The purpose of higher rates is to slow economic overheating. Once convincing signs emerge that the economy is indeed slowing, interest rates stop going up. We expect bond rates to peak at about three percent somewhere over the next year or so. If and when they do, it will mark a good opportunity to switch some money from risk assets such as stocks to safe assets such as government bonds and GICs.

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The Wealth Management Notebook

Everybody needs Estate Planning

They say that death and taxes are inevitable, which means almost everyone can benefit from estate planning. Indeed, many people are either named as executor in someone else's will (such as a parent) or have named an executor in their own will, or both. And yet, few people understand what this critical and legally complicated job entails.

As part of our commitment to provide holistic Wealth Management and advice, I am pleased to announce our next educational seminar, ***The Role of the Executor***, on May 24 at 10 a.m. in our boardroom at 2345 Yonge Street (just north of Eglinton).We have run this seminar in the past, and it is very popular.

Please attend this seminar to learn about the 10 steps every executor needs to know:

1) Locate the will;

2) Help make funeral arrangements;

3) Solicit professional counsel;

4) Notify beneficiaries and others;

5) Secure estate assets;

6) Submit will for probate;

7) Advertise for potential creditors;

8) Pay any debts and complete final tax return;

9) Distribute assets to beneficiaries; and

10) Keep accurate and complete records.

Our guest speaker is **Jackie Power**, Director, Tax and Estate Planning at Mackenzie Financial. In addition, **Elizabeth Church**, Will & Estate Advisor with RBC Wealth Management's Trust and Estate Services Group will be on hand to discuss examples of estate planning and executorships gone wrong, and how naming a corporate executor can be a desirable option for some.

Only eight seats remain – first come first served. Feel free to extend this invitation to anyone you know who might be interested in attending. To RSVP, please email Rosetta at rosetta.perrino@rbc.com.

Until next time, best regards,

David Serber

Feel free to forward ***Serber Speaking*** to anyone you think would find it of interest.