Serber Speaking

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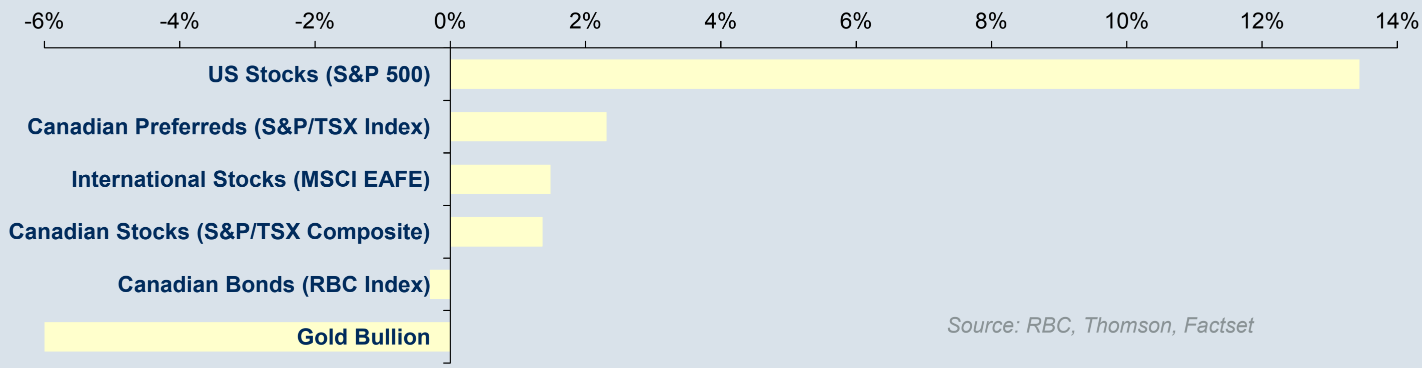
Commentary for the quarter ended September 30, 2018

Make America's Stock Market Great Again

Notwithstanding the steady stream of derision that many Americans and foreigners aim at the U.S. these days, it is currently the top economic bright spot on the planet, by a wide margin. Today's headlines (October 3) make the point rather eloquently: "Global opinion of US is historically bad under Trump" (*The Guardian*); "Trump has made America less respected than ever" (*Washington Post*); and "Dow jumps 100 points to all-time high" (CNBC). Go figure.

Performance by Asset Class: January 1 to September 30, 2018 (in Canadian $)



As the chart above shows, US stocks are the runaway best-performing asset class year-to-date with a gain of some 13 percent (in Canadian dollar terms), while Canadian and international stocks have each generated total returns of only about 1.5 percent over the same period. Meanwhile, fixed income has been a headwind for the typical portfolio, with the Canadian bond market delivering a slightly negative return so far this year. Preferred shares did somewhat better, generating just over two percent. After a decent gain last year, gold is in the doghouse with a six-percent-loss to date.

It's all about demand

Why is the U.S. doing so well - especially compared to other countries and regions? It's because it has been able to generate substantial aggregate demand, and aggregate demand drives growth. The three current key contributors to U.S. demand growth are: 1) Fiscal stimulus (Trump tax cuts and spending initiatives); 2) Low unemployment and wage growth (more wages = more spending = more demand); and 3) growth in consumer credit (higher confidence leads to more borrowing and spending—and less saving).

Other countries and regions are not in the same position. According to the IMF, U.S. fiscal stimulus (a.k.a. the budget deficit) will reach 6.8 percent of GDP in 2019, whereas the same figure for the Euro area is only 0.8 percent. The Europeans are being conservative, determined not to spend that much more than they make, whereas the Americans have a different plan.

Performance of ETF Holdings in Managed Portfolios, YTD

Total Return in CAD $

iShares Core S&P 500	14%
iShares Core S&P Mid-Cap	11%
Horizons Active Preferred	2%
BMO MSCI EAFE Hedged to CAD	2%
iShares Core U.S. Aggregate Bond	1%
iShares MSCI EAFE - Small-Cap	1%
Vanguard FTSE Developed Mkts	1%
iShares Strategic Fixed Income	-1%
BMO Mid-Term US Corp Bond	-3%

The Trump administration's idea is to get Americans feeling invigorated and confident, inspiring them to be entrepreneurial and to take risks. These "animal spirits" should then lead to faster growth in productivity and higher potential GDP. The calculation is that up-front deficit spending is worth it if the plan works. If not, as the naysayers claim, you wind up with higher debt and nothing to show for it. So far, the stock market seems to be giving the Trump plan the benefit of the doubt.

Fed Funds rate versus the neutral rate

As I've mentioned in past reports, the corollary of strong economic growth is that central banks begin to tighten monetary policy (i.e., raise interest rates) to slow down momentum. Left unchecked, rapid growth can lead to inflation and/or asset price bubbles. As we know, U.S. growth is strong and the Federal Reserve (Fed) has been raising rates.

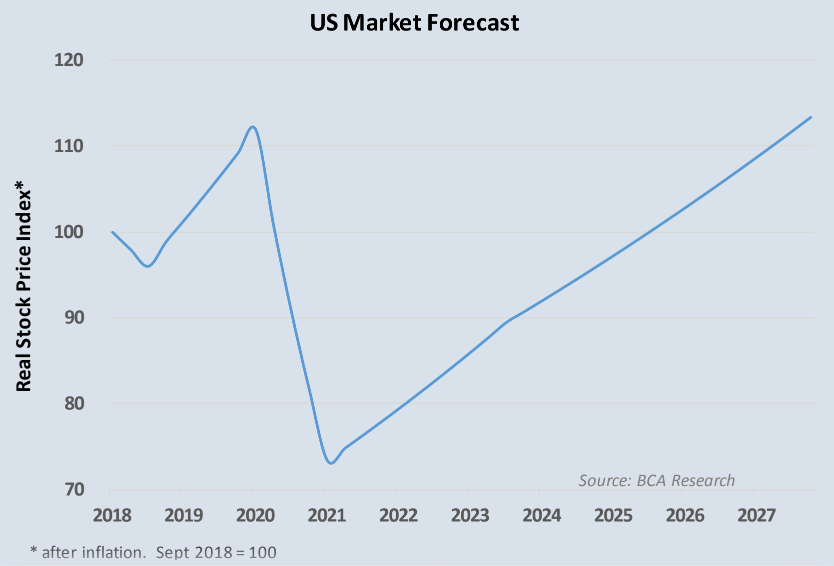
The only interest rate the Fed directly controls is the very short-term (overnight) lending rate, known as the Fed Funds rate, currently around 2.2 percent. This rate indirectly influences longer-term rates, such that increases in the Fed Funds rate lead to higher interest rates generally. All expectations are that U.S. rates are going higher over the coming year or two. The Fed's forecast is for a Fed Funds rate between 3.0 percent and 3.5 percent by 2020-2021, roughly one percent above today's levels. If that occurs, Canada's rates would likely move in a similar fashion.

The debate that rages among economists and market strategists is how high the Fed can raise rates without going too far and causing, or contributing to, a recession. The answer depends on how economists view the neutral rate of interest. This is the theoretical interest rate at which a given economy is in equilibrium, with interest rates neither speeding up growth (potentially causing inflation), nor slowing it down (risking recession and deflation).

The current thinking is that the neutral rate is between two percent and three percent. Now that the Fed Funds rate is above two percent, it is a fair guess that U.S. monetary policy is no longer stimulative. The Fed will continue to raise rates, typically one-quarter percent at a time, until it sees signs that the economy is slowing down.

Some, such as Chen Zhao, the chief strategist of investment research firm Alpine Macro, believe that the neutral rate is lower than most people think (the thesis is that we are in a world where growth will be chronically slow and that deflation will be more of a problem than inflation). If so, Fed rate increases from here on will start slowing down the economy sooner than later. Chen believes this will extend the current positive market cycle. Why? Because investors would quickly deduce that the Fed was going to stop increasing rates sooner then expected.

Others, such as BCA Research Senior Vice President Peter Bezerin, believe the neutral rate is higher than most people think - closer to four percent (the thesis is that fiscal stimulus, wage growth and credit expansion portend higher GDP growth and a higher neutral rate). If this is the case, then even at two or three percent, the Fed funds rate is below neutral and, therefore, expansionary. This will spur stronger than expected GDP and earnings growth, leading to a bull market peak in 2019-2020. As the forecast at right shows, Bezerin predicts the peak will be followed by a bear market, as the Fed hikes rates higher and higher into 2020 to bring resurgent inflation under control.



However, both analysts agree that, aside from a normal correction that could come any time, we likely have another year or more before the current bull market reaches its final top. I am managing portfolios according to this view.

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From The Estate Planning Notebook - Guest Article

The Fine Art of Cottage Co-Ownership

While leaving the family cottage to your kids may be your goal, it can all too often become a source of friction. Everyone has probably heard at least one unfortunate story about family members disagreeing over sharing the use of, the expenses for, or energy spent maintaining the cottage. Where successive generations are to hold the property for a lengthy period, the likelihood of disputes increases, in particular where beneficiaries have different levels of assets, income or interest in the cottage.

Cottages can be expensive and time-consuming to maintain, and family members may be unable to agree on how to share responsibility for upkeep and maintenance. Family members with less ability to pay expenses may expect other, more financially able, members to pay more. Family members using the property less often, or who are not as "handy," may expect to perform a smaller share of the upkeep chores than those using it more frequently or who are more "handy," despite equal ownership interests.

Then, there are the issues of scheduling visits and guest access. The prime cottaging season is relatively short in Canada, and family members usually value the peak opportunities (such as long weekends) available during the summer.

Fortunately, a solution is available to minimize friction where cottages are co-owned, for example by siblings after their parents have passed. A co-ownership agreement can be an effective planning tool for a family vacation property. Even where family members get along well, a co-ownership agreement is still a good idea so that multiple owners can jointly work out issues such as: use of the property; sharing and payment of expenses; deciding on improvements for the property and their payment; and determining how any default in expense payments will be dealt with.

The family cottage can be a joy, but can quickly turn into a nightmare if certain issues or problems are not anticipated and planned for properly. Another such issue can be the inability of multiple successor owners to make decisions together or agree on how expenses and maintenance will be taken care of. A co-ownership agreement can make all the difference in setting out guidelines and eliminating needless disputes, and keeping that wonderful cottage view ever so serene.

- *Susannah Roth*, O'Sullivan Estate Lawyers, osullivanestatelawyers@osullivanlaw.com

Thank you to Susannah Roth for providing the above article. Thinking through the implications of your estate planning decisions, and adding extras such as a cottage co-ownership agreement, could have a significant and positive impact on family harmony.

Until next time, best regards,

David Serber

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