Serber Speaking

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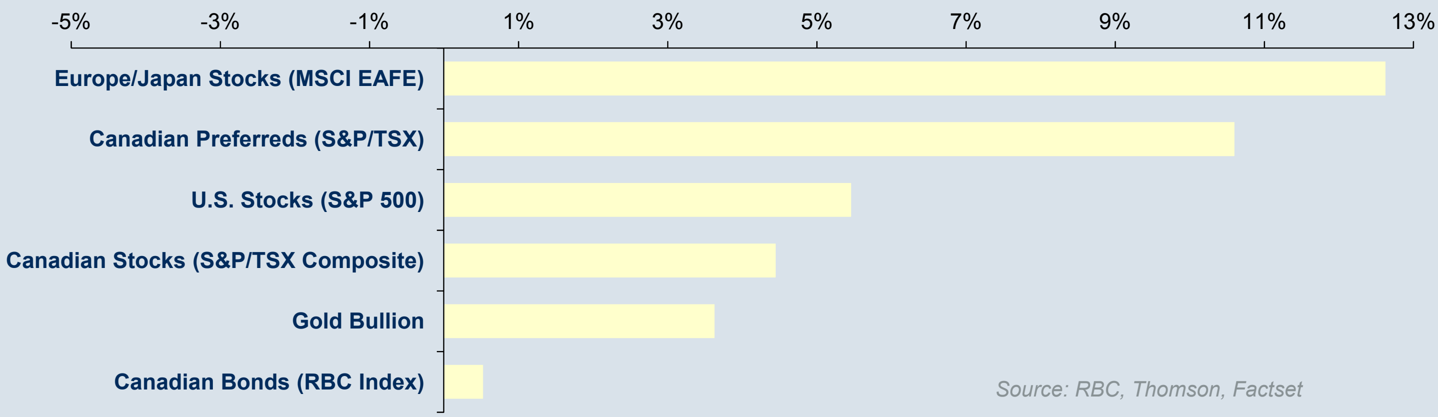
Commentary for the quarter ended Sept. 30, 2017

The global economy is doing well (wait, what?)

The third quarter of 2017 has come to a close, with financial markets maintaining the positive tone seen in the first half of the year. As can be seen on the chart below, the investment categories we track are all in positive territory, year to-date. European and Japanese stock markets have been the best performers, as their economies, which were in the doldrums a year ago, are now growing nicely. Canadian preferred shares have also made a strong contribution this year, especially when compared to their fixed-income cousins, Canadian bonds, vindicating the overweight position in preferreds I have advocated over the past 18 months.

Performance by Asset Class: Jan. 1 to Sept. 30, 2017 (in Canadian $)



Source: RBC, Thomson, Factset

Market Conditions

As I discussed last quarter, it is increasingly apparent that the global economy has emerged from its post-financial-crisis slump. In the U.S. and Canada, jobs are plentiful, and both the unemployment rate and initial unemployment insurance claims are approaching multi-decade lows. A strong labour market means income growth, and income growth leads to economic growth. A year ago, economists' expectations for global growth in 2017 averaged 2.6 percent. That figure has been repeatedly revised upward and now sits at 3.1 percent.

This may seem like a small thing, but it is notable: previously, in every year between 2011 and 2016, economists' GDP growth estimates started optimistically, only to be downgraded as the year progressed with actual results disappointing.

Economic growth however is only one of three key factors impacting financial markets and investment portfolios. The other two are valuation and liquidity.

There are many valuation metrics for stocks which compare the price of the shares to one or more underlying fundamentals, such as profit, cash flow, sales, or book value. The most common valuation metric is the ratio of a

ETFs in our Portfolios

YTD Return in CAD $

iShares China	19%
iShares MSCI EAFE Small-Cap	18%
Vanguard FTSE Developed Mkts	13%
Horizons Active Preferred	12%
BMO MSCI EAFE Hedged to CAD	12%
iShares Core S&P 500	6%
SPDR Gold Trust	3%
iShares Core U.S. Aggregate Bond	-4%
iShares S&P/TSX Energy	-13%

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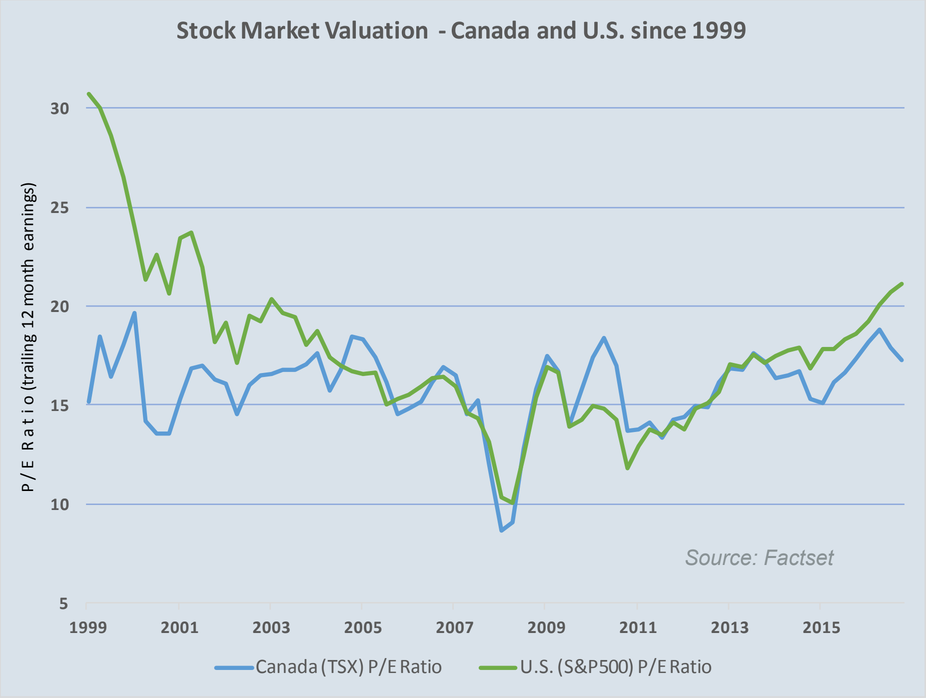
stock's price to its historical or expected earnings per share, known as the P/E multiple. As the Stock Market Valuation chart demonstrates below, a P/E multiple of 25 or more is historically high, while a multiple of about 12 or less is low. At 21 times earnings, the U.S. market is starting to move into the expensive range, while the TSX, at 17 times, is not.



Overvaluation occurs when investors generally have a high level of optimism. U.S. stocks traded at more than 30 times earnings in 1999 when the "dot-com" bubble was in full swing. Investors were willing to believe that technology companies could grow at 20 percent per year compounded, forever. This turned out to be overly optimistic, and when the bubble burst, the S&P500 lost 50 percent of its value between 2000 and 2002.

The reverse occurred after the 2008 economic crisis: when the global financial system appeared on the brink of collapse, investor pessimism was intense. People were willing to sell shares at only 10 times earnings because they wanted to get out at any price. If the general sentiment right now is still slightly on the pessimistic/skeptical side, which I believe it is, then it is unlikely that markets are about to suffer a meaningful drop on the basis of overvaluation.

This leads us to the third factor, liquidity. What do I mean by liquidity? Think of it like this: if you have an asset to sell and lots of buyers show up with lots of cash, that's liquidity. When liquidity is high, sellers are likely to get full value for their asset, and maybe even a little more. The opposite is also true: when liquidity dries up, either because there are fewer willing buyers, or because willing buyers do not have access to cash, selling an asset at full value is difficult and more likely to be at a discount.

Managing liquidity is the main way that central banks impact investment/asset markets, because they control the amount of cash in the banking system. The more cash in the system, the more liquidity, and vice-versa. More cash tends to increase a bank's willingness to lend on favourable terms; i.e., at a low interest rate. And the more that banks are willing to lend at a low interest rate, the more liquid are asset markets.

In the current environment, all three factors are supportive of high and rising asset prices. The global economic picture is healthy and improving, but not yet so robust that overconfidence has lead to widespread overvaluation. At the same time, liquidity is plentiful, as central banks have been flooding the banking system with cash ever since the 2008 financial crisis. It is, therefore, not hard to understand why market indicators such as the S&P500 and Dow Jones Industrial Average have been hitting a string of new highs recently.

What happens next? The economy, valuations and liquidity remain supportive of asset markets through mid-2018. That said, some central banks have started taking steps to reduce liquidity to prevent an outbreak of inflation down the road. The U.S. Federal Reserve and the Bank of Canada have raised short-term interest rates this year, and it looks like more increases will be coming. With continuing growth, we should indeed see signs of inflation next year, which will support further reductions in liquidity engineered by central banks.

By 2019, the cumulative liquidity reduction may lead to the next recession. If so, asset markets will begin to anticipate such an outcome sometime in 2018, when stock markets and interest rates will likely peak for this cycle. I will be watching for this transition with the goal of moving to a defensive stance some time next year.

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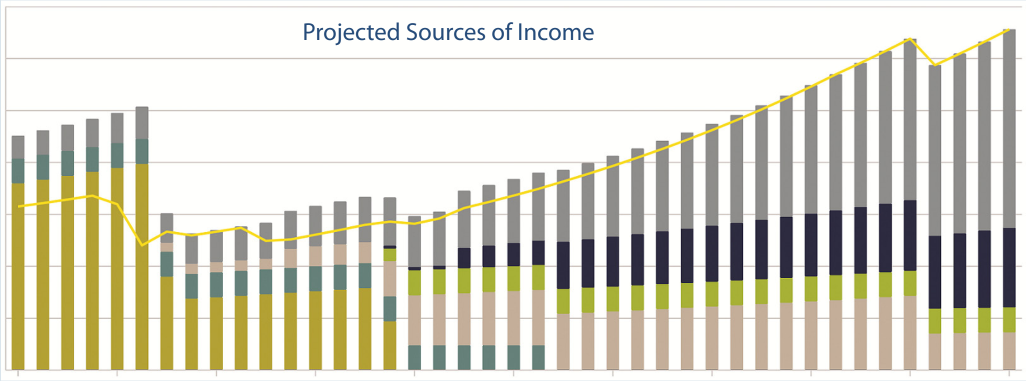
Creating Your Financial Projection using myGPS™

Most personal finance practitioners agree that planning is an essential part of keeping your finances on track. For many people, though, a full financial plan can be expensive, time-consuming to prepare and generates complicated outputs not appropriate in all situations. Wouldn't it be nice if there were a simpler way to get a holistic view of your changing wealth-management needs and track progress toward meeting your future financial goals?

RBC Wealth Management's fabulous new software tool, myGPS™, allows me to easily help you answer these important questions:

1. What does my current financial situation look like? myGPS™ provides consolidated summaries showing your sources of income, savings, expenses, investments, real estate and debt – all your critical financial information presented in one document.



2. If my spouse or I live to age 95, will we have sufficient funds to maintain our lifestyle? myGPS™ will project income, savings, taxes, expenses and the value of your assets into the future, using your specified set of assumptions.

3. If I die tomorrow, will my family be sufficiently provided for financially? Anticipating your future financial needs is a difficult task. Anticipating your family's future financial needs, should you or your spouse die unexpectedly, is even more difficult. myGPS™ can help you identify any potential financial shortfalls.

4. How does changing my financial assumptions impact my future? It's impossible to know what will happen tomorrow. To provide a financial projection, however, certain assumptions have to be made. But what if some of those assumptions prove to be wrong? What if, for example, you retire early? Or what if your expenses in retirement are higher than originally planned? The myGPS™ Retirement Analysis allows you to independently change the assumptions you have made about the future to see how that change will affect your overall finances.

5. What can I do to ensure my financial goals and priorities become reality? myGPS™ reports the key financial products, solutions and strategies, which are tailored to your financial situation and priorities, helping you to make the most of what you have – both now and in the future.

As a professional Wealth Advisor, I have learned that families who prepare and plan for the future are better off than those who don't. If you would like to review your retirement and estate plan, please feel free to contact me.

Until next time, best regards,

David Serber

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

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