# Quarterly Commentary

July | 2019

## Lower for longer, again

We have been cautiously balanced in our portfolio asset allocation during the last few months and remain concerned over the many potentially market moving headline events coming our way. We are underweight stocks and are using higher amounts of cash to offset what we see as material risks. Trade discussions between the U.S. and China are resuming with further tariffs on hold. The modest response from this positive development reflects a stock market that has priced in this anticipated outcome. The risk outweighed the reward, with the possible upside from a positive outcome on trade being much lower than the downside risk from a negative outcome. Still, with the uncertain future of Brexit, Trump's tariff threat to Mexico over non-trade issues, uncertainties relating to business with Huawei (China's largest telecommunications equipment supplier), and a renewed tiff with Iran, we have a host of negative possibilities. All of these factors have contributed to a slowing of the global economy, which has possible negative consequences on corporate profits in the near term.

Enter the U.S. Federal Reserve (Fed). 2018 saw a steady series of interest rate increases ("hikes") in the U.S. These rate hikes are designed to moderate economic growth rates and keep inflation under control. Recent fear of slower global economic growth (worsened by the other items listed above) and lower inflation expectations have brought the Fed to a point where they intend for, and the market expects, at least one if not three rate cuts (a reduction in interest rates, usually by 0.25% amounts). This could change the investment environment dramatically. Rate cuts lower the cost of borrowing and families with access to more funds are able to spend more, which in turn boosts economic growth. Lower rates also tend to make risk assets (stocks) more valuable.

***Chart 1: JOLTS Quit Rate***

Rate cuts by the Fed could help to lessen the negative impact on investment markets by many of the issues facing us. They would help neutralize a negative outcome from trade talks about to begin. Over and beyond that, cuts would likely extend the ageing economic cycle

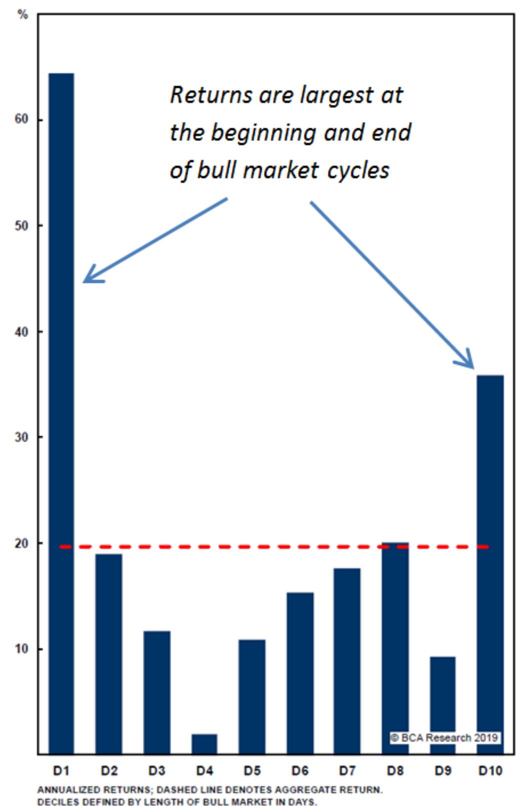
and bull market that has been going strong since early 2009. This could push back the onset of the next recession and accompanying bear market beyond 2020 (our current expectation) and into 2021 or 2022 and have important implications for investment management. If the Fed does begin a series of rate cuts at their July 29 meeting and the trade talks go positively, stock markets could surge again.

Beyond the short term however, and barring a trade deal collapse, lower rates along with a strong job market have the potential to reignite growth. The unemployment rate is viewed as a barometer of job market strength, yet another indicator is equally if not even more important, the JOLTS quit rate (Chart 1). A rising quit rate means that employees are quitting their jobs, which is what is happening now. The current quit rate is at the highest level since April 2001. A rising quit rate implies that employers are poaching employees from one another. It also implies that most employees are quitting their jobs in favour of higher paying ones. The quits are now occurring in low income jobs as opportunities to seek higher pay are numerous. Employers simply cannot find enough workers and the number of job openings in the U.S. now exceeds the number of unemployed. When higher income earners change jobs, the extra money they earn ends up in their savings or investment accounts. When lower income earners change jobs and see a bump up in their income, however, the propensity is to spend that extra income, leading to an increase in consumer spending. This along with a lower cost of borrowing translates into stronger consumption. Leading up to the U.S. presidential election in the fall of 2020, Trump wants the electorate to feel good about their personal finances.

**A sprint towards the finish line**

Short term risks aside, and beyond the near term uncertainties, there is good upside potential for the stock market. Looking at prior S&P 500 bull market cycles (this one began in 2009), and breaking down each of these bull markets in decile periods (separating the bull market into 10 equal periods based on equal lengths of time. See Chart 2), there's a tendency for bull markets to begin with a bang, the largest returns coming in the first decile (the earliest stage in the bull). Essentially the market takes off like a rocket catching most by surprise. The last decile has been the second most lucrative period in the cycle. There are many investors out of the market at this late point in the cycle. The fear that the next recession is about to begin increases the flow of funds going into bonds and bonds funds, while monies leave equity funds. The market at this juncture needs to "climb a wall of worry" to overcome these fears. Eventually, as market growth continues, investors become fearful of missing out ("FOMO") and make a late run back to stocks, leading to a crowding into what are considered the best growth stocks. The euphoria marks the end of the bull with stock markets declining, sometimes dramatically. The dotcom bubble in 1999 is a prime example of that market environment. For the six month period from October 1999 to March 2000, the Nasdaq Composite doubled. The subsequent decline led to a long bear market, with the year 2000 peak

***Chart 2: S&P 500 returns by market decile***




Source: BCA Research

not seen again until 2015.

The myriad of uncertainties facing us, even with a near term truce in the U.S. / China trade war could lead to short term market weakness. We see this as an opportunity to reposition cash holdings into stocks in advance of the coming rate cuts by the Fed. The tight jobs market and higher incomes both in the U.S. and in Canada should usher in renewed economic strength, led by the consumer spending. The Fed will likely succeed in pushing out the next recession to 2021 or 2022 leading to outsized gains in the last decile of the bull market (Chart 2).

We await an entry point to add to stocks in preparation for the opportunities in the last decile.

Worth Allaye-Chan Investment Counsel | www.worthallayechan.com | worthallayechan@raymondjames.ca
Suite 2100-925 West Georgia Street, Vancouver, B.C., Canada V6C 3L2
T: 604.659.8066 TF: 1.855.659.8066 F: 604.659.8449

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