First Quarter Commentary

April | 2017

Still positive, but beware of tail risks

"So, the question remains just how much of President Trump's policies can the market really be pricing in considering we still know very little about them or how long they will take to be passed and implemented. It still seems likely to most that we're not going to immediately get tax reform, an Obamacare repeal/replacement, regulation rollback, and infrastructure expansion all at once; this is the government after all, so things will have to be prioritized and negotiated. And as long as the market does truly understand this, it may mean there won't be as much disappointment as expected if one or more of the policies gets delayed. Meanwhile, as long as the economy and earnings continue to improve, there's a good chance this bull market can sustain itself as it awaits perhaps even more fuel for the fire. Interestingly, even as the stock market has done so well, analysts haven't really raised their earnings estimates yet – 2017 and 2018 numbers have remained roughly the same – meaning there still may be plenty more upside when it comes to expectations." – Raymond James Investment Strategy, March 2017

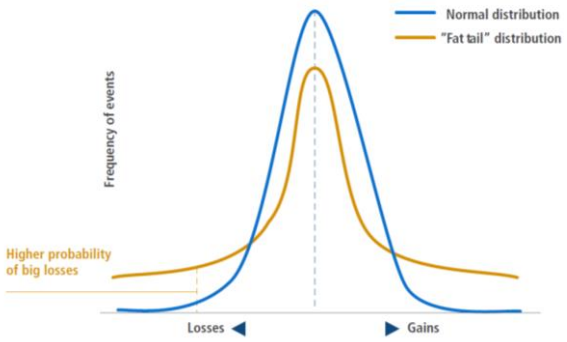
As far as the stock market is concerned, there has been an inordinate amount of focus on the potential "good" that the Trump administration brings, without so much as a pause about the potential "bad". Whereas the general public have mostly been focused on the negatives of the Trump presidency, investors have largely looked towards the potential positives that come along with his proposed fiscal policies centering on potential tax reforms, infrastructure spending, and a more pro-business regulatory environment.

As it becomes more apparent that the time it may take to deliver these promises is less immediate and the net changes may be a little less than hoped for, the shift of attention to the negatives should lead to periods of short term market weakness. An example is the recent failure of Trump's healthcare reform which was seen as an important stepping stone to more fiscal policy change to stimulate the economy. We see these bouts of weakness as an opportunity to add to stock exposures. As global economic growth has continued to improve, we believe that the solid corporate earnings outlook has just as much to do with the global markets' post-election strength as do Trump policy benefits. To guard against these countertrend moves however, including some defensive exposures (consumer staples, telecoms, healthcare) to compliment the growth exposures (financials, technology, industrials) should help moderate the short term volatility within the portfolio.

Even though the U.S. and Canadian stock markets are fully priced, and perhaps even overpriced by some valuation measures, stock markets are driven more by whether conditions are getting better or worse, rather than on an absolute valuation basis. In fact, although valuation is an important determinant of returns on a multi-year basis, it does not impact short-term stock market performance nor is it helpful as a market-timing tool. Moreover on a comparative basis, stocks compare favourably to bonds particularly given the improvement in the global economy. Bonds are no longer as overvalued, but remain relatively less attractive as total return prospects continue to be unappealing. This same train of thought regarding the relative improvement extends to individual stocks, particularly on a short term basis. A company that reports a net loss in a particular quarter may see its stock rise if the loss was not as bad as expected, or conversely a company that reports what appears to be a strong profit may see its stock fall should the profit be less than expected. Valuation plays a secondary role, as a pricey stock could maintain its high valuation should future sales and earnings growth continue outstrip expectations. The major risk with these higher valued stocks is when actual growth fails to meet anticipated growth, the premium investors are willing to pay could shrink quickly, leading to a drop in the share price.

We remain sanguine about the prospects for equity markets, particularly relative to bond market returns. However, it is important also to temper our positive outlook with a discussion about the tail risks. The unpredictability of Trump also means the possibility of higher than usual potential for a much more positive or much more negative outcome. A tail risk typically is an event that has a small probability of occurring, leading to a result that is much better or worse than usual. Should pro-economic growth policies gather steam and lead to stronger than expected corporate earnings growth, or if anti-trade protectionist policies lead to reduced global economic activity, the probability of an extreme scenario occurring is higher in today's market. This is illustrated in Figure 1. Today's "Fat tail" distribution in orange means a greater likelihood of a more unexpected outcome than the normal distribution in blue. The strategy taken to protect against countertrend moves will be helpful in lessening, but not eliminating the effects of these tail risks.

Figure 1: Tail Risks



Source: Pimco

Budget 2017 – how it affects you

Heading into budget 2017, there were concerns about potential tax changes, such as possible adjustments to the federal income tax rates for both individuals and corporations, and the capital gains inclusion rate which since October 2000 had been set at 50%. With the economic uncertainty facing Canada from yet to be determined Trump policies, the Liberal government went with the strategy of minor tweaks leaving the aforementioned unchanged. The budget showed the willingness to run a deficit in the coming years, with no plans to balance the books. Major highlights of the 2017 budget include:

- Skill training initiatives - increase in employment insurance (EI) premiums to fund some of the expanded EI benefits
- First Nations communities – additional $3.4 billion over the next five years mostly for infrastructure and health resources
- Allocations to Statistics Canada to form a housing statistics framework for in depth information on purchases and sales.
- Uber tax – implementing an identical taxation structure as for taxis.
- Proposal to increase excise duty rates on tobacco and alcohol in the coming years.
- Elimination of transit tax credit – previously allowed to claim 15% of the cost of transit passes annually
- Consolidation of three caregiver credits into one Canada Caregiver Tax Credit
- Billed-basis accounting – eliminate the ability for designated professionals (such as accountants, dentists, lawyers, medical doctors, chiropractors) to use billed-basis accounting

For a more detailed summary of the 2017 federal budget, please contact us.

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