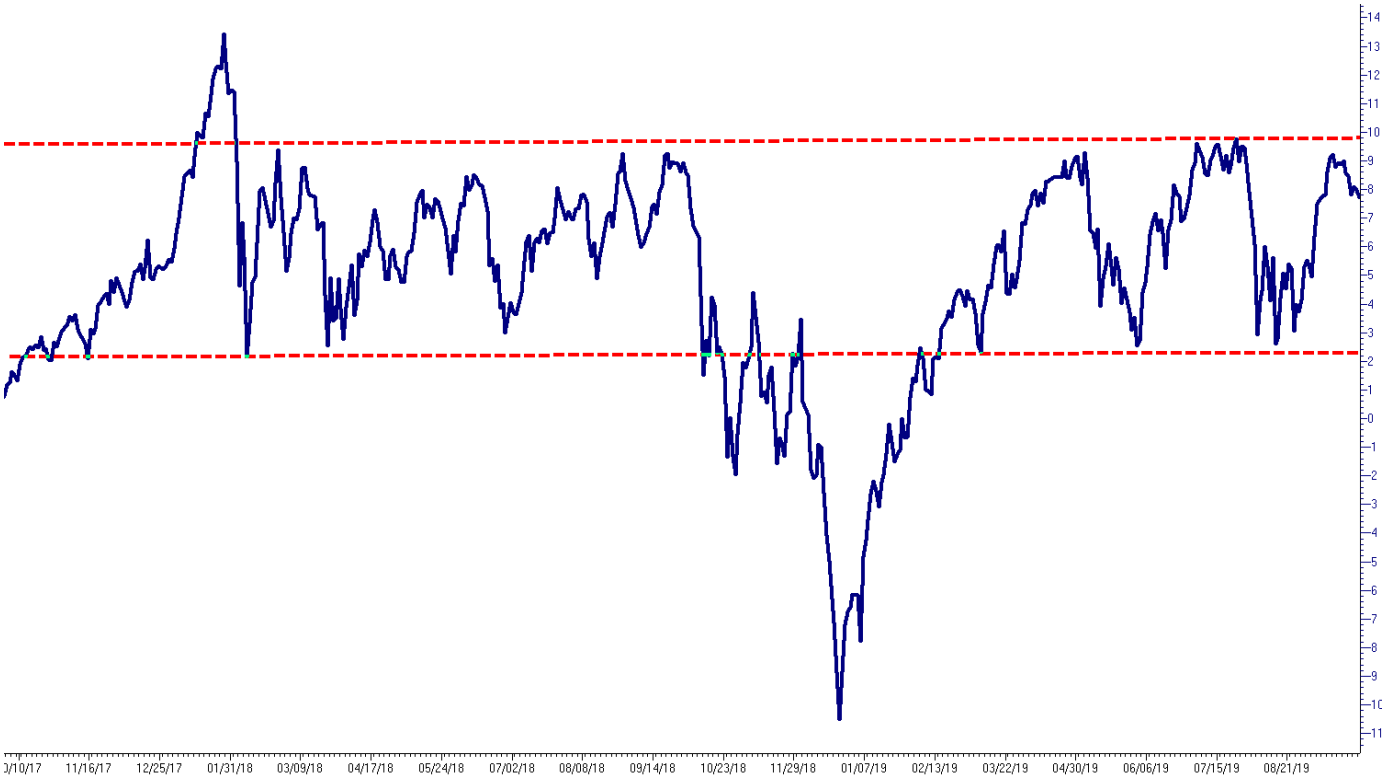
INVESTMENT DECISIONS UNDER UNCERTAINTY

September 2019

Over the last couple of years, geopolitical uncertainty has been elevated. Front and center has been the U.S. trade war with China, but there has been no shortage of other conflicts. A less talked about but equally contentious trade war is happening between Japan and South Korea. Europe and the U.K. are having difficulty getting divorced (Brexit). Hong Kong pro-democracy protests continue. Iran and North Korea sanctions are worsening. The new NAFTA (USMCA) agreement has yet to pass. Tariff battles, threats, and protectionism are widespread. To add to the confusion, the U.S. administration is having a spat with its own central bank (the Fed).

Is it any wonder that global stock markets have made no material progress since January 2018? We have seen a 19 month consolidation, courtesy of this uncertainty and fear. The following chart shows that global stocks (MSCI All

MSCI All Country World Index



Source: Thomson

Country World Index) have been stuck in a wide range through this entire period, as shown by the red dashed lines.

Opinions are widespread, and there's little agreement amongst market pundits. We do, however, know that the global economy, due to all these issues, has been slowing. Manufacturing activity throughout the world has been falling because of uncertainty. Business leaders are worried that the decisions they make now may need to be reversed later due to changes in policy. The global economy is much more intertwined than it was decades ago. What happens to the economy in China affects Europe, South East Asia and has an impact around the globe. The health of the U.S. economy is the most important given that it is the largest economy in the world. The trade spat between the two largest economies has driven this sideways grind in global markets.

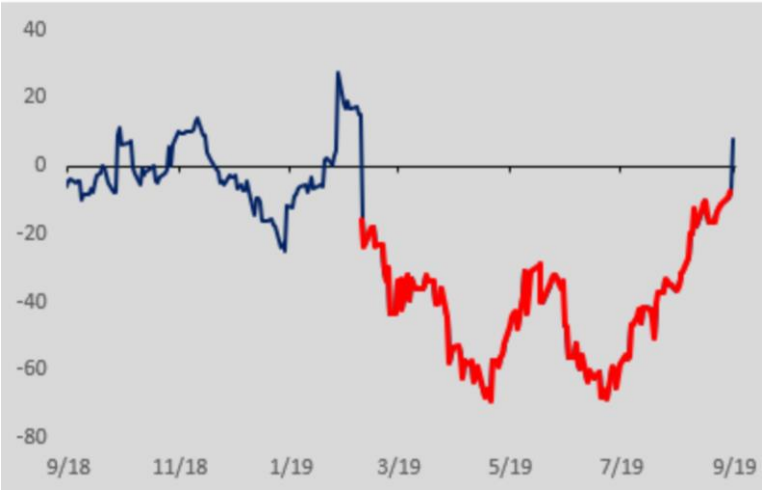
Meanwhile U.S. and Canadian economies remain on firm footing. Expectation that huge household debt levels in Canada, coupled with a fall in our real estate prices, would lead to a recession has not materialized. In fact, Canada's economy continues to hold up well, thanks to strong employment trends. In the U.S., consumer confidence is healthy and essentially drives economic growth and supports investor confidence.

Investors in other parts of the globe have been more pessimistic, so much so, that there is $17 trillion in negative yielding bonds worldwide, and people are buying them! In comparison, this makes 1-2% yielding bonds in North America look attractive on a relative basis and has led to a rush of foreign buying into U.S. government bonds. Usually and logically, short term bonds that mature in one or two years have lower yields than mid to long term bonds that mature in ten to thirty years. When the opposite happens and longer term bonds are yielding less than shorter term bonds, investors are fearful that a recession is coming. This "yield curve inversion" happens before EVERY recession AND occasionally happens and NO recession follows. Dr. Ed Yardeni, former professor at Columbia University, and president of Yardeni Research quipped "an inverted yield curve has predicted 10 of the last 7 recessions."

Even when the bond market correctly predicts a future recession, the time frame between that signal, and the actual recession is typically around 18 to 24 months! History also shows that the stock market marches higher to new peaks during the period! In other words, a true recession signal is not necessarily a trigger to get out of the market. *The last portion of an economic and market expansion is historically one of the most rewarding for investors.*

More recent economic data actually shows an improvement in the global economy. For the first time since early this year, the economic surprise index has recently turned positive! This means that the economy is actually doing better than what is expected. As has been the case throughout the Trump presidency, there's never a shortage of noise, nor flip flopping. The Democrats are now pursuing an impeachment probe against President Trump. One moment, it appears as though the US wants to make a trade deal with China, the next, they appear as far apart as ever. Brexit is still unresolved, and the Hong Kong protests continue.

Economic Surprise Index – turning positive!



Source: Citigroup

This fear and uncertainty has kept most investors underinvested and that is understandable given the elevated risks. Pension fund allocations to the stock market (versus bonds) are at approximately 36%, down substantially from 61% in 2007. Bond allocations have meanwhile risen from 32% to 49% in those 11 years. Holdings in money market instruments also reflect this trend, with holdings in U.S. money market funds at US$3.35 trillion this month, the highest level since October 2009. We're seeing similar statistics in Canada.

We too have been underinvested during some of the period (held higher cash positions than normal). This type of "insurance premium" leads to a drag on short term performance, but protects portfolios from the significant downside of a major "event". We remain in one of those periods where it's more important to not lose the money than to maximize performance.

We believe any move higher will be led by the late cycle secular growth stocks, companies that due to strong long term trends are able to grow their businesses even in a slow growth world. A low growth economy generally means slower growth in company profits. The companies which have the advantage of being able to grow their profits despite the economy are likely to lead. This is usually the case for the stock market at similar points in the economic cycle as we are in today.

Examples include Amazon with its robust online commerce (versus the decline of "bricks and mortar" stores), Microsoft with subscription based cloud services (monthly fees to Microsoft), Visa and Paypal as it's becoming more and more of a cashless society (the decline in use of cash and cheques). While stocks of these companies are not invulnerable to short term bouts of weakness, the opportunities for upside make them enticing investments.

Finally, it's also important to remember that President Trump's goal is to get re-elected in 2020, and his chance of being a second term president is highly dependent on both the health of the U.S. economy and the stock market. Perhaps someone should remove his access to Twitter.

In this investment environment although continued caution is warranted, it is also important to not lose sight of excellent investment opportunities in the late stage of the cycle.

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