OUR FAMILY PERSPECTIVES

INSIGHTS FROM CANADA'S LEADING FAMILY OFFICE

Second Quarter, 2019 - July, 2019

WHAT HAS HAPPENED

Despite some serious backtracking in May (when it dropped more than 6%), the widely followed S&P 500 Stock Index jumped 18.5% in the first half of 2019, its best start to the year since 1997, and the S&P/TSX composite here at home followed suit, gaining 15.2% in the first half of the year. Coming on the heels of a nearly 20% peak-to-trough decline in the latter part of 2018, a recovery was to be expected at some point. But the speed and trajectory of the rebound surprised even the most bullish investors, considering that very little had changed in the underlying economic fundamentals.

It now seems to be accepted wisdom that the Federal Reserve moved too aggressively in raising short-term interest rates nine times between late 2015 and 2018 and, here at home, the Bank of Canada raised interest rates five times over that same period. Investors became convinced that, south of the border, Chairman Powell was intent on continuing to lift rates in 2019, sending the economy into recession. After he signaled that the Fed was comfortable with postponing any more increases until there was further evidence of a sustainable uptick in inflation, stock prices took off.

TRADE DISPUTES & INTEREST RATES

The on-again off-again nature of the trade dispute between the U.S. and China contributed to a slowing global economy and weaker performance from European and emerging market stocks. Although the MSCI EAFE Index of developed market equities (+14.0%) and the MSCI Emerging Markets Index (+10.6%) posted impressive double-digit first-half gains, they trailed markets here in Canada and in the US once again.

Bond prices rose as yields fell across the globe in the second quarter. Continued stimulus from European and Japanese central banks have driven sovereign bond yields in Germany and Japan well into negative territory. The bellwether 10-year US Treasury bond, at 2%, represents an attractive alternative to fixed income investors looking for a return *on* their money, rather than just a return *of* their money.

Here at home, it appears that the Canadian economy is returning to potential growth after experiencing a weak stretch that nearly brought the economy to a halt late last year and into 2019. The Bank of Canada is expected to leave its key interest rate unchanged in an attempt to balance improvements in the domestic economy with an expanding global slowdown caused by trade conflicts, while policy-makers in the U.S. and Europe have signaled that they may cut interest rates in response to weakened global economic activity.

As the US expansion enters its 121st month (the longest on record), investors are paying close attention to evidence that would foreshadow a coming downturn.

Consensus estimates for global GDP growth have been falling all year, as economies grapple with the ongoing trade disputes between the US and most of its trading partners. As we have noted, a successful resolution in the dispute between China and the US which addresses many of China's abusive trade practices and eliminates the recent tariff increases between the two countries would be extremely bullish for stocks. Significant obstacles remain, and in the meantime, companies are shifting supply chains (at significant cost in time, energy, and resources) in order to mitigate the damage should the dispute persist.

WHAT TO EXPECT GOING FORWARD

Equity investors seem to be pinning most of their hopes for higher stock prices on the U.S. embarking on a significant easing campaign in order to reignite a weakening economy. But the markets may be too optimistic in their forecasts for easing and the impact of lower rates when rates are already at historically low levels.

Generally, stock markets react quite well when the governments begin easing monetary policy. In the U.S., the Fed executed five rate-cutting cycles between 1984 and 1998, and stock prices jumped each time. Returns over the following year ranged from 14% to 23%, according to data from Goldman Sachs. But in the next two rate-cutting cycles (2001 and 2007), stocks lost 12% and 18% in the following year, on their way to much more significant declines (41% and 54%) before recovering. Importantly, these rate-cutting cycles started from much higher levels than today's, ranging from 5.25% to 9.5%. As a result, the economic benefits of lowering rates from this point may be far more muted than in past cycles.

Is the market long in the tooth and could the bull market and expansion period (the longest in history) continue? Of course it could, but we wouldn't bet on it. One should always expect the unexpected. The expression "hope for the best and prepare for the worst" is an apt approach at this time.

RECOMMENDED APPROACH

As with our U.S. affiliate Ballentine Partners, we care deeply about the relationship between risk and return. We believe strongly, that it will be key in the coming years in preserving and growing your wealth.

At Our Family Office (OFO) we organize and build portfolios with a focus on the level of risk you are assuming for the return you expect. Risk-adjusted returns matter, and we are conservative in our approach to wealth preservation and growth. Studies have shown that investment success is not primarily about how much you make, but how much you avoid losing.

Our co-founder Neil Nisker was recently asked if he enjoys gambling and whether he goes to Las Vegas often. He responded: "I like the shows and restaurants, but don't really gamble much. My gambling philosophy is very much like my investment philosophy: I hate to lose much more than I like to win."

Behavioural economics suggests that most investors end up feeling the same way about their portfolios once they've experienced some losses. We believe, at this point in the cycle, that it's prudent to spend more time analyzing what can go wrong than what might go right.
As always, we thank you for your trust and confidence and appreciate your continued support.

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