THE RAE LIPSKIE PARTNERSHIP™ | PRIVATE WEALTH MANAGEMENT

December 2016 **Overview**

And now for something completely different…

We are changing up the format of this newsletter edition to (1) keep our readers alert and (2) report on a recent out of office experience. In November, our investment managers attended a day-long retreat at which we had the opportunity to hear investment presentations from several highly qualified industry professionals. We find these interactive sessions to be informative and beneficial in the management of investment portfolios, and thought our clients would be interested in some of their insights.

Dr. Ed Yardeni

Yardeni Research Inc., based in New York, provides in-depth empirical and analytical research on the global economy, which is the basis for Ed's investment strategy and asset allocation recommendations. As a highly regarded strategist, Ed is frequently quoted and viewed in the U.S. financial media. We receive daily briefings from his team, as well as teleconference opportunities on request. Here is a précis of his presentation:

The "Trump Effect" on financial markets has been astonishing. No one would have predicted a "melt-up" as a result of a Trump election win. Stock markets have been "on a tear" since the morning after; interest rates have shot up; commodity prices have risen; precious metals prices have fallen; and inflation expectations have turned upward. The world is now being viewed differently as analysts dissect the Trump election platform in search of market implications.

Essentially, though, Mr. Trump was elected with a pro-business, growth mandate supported by lower taxes, infrastructure spending (sound familiar?) and looser regulatory constraints. As well, he plans to reduce to 10% the tax rate on repatriation of the $2 trillion that U.S. multinational corporations are holding in overseas accounts, a possible spur to investment spending and, of course, a welcome boost to government revenue. One impediment to this growth trajectory is the protectionist stance espoused, but this could well change depending on his line-up of advisors which, Ed says, is 'so far so good'. With the U.S. economy already near full employment and adding jobs at a vigorous pace, Ed cautions that the coming stimulus could stoke now dormant inflation embers which would result in moderately higher interest rates.

As for market outlook, Ed is wary of bonds given the expected move to more 'normalized' (read: higher) interest rates. This could be a problem for economic growth and stock markets, but only if rates move faster and higher than expected. Already a stock-market 'bull' before the election, he thinks U.S. policy initiatives in a Trump presidency will further enhance corporate-profit prospects and, by extension, the stock market. While the U.S. should continue as a market leader, Ed has warmed up to other world markets, including Europe which he sees as cheaply valued and emerging markets which are also attractively valued and supported by stronger commodity prices. Equities generally could have a big "melt-up" as bond investors sell fixed income investments to buy stocks. Dr. Yardeni also sees Canada as a good place to invest, particularly as an "inflation play" given our market's hefty exposure to resource commodities and precious metals. Our Dollar is cheap vis-à-vis the US greenback, and the flood of global money coming to buy the natural resource stocks and our financials stocks could well lift our market back to the historic highs of September 2014. Our low Dollar is good for Canadian manufacturers and exporters too.

Aubrey Basdeo

Aubrey is Head of Fixed Income for BlackRock Asset Management Canada, a subsidiary of the giant U.S. investment manager. The parent organization manages over US$5 trillion (yes, you read that correctly) of investment assets, including the prominent iShares exchange traded funds. He spoke to us on the changing yield curve, which is simply the relationship between short-term interest rates and long term. He said that the election of Donald Trump has totally turned upside down the past many years of investment thinking and strategy when low rates have been the dominant premise. Aubrey stated that there are three central themes dominating the price action of bonds globally:

1. The first theme is "reflation". The United States is experiencing a tight labour market. Wage pressures are building. Rising housing prices and health care costs are going to exacerbate long-term inflationary pressures.

2. The second theme is the implication for higher yields across the maturities spectrum. Interest rates have bottomed. The yield curve has just started to steepen with longer-term rates moving the most. Although the Fed will have a bias to moderate any increase in interest rates, the financial markets will price in the expectation of higher inflation.

3. The third theme is that we will see a cyclical rise in nominal economic growth in the United States. Nominal growth has bottomed out and any surprises will likely be to the upside.

Post November 8th has produced higher interest rates and a steeper yield curve as the markets price in higher inflation. *"The Donald Trump presidency means significant tax cuts, deregulation, infrastructure spending, and potentially rising economic growth."* What a change in market sentiment. In Canada, local factors will affect the yield curve as the Canadian economy will likely have slower growth than the United States and that will moderate our yield pressures somewhat. Possible changes to NAFTA could result in lost trade with the U.S., but this will be offset by increased energy sales to the U.S. and an increase in Canadian manufacturing sales within Canada.

Aubrey commented that the economic cycle appears long in the tooth as it nears the eight-year mark. Nevertheless the Trump presidency could potentially elongate the cycle and put it in the long-awaited self-sustaining mode where it is not dependent on stimulus support. Mr. Trump has promised quite a bit – the uncertainty is not knowing what he might be able to accomplish. While rates will rise, we will still remain in a relatively low rate environment for the next five years so the economic impact will be muted. The cycle of consumer spending and higher economic growth will now be a function of the Millennials (aka Generation 'Y' – those born between 1977 and 1995) as they form households, create families, and spend their monies. It will be just like the 1960s and 1970s when the baby boomers controlled the world.

Ryan Kuruliak

Ryan, a Chartered Financial Analyst, is the Senior Vice president of Proteus Investment Consultants. Proteus has been in business since 1994 and has developed a strong reputation among large pension funds, especially regarding governance and best practices. He spoke to us about investment strategies in the institutional world and their potential tie-ins with Private Clients. His presentation pack was filled with charts and bullet points on Defined Benefit Pension Plans, how plan sponsors invest those funds and mitigate risk, Defined Contribution Plans, Endowments, and Asset Class managers.

Ryan talked about the pension industry and the big move from defined benefit plans (guaranteed pension amounts) to defined contribution (no guarantee) so that now the DB plans are mostly covering government and related employees. Interestingly, the statistics show that females actually enjoy better DB coverage now because of their prominence in those fields. Those big public plans, like the CPP, teachers, and municipal employees, have also adjusted their asset mix over time, diversifying from stocks and bonds into 'alternative' investments such as real estate, venture capital and infrastructure projects. Of course, direct investment in many of those alternatives requires big money (read: yuuuge), but it is interesting to see the trends. One other development of note is the increasing awareness across institutional brands of environmental, social and governance (ESG) investing, a topic of interest in our circle as well.

Ryan discussed another aspect of the big funds' investment approach that is probably not well known, the employment of leverage. Through the use of margin borrowing and investment derivatives, these funds hope to enhance investment returns over and above the plain vanilla results available. All of this seems entirely risky to us, and <u>we do not employ leverage for our clients.</u> When we asked Ryan why pension funds are taking on so much risk, he replied that prudence is a test of relativeness to others. If all the pension funds are employing leverage and you are not – then you are the one who is imprudent!

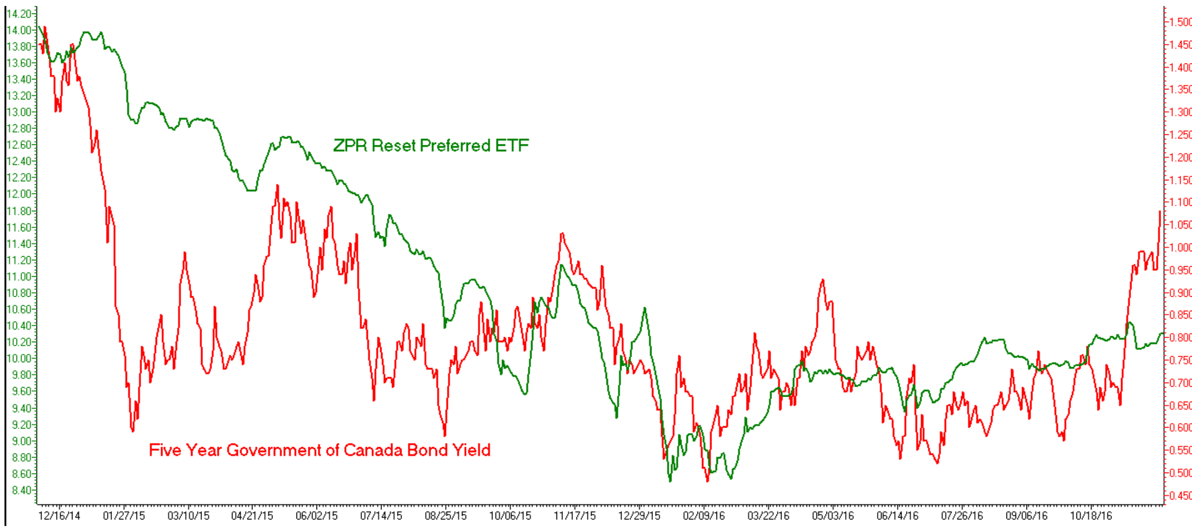
Today's Smile…

Steve Elgee

Periscope Capital is a Canadian Hedge Fund managing $300 million in client assets in a variety of strategies, including preferred share mandates. Steve Elgee, the Chief Investment Officer of Periscope and recognized preferred-share expert, provided his perspective on this market. As background, he noted the scale of the preferred market in Canada with a market capitalization of $57 billion and 352 issues outstanding, most of them from financial and utility-type companies. The rate reset market, which adjusts yields every five years and has been dominated until recently by individual investors, was surprised by the Bank of Canada rate cut in early 2015 and sold off sharply in response (see the chart below of the ZPR ETF, an indicative index for this market). Issuers, who still needed access to this market "sweetened the pot" by substantially increasing the premium they would pay over the Government of Canada five-year bond yield (the red line in the chart… note the sharp upward swing recently, a positive sign for reset preferreds). The "sweetener" was an increase in that spread from the typical 200 basis points (2.00%), to 400-500 basis points and, for some issuers, an attractive minimum-rate guarantee. The result is now a reset preferred market in three major segments:

1. Original Rate resets that generally trade at a discount to their original issue price (in order to make their yields competitive).
2. "High" resets that include the "sweetened" spread, mostly issued by the Banks and generally yielding around 5%.
3. Fixed Floor resets, which are "post-sweetener" issues but with the guaranteed-floor reset rate along with spreads and yields comparable to the High Resets, dominated by the Utility sector.

Steve reported that the sweeteners have brought significant institutional demand to the market, providing them the opportunity to replace low corporate bond rates with much more attractive yields at the same credit risk, and issuers have responded with more and bigger issues to satisfy that demand. Steve was careful to note (and you can no doubt see) that reset preferreds are complex issues. Future performance could be affected by a variety of factors including the trend in interest rates, the implied spread, future rate changes and the time to the reset date. Their expected return is not a mathematical relationship, nor is there a definite maturity date, unlike a regular bond. Still, based on an expectation of gently rising five-year Government of Canada interest rates and gently narrowing spreads, Steve predicted that returns in this sector, with representation from each of the above segments, would be substantially above the meagre bond alternative.



Our fifth outside speaker was **Maxim Sytchev**, Industrial Products Analyst with National Bank Financial. Maxim is responsible for covering the Engineering and Construction companies in Canada, including such stalwarts as SNC Lavalin, WSP Global and Stantec. The engineering sector is certainly of topical interest these days because of the global recognition that the infrastructure in place to support economic growth is woefully lacking. The spending required to build and rejuvenate roads, bridges, airports, power grids, etc., will be massive, well into the trillions of dollars on a global basis, and engineering expertise will certainly be required. Following rigorous analysis, Maxim concludes all three of these companies are in a strong position to benefit and offer smaller investors (i.e., non-pension funds) an attractive way to participate in the coming infrastructure spending wave.

Our out of the office event was successful. It allowed us to meet with other professionals who are tops in their fields, listen to their points of view and ask lots of questions. This is all part of the investment process at Rae & Lipskie, to read, listen, and debate the myriad of issues facing investors in today's fast-paced world. We will continue to do our best to manage your investment portfolios with prudence and consideration for your specific needs and financial goals.

We leave you with a Quote of the Day: "The laws of political life cannot be discovered by an analysis which takes men's words and beliefs, spoken or written, at their face value."

- from "The Machiavellians: Defenders of Freedom" by James Burnham, 1943.

The RaeLipskie Partnership

The RaeLipskie Partnership provides discretionary "fee-only" portfolio management for high net worth individuals, endowments and charities.

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