LEE, TURNER & ASSOCIATES INC.
INVESTMENT QUARTERLY

REVIEW October 2019

Three prominent fear factors confronted investors over this past summer and dialed up the volatility levels in the financial markets. First was a seemingly endless and hopeless trade dispute/war waged between the US and China, one of which neither party could possibly claim an honest victory. Second was a dramatic plunge in global bond yields, particularly those of European issuances which saw their yields dive into negative figures. Third was the bombing of a major Saudi Arabian oil processing facility that severely disrupted global oil supplies for a couple of weeks. On the trade dispute/war front, investors were flummoxed by the many rounds of tit-for-tat launched by both countries. Observers had a hard time deciphering the motives behind each country's tariff manoeuvres, were they strategic bluffs or genuine resolve? Plummeting yields on the European bond market reflected a high degree of pessimism in their economy. As that pessimism spilled over onto North America, bond prices in both the US and Canada climbed to new all-time highs, which meant that bond yields sunk to new record lows. In the aftermath of the attack on Saudi Arabia, crude oil prices spiked higher and global geopolitical tensions reached new heights. Given the critical nature that oil plays in the Middle East's and, indeed, the entire globe's economic stability, the uncomfortable consideration now is the likelihood of further attacks and the scale of ensuing responses. While the ride was bumpy, the finish was very good for all markets concerned. Stock markets advanced strongly; a few global indexes reached new all-time highs including that of our TSX. The Dow Jones Industrials Average rose 1.2% while the S&P/TSX Composite Index climbed 2.5% over the quarter. Canadian bonds had a 1.2% total rate of return. Short to medium maturity bonds showed small gains while the longest maturity ones had the biggest gains.

FORECAST

The near term forecast for the North American economy is quite divided, an equal mix of pessimism and optimism. An expected GDP growth rate of just 1.5% is indeed low but will be offset by a very low unemployment rate and healthy wage gains. Dangerously low interest rates will get balanced off by benign inflation rates. As for consumption and investments, both will remain a tad below optimal. Lastly, imports and exports levels will likely continue to weaken. These conflicting economic assessments must have played in the minds of North America's two Central Bankers as evidenced in their recent policy actions. The Federal Reserve deemed it a cautious necessity to cut its rates by 25 basis points twice in the quarter. Here at home, the Bank of Canada held off and left its interest rates unchanged even though it acknowledged the potential of trade related weaknesses in our economy. Our forecast falls closer to the Bank of Canada's perspective. We see resilience in the current economic cycle. We see equal parts of strengths and weaknesses in upcoming economic reports. We are assuming a glass half-full view of North America's near-term economic prospects.

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INCOME STRATEGY

Bonds

The term "negative bond yields" has appeared with increasing frequency in the financial media lately and has always been used in ominous tones to foreshadow impending economic doom. Given that it is somewhat of a newborn term, we like to address its meaning, explain its concept, and offer some insight into its implications for the financial markets going forward. To start, we need to define and differentiate between "negative bond yields" and "negative interest rates". These two terms sound confusingly similar and most media members use them interchangeably; which is wrong, because they are very different in meaning. Negative bond yields come about when investors are willing to pay more, up-front, for a bond than the sum of its time adjusted maturity value and all its interest coupon payments reinvested (at today's assumed rate of return) until maturity. Currently, the furthest into negative grounds for bonds that are of negative yield is about minus 1% at most. Negative interest rates, on the other hand, is the rate or amount of money that a lender (bond holder) must pay to the borrower (bond issuer) on an ongoing and regular basis over the duration of the loan (bond), a complete reversal of what goes on in the real-world. Both concepts seem counterintuitive, but while negative bond yields are currently prevalent in some parts of the world, the likelihood of negative interest rates ever offered to the general public (with no strings attached) is infinitely remote. Before addressing the mindset of someone willing to accept a negative yield on a bond, we need to point out that despite how it appears, when an investor buys a bond with a negative yield today, there is a slim chance, however slight, that he may realize a positive rate of return, even if just barely so, come maturity date if he can reinvest the bond's future coupon payments at a higher rate of return than currently assumed. Nevertheless, it is indeed a given that anyone committing funds into a negative yield bond must hold an extremely pessimistic outlook for the economy and is therefore undertaking a strategy of containing potential losses. Such investors believe that it is better to plan for a small capital loss without risk than to try to earn a return by putting their capital at risk. The implication here is that if this kind of investor mindset carries over broadly, then the economy will soon be starved of capital and a self-fulfilling recession will likely ensue. As well, the profitability and stability of the banking industry would be at risk because banks will have increasingly fewer customers, depositors as well as borrowers, to service. In conclusion, bond yields that are too low are indeed hazardous to an economy just as bond yields that are too high, although in different ways. At the moment, Canadian bond yields are still positive but are much too low to warrant our participation in the bond market.

EQUITY STRATEGY

We will know the outcome of Canada's latest federal election shortly. We have closely reviewed each parties' fiscal promises and proposed economic platforms; we came away completely underwhelmed. On the face of it, all those pledges and commitments are nothing but simple-minded vote-buying schemes designed to speed our economy down the road to perdition. While we are not confident of what to expect from a new governing party, we are quite sure that if the incumbents were to return, Canada's economic growth will remain constrained and its fiscal position will worsen. We will wait to learn more of our next group of parliamentarians before we adjust our investment strategy accordingly.