October 2017

Portfolio Review – Oct 2017

2017 – Third Quarter Review

Equities:

Worldwide equity markets were up modestly in the third quarter.

Worldwide equity market returns were up modestly in the third quarter.

The Canadian market[1] gained 3.7% in the third quarter bringing the total return for the year to 4.4%. The Canadian market saw most sectors post gains over the quarter, with Energy and Financials seeing the strongest gains, while the Health Care, Utilities and Real Estate sectors were modestly negative.

In CDN$, the U.S. market[2] gained 0.5% in the third quarter. Though the U.S. market posted a 14% return year to date in USD terms, because of the strength in the Loonie this year, that translated into a CDN$ return of only 5.9%. The International Developed[3] market was also up modestly in CDN$, returning 1.1% in the third quarter for a total return of 12.25% for the first nine months of the year.

Interest Rates and Currency:

Yield on 10-year Government of Canada bonds jumped from 1.75% to 2.10%.

Interest rates continued to increase during the quarter with the yield on 10-year Government of Canada bonds moving from 1.75% to 2.10%. This compares to a rate of 1.00% at the end of the third quarter last year. Even with this increase, interest rates remain very low by historical standards.

The value of the Canadian dollar relative to the U.S. dollar continued to increase in the third quarter - rising from $0.77 to $0.80 USD. So far in 2017 the value of the Canadian dollar hit a high of $0.82 USD in mid-September and a low of $0.73 in mid-May. As discussed in our previous Quarterly Reports, the current exchange rate for U.S. to Canadian dollar is in-line with “fair value” as estimated by the concept of Purchasing Power Parity.

Investment Concepts – Inflation and Interest Rates

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[1] S&P/TSX Composite
[2] S&P 500
[3] MSCI EAFE (Europe, Australasia, Far East)

A consistent theme in our Quarterly Letters is to address topical investment concepts that clients have likely seen in the news or other information sources.

Both the Bank of Canada and the U.S. Federal Reserve have recently increased their benchmark short term interest rates. This increase in the benchmark rates has set the stage for higher interest rates throughout the economy. This change is significant because for several years the central banks have been lowering rates to stimulate higher economic growth and reduce unemployment. This increase in the benchmark rates is a signal that the central banks are switching gears and are now focused more on containing inflation and less on stimulating economic growth.

This change in Central Bank Policy has led to increased discussion of *interest rates* and *inflation* across media outlets. To help clients less familiar with these topics we thought it timely to discuss them in more detail, highlighting the interconnection between the two topics and how they impact investment choices.

Inflation

At its most basic, inflation is a measure of how prices of goods or services rise (or fall) over time.

At its most basic, inflation is a measure of how prices of goods or services rise (or fall) over time. In Canada, inflation is tracked by the Consumer Price Index (CPI). The CPI is an indicator of the changes in consumer prices experienced by the average Canadian consumer. It is obtained by comparing, at different points in time, a fixed basket of goods and services that represent what a typical Canadian consumes. The components within the basket are assigned different weightings that reflect their portion of what a typical consumer spends. The content of the CPI basket is reviewed and updated periodically to ensure it remains relevant. The CPI is published monthly by Statistics Canada.

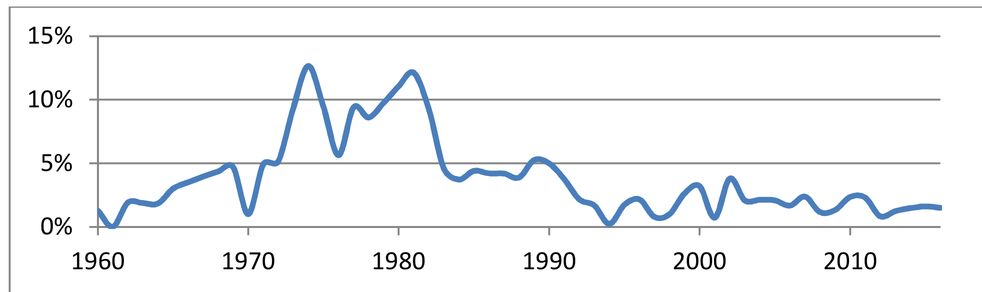
Measuring and understanding how inflation is calculated is important as it is used to adjust contractual payments such as Old Age Security, Canada Pension Plan, employment income or other pension payments. It is also used by central banks, such of the Bank of Canada, to guide monetary policy decisions that ultimately determine short-term interest rates.

Even at a relatively low inflation rate of 2% a year, in 15 years it would take about $1,350 to purchase the same basket of goods that could be purchased for $1,000 today.

Most importantly, inflation can have a significant impact on investors who are looking to protect and grow the *purchasing power* of their capital to support their future lifestyle. Even at a relatively low inflation rate of 2% a year, in 15 years it would take about $1,350 to purchase the same basket of goods that could be purchased for $1,000 today.

The rate of inflation has varied significantly over time but since the Bank of Canada implemented an inflation control target in 1991 (currently 2%, with a control range of 1% to 3% around this target), the variation in the annual rate has been reduced significantly.

Consumer Price Index Inflation Canada



Source: Statistics Canada

While understanding the CPI index and how changes impact investors, it is important to realize that there are some limitations to the calculation.

The CPI measures the change in price of a fixed basket of goods over time and does not necessarily represent the change in the amount of money required to sustain a lifestyle.

First, the CPI represents the change in prices encountered by a typical consumer in Canada but may not be reflective of the actual price changes experienced by a given individual or household. For example the basket of consumable for a retiree is quite different than the average consumer with a greater proportion of spending allocated to recreation, and health and personal care which have experienced more rapid price increases than the overall basket.

Second, the CPI measures the change in price of a fixed basket of goods over time and does not necessarily represent the change in the amount of money required to sustain a lifestyle. It may feel like the cost of sustaining a certain lifestyle is increasing by more than 2% a year but this is often driven by increasing lifestyle expectations. Twenty-five years ago, a mobile phone was a very expensive luxury. Today, it is considered a necessity that costs $600 a year. This additional cost makes life “feel” more expensive but is not necessarily captured in the inflation data.

Each individual has their own and potentially higher, inflation rate that needs to be accounted for.

Finally, how the CPI accounts for changes in housing costs is another key limitation. The CPI does not directly reflect increases in housing prices (particularly in places like Vancouver). The CPI measures changes in the price of consumables, so increases in rental rates and interest payments on mortgages are captured but the high cost to purchase a home is not reflected in the calculation of the inflation number.

The important take-away is that while the published inflation rates may be relatively low, each individual has their own (potentially higher) inflation rate that needs to be accounted for, which puts additional emphasis on investing in securities which will, over time, protect and grow purchasing power.

Interest Rates

The interest rate is the price paid for borrowing money.

There is no single interest rate. Each transaction between a lender and a borrower has a different interest rate but there are key benchmark interest rates against which other transactions are measured. Three key benchmark rates in Canada are:

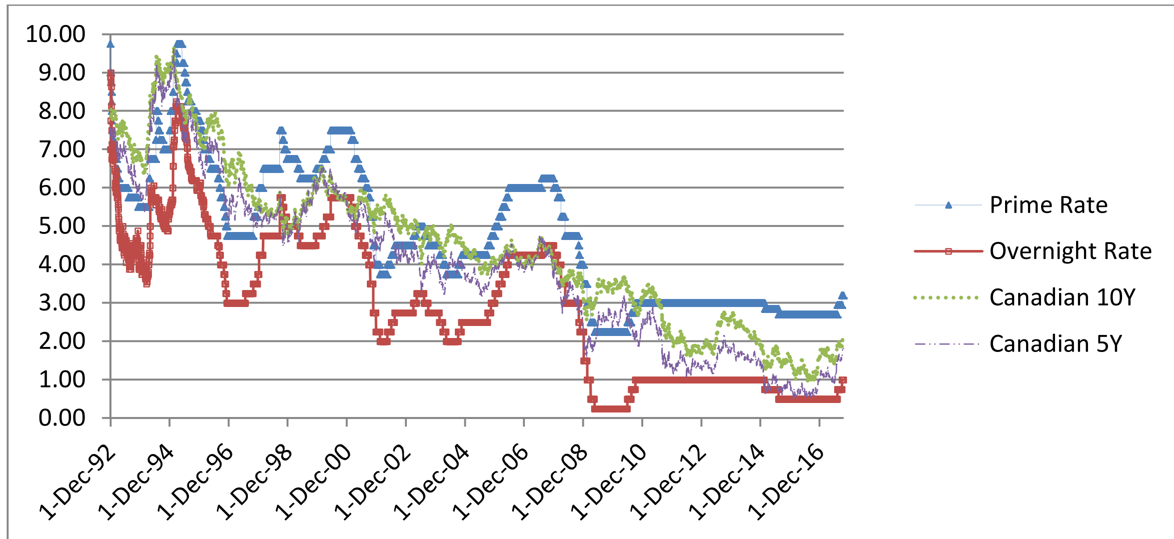
- Overnight Rate: The overnight rate is the interest rate at which major financial institutions borrow and lend one-day funds amongst themselves and is set by the Bank of Canada. This rate serves as the benchmark that financial institutions use to set interest rates for loans. To achieve their inflation target, the Bank adjusts the policy rate. The objective of the Bank of Canada is to preserve the value of money by keeping inflation low, stable, and predictable. If inflation is above target, the Bank may raise the policy rate of interest. Doing so encourages financial institutions to increase interest rates on their loans discouraging borrowing and spending and thereby easing the upward pressure on prices. If inflation is below target, the Bank may lower the policy interest rate to encourage financial institutions to lower interest rates on their loans and mortgages and stimulate economic activity through borrowing and spending.

- 5 and 10-year Government Bond rate: As the Government is considered the least likely to default on its debt the rate at which it can borrow strongly influences the rate at which others can borrow. If a company wishes to borrow, the interest rate they need to pay will be more than the Government of Canada bond rate.

Interest rates are ultimately determined by the supply of funds available to be lent and the demand for credit.

- Prime Rate: The prime rate is the interest rate Canada's major banks and financial institutions use to set interest rates for loans with variable rates. The prime rate is influenced by the overnight rate but is not directly tied to it. Each financial institution sets their own prime rate but, in reality, the prime rate between institutions is very consistent.

Key Benchmark Interest Rate January 1st 1993 to September 25, 2017



Source: Bank of Canada

Interest rates are ultimately determined by the supply of funds available to be lent and the demand for credit, but there are a number of other factors that influence the interest rate.

- Tenor of loan: In general, the longer the loan, the higher the interest rate.

- Credit quality: The more likely a borrower will default, the higher the interest rate.

- Structure of the loan: Different loans have different priorities in terms of being paid back in the event of default of the borrower. The lower the priority, the higher the interest rate.

- Inflation expectation: The higher the inflation rate is expected to be, the higher the interest rate to compensate for the expected loss of purchasing power.

For investors, there are a number of key take-away:

Government of Canada bonds currently would provide long-term investors with very little opportunity to grow their purchasing power over time.

1. Over the past 30-years, there has been a downward trend in interest rates and inflation, with interest rates appearing to have reached a bottom. While we are not anticipating a rapid increase in interest rates from here, increases in interest rates will have a negative impact on bond prices as interest rates and bond prices are inversely correlated.

2. Interest rates have remained relatively low, and with the rate on a 10-year Government of Canada bond currently just over 2%, interest income provides long-term investors with very little opportunity to grow their purchasing power over time.

3. Earning higher interest rates always comes with taking on more risk. A lender can be compensated for this risk, but it is important to remember that an investment that pays significantly more that the Government of Canada rate comes with some form of risk.

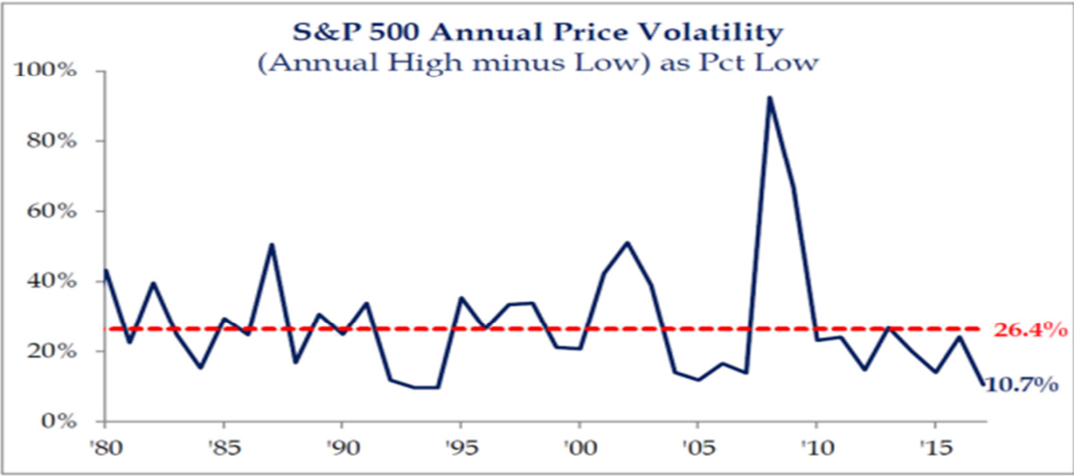
Outlook & Strategy

So far in 2017, volatility has been exceptionally low.

At the top of our list of Investment Fundamentals is the idea that earning higher investment returns requires accepting short-term volatility. Investors control for risk through diversification and having an investment portfolio that is appropriate to their circumstances. Learning to live with short-term market volatility is crucial to long-term investment success.

So far in 2017, volatility has been exceptionally low. The following tables show how few days the U.S. Market has experienced price movements in excess of +/- 1% and how small the difference has been from the high to low. The same has been true for the Canadian Market where there have been only three days with moves in excess of +/- 1%.

We do not expect this phase of low volatility to continue.



Source: Strategas Research Partners

We do not expect this period of low volatility to continue. Investors must be aware that volatility is a reality in the equity markets and that corrections will occur.

With that said, we continue to believe that a well-diversified portfolio of equities offers the best way for investors to protect and grow the purchasing power of their capital.

We will be reaching out to you in the next few weeks to review your portfolio. ***However, if there have been any changes in your circumstances which would impact or change your investment objectives, please give me a call immediately to discuss.***

Sincerely,

CYPRESS CAPITAL MANAGEMENT LTD.