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Investing based on reality, not hope

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Hope is like that colourful paper umbrella we occasionally find in our cocktails. It elicits a warm and sunny feeling but it does not change the ingredients of the drink. In investing, the comforting effects of hope tend to obfuscate the truth and lead to excessive risk-taking, typically resulting in undesirable outcomes. The recent rally in equities along with a cheerful narrative in the media suggests that the anticipated actions and policies of U.S. President-elect Donald Trump are the cure to current global economic ailments. Yet leading up to the election, his ideas were regarded as harmful to the economy. There is also much confusion about what Trump's actions and policies will be. Facts and fundamentals do not justify the recent market moves.

What remains clear is that the cyclical and structural headwinds to global growth still exist today as they did prior to election day. Most developed nations and many developing ones, including China, are mired in record high levels of debt. Wage growth in the developed world continues to decline, mainly driven by technological advancements, constraining consumers' spending power while keeping a lid on inflation. Aging demographics continue to limit potential growth, putting the onus on productivity enhancements to do more of the heavy lifting for the economy. More recently, the rise of populism has been about levelling the playing field by reversing key growth drivers such as free trade and immigration. Based on reality, investors should be treading carefully and moderating their expectations for corporate earnings and GDP growth.

The ideas put forth by the President-elect are potentially stimulative in the short term at best but likely not helpful in the long term. Tax cuts and infrastructure spending can provide a short-term boost through higher net profits, higher disposable income and increased jobs. This would, however, add to an already-heavy national debt load and therefore amount to borrowing from the future of American people and businesses through ultimately higher taxation. The hope is that the economic lift provided by the fiscal stimulus would offset the debt-servicing burden, similar to past experiences in U.S. history. Note, however, that in 1981 when the late U.S. President Ronald Reagan took office, the public debt-to-GDP ratio was a manageable 31%. This figure has more than tripled since then and currently stands at 105%, making it much more difficult to "make America great again" through additional government spending. Lastly, backpedalling on globalization through trade restrictions and tariffs cannot be constructive to growth.

Although Trump's actual plan is fuzzy and many holes can be poked into his proposed ideas, investors are giving the next administration the benefit of the doubt and voting with the buy button. We think this is premature. However, the current positive sentiment can continue to drive equity valuations higher, in which case we will look to progressively increase protection across the portfolios. In the recent "risk-on" environment, government bonds have been on the defensive due to expectations of rising inflation and accelerated interest rate hikes by the U.S. Federal Reserve. We believe that any rise in inflation would be short lived and would eventually give way to the longer-term, disinflationary trend that is driven by technology. As such, many sovereign bonds are now priced attractively at the long end of the maturity curve. We value long bonds as a low-cost hedge against recession risk and they will continue to play an important role in the income-centric portfolios.

We all know that investing and emotions do not mix well together, yet we are seeing this take place in the market today. The narrative in the media to date has been mostly positive on "Trumponomics" and the financial markets have clearly reflected this optimism. Despite the holiday season, we believe it is our duty to ignore the cheerful hype, as intoxicating as it may be, and focus on facts and fundamentals. It certainly feels good to have hope, just as it feels good to have a paper umbrella in your cocktail. As investors, we simply appreciate the umbrella for what it is, then set it aside and make investment decisions based on reality.

Best wishes for the holiday season!

Combined top 15 equity holdings as of November 30, 2016 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Microsoft	6. Toronto-Dominion Bank	11. Roche
2. Wells Fargo	7. Tourmaline Oil	12. Apple
3. Altagas	8. UnitedHealth	13. Walgreens Boots Alliance
4. Chubb	9. Alphabet – Class C	14. Bank of Nova Scotia
5. PrairieSky Royalty	10. Atco	15. Loblaw Companies