# TURNER INVESTMENTS COMMENTARY

**Hon. Garth Turner PC**

*Senior Vice President, Private Client Group, Financial Advisor*

416-346-0086

**Douglas Rowat**

*Vice President, Private Client Group, Portfolio Manager*

416-777-6403

**David Finley**

*Senior Vice President, Private Client Group, Financial Advisor*

416-777-7002

## WHAT TO EXPECT WHEN YOU'RE EXPECTING (A RATE INCREASE)

*"I'm too blunt to be a politician."*

*- Donald Trump explaining in 2004 why he wasn't interested in running for president*

### REMEMBER 2004?

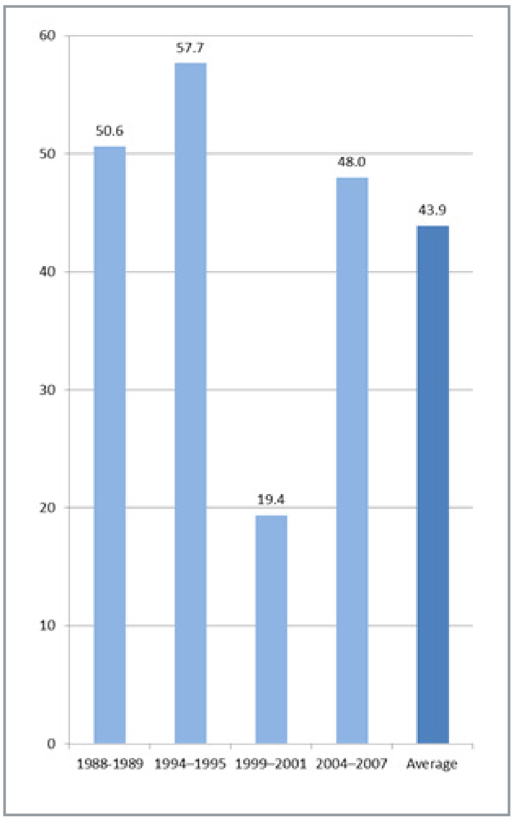
The last time we were at the precipice of a US Federal Reserve (Fed) rate tightening cycle was 2004. George W. Bush was still the president (Barack who?), Paul Martin was our prime minister, Stephen Harper had only just entered the leadership race for the new Conservative Party of Canada, Greece made headlines only because it was hosting the Summer Olympics and Donald Trump was still just a humble businessman. In other words, an entire generation of investors has never experienced a rising interest rate environment. While it's unlikely (though not impossible) that a rate increase will come at the Fed's next meeting on September 17, it's a virtual certainty that the Fed will begin raising interest rates at some point later this year. Given the incredible length of time that rates have been kept at the historically low 0.25% level—almost seven years—the first rate hike will be, even though it's widely expected, the biggest business and economic story of the year. It's also assumed that the first Fed rate increase will simply be the start of many more to come. Historically, rate increases are virtually never done in isolation—one is typically followed by many and the Fed has clearly been telegraphing its intention to gradually move back to a more normalized interest-rate environment. What "normal" means is subject to much debate, but it certainly isn't 0.25%, which is massively below the long-term, 30-year average of almost 4%. The past four rate-hike cycles also all ended north of 5%, though admittedly such levels are hard to envision at this stage.

So, given the magnitude of the Fed's remaining meetings this year and the likelihood of steadily rising US interest rates, what should our clients expect from the holdings in their portfolios? Our client portfolios are divided into three major asset classes: equities, bonds and preferred shares. Below is how we expect each to react as we enter a new era of higher rates.

## EQUITIES

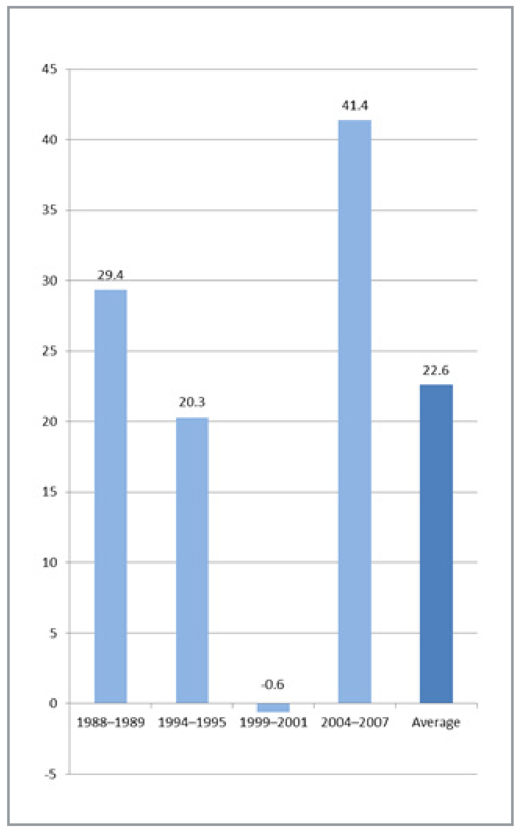
Equity investors often fear higher interest rates because it's assumed that higher borrowing costs will stifle corporate growth. Just as higher interest rates make it more difficult for us to finance a new home or car, they also make it more difficult for businesses to fund their own purchases and expansions. Also, the improved yields for bonds after an interest rate hike make a position in stocks relatively riskier and therefore less appealing. Sound arguments. However, rate increases are generally only considered by central banks during periods of strong economic expansion—and a stronger economy means increased corporate profitability. There have been four US rate-increase cycles in the past 30 years and each has been accompanied by strong earnings growth for S&P 500 companies (see chart below).

**S&P 500 Earnings Growth (%)**
**During Previous Fed Rate-Hike Cycles**




Source: Bloomberg, Raymond James Ltd. A rate-hike cycle is defined as a period of multiple increases in the Federal Funds benchmark overnight rate. Any rate cut ends the cycle. Earnings growth not annualized.

**S&P 500 Returns (%)**
**During Previous Fed Rate-Hike Cycles**




Source: Bloomberg, Raymond James Ltd. A rate-hike cycle is defined as a period of multiple increases in the Federal Funds benchmark overnight rate. Any rate cut ends the cycle. Market returns not annualized. Total return.

Further, and most importantly, rate increases have usually been accompanied by strong equity market performance. The only exception was the 1999–2001 cycle and this was a result of the rapid collapse of the Internet bubble. We don't see nearly the same level of 'bubble' danger in the US market currently, as valuations are far more reasonable now than they were in 1999 when investors were rampantly speculating on unprofitable companies. We also continue to believe that the US economy is quite stable. A few examples:

- US light vehicle sales have grown for six consecutive years (with 2015 shaping up to be the seventh consecutive year). At a seasonally adjusted annual rate in August of more than 17.5 million vehicles, US auto sales have fully recovered to pre-credit crisis levels and have almost doubled from their 2009 credit-crisis lows.
- US existing home sales are similarly strong, sitting at their highest levels since February 2007. According to The National Association of Realtors, existing home sales this year are on track to record their biggest gain in eight years.
- US Non-Farm Payrolls, a critical labour market indicator, have now recorded gains of at least 100,000 workers for 38 consecutive months! And have averaged a monthly gain of 243,000 workers over the past 12 months. Compare this to 2009, which had job losses every month for the entire year, often with employment dropping by more than 700,000 per month. Further, the US unemployment rate at 5.1% is now roughly half of what it was at the height of the credit crisis.

Therefore, while rate hikes may increase near-term equity market volatility, we don't believe that they will derail the strong US economy or the current US equity bull market. Corporations and markets have fared just fine during previous periods of Fed tightening. Within the growth asset portion of most of our clients' portfolios, US equities have the largest weighting.

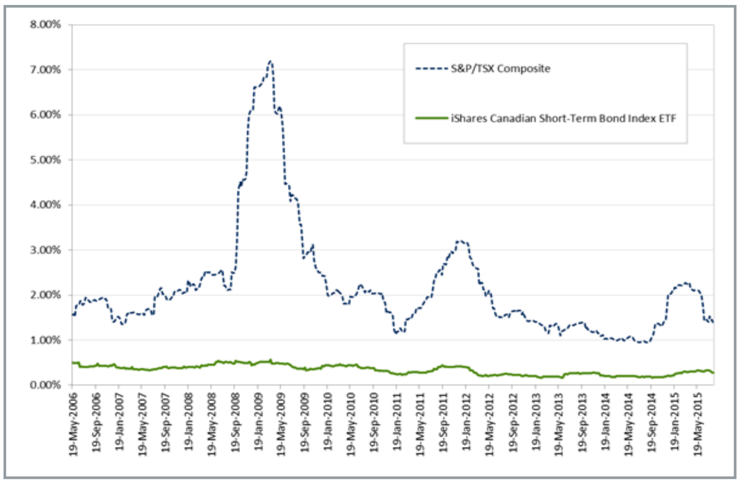
## BONDS

While the correlation is not perfect, central bank rates definitely shape the long-term direction of bond yields. Therefore, as benchmark interest rates go up, it generally means bond yields will go up as well, which, of course, means bond prices will fall. This means bond prices may move lower once the Fed starts raising rates. Indeed, the market has already begun pricing in this likelihood as US Treasury yields have been moving steadily higher since February. Canadian bond yields have done the same albeit at a more modest pace.

To guard against a potential decline in prices, we have positioned Canadian government bond exposure in our client portfolios towards the shorter end of the yield curve through the inclusion of the iShares Canadian Short-Term Bond Index ETF (XSB-T). So, what does this mean, and why have we adopted this strategy? Short-term bonds have less sensitivity to interest rates. It's actually attributable to the number of coupon payments bondholders are entitled to. Years ago, investors would physically detach a paper coupon, which entitled them to a payment from the bond issuer. Naturally, long-term bonds had many coupons and short-term bonds had fewer. This forms the basis of their interest rate sensitivities. If interest rates move higher, all coupons for existing bonds automatically become less valuable because new bonds are being issued with higher, more valuable coupons. Therefore the prices of existing bonds will correct to adjust for all of their now below-market coupons. Naturally, if you hold a short-term bond you will have *fewer* below-market coupon payments and therefore its price will correct less. This is why it's better to hold short-term bonds in a rising rate environment and this is how we've positioned most client portfolios.

We also highlight that the central purpose of bonds is not capital gains, but rather to provide steady, reliable income and, even more critically, to control volatility. For example, the chart below illustrates the difference in standard deviation (also known as volatility or risk) over time between the broad Canadian equity market and the iShares Canadian Short-Term Bond Index ETF we highlight above. Notice how much smoother and more predictable the bond ETF line looks? This is the point: effectively the bond ETF is 'calming' investors' portfolios and discouraging them from making reactionary, emotional decisions during periods of equity market volatility.

**The Main Purpose of Bonds is to Control Volatility:**
**Canadian Equities vs. the iShares Canadian Short-Term Bond Index ETF (Rolling Standard Deviation)**




Source: Bloomberg. Raymond James Ltd. Six-month rolling standard deviation. Standard deviation measures the amount of variation or dispersion within a particular index. In other words, it measures the risk of owning that index.

## PREFERRED SHARES

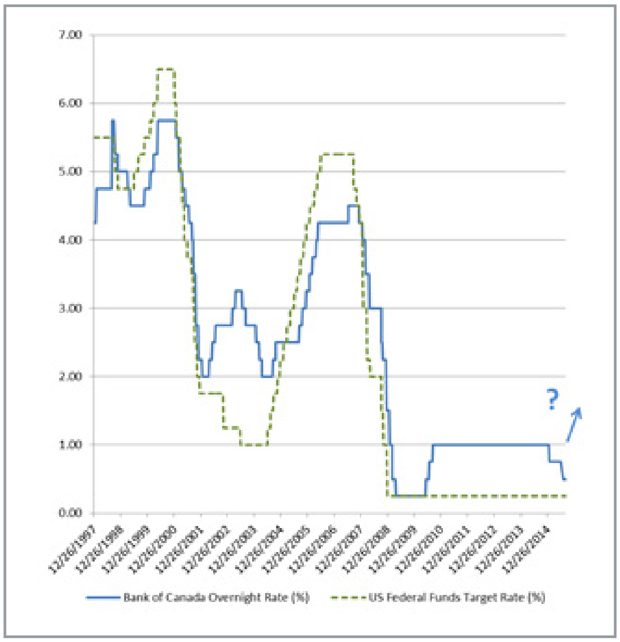
We have detailed how preferred shares are poised to strongly benefit from higher interest rates and higher bond yields in our previous newsletter ("The Case for Preferred Shares"), which is available on the www.turnerinvestments.ca website. However, to summarize briefly:

- The Bank of Canada almost always adopts an identical interest rate policy to the US Fed (see chart below). If the US raises rates, eventually Canada does as well. Most Canadian preferred shares are structured as rate-resets meaning their dividends are indirectly pegged to the Government of Canada (GoC) 5-year bond yield. Therefore higher bond yields are positive for their prices. The correlation between US 5-year Treasury and GoC 5-year bond yields is nearly 93% over the past 25 years! In other words, if US bond yields move higher as result of Fed rate hikes, Canadian bond yields will almost certainly move higher as well.

- Preferred share yields are compelling. Preferred shares yield roughly 5% currently, which is attractive relative to almost all other income-generating investments particularly corporate bonds. And this yield is in addition to their price appreciation potential. We believe that bond yields will continue to slowly advance and if bond yields move higher, preferred share prices will likely move higher as well.

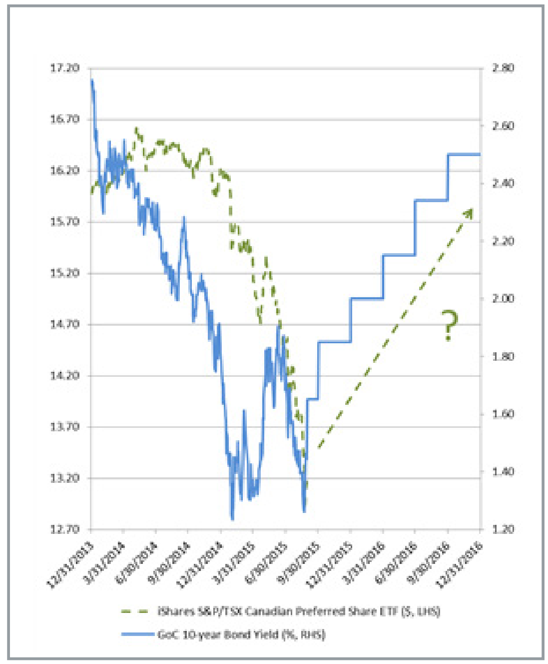
We've stated previously that we believe preferred shares represent one of the best asset classes for protecting against rising interest rates. We believe that a few years from now Canadian preferred shares will likely be seen as one of the biggest beneficiaries of the Fed's upcoming rate-hike cycle.

### Canada's Interest Rate Policy Moves in Lock-Step with the US




Source: Bloomberg

### If Bond Yields Move Higher, So Should Preferred Share Prices




Source: Bloomberg. Rate-reset preferreds are pegged to GoC 5-year bond yields, but forecasts are only available for the 10-year yield. The overall relationship is similar however. The bond yields beyond mid-2015 represent the consensus forecast of 20 leading economists.

## HIGHER US INTEREST RATES: WE'RE READY

Higher interest rates are on the horizon, but we believe our client portfolios are effectively positioned for when this occurs. We believe a higher Fed funds overnight rate will not derail the US equity bull market because the US economy continues to do well. Bond prices may gradually decline, but bonds are necessary for controlling market volatility and most client portfolios have been positioned in short-term bonds, which have less interest rate sensitivity. And, finally, there are preferred shares. We believe this is an exceptional time to own preferred shares because their rate-reset structures allow them to do well as bond yields rise. It seems odd, but *Canadian* preferred shares will likely provide some of the best portfolio protection against the future interest rate action of the *US* Federal Reserve. Overall, we think the three main asset classes in our client portfolios—equities, bonds and preferred shares—are well positioned for higher rates. It's been a long wait, but a US rate-hike cycle is almost upon us. Like it or not, it's happening—like a Donald Trump run for president.


TURNER INVESTMENTS OF RAYMOND JAMES LTD.

40 King Street West
Suite 5300, Toronto, Ontario M5H 3Y2

Tel: 416-777-7000 | Fax: 416-777-7020

www.turnerinvestments.ca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