KEATSCONNELLY
ENRICHING YOUR CROSS-BORDER LIFESTYLE

March 31, 2017

REVIEW OF THE FIRST QUARTER

The first quarter of 2017 saw the continuation of strong stock market performance we have seen over the past several years. The S&P 500 total return index (an index of US large company stocks), ended the quarter up 6.1%.[1] Canadian stocks, as measured by the TSX were up 2.41%.[2] The performance of foreign stocks was also strong, and fared even better when adjusted for currency (USD weakened which bumped returns from foreign stocks). Investors seem to only remember one direction for stocks, and that is up!

The US economy has been strong lately and the Federal Reserve, the central bank of the US, has taken note. During the Fed meeting in March, they raised interest rates by another quarter point, which marks the third time that interest rates have been raised recently. After a period of seven years since the downturn and the recovery, the Fed has kept interest rates near zero. Only in December 2015 did they finally raise rates a quarter point after discussing the option to do so for several years. The rate hike in March 2017 is the third rise; with the second occurring in December 2016. Janet Yellen, Chair of the Federal Reserve, has come out with the bold assertion that she expects the Fed to raise interest rates three more times in 2017. The Fed has set expectations of higher rates several times in recent years. We remain skeptical of any future rate hikes.

Rate increases generally have an impact on bonds, and investors are concerned about bond positions in a potentially rising rate environment. Whenever we have discussions with investors about this topic we communicate these three main points:

One, rate hikes are not necessarily a bad thing. If rates are rising, bond market participants generally perceive the economy is doing well. A strong economy may impact your investments in other positive ways and may be good for your overall portfolio.

Secondly, potential losses in bonds are rarely of the magnitude of stock losses. By way of example, if rates rise 1% a diversified bond portfolio might lose 5%. Rarely have investors seen losses of 10% in investment grade bonds in a one or two-year period. Contrast that to stocks, where losses of 10% or more occur every couple of years throughout history. [1]

Lastly, higher income can make up for some of the loss to principal that occur if interest rates rise.

To sum up our view concerning bonds and rising interest rates, we think investors should not be too concerned about the potential of rising interest rates. We continue to believe that bonds are an important part of a diversified portfolio and can protect in times of stress in markets.

We do however have concerns about market valuations. US and Canadian stocks are at high valuations relative to their historic values, and very high valuations relative to their CAPE P/E ratios. The CAPE P/E stands for cyclically adjusted price-to-earnings ratio and is a metric that measures current valuations relative to their long-term averages, considering the vagaries of the business cycles. Using this measure, US stocks are at or close to the valuation levels seen in the late 1990s tech bubble.

KeatsConnelly
ENRICHING YOUR CROSS-BORDER LIFESTYLE

This will likely not continue forever. We are not recommending investors reduce their exposure to stocks because we believe stocks are the best place to get growth in a portfolio over the medium to long term. We have seen investors that have stayed the course through downturns in the technology bubble and the mortgage crisis and have been rewarded with long-term returns that have allowed them to grow their portfolios by remaining allocated to stocks.

We don't recommend our clients reduce their exposure to stocks simply because some pundits predict a stock market drop. However, we do have some investors with relatively conservative portfolios asking if they should increase their allocation to stocks. Our response is to continue with the current allocation, but should we see a significant pullback in the market, we would consider an increase to stocks in the portfolio.

We have also been monitoring the US dollar (USD). Historically, when the Fed raises short term rates, the US dollar strengthened. [3] As some investors around the world see that they can achieve a higher interest rate on their short-term cash in USD than they can in their local currency, money has poured into USD, which caused the US dollar to strengthen. Although this is the historical relationship, it does not always hold, and it may not hold this time. USD has strengthened so much in the past two years that it is, by some measures, "over-valued" relative to its past ten year averages.[1]

Investment Research

We have embarked on a new calendar of investment research for 2017. In the next few months we intend to review US stocks, including our evidenced based factor investing approach to value and small cap stocks. We are taking a closer look at the emphasis we place on factors and building a valuation based approach to monitor and adjust it in the future. We are also looking at fundamental indexing as a possible replacement to the DFA approach we have used for nearly two decades. There are many new smart beta products in the marketplace today. Most of these are just variations on the same theme, however some have merit and deserve a deeper review of their methodology. It is our intent to keep you informed on the investment research we are conducting through monthly updates like this research note.

Recent Developments

If you have not had a meeting to review your investment portfolio, you should expect to hear from your KeatsConnelly planner soon.

Please notify us should you have any life changing events that may require a review of your current asset allocation. If you have any questions concerning this communication, please contact us.

[1] JPMorgan Guide to the Markets – April, 2017, [2] Morningstar Office – Performance Charting – April, 2017, [3] Wall Street Journal – Currency Charting – April, 2017

Sincerely yours,
KeatsConnelly

John E Rice

John E. Rice, CFA®, CFP®
Chief Investment Officer