CIBC
CIBC Wood Gundy

CIBC World Markets Inc.
606 – 5811 Cooney Rd
Pacific Business Centre
Richmond BC V6X3M1

Tel: 604 270-6457
Fax: 604 273-7684
Toll Free: 1 800 341-9909

January 2018

Year Ahead Outlook

In this issue:

Record low stock market volatility, can it continue?
Bitcoin mania provides a warning sign
Artificial Intelligence (AI) and Electric Vehicles (EV) – exciting new industries but are they “investible”?
Risks in the bond market
Calls and puts (also known as options) – how they can be used to increase income and decrease risk
Private equity/debt, potential new asset classes
Advisor Managed Accounts (AMA) - our new discretionary account service
Miracle Day

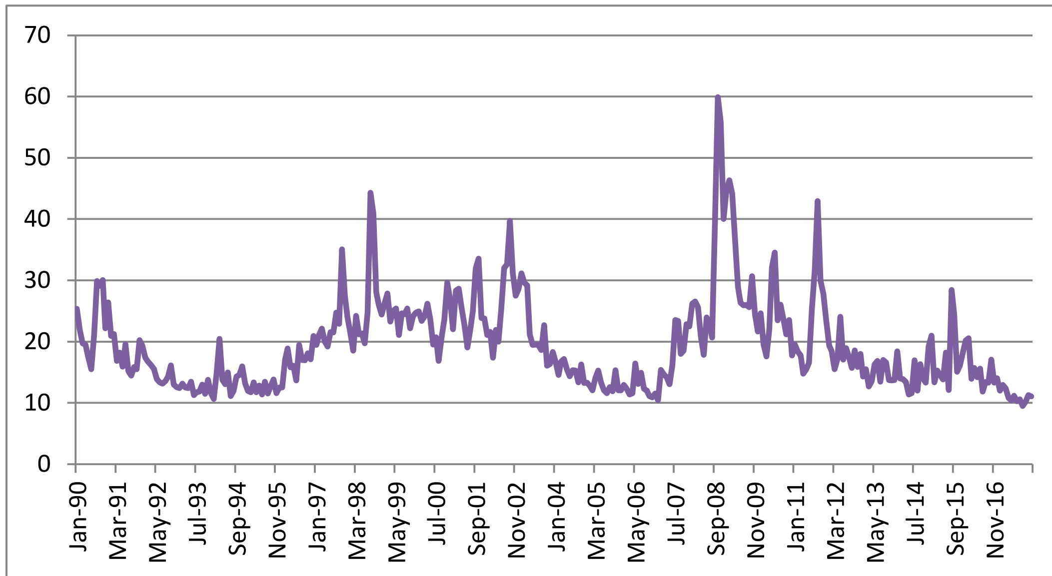
Record low stock market volatility, can it continue?

In our January of 2017 “year ahead outlook”, we said that returns may be lower than what we had been experiencing over a good number of years. As it turned out, accounts performed well in 2017.

While returns in 2017 were decent, we remain somewhat cautious heading into 2018. With about forty percent of our typical account in fixed income investments (yielding about 3.5% on average), we repeat what we said last year. To generate an 8% return overall, the remaining (sixty percent) equity portion of a portfolio will need to generate a return of 11%. That will be difficult to earn over the long-term from levels that markets currently trade.

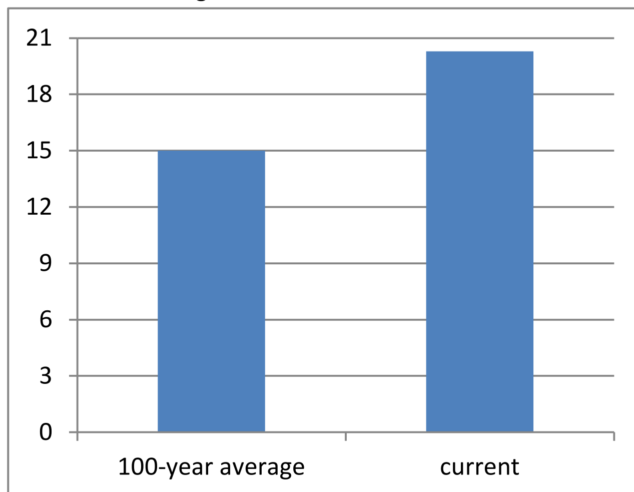
Now, let’s talk about risk. There is a measure of volatility called “The VIX index”. See Figure 1. This measures the extent of “ups and downs” experienced by the stock market and these days the VIX index is very low. In fact, it’s been so low for such a long period of time, that investors may be getting lulled into a false sense of security. The next material drop in stock prices (when it comes) may seem like a shock, when in fact, it will be a normal part of the investing process, correcting a degree of overvaluation. This unusually low volatility is surprising given the uncertainty in Washington and the instability in geopolitics around the world. All we can say for sure is that there will inevitably be a period when volatility will increase and typically this happens during a “down market”. Later on we will outline our game plan for handling this scenario .

Figure 1 – The VIX index is a measure of volatility of stock markets
Source: Thomson One



With the most expensive developed market being the high flying U.S., let's now look at how expensive U.S. stock prices are versus historical norms.

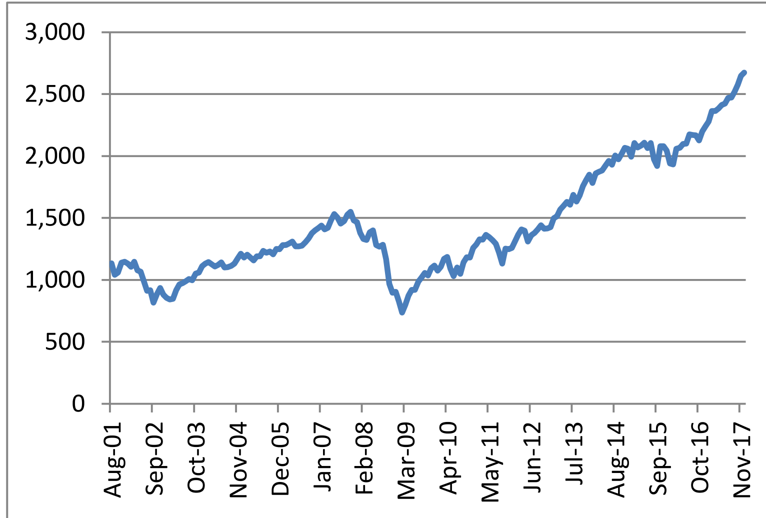
Figure 2 – The current S&P 500 price-earnings ratio vs the 100-year average
Source: Bloomberg



As you can see the U.S. stock market is expensive, thus we need to somewhat dial back future return expectations. The 100 year average price-earnings ratio is about 15, and at the moment, the U.S. stock market is trading at close to 20 times forward earnings. We have to be particularly careful when we see a high price to earnings ratio when the economy is doing fairly well and earnings are above historical norms (like now in the U.S). That does not mean markets can't keep increasing, climbing the proverbial 'wall of worry' for a while longer, given we are still in a low interest rate environment (causing many investors to choose stocks over bonds); but when stock price valuations get stretched, that's a "caution signal."

Now, let's take a look at where stock markets are trading from a long-term standpoint by looking at charts on the three main geographical areas we can invest in:

Figure 3 – Performance of the S&P 500 (U.S. stocks)
Source: Thomson One



As Figure 3 shows, the U.S. stock market is trading at very high levels. Fortunately, the other two main areas we can invest in (Canada and Europe/Asia) are not looking nearly as high price wise.

Our Canadian stock market looks in a normal long-term price range while Europe/Asia is actually trading lower than about ten years back (prior to the big downturn of 2008/09). Valuations (price-earnings ratios) are also a bit cheaper in Canada, Europe and Asia, relative to the U.S.

Figure 4 - Performance of the S&P/TSX Composite Index (Canadian stocks)
Source: Thomson One

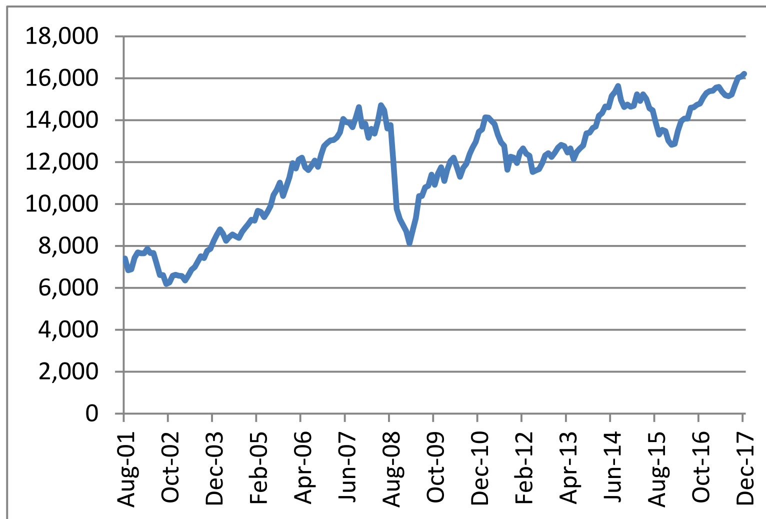
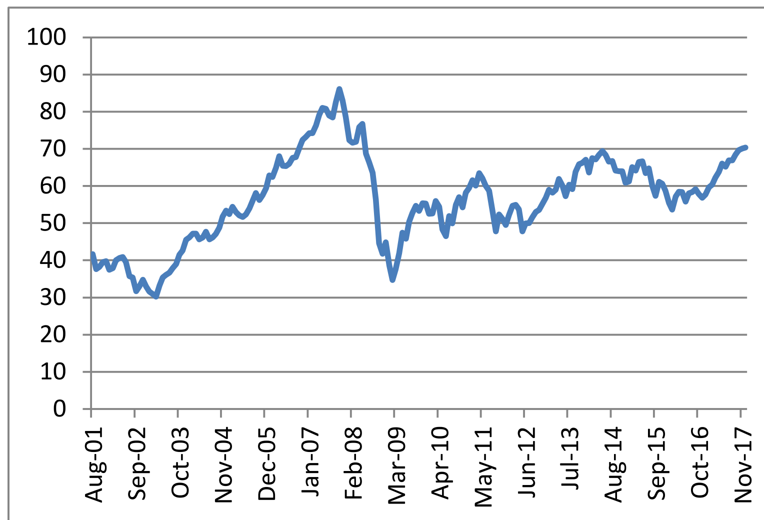


Figure 5 - Performance of iShares MSCI EAFE ETF (Europe/Asia stocks)
Source: Thomson One



We attribute outperformance of the U.S. market to various factors:

- The U.S. federal reserve was the first Central Bank in 2009 (under then Federal Reserve Board Chairman Ben Bernanke) to drop short- term interest rates to close to zero and engage in the economic experiment of "quantitative easing" or "QE" (a term to describe printing money and using the same money to buy back bonds and mortgages with the objective of lowering medium and longer term interest rates). I call this an 'experiment', as we have yet to see how this incredibly aggressive approach to monetary policy will fully play out. So far so good, but potential "asset bubbles" in stocks/real-estate plus a doubling of global government debt in the past ten years, incented by low interest rates, are issues that we have to pay attention to.
- Largely due to this aggressive monetary policy, the U.S. economy recovered at a faster rate than most economies to the point where today, it sees close to full employment.
- The Trump administration and the Republican Congress have just passed significant corporate tax cuts. While this has some probable negative long-term consequences (through worsening an already too high level of government debt), the U.S. stock market loves corporate tax cuts in the short- term due to resulting higher (after tax) corporate profits.

Our stance in terms of geographical diversification is to have an appropriate mix of Canadian, U.S, European/Asian, and small amount of emerging markets (China, India, Brazil etc.). We will not fall for the conventional trap of looking in a rear window and being overweight what has done the best (namely U.S.). In addition, we are underweighting the very expensive U.S. tech sector that is largely responsible for the high U.S. stock market.

Bitcoin mania provides a warning sign

A warning sign in terms of markets getting too high and greedy is when speculative areas of the stock market do well. An example is "cryptocurrencies". There are numerous new cryptocurrencies being

launched, as manufactures look to profit from the current ‘mania,’ with the main cryptocurrency, “Bitcoin”, trading at an incredibly high price.

While ‘blockchain technology’ (which Bitcoin depends on) is very promising in terms of bringing administrative and clearing costs down in the financial services industry, Bitcoin itself (as Ben Bernanke recently said at a conference in Vancouver) has no material societal value, but does provide criminals and tax evaders a method to avoid scrutiny. Clearly, cryptocurrencies are at risk of being regulated and if that happens, the price of these, Bitcoin included, could drop to fraction of what they trade for today.

Speculative plays like this may keep going up for a while but past history tells us these types of investment scenarios seldom end well.

Artificial Intelligence (AI) and Electric Vehicles (EV) – exciting new industries but are they “investible”?

With respect to artificial intelligence (AI) and electric (or fuel cell) operated cars (some of which will be self-driving as early as 2019); these emerging industries will certainly play a key role in the global economy going forward.

The world is changing exponentially these days - in terms of the speed of industry disruption - led by companies such as Uber, Tesla, Amazon, and various (small) robotic and AI companies.

Estimates are that in twenty five years, about forty percent of current jobs will be eliminated (or significantly changed) due to more efficient administration (powered by computers that learn using AI), robotics and self-driving cars/buses/trucks.

Almost any task that can be done manually and simply will be automated. How the world economy adjusts to this new reality is hard to say. We can expect a positive impact on corporate profit growth as companies get more efficient, but can the global economy create enough new jobs to make up for those that will be lost?

Many investors look at fast growing industries like these as a good way to make money through investing in stocks in these sectors. From experience though, this is trickier and riskier than one might think. For example, years back someone could have successfully predicted that cell phones would become ‘pretty popular’. In looking at how to invest in that emerging industry, one could have invested in all three of the companies that made most of the world’s cell phones back then (Motorola, Nokia, and Canada’s own Blackberry). Each turned into a disaster in terms of share price as Apple and Samsung emerged and took over. Throw in internet companies like Netscape, Yahoo, AOL and MySpace as examples of companies that performed poorly after a promising start despite being in fast growing industries.

Even when we clearly identify winners, they always seem to be very expensive share price wise (e.g. Amazon, which is only now earning a profit after many years of losing money, and trades at an incredibly expensive 400 time earnings). Tesla is a great company but it has yet to earn any degree of

profit and its valuation is so rich that it's market capitalization is larger than Ford, while it sells only a fraction of the cars that Ford sells. Tesla will have to deal with intense EV competition in the future so buying the stock at these levels is dangerous. This is not to say the company won't do well in future, but the share price risk is too high for our liking.

There is a much safer way to ensure we always own the companies that are successful over the long-term and that is to invest in what are called "market capitalization weighted indexes" through exchange traded funds (ETFs).

Our average client has about fifty percent of total stock exposure in six equity ETFs; which in turn, own over 10,000 companies around the world. As capitalization weighted indexes are weighted more towards the largest companies (as ranked by market capitalization), we will always own companies that are prospering well (as measured by the firms 'total market value'). Thus investing through ETFs means we automatically stay up-to-date with whichever companies emerge, adapt, and grow successfully.

As we are trying to minimize downside risk right now, we are ensuring our individual stock positions (that typically represent the remaining fifty percent of stock exposure), are more defensive and reasonably priced companies. In addition, we are investing in companies that sell products or services that are (on average) less sensitive to an economic downturn.

While we don't foresee a recession in the short term, we are getting very long in the economic and stock market cycle so, we want to ensure each and every individual stock we own can hold up reasonably well in terms of its fundamental business during a downturn.

Risks in the bond market

Now let's turn ourselves to the bond market. Our three main challenges are:

- Low interest rates.
- Interest rates are increasing which pushes bond prices down.
- Investors are not getting 'paid' to take much risk in terms of investing in issuers that are rated below investment grade, namely "high yield bonds". At a current six percent average yield, given default risk, the risk /return trade-off is not that attractive. Plus, to avoid taking 'individual issuer risk' with these riskier, but better paying bonds, we need to use a fund or ETF, which means a higher money management cost than owning individual bonds.

Our overall stance is to avoid very low yielding risk-free government bonds and GICs (for most clients), and instead continue to concentrate on decent quality corporate bonds, with only a small degree of exposure to high yield bonds. We continue to avoid long-term bonds as they can fall sharply in price when interest rates increase.

As said earlier, our target return on the bond portion of client accounts is about 3.5%. Targeting a bond return higher than this carries too much risk at present.

Calls and puts (also known as options) – how they can be used to increase income and decrease risk

Is there anything else we can invest in other than conventional stocks and bonds?

This leads us to introducing two new potential assets classes that can we believe can assist us in this somewhat challenging (going forward) bond and equity market.

One is to utilize a conventional option strategy called "covered call writing" the other is called 'private debt/equity.

Thirty years back, yours truly, along with almost all rookie financial advisers, were encouraged by our then investment industry to take the options course and exams. Rick and Susan are also licensed to trade options. The only method I ever used was "covered call writing" which gives up most of the upside of common stock prices in exchange for locking in total yields of 8% to 10% per year. This can be a good strategy when stock markets are starting to look high in price (when we do not mind giving up most of the share price upside in exchange for this high - tax efficient income). This in an active strategy that can only effectively be implemented in our commission free discretionary accounts- to be discussed shortly.

There are numerous other ways to invest in options, some of which entail taking high risk. In our practice, we will take the safe approach; thus, only use options to either increase current income or minimize downside risk. We will never use this asset class for speculation.

Private equity/debt, potential new asset classes

Canada's three largest pension funds (CPP, OMERS and Caisse Depot) have gone from almost zero to about thirty five percent exposures to private debt and private equity. Examples of private debt are owning portions of toll roads, toll bridges, or pools of private loans and mortgages.

What has attracted pension funds to these asset classes is the higher income than can be earned (vs. conventional bonds) combined with low to no degree of price correlation to publically traded equities and bonds. Thus, this can be a good hedge method/strategy to help us through a down market. Most of our interest is in "private debt", not "private equity".

The only type of "private equity" that is attractive to us is owning a pool of commercial buildings privately in order to eliminate the public market risk of real estate investment trusts (REITs). As the value of a portfolio of privately owned buildings is determined by appraisals, not its market trading price, volatility is normally low. This avoids the risk of publically traded REITs getting caught up in a broad financial market downturn such as the 2008/09 recession. At that time, REITs dropped almost as much as stocks (while the value of the buildings they owned hardly dropped at all).

Our firm (and industry) is taking a cautious approach in terms of allowing use of these products in client accounts; but I anticipate our industry will do go down the path that pension funds have, and approve

more of these products for consideration. We will be very careful with this asset class in terms of any investment we choose.

Ideally we would like our clients to own up to four different private debt pools and one private equity pool representing perhaps ten percent of overall exposure (so two percent in each pool). Hopefully this strategy can be implemented in the not too distant future as more products are approved, for our consideration.

Advisor Managed Accounts (AMA) - our new discretionary account service

This new service platform allows us to take care of trading decisions for you automatically, while continuing to communicate with you on "big picture" items like account reviews, financial planning, tax and estate planning, etc.

Suffice to say we believe that more proactive investment management and quicker trade execution will help us do the best job we can in terms of portfolio management. We also prefer to group our trades together in one large block so we can trade "institutionally". This eliminates most of what is called "bid/offer spread cost", which occurs when we have to trade out each security one at a time.

The commission free aspect of trading also allows us to better keep portfolio's up to date (ensuring all investments are in what we would buy today for new money); and it will allow for the use of "covered call writing" discussed earlier.

By now we have introduced this method to most clients and many clients are now set up this way. What we thought might be a one year process is taking us a little longer, but we hope to have a significant majority of clients set up in this manner by the end of this year; and all new clients are being set up this way.

All existing clients have a choice as to carrying on "as is" or to use this new method. Cost for this method of money management is typically about the same as what a client pays currently. We are pricing this service as low as our firm will allow us to.

We are under no illusion that trading quicker and more efficiently through this process will magically enable us to escape bad markets or substantially add to client returns. No matter what method we use, the theme of this letter remains that we have challenges going forward. Having said this, we would not be implementing this method if we did not believe it will add value.

Miracle Day

We are happy to announce that (together with the other financial advisor team in our Richmond branch), that we have we added a second school to our annual support of the "Scientist In Residence Program".

All funding is from a portion of earnings from you, our valued clients. Thank you for supporting this innovative program whereby scientists from UBC works with teachers and children taking science at inner city elementary schools. This year we are supporting Strathcona and General Brock schools in East Vancouver.

Final Thoughts

The deadline for RRSP contributions is the end of February. Maximum contribution for 2017 tax year is $26,010. And for early birds, the maximum 2018 contribution is $26,230. Refer to your Notice of Assessment from CRA for your contribution limit.

Thank you very much to our clients who mentioned our team to friends, colleagues, or family members this past year. We continue to take on new clients with present or future investible assets in the one million dollar range (or sons or daughters with ANY amount of funds whatsoever).

We cannot thank all clients enough for allowing us to work with you. It's an honor and privilege.

All the best in 2018!

Kind regards,

The Pope Team

Neil Pope, MBA, CIM
First Vice-President, Portfolio Manager
(604) 207-8578
neil.pope@cibc.ca

Rick Aulik, CFP, CIM, FCSI
Investment Advisor
(604) 207-8585
rick.aulik@cibc.ca

Susan Christie, CFP, BA, CIM
Associate Investment Advisor
(604) 207-8570
susan.christie@cibc.ca

Melanie Burns
Client Associate
(604) 207-8583
melanie.burns@cibc.ca

Cheryl Sy, BSc
Client Associate
(604) 207-8581
cheryl.sy@cibc.ca

Sophie Tu, BComm
Client Associate
(604) 207-8576
sophie.tu@cibc.ca

Disclaimers

This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2018

CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada.

Clients are advised to seek advice regarding their particular circumstances from their personal tax and legal advisors.

Options involve risk and are not suitable for all investors. Investors should be aware of tax considerations, margin requirements, commissions and other transaction costs, as they may significantly affect the economic consequences of any option transaction strategy and should be reviewed carefully with your Investment Advisor and personal tax advisor before the strategy is undertaken.

Securities

BlackBerry Limited 2g,7

Disclaimers

2g CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.

7 CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.