GROW TOGETHER

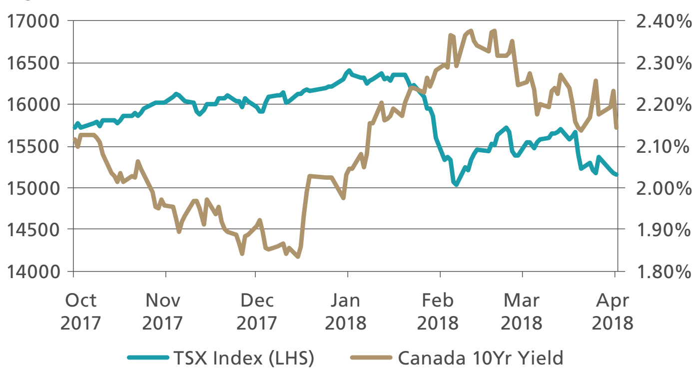
CWB Wealth Management Newsletter | **Apr 2018**

Message from David Schaffner, President and CEO

Are we there yet?

To answer the question, let's consider what "there" is. Is it referring to the stock markets potentially having peaked back in January? Or is it the possible bottoming process in the stock markets since then? Is it yields possibly having reached their peaks in February along with expectations of U.S. and Canadian central banks raising short term rates due to higher inflation risk? Or is the recent modest decline in rates the most we will see? It will come as no surprise to the readers of GT Quarterly where we stand: don't focus on the short term, think of "there" as the destination in your financial plan.

Figure 1



Source: Bloomberg

Last quarter we talked about a number of fundamental and market factors that supported the long term growth of our portfolios.

Let's review what, if anything has changed. Economic growth is still supportive, earnings are growing, and central banks are only gradually removing the monetary stimulus punchbowl. Interest rates, while higher than last year, are nowhere near punishing levels.

But risk is on the rise, with burgeoning trade wars figuring prominently among the political factors. The increase in risk to the stock markets has reduced the prices investors are willing to pay for company earnings. It is this reduction in the price/earnings ratio that has been a big driver of lower market prices so far this year. As shown in figure one, there have been modest declines in equity prices and modest increases in bond yields (the inverse of a fall in bond prices). The volatility of stock prices has also increased.

While lower prices, higher yields and higher volatility are not good in the short run, using a longer term perspective on getting "there" in our financial plans, this has provided opportunities to add some attractive companies to our client portfolios.

As the M&P teams outlines in their article on international investing, the uncertain political climate in Germany along with higher interest rate expectations have increased the attractiveness of two German utility companies.

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And as the AIM team points out in "Are Rates on the Rise", even if interest rates do continue to increase of over time, higher rates are beneficial for savers in the long term. The bottom line is to pay less attention on what the media fixates on as "there", and more on what opportunities this can provide to get to "there" in your financial future.

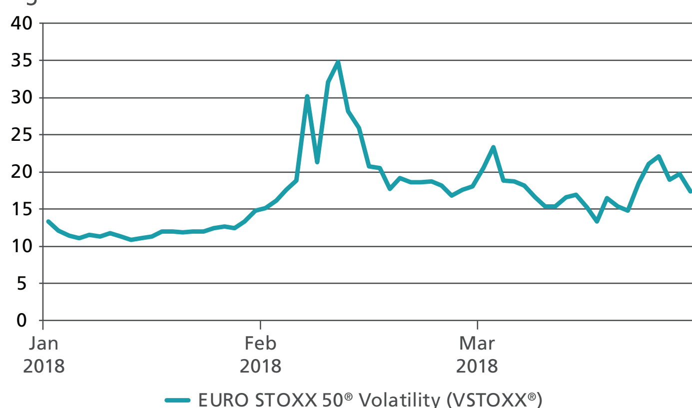
Confusion in Europe

by M&P research Team

On the international side, Europe has not been spared from investor concerns around macro uncertainty. The FTSE Developed Europe Index has returned -4.8% in Euros YTD. However, the monthly performance numbers have reflected anything but stable trends. European markets started the year on a positive note with January returning 1.55%. However, the index turned negative and returned -4.1% in February.

The VSTOXX index measures the volatility in returns of the EURO STOXX 50 Index, Europe's leading blue-chip index. The index covers 50 stocks from 11 Eurozone countries. Higher VSTOXX levels are indicative of higher levels of volatility. The spike in volatility in February and generally higher levels of volatility post-January within the EURO STOXX 50 index is shown in Figure 2:

Figure 2



Source: https://stoxx.com/index-details?symbol=V2TX

The first tenet of our investment philosophy is "Seek The Truth," which leads us to focus on objective and fundamental data beneath the headlines. We feel that the market's concerns, as they relate to the European region, are premature and exaggerated. According to a BofA Merrill Lynch Global Fund Manager survey, the top concerns at the back of global investors' minds include a trade war, followed by high inflation expectations and Central Bank policy mistakes such as tapering bond purchases abruptly or hiking rates aggressively. While in January the narrative was one of strong growth in the Eurozone, it has recently changed to the potential negative impact of a stronger Euro on exports from the region. However, according to the latest PMI data, the region continues to demonstrate a robust pace of expansion. Even a pickup in inflation is not negative given that it is a lagging indicator of growth. Moreover, equities provide a natural hedge against inflation as they produce nominal earnings and sales growth, which grow faster when inflation rises. On the policy front, the ECB has dropped its pledge to buy bonds in larger sizes or increase monthly asset purchases once again. Even though this was an expected incremental shift, it surprised the market. However, in our view this does not represent an abrupt policy shift and is also a signal of ECB's expectations of continued strong growth within the region.

Finally, political uncertainty in the continent has been another cause for investor pullback. The Italian elections did not deliver a clear winner while in Germany a coalition announcement between two of Germany's leading political parties, the SPD and Angela Merkel's CDU, was delayed.

Uncertainty and confusion amongst the broader market participants can provide us with opportunities to purchase businesses at greater discounts to their intrinsic value. The uncertain German political climate along with rising interest rate expectations provided us with opportunities within the German utility sector, one of which we highlight below.

Company in Focus: RWE

Since 2008, German integrated electricity providers have been plagued by a number of issues including weak European energy demand, falling coal and gas prices, and capacity additions from renewable sources. Furthermore, the sector was facing enormous nuclear decommissioning liabilities, following the German parliament's May 2011 decision to eliminate nuclear power production in the country. One of the tenets of our investment philosophy is "We Are Different." Our process leads us to closely examine areas of the market that may not be popular with consensus views as this inspection can sometimes lead to a discovery of appealing opportunities. What attracted us to the German utility sector was a changing industry landscape coupled with attractive valuation levels. From a legal and regulatory standpoint, two developments removed uncertainty regarding the liabilities associated with the abolition of nuclear plants in Germany. First, the German government passed a law that reassigned responsibility for the country's nuclear waste from the utility providers to the state, thus removing future recourse against the companies. Second, the German Constitutional Court retroactively annulled the nuclear fuel tax that was paid from 2011 to 2016 by the German utilities, resulting in material refunds and enabling the companies to de-lever their balance sheets.

Although the German utilities were entering a new era for the industry in a much healthier state, their stock prices declined during 2018 due to the uncertain German political environment and the expectation for rising interest rates, as discussed above. This allowed us to start positions in two of Germany's leading utilities, EON and RWE, at favourable entry points.

Figure 3: EON and RWE Stock Prices

Source: Capital IQ

RWE is historically the second-largest electricity producer in Germany after EON. RWE housed the conventional coal generation assets in addition to owning 77% of Innogy, a company that held the grid infrastructure (regulated transmission and distribution) and the renewable generation assets. For RWE, the valuation was building in extremely pessimistic scenarios. For some context, RWE was trading at a stand-alone EV/ EBITDA multiple of 2x versus an average of around 8x for the European utility sector. In our base case, we saw an improving cash flow profile with an assumption of stable power prices supported by nuclear capacity closures.

In RWE's case, we also did some valuation work on what we referred to as a bull case. RWE's holding in Innogy attracted a lot of M&A interest in the last year. Innogy's CEO also resigned in December 2017 after revising down the company's mid-term earnings targets, as well as focusing on growth versus a Board of Directors and investor base that wanted more cash flow and dividend stability. This impacted Innogy's share price negatively. In our bull case we expected Innogy to either appoint a new CEO that would restructure the company or that RWE would find a willing buyer for Innogy.

Finally, RWE also has earnings upside from refinancing its debt at lower interest rates similar to EON. We initiated a position in EON in January 2018 and RWE in early March. Shortly after we initiated our position in RWE, it was announced that EON and RWE reached an asset swap deal under which EON will get all the transmission and distribution assets of the combined business and RWE will obtain the renewable assets. We see the transaction as accretive to both company's earnings and, hence, we further increased our weight in both companies post the announcement. The stock prices of EON and RWE over the last one year are highlighted in Figure 3, along with our approximate entry points.

Are Rates on the Rise?

by AIM Research Team

For decades, interest rates have been marching lower and lower, testing the "how low can they go" question. It seems that question was finally answered in September 2016, when Canadian 10 year bond yields plummeted to 0.95%, and a number of European issuers traded at negative rates.

The question now on investors' minds is, are rates finally heading upwards? And what does this change mean for us?

Canadian inflation in February surged to its highest rate in more than three years. As reported by Statistics Canada, the 12 month increase of 2.2% was significantly higher than consensus estimates, driven by higher gasoline prices, cost of housing, interest on mortgages, auto loans and restaurant food. The strength in inflation makes it increasingly likely the Bank of Canada will raise its key rate by another ¼ % in May.

Events south of the border are feeding inflation as well. The tax bill recently passed in the US provides fiscal stimulus at a time where the US economy is already doing well. Promised infrastructure spending will only add to the stimulus, as will major promised outlays for disaster relief and the military. It is estimated the effects of this fiscal policy will add .8% to GDP growth this year, and 1.2% next year. *(BCA Feb.26) As a result, the US Fed is expecting to raise rates 3 or 4 times this year.

Central banks are not the only ones who have an effect on interest rates. Look no further than Mr. Trump's recent instructions to impose tariffs of $50 billion on Chinese goods. Among China's possible responses was that they would reduce purchases of and possibly holdings of US Treasuries. China accounts for close to 20% of all foreign holdings of U.S. government securities.

Weaker demand from major debt buyers will drive up interest rates on Treasuries. Combined with all the fiscal stimulus promises detailed above, the US deficit is estimated to jump to 5.5% of GDP next year, from 3.3% in last year's forecast. Potential weaker demand from international buyers at a time of increased government borrowing could lead to a double whammy.

"Bond vigilantes" are yet another factor that could have an impact on interest rates. Bond vigilantes were last active in the 1970's and 80's, when bond holders grew concerned about profligate government spending. Bondholders used to pay more attention to government deficits, forcing officials to curb inflationary policies, or risk an upward spiral in interest rates. Today, as deficits continue and debt levels grow, and central banks slowly move to normalize rates, the cost of funding the accumulated debt increases greatly. At some point, bondholders are bound to take note again.

Increased stimulus spending and growing debt levels are not unique to the US. In our own backyard, our recent Alberta budget puts us on track to accumulate a total debt of of ~$96 billion within 5 years. At more than 170% of household income, household credit debt is at record highs, and continues to edge higher. Corporate debt is also up – the debt service ratio for Canada's (non-financial) sector is the highest in 20 years.

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What does this mean for investors? Key indicators point to continued economic strength in developed economies. Upward pressure on inflation is growing, but slowly. Earnings projections for companies remain strong. In the short term, our "Goldilocks markets (not too hot, not too cold)" can continue.

In the long run, the two trends of growing debt and rising interest rates are like a slow moving train wreck. They will collide. The mountains of debt will cost more and more to service, for governments and individuals alike.

Savers will benefit. Allocators of capital will benefit – as capital becomes more expensive, more sensible allocations decisions will be made. Those who rely on their investments for income will no longer be forced to reach for yield in low quality investments.

As governments start to come to terms with the increasing interest payments on accumulated debt, taxes will almost certainly increase. Forward looking investors will make sure they are taking maximum advantage of TFSA's, RRSP's, and other tax planning strategies.

Please keep in mind that nothing is certain other than death and taxes – so our view on interest rates could be wrong. Regardless of how our financial landscape unfolds, a financial plan that is updated regularly to reflect current realities will allow you to navigate any environment with confidence.

After-Tax Rate of Returns

by Wealth Advisory Services

Just as taxes only let you keep a portion of your paycheque, they also reduce the return on your investments. Focusing on after-tax returns allows you to better assess investment choices.

How Investments are taxed

To determine your after-tax rate of return involves understanding how investments earn income and how they are taxed. Investments earn income in three ways: interest, dividends and capital gains.

Interest is earned within savings accounts & GIC's or by buying a debt instrument like a bond, either on its own, or through a fund/ETF. A company will make payments to you (interest) on the amount that you have lent to them. Interest income is taxed at your current marginal tax rate. For example, a Saskatchewan (SK) professional earning $141,000 per year will pay 40.5% of the interest they receive in taxes. A 4% interest payment has an after-tax rate of return of 2.38% (interest x (1 - tax rate)).

Dividends are a company's after-tax earnings paid out to shareholders and are taxed less than interest. When individual Canadians receive dividends from a Canadian company, the government gives a tax credit to help offset the tax that the company already paid on those earnings. After accounting for the tax credit, the tax rate applied to dividend income for someone earning $141,000 per year in SK is 19.98%. This reduces 4% in dividend income to 3.20% after-tax (dividend x (1 - eligible dividend tax rate). That's much better than the 2.38% they were left with on the interest payment.

Capital gains are the profit from selling an asset at a higher price than you paid for it. Taxes are assessed on 50% of the gain that was earned, reducing the tax rate of a Saskatchewan resident earning $141,000, on realized gains to 20.25% (0.50 x 0.405). An investment which has increased in value by 4% results in an after-tax rate of return of 3.19%. Another benefit of earning income through capital gains is that the gain is only taxed once the asset is sold. This allows you to time when you receive the income from capital gains, as opposed to interest and dividends that tend to pay on a set schedule.

Portfolio Returns What does this mean to the investment return that is presented to you by your portfolio manager or on your statement? For an investment portfolio return of 5% (1% interest + 2% dividends + 2% realized capital gains), your return is reduced to 3.79% after tax (1% interest x (1 - 0.405)) + (2% dividend x (1 - 0.1998)) +(2% capital gain x (1 – (.5 x 0.405))).

Strategies for minimizing tax in your portfolio

There are ways to arrange your investment portfolio to increase your after-tax rate of return. A thorough discussion with your portfolio manager about the mechanics of asset location may uncover opportunities to place higher taxed investments into low or tax deferred registrations. This discussion should examine all areas of your personal wealth including TFSA, RRSP, Locked-in accounts, savings, cash and corporate investments.

A CWB Wealth Management Specialist can help you walk through these planning techniques and work in-step with your Portfolio Manager. Considering all the factors is important and reviewing your tax situation goes hand-in hand with your overall wealth management strategy. Learn more at cwbwealth.com

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