The Navigator

A Quarterly Newsletter for Clients and Friends of Lighthouse Wealth Management

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Q3 2018 Market Update:

As people return from summer holidays, we have started to receive questions and concerns about the financial markets. We find ourselves in tumultuous times with active trade wars and other geo-political risks making headlines each day. We are pleased to bring you our 2018 Third Quarter Market Update, which we hope will answer some of your questions. More importantly, we will explain how we are recommending your portfolio should be positioned to manage the many risks we face as you seek desirable risk-adjusted returns from your investments.

We realize that recent gains have been strong. While we are pleased with the results that we are seeing, we are mindful of the many risks that could lie ahead and are working to protect your gains as we move into what we believe are the later stages of this bull market. At present, despite elevated levels of risk, markets continue to see reasons for optimism as strong economic fundamentals, accommodative monetary and fiscal policy, and technological change contribute to a year of strong earnings growth and allow share prices to catch up to lofty valuations, giving hope that there is still room for markets to run in tandem with a strong North American economy.

Valuations aside, we are also acutely aware of the key risks facing markets and have already taken steps to reduce risk in portfolios: being selective in the equity names that we suggest you own and increasing fixed income, preferred shares and cash allocations to both reduce risk and take advantage of what we view as attractive income opportunities. In doing so, we seek to strike a balance between desirable rates of return and managing risk to protect your capital and the gains that have been achieved. While we are mindful of making a mistake with respect to the timing of selling equities, we prefer to be conservative six months too early instead of six months too late. After many years of strong gains, the probability of approaching the end of this market cycle is rising, and with high valuations for most assets, the level of risk per unit of investment has risen. We believe now is an appropriate time to start deploying a more defensive strategy.

Clients who have been with us for a while will know that we were quite overweight equities, especially in the US. As the US Federal Reserve and other central banks slashed interest rates to generational lows and significantly increased the size of their balance sheets in response to the financial crisis, it pushed investors into equity markets in search of acceptable returns. The Eurozone crisis contributed to a flight to safety into US assets, which, at the time, seemed like the only place to go as the US Federal Reserve was providing unprecedented support for equity markets. With US fiscal policy doing very little to support the economy at that time, the recovery took much longer to materialize than was generally expected.

Today, it is fair to say that we have finally witnessed the long-awaited recovery, despite – to put it nicely – a US president with a very strong personality that has made most world leaders question the post Second World War international order and upset long-standing trade practices and alliances.

Indeed, US equity markets, as measured by the S&P 500, are within spitting distance of their recent all-time highs and the US economy has been churning out jobs as evidenced by very low unemployment and rising wages. While a booming economy is generally good for equities, the low unemployment and rising inflation that this generates has prompted the US Federal Reserve to commence an interest rate hiking cycle and monetary tightening campaign, calling into question how much support the market will receive in the form of easy monetary policy. As easy liquidity from the Federal Reserve was a key support for markets on the way up, it is reasonable to be concerned about the detrimental effect the Federal Reserve's plan to reduce liquidity could have on equity and other asset prices. Those who follow the bond market will note that falling yields on the longer end of the curve are suggesting there is reason to be concerned, although we have yet to see an inversion of the yield curve – an important predictor of a weaker economic period.

In addition to the risks posed by rising interest rates and monetary tightening, the volatile US administration poses its own set of challenges for investors by making markets and the global economy far less predictable, at least from a policy perspective. With unconventional decisions such as trade wars and significant deficit-financed fiscal stimulus being applied when its economy is already near capacity, the US administration has introduced a great deal of uncertainty that makes many people very uncomfortable as they make their own investment decisions. Canada, unfortunately, has been particularly hard hit by US trade demands to date, both socially and economically. While a positive resolution to trade disputes would be welcomed by the markets (and the opposite if negative), it is very difficult to know with any degree of certainty which way it will go, underlining the importance of diversity and balance in portfolios.

If we had to sum up the year-to-date, we are pleased with the returns that we are seeing and are happy that we suggested marginally reducing equity positions and adding to fixed income, preferred shares, and cash positions in January as the equity market was peaking, and these other investments were attractively priced. This reduction of risk cushioned the blow of a sharp equity market decline in February and has been a useful shock absorber as we cope with the era of volatility that seems to characterize the US under the current administration. By continuing to recommend an allocation to quality equity names, we were also able to participate in an equity market rally that pushed the S&P 500 to an all-time high of 2914.04 on 29 August 2018.

As we write this newsletter, the current bull market which began on 9 March 2009 (with the S&P 500 at 676.53 – this not a typo), is the longest running bull market since the Second World War and recently became the longest on record. The financial media made much about this achievement, and while the length of the bull market certainly does register as an outlier, we must remember that bull markets do not end for the sole reason that stock prices have gone up a lot – in each case, there was an external factor or set of factors that caused market perception and/or fundamentals to change, which caused the bull market to end.

We remain cautious and look for factors that could end the current bull market, believing there is no shortage of issues that could be the catalyst for lower stock prices. We also realize that we continue to be in one of the slowest moving recoveries on record, and while the current bull market is the longest in terms of time, the magnitude of this rise is not an outlier when compared against other bull markets: the S&P 500 rising by more than 300% since March 2009. This "low rise", when combined with strong economic fundamentals in North America suggests that this market could continue its ascent for a while to come, especially if we get a favourable outcome in trade disputes.

The distribution of risks in the market today and the uncertain political situation reiterates what has proven to be good advice: have a balanced and diversified portfolio. As the greatest political experiment in many generations continues to unfold, we will work to ensure that you have diversity in your investment portfolios, and that we balance the desire for satisfying market returns with the risks taken to achieve them.

Office Updates:

As the calendar turns to autumn, we find ourselves asking where the summer of 2018 has gone and preparing for what is poised to be an exciting fall season.

We enjoyed a little vacation time and took on two major tasks this summer: welcoming a new member to our advisory team and launching our website.

Sarah Middleton joined us in mid-August as an Administrative Assistant. Her voice will now greet you on the main phone line. We ran the summer months without admin support as Ashlee left in late June to pursue another opportunity. It took all of July and the early part of August for us to find the right person to fill this role.

Sarah brings several years of experience from another firm, having worked in both the administration office and in an admin role with a large advisory team. A local girl, Sarah was born and raised in Victoria and is a graduate of Belmont Secondary. Sarah and Dillon have a very energetic young daughter, Isla, and a busy home life on their small acreage in Shirley. We're happy to have Sarah join our team. Please feel free to reach Sarah by email at **sarah.middleton@holliswealth.com**.

Getting our website up and running has long been a goal of ours. We want our site to be unique and reflect our core values. When we started on the design and layout, we soon realized a theme was needed: one which reflects our West Coast location and geography, our core values and beliefs, and provides a unique identity in a crowded market place. After kicking around many names and images, we kept coming back to the image of a lighthouse. We believe this "checks all the boxes": an easy-to-recognize coastal landmark, an image of safety, strength and stability in all conditions, and a symbol that we can creatively use to brand our business according to our core values.

Lighthouse Wealth Management is our new business trade name. This name will now appear in our email signatures, on our business cards and letterhead, and was the design theme for our new office location. Our new website address is www.lighthousewealthvictoria.com. While there is still work to be done on the site, please bookmark it and refer back frequently. There is a link on the top-left corner of the "Your Resources" page labelled "Online Account Access" that will take you to view your accounts online.

We hope you like our new name and welcome your thoughts and feedback. **Our phone numbers and email addresses remain unchanged, as does our affiliation with HollisWealth.**

A Focus on Income:

We believe there are several interesting opportunities in the income space which may be of interest to investors who focus on investments which provide a steady stream of regular income. These consist of dividend paying stocks and REITs (Real Estate Investment Trusts), bonds, and preferred shares.

Rate-reset preferred shares remain at the top of our list as good income producing assets that should fare well in the current rising interest rate environment. We have identified select issues which currently trade below their original issue price and have attractive dividend yields that are now set for up to 5 years. **Please call us for specific examples and suitability in your portfolio.**

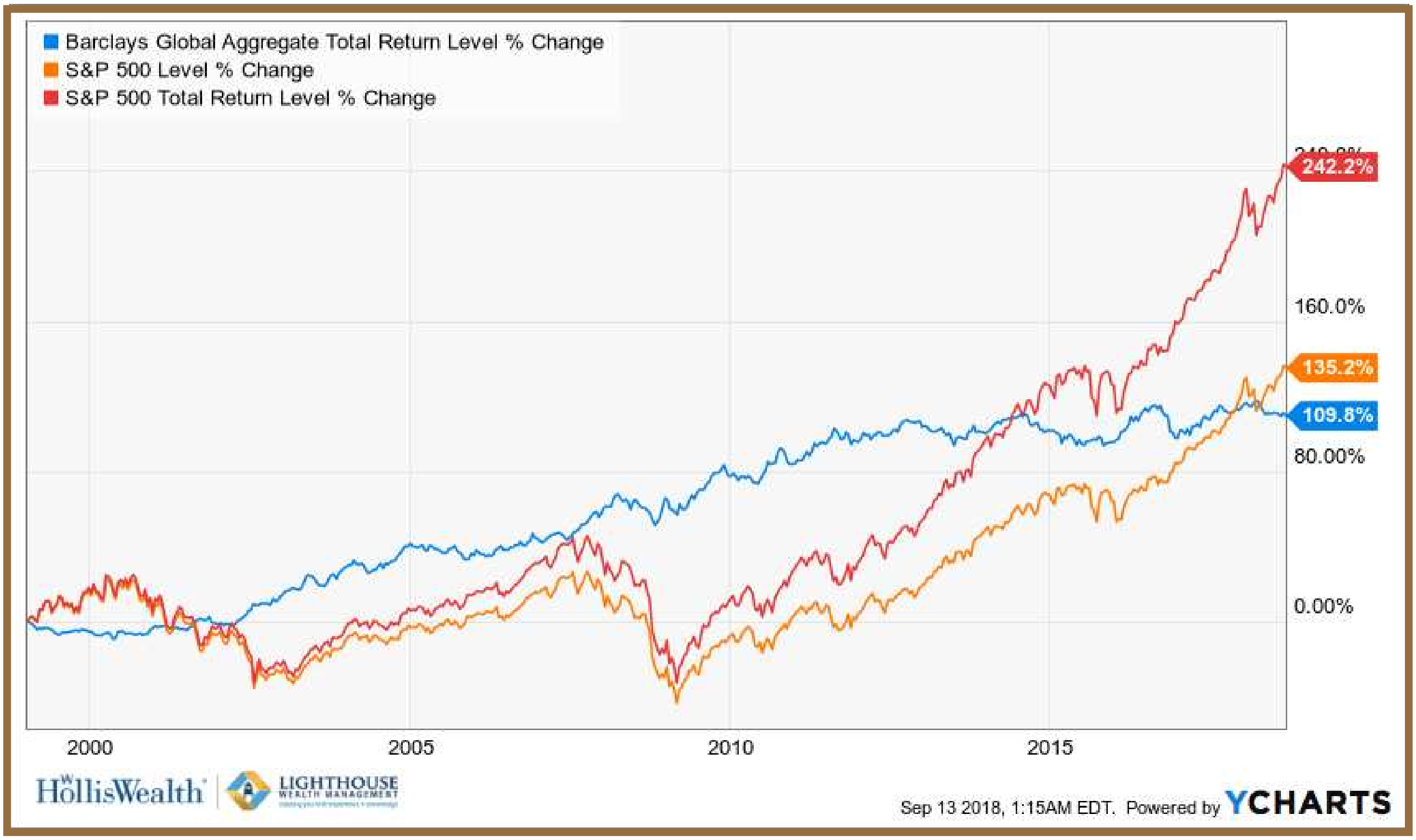
This quarter we show you a chart (see page 5) highlighting the importance of income, diversity and balance in your portfolio. In this example, we compare the difference in returns on the S&P 500 with dividends (red line) and without dividends (orange line) starting from January 4, 1999 to today.

The chart illustrates two important points regarding the equity portion of your portfolio: 1) dividends (the income portion of the return from holding a stock), represents almost half of the overall return in the 18 year period; and, 2) the difference between the price only return (orange) and the total return (including dividends - red) widens significantly post financial crisis after the US Federal Reserve and other central banks started to purchase government debt, thus lowering interest rates and making dividend yields more attractive relative to bond yields.

The blue line on the chart is the total return from the Barclays Global Aggregate Bond Index - a broad basket of global bonds across a range of maturities. For bonds, yield is the interest payment received, whereas for equities it is the dividend received. In both cases, yield is measured as a percent of price paid. If market interest rates remain constant over the life of the bond, there is no change in the price of the bond, and the return would equal on the fixed interest payments collected over the term of the bond.

If interest rates change over time, it impacts the price of bonds - rising interest rates reduce bond prices and falling interest rate increase them, all else equal.

Returning to the chart, we can see two interesting takeaways from the blue line: 1) The line has a consistent upward trend, and 2) it is far less variable than the other two lines. This consistent uptrend is the direct result of the general declining trend in market interest rates (and inflation rates since peaking in August 1981).

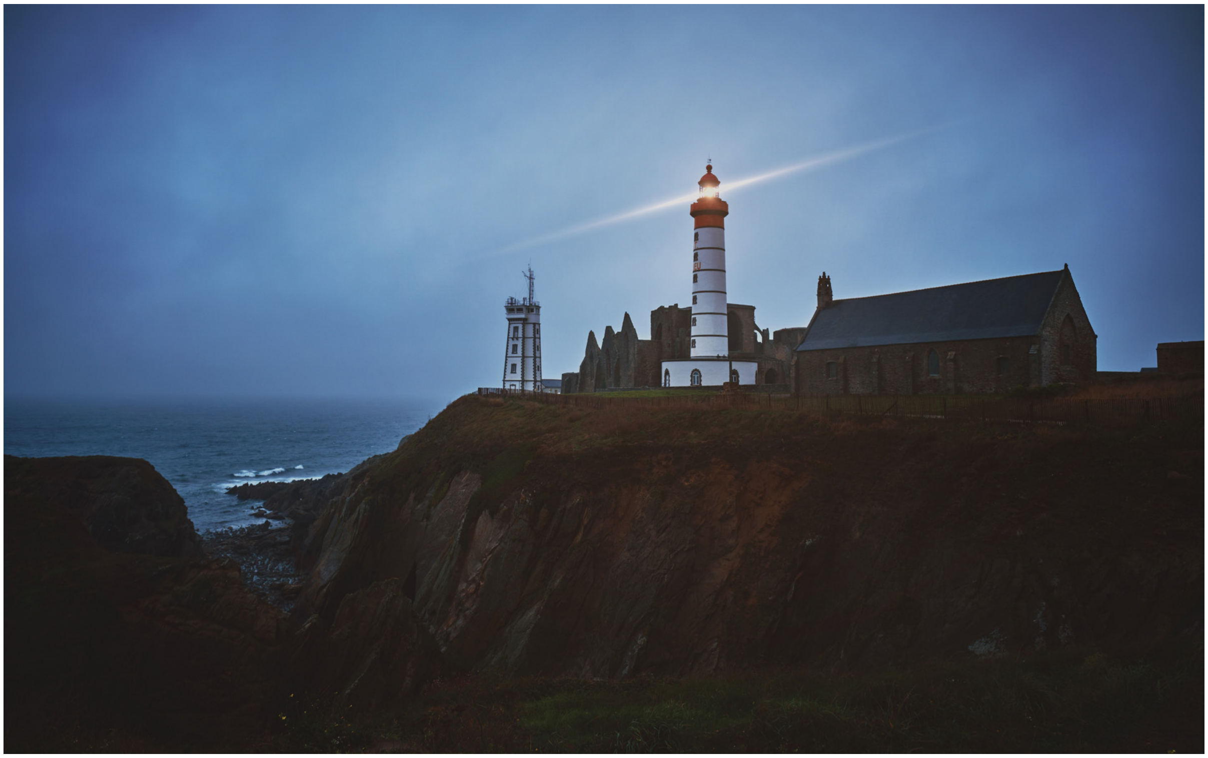


As falling interest rates push bond prices higher, the general decline in rates over the past 25 years resulted in significant capital gains for those holding bonds with coupon payments in excess of newly issued bonds (which are issued at lower rates). If the bondholder holds the bond until it matures, the unrealized gains will erode over time as the bond is redeemed at face value - the issue price.

However, the bondholder may choose to sell it prior to maturity, in which case, they would realized these capital gains (or losses should they be in a rising rate environment). In this case, we have gains and they have come with less volatiliy - what is not obvious from the chart is that fixed income tends to be negatively correlated with equity markets - meaning they move in opposite directions, reducing portfolio volatility.

There are differing views as to the direction of interest rates, this will be the subject of future newsletters. For now, we know that interest rate movements will be an important determinant of portfolio returns - as will the income you generate from your investments.

The next issue of The Navigator will be published in mid-December. Please check our website for other publications.



What We Believe You Should Know:

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Lighthouse Wealth Management is a personal trade name of David Charlebois and Stephen Gaskin.

What You Need to Know:

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