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Spring Showers Bring Flowers…and Budgets

Read more about some new announcements from the 2019 Federal Budget

Although it may not seem like it, March is an exciting month: the blooming blossoms signal the transition from winter to spring, days get longer through Daylight Saving Time, and the Federal Budget is typically released. As lovely as blossoms and longer days are, we at Hillside Wealth find the 2019 Federal Budget (titled *Investing in the Middle Class*) as the most exciting sign of spring – especially in this election year. We're going to table the promised discussions of risk management for next month and focus our attention on the meaningful items in this year's budget.

Perhaps the most surprising budget announcement has to do with the Home Buyers' Plan (HBP). The HBP is an initiative that helps Canadians purchase their first home by allowing them to withdraw funds from their RRSPs to help with the down payment. Funds withdrawn from an RRSP are 100% taxable, but under the HBP withdrawn funds are not taxed as long they are repaid to the RRSP beginning 2 years after the date of withdrawal in an amount equal to 1/15th of the amount withdrawn.

There were three proposed enhancements made to the HBP in this year's budget. First, the Government increased the amount eligible to be withdrawn from $25,000 to $35,000. Second, they want to allow those involved in a marriage or common-law relationship breakdown to be able to participate in the HBP even if they don't qualify. Last, but certainly not least, the Government is proposing to provide up to 10% of the value of the purchase price of the home as a "shared equity mortgage" that doesn't need to be repaid for years into the future.

Essentially, if the household net income is under $120,000/yr, then the Government will lend 5% as an interest free loan on resold homes or 10% if the home is newly built. The value of the mortgage and the interest free loan can't exceed 4 times of the household's annual income which puts the maximum amount available to be loaned out through the mortgage and the interest free loan at $480,000. $1.25B have been earmarked for the program over the next three years. There are still a lot of questions surrounding the revamped HBP; when do the funds need to be repaid, what happens if the value of the home increases or decreases. We will be sure to share more details as they develop.

Other meaningful announcements include the introduction of a Canadian Training Credit. Every year, Canadians between the ages of 25 and 64 can accumulate a credit balance of $250, to a lifetime maximum of $5,000. Beginning in 2020, Canadians could use their accumulated credit balance to cover up to 50% of the costs associated with taking a course or training program at an eligible institution. Information on Canadians' credit balances will be sent to them from the CRA. The credit will be available to Canadians who have earnings between $10,000 and $150,000/yr.

The Registered Disability Savings Plan (RDSP) is a fantastic way for Canadians, and their families, who qualify for the Disability Tax Credit (DTC) to save for their future (click here for a detailed description of the plan from a past newsletter). Under the current RDSP, when a beneficiary no longer qualifies for the DTC, they must close the plan and all grants and bonds paid to the plan must be repaid to the Government of Canada. Budget 2019 proposes that Canadians who no longer qualify for the DTC not be forced to close their RDSPs which in turn would allow them to keep the grants/bonds that were previously paid to their RDSPs.

Stock options are a way for a company to reward employees with the option to buy the company's stock at an agreed upon price and on an agreed upon date. If the stock price is trading above the price at which the employee has the option to buy it, the employee could buy the stock and then immediately sell it at the higher price. The difference between what the employee paid for the stock by exercising their option and what the stock was worth at the time they exercised their option is taxable as income. Canadians can typically deduct 50% of the taxable benefit; the result is that stock options usually benefit from the same beneficial tax treatment as a capital gain in that only 50% is taxable. Budget 2019 proposes to cap the amount that can be benefit from the preferential treatment at $200,000, but only for employees who work for large mature companies. Employees who work for start ups or rapidly growing Canadian companies would not be impacted by the cap.

Finally, the budget proposes to close certain tax loopholes that allow certain mutual funds to convert interest income to capital gains, also known as corporate class mutual funds. Also included in the budget is a proposal to prevent people from transferring the commuted value of their defined benefit pension tax free to a newly created Individual Pension Plan. There was no change to the capital gains inclusion rate of 50% and there was no change in the Federal income tax rates.

Enjoy the warmer weather, beautiful blossoms and longer days. If you have any questions about how the 2019 Federal Budget impacts you, please don't hesitate to reach out.

Portfolio Update

This month's update looks at why we think the current environment is particularly well- suited for our style of investment management.

Our model portfolios generally continued their strong start to 2019, advancing through March. The "Growth" portfolio is a notable exception trading down 1% for the month. We have generally kept pace with our benchmarks which we deem satisfactory given we remain underweight in equities and overweight in fixed income/cash.

March saw a marked drop in interest rates, and we'd like to use this month's newsletter to focus on rates. We will examine the history of interest rates and look at how interest rates play a role in determining asset prices. We will look at how interest rates relate to GDP growth, as well as provide our opinion on where rates are headed from here. We will touch on how you can think about rates as it pertains to your own personal debt – be it mortgage, car loans or line of credit obligations. Lastly, we'll tie this all together and suggest that a low rate, low growth environment is perfectly set up for our style of selective investment management.

Fair warning: this will be of keen interest and fascinating to some but VERY boring to others! The following bullet points provide a brief summary of this long monthly newsletter:

- Interest rates are currently at a historical low.
  - The last time they were this low was during the 1930s-50s.
  - Both periods are linked to elevated debt levels.
- Significant debt deleveraging occurred post WW2.
  - We have more debt today than we did in 2008; on aggregate no deleveraging has transpired this time around.
- Interest rates are the single most important factor in determining asset prices.
  - Low rates = higher asset values.
  - High rates = lower asset values.
- Interest rates are generally correlated to inflation and growth.
  - High inflation & high growth → high rates.
  - Low inflation & low growth → low rates.
- High levels of debt crimps growth. Once debt/GDP exceeds 90%, growth begins to fall markedly.
  - Japan represents a modern example of above in action. They have been in a low growth, low inflation, low interest rate environment for > 3 decades with no end in sight.
  - It would appear the rest of the world is headed down the same path.
- Putting this all together suggests lower returns are likely going forward.

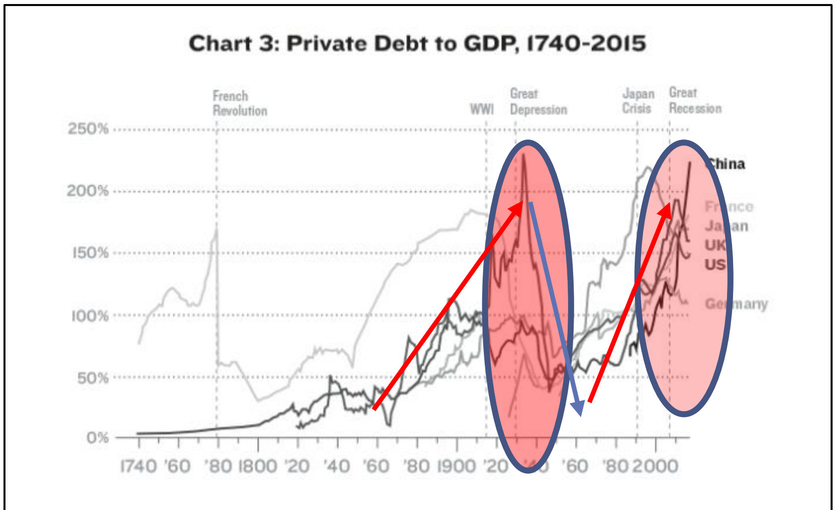
- There will always be companies growing at above average rates.
- Our process is designed to shine during this type of macro environment.

What follows are the gory details and evidence supporting our views of the current and future interest rate environment.

Source: Credit Suisse

The chart above illustrates the long-term composite rate on US Treasury bonds dating back to 1800. We observe that the long-term average rate has been ~5%, while at the same time noting that the rate has only been consistently near this rate during the mid-19th century. A classic example of an 'average' not really reflecting the behaviour of a signal. Most relevant, and important, to note are that rates have only been as low as they are today during two distinct periods: 1930s-1950s and more recently 2008-present. The world is clearly different now that it was during the 1930s. Is this therefore a coincidence or are there in fact similarities between the two periods that warrant careful examination?

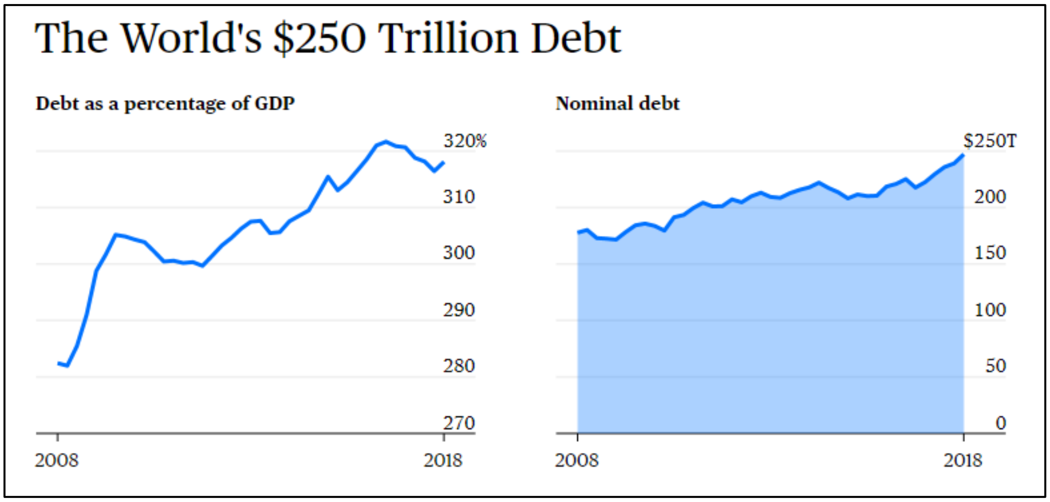
Given that interest rates and debt are interconnected, it seems to reason that looking at world debt levels may give us some important clues. The chart at right is very busy (a simpler one follows) but we can see that both the 1930s/40s/50s and present day have seen very high levels of debt. This chart only looks at private debt to GDP but sovereign and corporate debt have followed similar paths.



Source: U.S. Treasury; Mitchell; Measuringworth.com; UN data; Piketty & Zucman, Capital Is Back: Wealth-Income Ratios in Rich Countries 1700-2010, copyright Oxford University Press; Goldsmith; World Bank, U.S. Census; BEA; The Federal Reserve

The key differences between now and then were that in the 1930s, governments originally tried austerity (spend less) which yielded the great depression. Only after this extremely difficult economic time did they engage in quantitative easing (QE: money printing). We know after the great recession of 2008, governments were quicker to respond with QE and central bankers are quick to point out that this saved us from a 2nd terrible depression.

However, it is worth noting that while debt levels eased during a period of deleveraging post WW2, we have yet to see any meaningful deleveraging since 2008. In fact, quite the opposite has occurred:



Source: Bloomberg

Let's review the facts:

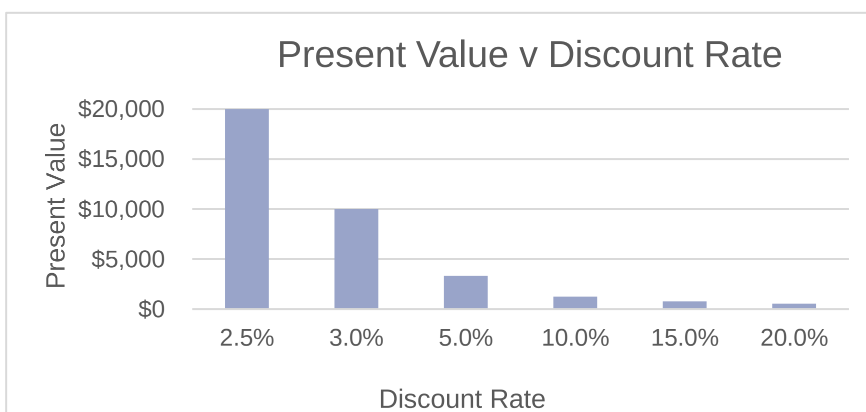
- Interest rates have only been this low twice in history: now and in the period during and after the Great Depression.
- World debt levels have spiked twice in history: now and in the period leading up to the Great Depression.
- While the world deleveraged through the 1940s/50s, we have yet to see meaningful deleveraging post 2008.
- For an in depth analysis and some nifty infographics on world debt levels, please visit this Bloomberg piece.

Why do interest rates matter in the context of investing?

During a May 8, 2018 CNBC interview, Warren Buffett said that 'interest rates are the most important' thing in determining stock values. What does he mean by this? The value of any asset is the present value of discounted future cash flows. When interest rates are low, the rate used to discount those future cash flows into present terms is low and vice versa when rates are high. When the discount rate is low, the present value is high and vice versa. This is easiest to understand using an example. Let's imagine we have a <insert asset type> (could be stock, house, bond or any income producing asset) with a cash flow today of $100 and expected to grow at 2%/year into perpetuity. We can see the how the present value varies depending on the discount rate in the table and graph below:

Discount Rate	Present Value
20%	$556
15%	$769
10%	$1,250
5%	$3,333
3%	$10,000
2.5%	$20,000

Source: Hillside Wealth

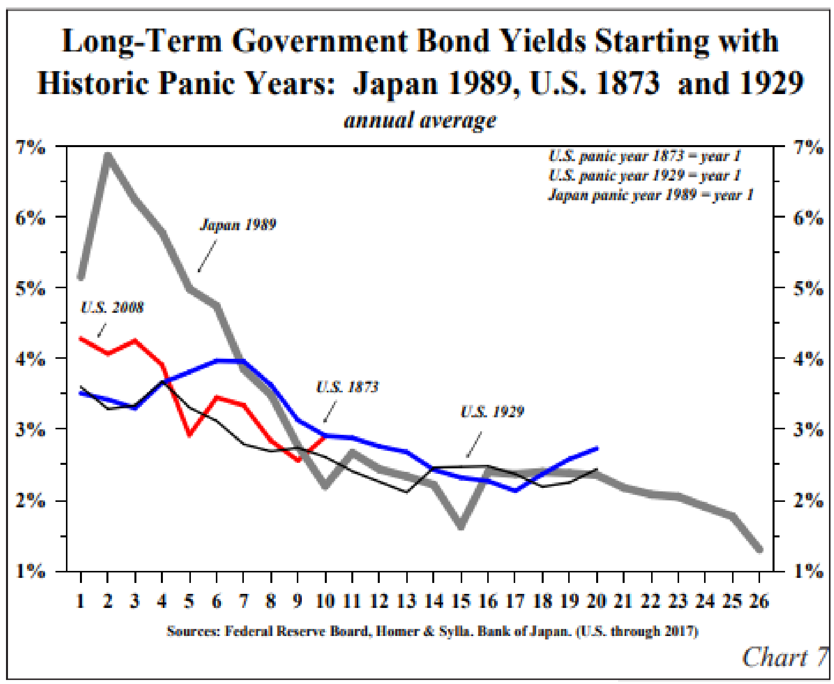


Buffet continues… "*If interest rates are destined to be at low levels. … It makes any stream of earnings from investments worth more money. The bogey is always what government bonds yield. We've had this period of extended long-term low rates not only here but around the world, and now it looks like we're not going to jack them up very fast. We may be in a new world, the world that Japan entered back in 1990. And if so, stocks will look very cheap*."

We also note that the relationship is not linear. For example, a drop in the discount rate from 20% to 15% increases the present value by $213 while a drop from 15% to 10% yields an increase of $481. As the discount rate approaches zero bound, the increase in present value of an asset rises dramatically.

In our minds the next logical question becomes: where are rates likely headed in the next few decades? Before we attempt to answer this very loaded question, let us remind our readers that our investment process does not hinge on us being 'right' on this front. It certainly helps to have an accurate assessment of where rates are headed but we readily accept that our analyses may prove to be incorrect. We won't put ourselves in a position of 'fighting the tape' and will adjust our positioning to reflect conditions at that time.

Reflecting on where rates are likely headed requires us to think about GDP growth rates going forward. Reinhart & Rogoff's 2010 paper titled Growth in a Time of Debt is the seminal work on this subject. They showed that as debt to GDP moves from 30% to over 90% growth falls by 50% in advanced economies and upwards of 75% in developing economies. They studied 44 economies in upwards of 200 years in this exhaustive analysis. We've seen earlier in this piece that debt levels are elevated across the world. For example, Japan's debt to GDP sits at an eye watering 253%, Italy 132%, US 108% and Canada 77%. In none of these countries is this figure dropping so it's safe to assume these levels will continue to rise and perhaps dramatically during periods of economic weakness.



Source: Hoisington IM

Putting this altogether we feel that rates are likely to remain low for years to come. A recent paper by Hoisington Investment Management demonstrated how the current environment (US 2008 to present) might look in the context of the US 1873, 1929 and Japan 1989 experiences. Every scenario saw greater than 20 years of ultra-low interest rates. We are 10 years into the current rate regime.

Critical analysis always requires one to consider the counter argument or scenarios which could lead to the opposite outcome. In other words, what could skewer our analysis and lead to rising rates? Below are a few scenarios that could lead to rising rates:

- Growth does pick up counter to previous experiences perhaps as a result of the velocity of money reversing higher.
- We experience a long period of austerity and widespread deleveraging setting us up for another secular debt cycle.
- Central banks create inflation through zero or negative rates and/or quantitative easing and inflate away the value of current debts.
- As debt levels rise, investors become weary of borrower's ability to pay back debts. They demand higher rates to continue lending.

Of the above, we feel the last scenario poses the greatest risk to our lower for longer view on rates. We however point to Japan where debt to GDP has risen dramatically while rates have continued to remain low. We note that most of the Japanese sovereign debt is domestically held due to Japan's high personal savings rate. This, in contrast to the US where savings rates are low and treasuries widely held across the globe. We will continue to monitor these developments.

We'd be remiss not to discuss how these views tie into our own personal debt obligations. Most of us have some form of personal debt, be it a mortgage, car loan, or line of credit. Below is a chart illustrating prime lending rates back to 1935. Prime rates are closely related to mortgage rates and other consumer lending rates. It should come as no surprise that these rates were also low during the 1930s-50s and and now again low post 2008.

Source: www.ianmucignat.com

Does this mean we should pile on consumer debt and party like it's 1935?... no, quite the opposite. If we are correct and we are in a lower for longer rate environment, this is a perfect time to get one's financial house in order as more of one's debt payments will go towards paying down principal than interest. While our governments and corporations pile on debt, we should in fact be doing the opposite. Lower for longer doesn't mean lower forever; there will be a time when rates march higher much like they did in the 1960s and one does not want to enter that cycle with high amounts of consumer debt.

By now we should all be champing at the bit… because lower rates for longer surely means higher risk asset prices… correct?! Well, not so fast. While we noted earlier that all things being equal, lower rates translates into higher present values of assets, we've also noted that high levels of debt translates into lower growth. We therefore have two competing forces: low rates (higher asset prices) versus low growth (lower asset prices).

If you're still with me, I thank you. I promise the effort and attention will be worth it. We can't control interest rates unless we work our way into a central banker position and even then I would argue we wouldn't have as much control over rates as we'd like. So that leaves growth. While we are likely headed into an environment where the economy (and broad market indices) in aggregate will experience lackluster growth, there will always be companies that are launching new products, services and ideas that will produce above average returns for shareholders. We can't control growth but we can hunt it down and isolate those assets/stocks/companies that have exhibited a history of above average growth and profit margins. To the extent these companies have a strong competitive advantage or economic moat they will be able to continue to generate above average growth rates going forward.

> **Lastly, we feel strongly that, in any environment, owning a concentrated group of high-quality companies will provide above average returns for investors over time, but suggest that a low rate, low growth environment is perfectly set up for our style of selective investment management.** It is our goal at Hillside to be judicious in the implementation of our strategy. We are excited to work with our clients in helping them achieve and exceed their financial goals.

March Performance Results

An overview of our three portfolios to date.

Performance to March 29th, 2019	YTD	1 Mo	6 Mo	1 Yr	3 Yr**	Inception**	Added Value vs. Benchmark**
HILLSIDE MODERATE GROWTH*	**6.42%**	**1.7%**	**1.21%**	**5.59%**	**8.98%**	**10.03%**	**+7.9%**
MG Benchmark[1]	*5.34%*	*1%*	*0.77%*	*2.97%*	*6.14%*	*2.13%*	
HILLSIDE GROWTH*	**7.92%**	**-1.02%**	**-6.95%**	**-3.37%**	**8.22%**	**8.5%**	**+2.76%**
HG Benchmark[2]	*8.95%*	*1.42%*	*1.68%*	*7.77%*	*10.59%*	*5.74%*	
HILLSIDE INCOME & GROWTH*	**4.87%**	**2.01%**	**1.91%**	**4.68%**	**7.03%**	**7.35%**	**+5.62%**
IG Benchmark[3]	*5.21%*	*1.29%*	*1.3%*	*2.73%*	*3.93%*	*1.73%*	

Past performance is not an indication of future returns.
** Performance is presented gross of fees.*
***Inception: Sept 2, 2014. Results beyond 1 year are annualized.*
[1] MG Benchmark: 30% TSX | 35% Universe Bond | 20% S&P Pref | 15% TSX Small Cap
[2] HG Benchmark: 50% TSX | 25% S&P500 | 25% TSX Small Cap
[3] IG Benchmark: 25% TSX | 55% Universe Bond | 20% S&P Pref
Source: SIACharts.com

The performance presented in this portfolio report is hypothetical and does not represent a specific client account. Details regarding actual returns of an investment account are available from the client's advisor.

Performance is calculated using month-end market values of the model portfolio. Since we use a model portfolio to calculate performance there are no client-initiated cash flows (deposits/withdrawals) to account for. Performance is calculated by dividing the change in the model portfolio's market value by the model portfolio's market value at the beginning of the performance period. Also, all income generated by the portfolio's holdings are held within the model portfolio in cash and is accounted for in the portfolio's month-end market value - this results in a total return measure of the model's performance.

Returns for periods less than 1 year are shown as periodic returns while returns for periods greater than 1 year are annualized. Returns do not include fees and actual returns experienced by an investor may differ from those shown. Past performance is not a guarantee of future results.