# QUARTERLY MARKET COMMENTARY

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**"When I look back on all these worries, I remember the story of an old man who said on his deathbed that he had had a lot of trouble in his life, most of which never happened."**
*- Winston Churchill*

## History Repeats Itself

Just like in 2016, Donald Trump is now the president-elect of the United States. It was a commanding win against Kamala Harris, where he won the popular vote, which only one other Republican has done, since Bush Sr. won it in 1988. Trump will be only the second president to serve two non-consecutive terms. The only other president was Grover Cleveland, who started his second term in 1893. Also like in 2016, the Republicans won control of the House and the Senate. In typical fashion, the stock markets in North America rallied, once the presidential results were in and some uncertainty was removed. Shortly after the win, president-elect Trump started announcing unorthodox cabinet ministers and that he would put 25% tariffs on imports to the U.S. This seemed to spook the market, causing a sharp move down in December. Despite this, the quarter was a very strong one, just like it was in the fourth quarter of 2016, when Trump won the first time. Below are the performance numbers for the markets and the Moderate Risk Equity and Balanced portfolios in which many of you invest. Keep in mind the below model portfolios are designed to carry less risk than the market in general, but provide similar or better returns over the long-term.

### Moderate Risk Equity Portfolio vs. Canadian and U.S. markets over the last five years:

| | Three Month | One Year | Three Year | Five Year |
|---|---|---|---|---|
| TSX | +3.03% | +17.99% | +16.52% (5.21%/yr) | +44.92% (+7.71%/yr) |
| Dow Jones (in CDN$) | +6.82% | +22.23% | +33.19% (10.03%/yr) | +64.90% (+10.51%/yr) |
| Moderate Risk Equity Portfolio | +3.72% | +20.06% | +25.76% (+7.94%/yr) | +66.77% (+10.77%/yr) |

### Balanced Portfolio Returns vs. Benchmark over last three years:

| | Three Month | One Year | Three Year | Five Year |
|---|---|---|---|---|
| Benchmark* | +1.48% | +11.06% | +7.23% (+2.26%/yr) | +24.22% (+4.20%/yr) |
| Balanced Portfolio | +4.92% | +21.61% | +17.0% (+5.37%/yr) | +46.59% (+7.95%/yr) |

**50% TSX/50% Canadian Bond Universe Index ETF (XBB)*

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## Tariff Talk

Trump claimed, at the end of November, that he will put 25% tariffs on Canadian and Mexican imports to the U.S. and a 10% tariff on Chinese imports. He did this on various items, when he was President previously, and it resulted in higher prices to the U.S. consumer. Most economists agree that there would be no economic benefit to the U.S. if tariffs were raised and some say it would have some modest negative effects on the economy. Canada's economy would suffer much more, as one third of our $1 trillion worth of exports go to the U.S., and the Canadian economy is much more dependent on the trade relationship than the U.S. is on us. If tariffs were implemented, prices on Canadian goods would have to be raised and there would be less demand in the U.S. for these higher priced products. This would likely result in layoffs and tip Canada into a recession.

The same threats of tariffs were made during Trump's previous term as President. In the end, only some were implemented, and most were eventually removed. Last time, the threat of tariffs was used as a negotiating tactic by Trump to gain an advantage during the renegotiation of the North American Free Trade agreement. The final result of this was a free trade agreement that ended up being to the benefit of Canada, U.S. and Mexico. It resulted in more trade between all of the countries in the years after.

Despite all of Trump's tough talk about trade with Canada, the Canadian stock market ended up doing quite well during Trump's previous term. The TSX was up 7.4% per year from the point when he won the election to just before the outset of the pandemic. The situation is also a little different now, as the U.S. economy is near full capacity and inflation is much higher than it was in Trump's first term. Any new tariffs and their inflationary effects will likely force the Federal Reserve to raise rates right away. This will make it more difficult for Trump to actually go ahead with tariffs, as his voters will not be happy if gas, food and interest rates go higher. Trump's negotiating tactics are well known, and it is likely his tough talk gets distilled down into more reasonable negotiations with Canada.

Canada and the U.S. are very important trade partners for each other, and this trade has enormous financial benefits for each country that translate into a better standard of living for most. I expect this trade relationship to continue to be a positive one, despite all the fear in the media about it.

## Trudeau's Legacy

At the time of writing, Justin Trudeau announced his resignation as Liberal party leader, which will force a federal election in Canada in late spring this year. Trudeau's popularity has been suffering significantly in recent years and has been in steady decline since he won by a landslide in 2015. The Conservative Party led by Pierre Poilievre now has a huge lead in the polls. I have mentioned in my other newsletters that inflation tends to spell trouble for incumbent parties and often more right-wing governments end up taking power. The average person struggles to afford everyday items during inflationary periods and becomes hostile towards the current government. This has been happening in the U.S., Europe and the rest of the world in recent years, and now, it is happening in Canada. This, in part, has led to the downfall of Trudeau and the Liberal party.

However, can Trudeau's administration be blamed for at least a portion of this downfall? From 2018-2023, the Trudeau government recorded the six highest levels of spending (per capita, adjusted for inflation) in Canadian history. They never balanced the budget once in nine years, despite claiming in 2015 that they would balance the budget by 2019. This year's budget was particularly bad, at an expected deficit of almost $62 billion, or $21.9 billion higher than the Liberals' previous estimate and well above the $40 billion they said they would not exceed. The Liberals are not even close to balancing the budget and this is after increasing taxes on 86% of middle-class Canadians.

Government deficits are not always bad, as the spending can support the economy. It can be used to develop technology and infrastructure that will provide jobs and productivity gains, that increase future economic growth and corporate and personal tax revenues that more than pay for the initial outlay of capital from the government. However, it does not look like this is the case in Canada over Trudeau's reign. The GDP growth per capita has been negative in all of the last six quarters. One would think nine consecutive budget deficits and the record government spending would have started to bear economic fruit by now, but it hasn't. In fact, Canada is very close to a recession. Even the rapid 1.75% reduction in interest rates in the last year has not put Canada's GDP per capita into positive territory.

Our anemic economy hasn't exactly inspired business investment either. From 2014-2022, business investment, adjusted for inflation, has declined from $20,264 to $16,515 per worker. Reduced business spending eventually results in lower productivity relative to other countries and lower living standards for Canadians. Trudeau has had some accomplishments in his time as Prime Minister, such as the Canada Child Benefit and a solid result in the new NAFTA agreement with the U.S. during Trump's first term, but the history books will see Trudeau as the out-of-control spender who saddled Canada with debt and higher taxes

### Debt

Speaking of debt, Canada's federal debt now sits at around $1.24 trillion. The interest to be paid on this debt comes to $53.7 billion per year or $1,300 per year per person in Canada. And this only includes the federal debt. If you include provincial debt as well, the overall Canadian debt is around $2.2 trillion, which would cost each Canadian around $2,000/year in interest costs. The Liberals often claim that Canada's debt to GDP ratio is the strongest of the G7 countries, but this is very misleading, as it doesn't include provincial debt. Other countries, such as the U.S., have much less or no debt at the state levels (balanced budget for most states are mandatory).

In Canada, the provinces take care of lots of the spending that is typically funded by federal governments such as healthcare, education and transportation. Therefore, the debt number of $2.2 trillion is the better number to be used for comparing Canada to other countries. Using that metric, Canada's debt to GDP ratio comes in around 104% which is somewhere in the middle of the pack compared to other advanced countries. The good news is that we are not in a debt spiral situation yet. The interest on debt, however, is starting to become significant. The interest we are currently paying on the debt is more than all of the GST collected in Canada and higher than all federal healthcare spending. It now represents about 10% of total federal government spending.

This interest burden will prevent government from spending on new infrastructure, technology, badly needed healthcare and other items that can help Canada compete globally. This will also result in higher future budget deficits which will force governments to increase taxes even more or make cuts to government programs. This leads to reduced business investment, a lower dollar and higher inflation which, in turn, forces layoffs and lower economic growth and, even worse, budget deficits. A vicious cycle.

We need to do something about out-of-control government spending and/or stimulate the economy while we still can. I know this is possible, but it will be painful. In the early 1990s, Canada faced a similar situation and the Jean Chretien Liberals did address it by cutting government spending on healthcare and welfare payments, which eventually created budget surpluses. The surpluses enabled the government to reduce taxes and revive the economy. By the early 2000s, Canada was back on track and in a much healthier economic situation.

### Market Response to Trump

I've had lots of phone calls regarding the market expectations, given another four years of Trump as president. So far, the market has had a mixed response. When Trump declared victory, it initially surged, as he was expected to reduce regulations, taxes and illegal immigration. The biggest benefactors of these policies were the U.S. banks, small and mid-cap U.S. stocks and U.S. commodity producers. Banks benefit from decreased regulations that allow them to lend more. Smaller companies benefit from this and lower U.S. taxes, as most of their revenues are from domestic consumers. Commodity producers stand to benefit from tariffs on imports of things like steel that keep domestic prices high enough to make a profit. Shortly after this market jump, Trump started to announce his cabinet picks. Almost all of them were considered controversial picks and/or not qualified. Here are a few examples:

*Matt Gaetz for Attorney General:* Previously the subject of Justice Department sex trafficking investigation that ended without charges. He was also investigated by the House Ethics Committee over allegations he was part of a plot that led to sex trafficking of a 17-year-old girl. Gaetz eventually withdrew himself from consideration.

*Pete Hegseth for Defense Secretary:* This is a former Fox News host who was also accused of sexual assault in 2017.

*Elon Musk for Coleader of Department of Government Efficiency:* Musk has supported a wide range of conspiracy theories such as the displacement theory. He claims the Democrats are purposely increasing immigration, as immigrants tend to vote democrat. He also has indicated Anthony Fauci should be prosecuted. Musk is also being sued by eight former SpaceX employees for wrongfully firing them after they accused the company of tolerating sexual harassment.

*Robert F. Kennedy Jr. for Health and Human Services Secretary:* Has a history of spreading discredited theories on vaccines and other public health issues.

*Tulsi Gabbard for Director of National Intelligence:* Gabbard's selection alarmed U.S. intelligence analysts who point to her past criticism of Ukraine and supportive comments of Russia. She also had a secret meeting with Assad of Syria who is a close ally of Russia and Iran, despite U.S. sanctions against his regime at the time. She has never worked in the intelligence community previously.

These picks started to sour the mood for markets and, by December, the markets started to drop. Then Trump announced 25% tariffs on Canada and Mexico and 10% on China. These are three of the top U.S. trading partners. Trump's policies were already considered to be inflationary but these tariffs potentially causing higher prices for hundreds of billions worth of imported goods could potentially increase prices much further. Suddenly, the Federal Reserve was now expected to cut rates once in 2025, instead of four times as expected before Trump won. Longer-term bonds also dropped in price, leading to higher long-term interest rates. U.S. stock prices dropped back down close to where they were before Trump's win, due to the higher long-term interest rates and the slower anticipated cut of short-term rates from the Fed.

### The Real Concern

As I mentioned, long-term U.S. interest rates jumped up since Trump won. A 10-year U.S. bond now pays 4.7% interest. The earnings yield on the S&P 500 is now only 4.7% as well. Usually, investors expect to get a better yield on an equity investment versus a bond in order to compensate them for the higher volatility and risk of a stock vs. that of a bond. This is called the risk premium. Future returns are not usually high when there is no risk premium. This is just another measure showing how expensive the U.S. market, especially larger companies, are currently. This concerns me and I have reduced U.S. large cap stock exposure in portfolios. Another concern is that fiscal spending, such as Biden's infrastructure bills, will be coming to an end as the U.S. looks to cut government spending. The Biden fiscal spending certainly provided a lift to the economy, but this tailwind is not likely to continue. There is a similar situation brewing in Canada as the Conservatives are likely to gain more power in the next election. One of the knocks against Trudeau has been his out-of-control spending, so campaign promises may revolve around austerity measures, which means the Canadian government spending tailwind may also come to an end. The good news about the Canadian market is that stock prices are much more reasonable and do provide a good risk premium. It's a similar story for the rest of the world too.

## Final Thoughts

New leaders, especially unpredictable ones like Trump, tend to spook investors. Many people were alarmed in 2016, when Trump won for the first time and lots of investors are concerned now. However, people underestimate the resiliency of the markets. They had some volatility in Trump's first term but ultimately provided good returns for investors in both the U.S. and Canada. Even the pandemic only derailed market returns for a very short period. There is no way to know the results of a second Trump term on the markets and there is certainly no reason to worry excessively about it. Our portfolios continue to be in a cautious stance but that is mostly because prices do not meet my criteria and some lower risk options pay a relatively good return. Trump is likely to create some unexpected market opportunities like he did in his first term, and I will try and take advantage of these as they present.

I wish all of you health and happiness and prosperity in 2025.

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