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Editor and Publisher: Gordon Pape

Associate Publisher: Richard N. Croft

Website: www.buildingwealth.ca

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DIVIDEND STOCKS LOSING GROUND

By Gordon Pape, Editor and Publisher

Ever since the financial crash of 2008, investors have poured money into dividend stocks and the funds that invest in them. They offered a safe haven with predictable cash flow at a time of market uncertainty.

That strategy paid off handsomely. The price of utilities, telecoms, REITs, and other cash-generating securities increased while dividends rose as profits improved.

It was great while it lasted, but that particular bull market is over. Rising rates are putting pressure on interest-sensitive stocks, and we're probably just at the beginning of that cycle. As of Friday's close, the S&P/TSX Capped Utilities Index was down 7.4% for 2018, while the Telecom Index had lost 5.5%.

None of these stocks has lowered its dividend, nor are any expected to. But with safe fixed-income securities offering better returns as rates rise, investors want better yields from more risky stocks. Driving down prices achieves that.

Take BCE for example. It hit a 52-week high of $63 last April. At the time, the annual dividend was $2.87, for a yield of 4.55%. The company raised its dividend this year to $3.02, but the stock has dropped to $56.44 despite that, pushing the yield up to 5.3%. You'll find a similar pattern across almost all interest-sensitive stocks.

You can see the effects of this change in market psychology in two high-profile ETFs, one Canadian and the other U.S. Let's look at each.

iShares S&P/TSX Dividend Aristocrats Index ETF (TSX: CDZ)

Originally recommended on April 9/12 (#21214) at $22.29. Closed Friday at $25.41.

Background: This fund invests in Canadian stocks that have increased their dividends for at least five consecutive years and have a market cap of $300 million or more.

Performance: Dividend stocks tend to perform poorly when interest rates are on the rise, and we are seeing that here. As of March 15, this ETF was down 5.38% for 2018. The five-year average annual

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Dividend stocks – continued from page 2…

compounded return to Feb. 28 was 5.2%, but don't expect to see that going forward if rates continue on their current course.

Key metrics: The fund has total assets of $955 million, which is down from our last review in the fall. That reflects the drop in the value of the securities in the portfolio, plus some withdrawals. The expense ratio is 0.66%, which is looking a little pricy. The p/e ratio is15.51, which is down almost two points from my last review. There are 81 positions in the ETF. These include some large-cap firms, but the biggest weightings are in small- to mid-cap companies such as Corus Entertainment, Alaris Royalty, and Enbridge Income Fund – all of which have been struggling lately.

Distributions: Payments are made monthly, with the level adjusted every three months. The latest monthly payment was $0.075 per unit, which would work out to $0.90 over a full year if maintained. On that basis, the current cash yield is 3.5%.

Outlook: The portfolio appears to be solid and the yield is quite good, so if you're looking for cash flow, you may want to keep holding. But don't expect to see much, if any, upward price movement if interest rates keep rising as expected.

Action now: Hold.

SPDR S&P Dividend ETF (NYSE: SDY)

Originally recommended on April 9/12 (IWB #21214) at $56.33. Closed Friday at $93.16. (All figures in U.S. dollars.)

Background: This is the U.S. equivalent of CDZ, reviewed above. It's from State Street Global Advisors and tracks the S&P High Yield Aristocrats Dividend Index, which includes companies that have increased their dividends annually for at least the past 20 years. They include companies like Target, AT&T, Tanger Factory Outlets, and IBM.

Performance: This fund has a little better than its Canadian equivalent this year, because the U.S. market has been stronger. But the same underlying factors prevail, and the fund was down 2.95% year-to-date (to Feb. 28). By comparison, the five-year average annual compound rate of return was 12.7%, which shows to what extent the investment climate has changed.

Key metrics: The fund has total assets of about $15.7 billion. The expense ratio is 0.35%. The price/earnings ratio of the portfolio is 18.21.

Distributions: Distributions are paid quarterly and may vary significantly from month to month. The 12-month trailing total payout was US$4.4281 per unit, including a 2017 year-end payment of $2.958.

Outlook: This fund is interest-sensitive because of the nature of its holdings, so expect it to be sluggish this year as the U.S. Federal Reserve Board continues to raise rates.

Action now: Hold.

VOLITALITY AND THE MARKETS

By Richard Croft, Associate Publisher

What we know is that volatility has returned to the financial markets. Less clear is whether the volatility tailwind was in response to an adverse move in the underlying stock market or whether a spike in volatility caused the market selloff. Surprisingly, it may have been a combination, and if it was, it raises some interesting questions.

It began on Friday, Feb. 2 when the Dow Jones Industrial Average (DJIA) closed 540 points lower while the S&P 500 Composite was down 60. Never a good thing going into a weekend! The CBOE Volatility Index (VIX) rose that day but not as much as one might have expected given the degree of the move in the underlying stock market.
On Monday, Feb. 5, the rout began, as the DJIA tumbled another 1,175 points with most of those losses occurring in the last two hours of trading. On Tuesday, Feb. 6, the Dow traded in a 1,596 point range from low to high. Volatility spiked on Monday as the VIX went to 40% implied from 18% implied and again on Tuesday when the VIX crossed 50% implied during the day (see Figure 1 – VIX is the lower graph).

You can be excused for thinking conspiracy theory, but I believe the volatility spike on Monday caused the crash, as large institutional hedge funds that were short volatility had to sell stocks to meet margin calls.

Normally the market sells off based on some macro fundamental change. The selloff impacts volatility as traders pay up to buy protective puts. Not so this time. There was no real change in the economic fundamentals aside from the fact that the market had gone straight up for quite some time and probably got ahead of itself.

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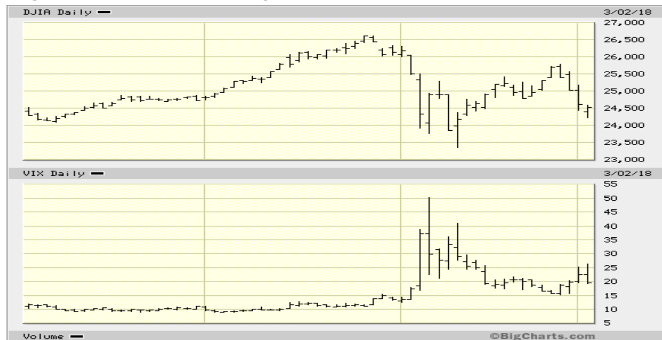
Volatility – continued from page 2…

Figure 1: VIX (lower graph) vs. DJIA



The only explanation that has any weight was the forced sale of securities to meet margin calls, particularly among some large institutional hedge funds that had been shorting volatility – successfully I might add – for the past two years.

The short volatility trade was one of the favorite strategies for some large hedge funds. Typically, you initiate this trade by selling short exchange traded funds like the iPath S&P 500 VIX Short-Term Futures ETN (NYSE Arca: VXX). There are four of these products that have sufficient liquidity for institutions to trade, some of which, if you can believe it, track the CBOE Volatility Index by a factor of two.

Think about that in terms of the gambling psyche that permeates this segment of the financial markets. These 2X Volatility ETFs are instruments that track a highly volatile underlying index (the VIX is six time more volatile than the S&P 500 Index) and then purport to double the exposure both up and down.

Still, shorting volatility has been a successful trade since 2016. I talked about this in previous columns where the VIX at one point in late 2017 closed at its lowest level in history (below 9% implied). If you were selling short these instruments, you were engaged in a strategy that was akin to printing money. At least that was the case until Feb. 5.

The problem is that volatility can explode to the upside in a matter of minutes. Short sellers must have capital set aside to collateralize the short sale. But in most cases, a hedge fund would simply employ securities held in the portfolio, using, for example, blue-chip stocks as collateral for the short positions in the volatility exchange traded securities. Think of that as using leverage on top of leverage to take aggressive positions in extremely volatile securities.

When volatility spiked in early February, the value of the exchange traded securities surged, which encroached on the collateral being used to support the strategy. It was a perfect storm that required hedge funds to sell securities to meet margin calls used as collateral for the short volatility positions. While we may never know with certainty, conspiracy theory or not, that appears to be the best explanation of the cause and effect of the market selloff.

This raises serious issues for long-term investors, not the least of which is the negative implications that come from engaging in strategies that look suspiciously like playing the odds at a roulette table. This is not something that gives comfort to serious investors looking to build retirement nest eggs.

Since then, volatility has retreated, although the VIX is still well above the levels of late 2017. I suspect that will continue throughout the remainder of 2018, which suggests that traders may want to re-think their investment thesis. This means working to understand the fundamentals that impact markets over time and deploying capital to take advantage of those metrics, while setting some cash aside for opportunities when they present themselves.

WHERE NOW FOR STOCKS?

The bull market for U.S. stocks had its ninth birthday making it the second longest in history. If it continues through March 2018, it will set a new standard. Even with the February selloff, we have still not entered territory that would suggest an end to the upward trend.

In my January column, I wrote that there are dynamics in place that could keep this bull going to its tenth anniversary and even beyond. One of these is the U.S. tax reform bill that President Trump signed into law just before Christmas. Most analysts have argued that very little of the impact of tax reform has been baked into the U.S. equity markets. I'm not sure this is the case.

We know that free cash flow will increase significantly. But it's not clear how management will allocate these new resources. If companies use the after-tax windfall to fund major capital projects, that could push the growth of U.S. gross domestic product (GDP) above 3% annually.

To add some fuel to that fire, there are healthy incentives built into tax reform to encourage how companies allocate their capital. Capital expenditures can now be expensed immediately rather than over the life of a project. From my perspective, this is the most important part of tax reform and has probably not been factored into current valuations.

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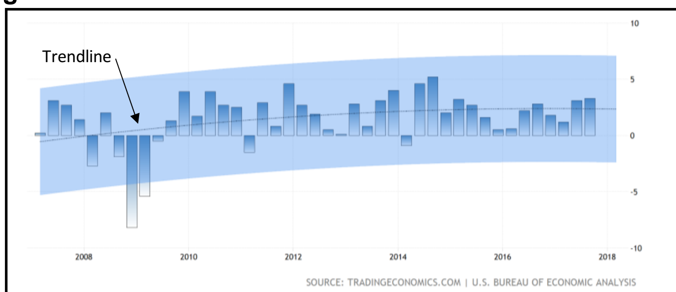
The bull case for 2018 is that the U.S. economy is on solid footing based on recent economic data. That should support equity valuations beyond any potential impact from tax reform. If companies take advantage of the capital cost provision, that should spur economic activity, push up wages, lower unemployment, and trigger upward revisions to GDP.

To that point, I think U.S. GDP – a measure of the nation's economic output – will break free of the 2% to 3% range it has held for the past five years, and unemployment will come in somewhere between 3.9% and 4.2%, which for all intents and purposes, represents full employment. To put some meat on this skeleton, in this issue and the next, I will dissect the main economic indicators to lay out a macro overview. From that, I'll extrapolate the likely impact on global equity and fixed-income assets.

U.S. Gross Domestic Product

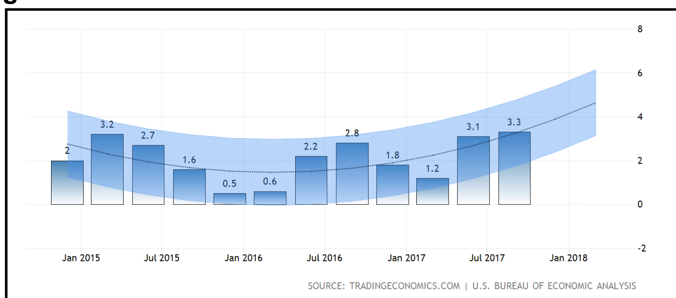
I think the trend in U.S. GDP will range between 2.75% and 3.25% in 2018 (see the black line that cuts through the quarterly GDP data in Figure 2).

Figure 2: Historical year over year quarterly GDP growth



The White House believes the tax measures will cause an immediate increase in growth that could eclipse 4% (see Figure 6). In my view that may be over-optimistic and not particularly healthy. Excess growth can lead to a boom-and-bust scenario that does not usually end well.

Figure 3: Forecast year-over-year quarterly GDP growth



At the same time, I think consensus GDP estimates between 2.5% and 3.0% may understate the benefits of tax reform. Note, for example, that GDP spiked to 3.3% in the third quarter of 2017 before the tax package was signed into law. And while a single data point does not a trend make, one could make a case that the third-quarter data were the result of economic fundamentals unencumbered by tangential factors such as tax reform. If tax reform has the requisite impact on capital expenditures, and I think that it will, that could set the stage for massive corporate expansion, pushing economic output to the higher end of the forecast.

U.S. unemployment

The U.S. has the lowest unemployment rate since 2001. Unemployment is expected to continue declining into 2018 (see Figure 4). The current 4.1% rate is ostensibly full employment and represents transitory effects of people moving from one job to another. The Federal Reserve Board expects the U.S. unemployment rate to decline to 3.9% 2018 and 2019 followed by a slight increase to 4% in 2019 and 2020. That's better than the 4.1% rate in 2017, and the 4.7% rate in 2016. It's also well ahead of the Fed's 4.7 % target.

Figure 4: U.S. unemployment rate

But, as always, there are caveats! Most of the job growth is in low-paying retail and food service industries. Unless we see a return of manufacturing jobs, there will be displaced workers near retirement age, who will never be able to return to anything that resembles their former high-paying jobs.

The unemployment numbers are also skewed by part-time workers who would prefer full-time employment. The challenge is that employers are reluctant to hire full-time workers for fear they may breach federal guidelines related to Obamacare enrollment. But at some point they will have to decide if they wish to retain skilled employees or see them move elsewhere.

U.S. inflation

Inflation rose at 1.7% in 2017 and is expected to gravitate to 1.9% in 2018, and 2% in 2019 and beyond. These

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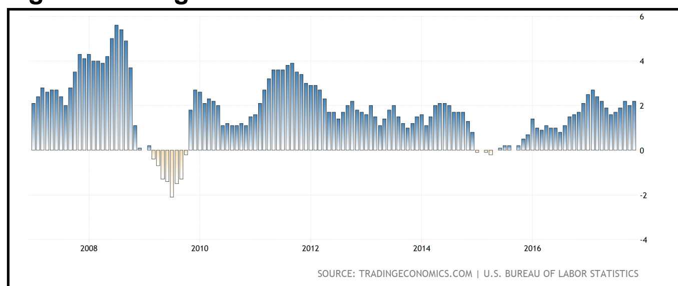
consensus estimates represent a decline from the 2.1% rate through 2016 and in my view, may be too optimistic.

One can argue that inflation has been rising at a solid pace given that the core rate for 2015 was 0.7% (see Figure 5), although the 2015 rate was the result of a lower oil price, which is a major component of the consumer price index. But like most things, there are two sides to this coin. If you buy into the narrative from the long end of the bond market, inflation may decline in 2018. Despite hawkish announcements from the Fed, not all members are onside with rate hikes. In fact, some members of the Fed's rate-setting Federal Open Market Committee (FOMC) believe that the Fed should hold back on further hikes until inflation moves towards 2%, which is the upper end the Fed's comfort zone.

Figure 5: Longer term U.S. inflation rate



In keeping with the muted inflation view, there is little argument surrounding the lack of wage inflation. And this is something that is not easy to explain. My best guess is that there's reluctance among global companies to increase wages by shifting workforces towards part-time workers, which anecdotally may be the result of government programs that pushed up minimum wages in various regions.

On the other hand, if the labor market tightens (see my comments on U.S. unemployment), wage pressures should surface in the latter half of 2018. If wages begin to gain momentum, inflation will certainly push towards 2% (see Figure 6).

Figure 6: U.S. inflation rate forecast

The bottom line is I believe there is a strong case to be made for a continuation of the bull market, but likely at a slower pace than we saw in 2017.

Next time: I'll continue my outlook for 2018 with a look at how these factors will impact interest rates and the yield curve, plus I'll give my take on key sectors. – R.C.

GORDON PAPE'S ETF UPDATES

Horizons Euro STOXX 50 Index ETF (TSX: HXX)

Originally recommended on July 31/17 (#21729) at $29.30. Closed Friday at $32.13.

Background: This ETF tracks the performance of the Euro STOXX 50 Index. It's somewhat like Dow of Europe except it's a little larger as it consists of the top 50 companies in the eurozone (the Dow Jones Industrial Average tracks 30 stocks).

Performance: The units hit a 52-week high of $32.74 in late January before sinking in the early-February market slump. The ETF has since rallied, rising to the current level even as investors remain nervous about the increasingly aggressive U.S. trade policy.

Key metrics: The ETF has a low management fee of 0.17%. The fund is quite small with only about 3.2 million shares outstanding, so trading volume is very light – rarely more than 5,000 shares a day.

Distributions: There have been none since the fund was launched in late 2016, so investors who need cash flow should look elsewhere.

Outlook: The European economy continues to recover, but U.S. trade policy will be a key determinant of how this ETF performs in the coming months. If Europe does not get an exemption from the steel and aluminum tariffs, it has threated to impose a range of counter-measures against such American products as Kentucky bourbon

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and Harley-Davidson motorcycles. President Trump says if that happens, he'll slap higher tariffs on European cars like Mercedes, BMWs, and Volkswagens. You can see how a tit-for-tat trade war like that could get completely out of hand. Hopefully it won't work out that way, but with the President in his current state of mind and moderates on his staff either quitting or being fired, who knows?

How to buy: As mentioned, this fund tends to be thinly traded, so enter a limit order and be patient.

Action now: Hold. A U.S.-Europe trade war would be bad news for many of the companies in this index.

BMO India Equity Index ETF (TSX: ZID)

Originally recommended on April 10/17 (#21715) at $22. Closed Friday at $24.34.

Background: This ETF tracks the performance of the BNY Mellon India Select DR Index, which holds a basket of depositary receipts that trade in New York and London. This is a highly concentrated fund, with only 16 stock holdings.

Performance: This fund provides exposure to blue-chip India stocks like Infosys, State Bank of India, and Reliance Industries. It performed well in 2017 with a gain of 34.3%, but so far this year it is pretty much at the breakeven level.

Key metrics: At 0.72%, the management expense ratio (MER) is on the high side for an ETF. That's one of the reasons for the underperformance so far this year. The index on which it is based showed a gain of 0.36% for 2018 as of the end of February, while the ETF was off 0.01%. Assets are about $335 million, and there are about 13.6 million units outstanding.

Distributions: The fund makes annual distributions. For the 2017 fiscal year, investors received a cash payment of $0.093 per unit, which was paid on Jan. 5.

Outlook: After a strong run, the Indian stock market has been flat this year. Growth prospects are still considered to be good, and India is on track to surpass China for world population leadership within a few years, creating a huge new market for consumer goods as incomes rise. But for the moment, problems within the government have stalled the upward trend.

Action now: Buy. I still like India's long-term prospects.

iShares Core S&P U.S. Total Market ETF (TSX: XUU)

Originally recommended on March 2/15 (#21509) at $20.42. Closed Friday at $27.88.

Background: This ETF tracks the entire U.S. market, covering small-, medium-, and large-cap stocks. It comes in both a hedged version (XUH) and an unhedged version (XUU). We originally recommended XUU two years ago.

Performance: The momentum appears to be slowing on Wall Street, in part because of the uncertainty over Donald Trump's protectionist policies, in part because of concerns about higher interest rates and the possibility of a return of inflation, and in part because of an unexpected pullback in consumer spending. Despite this, the fund is up from our last review in January and hit a 52-week high last week. As of Thursday, the year-to-date gain was 6.5%.

Key metrics: This is one of the cheapest ways to invest in the broad U.S. market. The fund has an MER of only 0.07%. The low cost has helped to make it highly popular with ETF investors; the fund has over $1.3 billion in assets. There are almost 49 million units outstanding. The fund is heavily weighted towards technology stocks (24.1% of the total), with strong exposure to financials (15.2%) and health care (13.4%).

Distributions: The units make quarterly payments, which are erratic. For 2017, the total payout was about $0.39 per unit, which would translate into a yield of 1.4% at the current price. The March distribution has not yet been declared.

Outlook: The U.S. market looks a little wobbly at this point. However, it's in better shape than most of the other world markets, and U.S. growth remains strong, so you need to be there.

Action now: Hold.

iShares MSCI EAFE Index ETF (CAD-Hedged) (TSX: XIN)

Originally recommended on March 18/13 (#21311) at $19.68. Closed Friday at $25.82.

Background: This ETF is the Canadian-dollar hedged version of a U.S. fund (NYSE: EFA) that tracks the MSCI EAFE Index, which covers Europe, Australasia, and the Far East. Most of the assets are invested in the U.S. version of this ETF.

Performance: It has not been a good year for most

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international markets thus far. As of mid-week, Japan was down 6.7% for 2018, while the British Dow was off 6.9%. Germany, France, Australia, and Hong Kong were also in the red to varying degrees. Therefore, it's not surprising that this fund was down 2.6% for the year to date as of March 16.

Key metrics: At 0.49%, the MER is in the mid-range for exchange-traded funds. The fund has 57 million units outstanding and net assets of almost $1.5 billion. It is 100% hedged back into Canadian dollars. Japanese stocks are the number-one holding at 24.9% of assets, so the big drop in the Nikkei this year has been a major drag on the results. The U.K. position is at 17.2%, down slightly from the last review, while France is at 11%, up a bit. No other country has more than a 10% position.

Distributions: The fund makes semi-annual payments, in June and December, and they vary significantly. Payments over the past 12 months totaled about $0.57 per unit for a yield of 2.2% based on the current price.

Outlook: Although world economic growth is continuing, there is renewed uncertainty about the future, especially as it relates to U.S. policy. It pays to be cautious at this point.

Action now: Hold.

iShares Core Canadian Short Term Corporate + Maple Bond Index ETF (TSX: XSH)

Originally recommended in fall, 2013 as part of the Conservative Portfolio. Closed Friday at $19.11.

Background: This is a short-term ETF that provides some exposure to Maple Bonds, which are Canadian-dollar bonds from foreign issuers such as Bank of America, JPMorgan Chase, and Goldman Sachs.

Performance: This fund did a little better than breakeven in the 12 months to Feb. 28, but not by much. Over the past five years, it has delivered an average annual compounded rate of return of 2.1%, which isn't great but not bad for a short-term fixed income fund.

Key metrics: The fund has a management fee of 0.9%, which looks low at first glance but is on the high side when measured against returns. Assets under management are $847 million, which is surprisingly high for a fund that is little known and generates such low returns.

Distributions: Distributions are paid monthly and are currently running at $0.046 per unit, or $0.552 annually. At the current price, the yield is 2.9%, but don't let that excite you. Although you are getting decent cash flow, the unit net asset value (NAV) has been declining. Right now, you are more or less breaking even.

Outlook: Short-term bond funds are a defensive position. But right now, holding cash (which has no management fee) is a better alternative. Put the money into a high-interest savings account for now (some offer more than 2%).

Action now: Sell

MEMBERS' CORNER

TurboTax glitch on foreign income

Member comment: I have used the downloaded version of TurboTax for many years and had become so confident in it that I hadn't been checking the results as much as I probably should. Last year (2016 taxes), I got a letter from the CRA which exposed an error in my return. After some investigation, I attribute this to a misleading property of TT. It's about foreign income.

I had some foreign income, dividends on U.S. shares, which appeared on my T5 in the boxes. Going through the step-by-step method of TT, I entered the T5 information. Then, there was the request to enter foreign income, no mention that it should not include what was on the T5. So, I entered this income again. TT then generated a "foreign slip," something like a T-slip with that income, interpreted as U.S. dollars, which it converted into Canadian. As you can guess, the result was a duplication (approximately, because of the conversion) of both the foreign income and the foreign tax exemption.

My confidence in this product was shaken. I let them know about it. From what I can see from this year's version, things haven't changed much. They still ask about foreign income without making it clear that they don't mean what is already on the T5 or T3 slips. I can't say that they paid any attention to my phone call. That's a mistake I won't make again. I'm still waiting for CRA to correct my return for 2016. – Mike F.

Response: Thanks to Mike for pointing this out. I'll be reviewing a couple of software programs in upcoming issues, but I would also like input from readers about what they find good or bad about electronic filing. Suggestions for improving any tax software you use are also welcome. Send your comments to be directly at gpape@rogers.com.

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