CANADIAN INVESTORS' COURSE

Session 5 – The Economics that move various Investment Assets

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This is not an economic course.

Basic events/items to watch for as an investor:

1. Government – Federal Reserve
2. Interest Rates – yield curve
3. Currency
4. Economic Cycle

Government

Fiscal policy **involves the government changing tax rates and levels of government spending to influence demand in the economy. Consumer demand, corporate demand, etc.**

Monetary policy **involves changing the short term interest rate and influencing the money supply.**

Fiscal Policy – What can elected politicians do that affects the economy?

1. Lower Taxes to stimulate the economy. Raise them to slow it down. Change tax rates on certain industries or products to pinpoint stimulus or slow things down. Change taxes on investments like lowering capital gains tax. This stimulates Stocks and real estate.

2. Create deficits in bad times to stimulate the economy and cut back on spending in good times. Keynesian economics.

3. Automatic stabilizers are programs that cause Government to spent more or less depending on what is going on in the economy. An example is Unemployment Insurance an automatic increase in spending as jobs are lost and vice versa.

Monetary Policy – Actions performed by the Central Bank

1. Examples of Central banks: Bank of Canada and the U.S. Federal Reserve. Policy is basic microeconomic activity used to promote economic growth, job growth, steady and/or low inflation

2. Central banks can expand or contract money supply depending on their objectives

3. Central bank determines short-term interest rates

4. Central Banks are practicing Quantitative Easing (money printing) and buying back bonds with the money. Buying new Government issued debt or bonds and debentures on the open market to keep rates low.

Monetary Policy - Central Banks can react to economic data

- Will stimulate in reaction to poor economic data
- Stocks have a tendency to do well when the Fed is not threatening to raise rates, therefore poor or slow growth and economic data can actually have a positive effect on stocks.
- Real estate sales do well as interest rates fall or remain low
- Interest sensitive investments favour weak economic data and falling interest rates
- Low inflation helps the FED to keep rates low
- Quantitative easing and money supply growth promote economic activity, versus tightening

The Yield Curve and the Economy

- The yield curve is a set of data that reflect interest rates at all maturity levels
- Since 1950, with the exception of one instance, an inverted yield curve has been a precursor to every recession. This has been a reliable recession indicator.
- An inverted yield curve is where short term interest rates are lower than long term rates
- Usually its the difference between 2 and 10 year rates
- This occurs when the Central bank raises short term rates and causes Bond investors to buy long term bonds in anticipation of a slower economy. A slower economy usually brings lower inflation which is attractive to longer term bond holders.
- Unfortunately, the FED may over do it and cause a recession
- Buy interest sensitive investments when you see an inverted yield curve

Note: USA Treasury yield curve site: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield

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Inverted yield curves and recessions. In the chart below, when the blue line goes to Zero or below the yield curve is inverted, the gray shaded areas show the recessions that soon followed.

Chart 1: Curve flattening tends to precede recessions

The chart shows the 2s5s Treasury curve, adjusted curve, and the current level (as of 9/29/2011) of the adjusted curve. The gray bars indicate US recessions. Last data point: 9/29/2011. Source: Federal Reserve Board, BofA Merrill Lynch Global Research.

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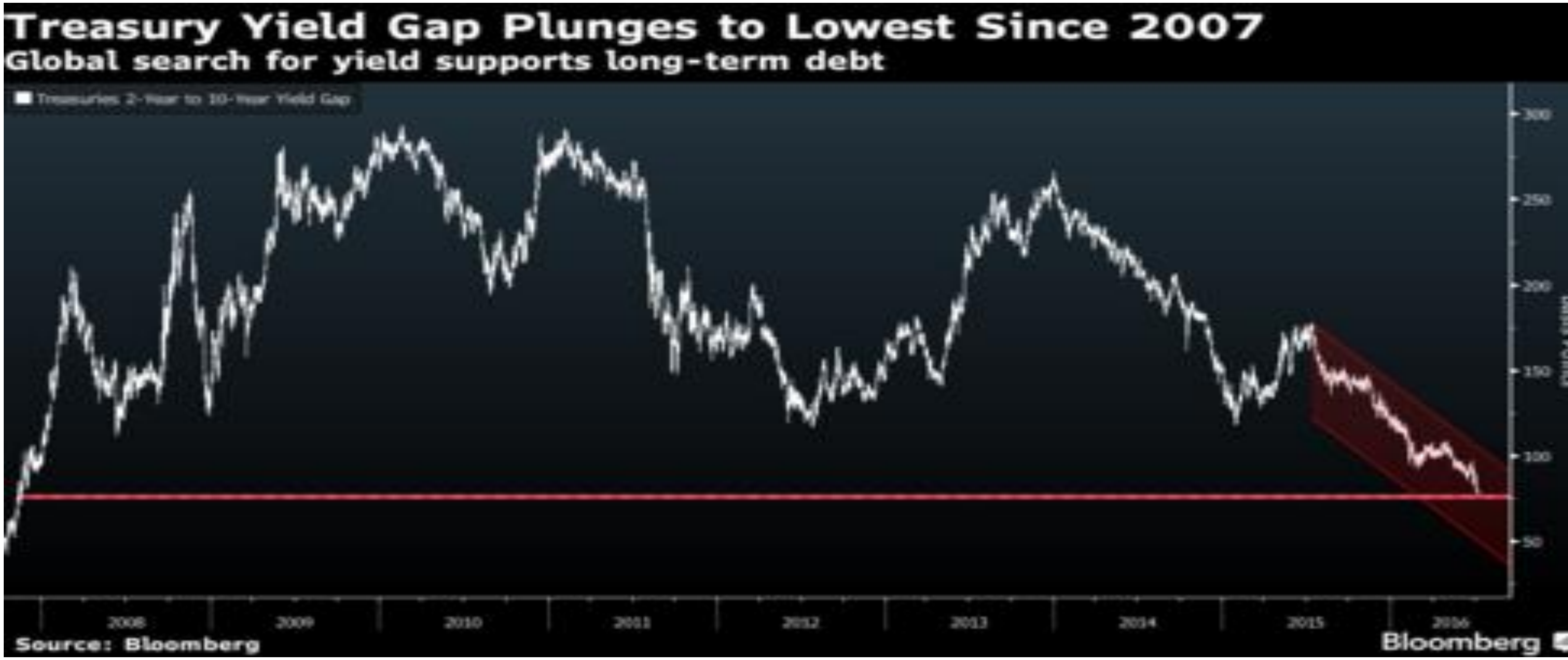

Inside the Unprecedented World of Negative Yields

The gap between yields on two- and 10-year Treasury notes, a measure of the yield curve, fell to about 75.5 basis points in mid 2016, the flattest since November 2007, as show by this data compiled by Bloomberg. The narrowing accelerated after the U.K. vote to exit the European Union dimmed world economic growth prospects and pushed more global yields below zero, boosting the appeal of Treasuries. Add to that the Federal Reserve's tightening bias, the trend is set to continue. We could be heading towards another inverted yield curve.

Central Banks and Currency Rates

Currency manipulation occurs when countries sell their own currencies in the foreign exchange markets, usually against U.S. dollars, to keep their exchange rates weak and the U.S. dollar strong. These countries thereby subsidize their exports and raise the price of their imports, sometimes by as much as 30 - 40%. Usually, there are agreements between Central banks to regulate these flows.

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Economic Cycle

ECONOMIC CYCLE

RECOVERY PHASE
- Stimulatory economic policies
- Confidence picks up
- Inflation falling

MARKETS :
- Short rates low or falling
- Bond yields bottoming
- Stock market rising
- Commodities rising
- Property prices bottoming

EARLY UPSWING PHASE
- Increasing confidence
- Healthy economic growth
- Inflation remains low

MARKETS :
- Short rates at neutral
- Bond stable
- Stock market strong
- Commodities strong
- Property prices picking up

LATE UPSWING PHASE
- Boom mentality
- Inflation gradually picks up
- Policy becomes restrictive

MARKETS :
- Short rates rising
- Bond yields rise
- Stock market topping out
- Commodities rising strongly
- Property prices rising strongly

ECONOMY SLOWS/ENTERS RECESSION
- Confidence suddenly drops
- Inflation continues to rise
- Inventory correction begins

MARKETS :
- Short rates peaks
- Bond yields tops out
- Stock market starts falling
- Commodities starts falling
- Property prices tops out

RECESSION
- Confidence weak
- Inflation peaks
- Production falling

MARKETS :
- Short rates drops
- Bond yields drops
- Stock market bottoming
- Commodities weak
- Property prices weak

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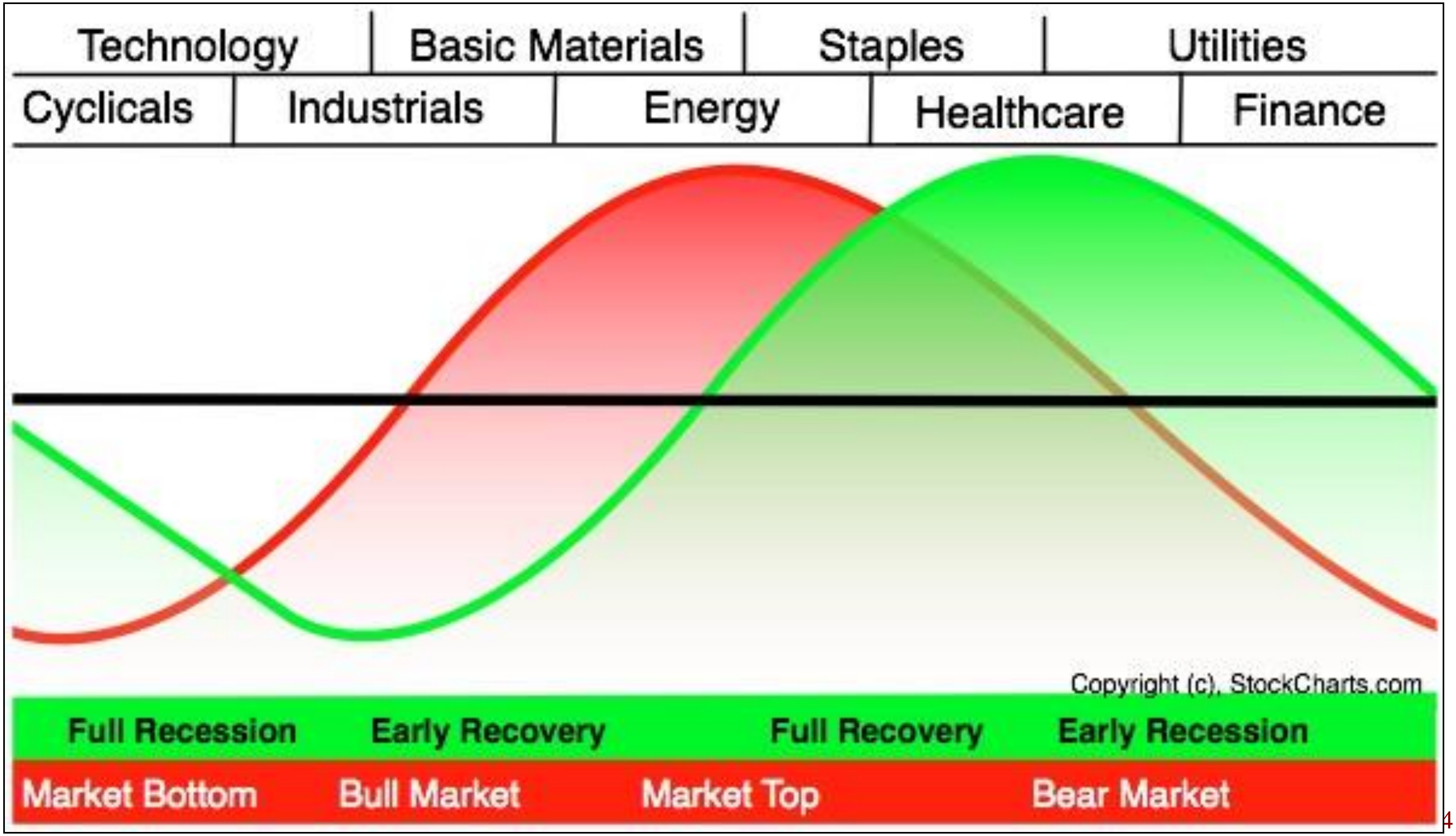
Investments for different Economic Cycle Stages



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LATE CYCLE (decreasing growth)

Sentiment
- Inflation a worry
- Fin'l advice stresses gain
- Warnings of "Boom"
- Consumer confidence peaks

Economic Indicators
- Leading Indicators begin to point down
- Capacity utilization is high
  Wages increase
- Manufacturing level is high

Monetary Indicators
- Short rates rise
- Long rates rise
- Fed tightens
- Yield curve initially positive

RECESSION (decreasing growth)

Monetary Indicators
- Short Rates Fall
  Long Rates Fall
- Fed begins to ease
- Yield curve steepens as short rate falls

Economic Indicators
- Leading Indicators are down
- Corporate profits are down
- Inflation less of a worry
- Manufacturing Contracts
- Unemployment Rate rises

Sentiment
- Employment news negative
- Consumer confidence falls
- Fin'l advice suggests safety
- Money flows from stocks to bonds
- Stock prices fall going into recession but rise before end

MID-CYCLE (increasing growth)

Sentiment
- Inflation concern expressed
- Fin'l advice stresses appreciation
- Consumer confidence rises
- Money flows from bonds to stocks
- Stock prices rise

Economic Indicators
- Corporate profits are positive
- Leading economic indicators rise
- Inflation picks up
- Manufacturing expands
- Capacity utilization increases

Monetary Indicators
- Short rates flat
- Long rates rise
- Fed is neutral
- Yield curve is positively sloped

EARLY RECOVERY (increasing growth)

Monetary Indicators
- Fed no longer easing
- Short rates flat
- Long rates flat
- Long rates higher than short rates

Economic Indicators
- Leading Indicators turn up
- Capacity utilization no longer shrinking
- Manufacturing stabilizes
- Inventory levels initially contract

Sentiment
- Corporate profits a concern
- Fin'l advice less cautious
- Consumer confidence rises
- Stock prices improve

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