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Factors that may derail the current bull market

Currently the bull market is alive and well and has been in place since the last recession in 2007-2008. There are many young investors who have not experienced a bear market of any magnitude and may not know how to react if it happened.

The recent US tax reform coupled with domestic banking deregulation are certainly keeping the US equity market in a decisive uptrend.

However, many economists and strategists believe that tax reform is front end loaded, implying that the year over year benefits decrease over time. For example, corporate tax rates fell at the end of 2017 and the marginal percentage annual benefit to the domestic economy will cease by 2019.

Secondly the jury is still out if the strong US fiscal stimulus in the form of declining corporate tax rates will result in a sharp increase in economic growth. So far, the lower taxes have principally resulted in massive stock buybacks and dividend increases rather than the benefit directed into higher capital spending and new projects. Stock buybacks are largely cosmetic and only improve earnings per share, not overall profitability.

Historically lower taxes have been accompanied by cuts in spending to ensure that the overall budget deficit is kept under control. However, it clearly looks like this Republican administration is also spending heavily, thereby increasing the deficit even further.

In addition, the US Federal Reserve is now firmly in the hawkish camp and expects to continue their current course of increasing interest rates.

Historically it is rising interest rates that eventually puts a strangle hold on the economy that leads to an economic recession and falling stock markets. We have all heard some pundits say that this economic cycle is different and that we should not expect the same results. I am a student of history and firmly believe that history will repeat itself and that never changes. All that differs from one cycle to another is the length and severity of the ups and downs in both economic growth and stock market movements.

Rising short term rates from a hawkish Federal Reserve are not yet resulting in a steepening of the yield curve. The spread between two and ten-year Treasuries remains around 50 basis points which is historically very low at this point in the economic cycle. Normally when the yield curve becomes inverted, short rates above long rates, an economic recession is not far off. Stock markets normally fall at least six months before the beginning of an economic recession.

Currently corporate profit margins are at record highs propelling strong profit growth. However, we may be at the peak of corporate profits. Inflation is just beginning to accelerate in the form of higher labour rates and material and commodity costs. Energy prices have rebounded sharply from last year and are still materially higher year over year even after the recent 8% price correction.

Economic growth is slowing from peak levels in Europe and in Emerging Markets. A higher US dollar puts a lot of pressure on Emerging Market economies as their debts are mainly denominated in US dollars.

Geopolitical shocks can also cause an economic recession. Currently the relationship between North Korea and the US seems to be looking up but all that is predicated from a positive outcome from Trump's upcoming meeting.

Donald Trump and his goons seem completely obsessed with trade protectionism and are very unlikely to back down in confrontations with Canada, Mexico, European Union and China. This is a very disturbing situation that is not all based on actual facts. Canada has a balanced trade situation with the US when you include both goods and services. Trump is only looking at the goods imbalance and not taking services into consideration, even though this has been brought to his attention many times. Robert Shiller, the Yale professor and Nobel Laureate, believes that an all out global trade war will be devastating for global economic growth. If history is any judge, the US government commenced a massive campaign of trade protectionism in the middle of the Great Depression in 1929. These protectionist trade policies extended the Depression by an additional ten years.

Evidenced by his behaviour in the last G7 summit in Quebec, Trump is not interested in renegotiating NAFTA nor is he willing to back down on trade tariffs towards most global countries.

The retaliation expected from the countries negatively affected by these US tariffs, through the introduction of their own import tariffs, will further exacerbate the situation. The consequences from a global trade war are higher inflation combined with a slowing of global economic growth.

Much of the positive effects of the US tax reform may end up being offset by the negative repercussions of a trade war.

A possible presidential impeachment would also lead to a bear market, but this is considered highly unlikely despite Trump's behaviour.

Conclusion

Rising interest rates and inflation will eventually lead to a global recession. At this point in time we cannot accurately predict the exact timing of this occurring. Most strategists feel that we are in the later stages of an economic cycle and that in about 1-2 years another global recession will rear its ugly head. As leading indicators, stock markets normally go down six months before the onslaught of a recession.

We all need to keep a close eye on the trade wars. We may well end up with stagflation, rising inflation accompanied by low economic growth. Equity markets would clearly not like that scenario.

It is still too early to become overly defensive in your portfolio asset mix. The outlook for bonds in a rising interest rate environment is not good.

My advice is to further increase cash levels by 5.5% for both portfolios with the Income and Growth portfolios reaching cash levels of 30% and 25% respectively.