THE ABC PERSPECTIVE

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Free Money: Driving Stock Prices Higher

When one borrows money one must pay interest. This is logical and indisputable. However, over the past few years there have been numerous fixed income financings that have been publicly offered and successfully sold at negative rates of return. Although negative yielding bonds might sound completely absurd to a rational investor, the fact is they have grown globally to over $12.5 trillion outstanding.

The question is: why would investors purchase debt securities which will repay them less than what they have lent? Possible explanations might include: concerns of a major economic downturn; fears of deflation; desire for security of capital via sovereign government and prime corporate paper investments; perception of excessively easy global central bank monetary policies; and/or simply supply and demand. Regardless of the reasoning, it is our view that this "free money" phenomenon is unnatural and transitory. While it is uncertain how long this financial phase will endure, it will eventually correct and interest rates will reverse. In the meantime, this serendipitous free money setting is driving stock prices higher.

With the present U.S. economic expansion now entering its eleventh year and American stock market indices reaching new all-time highs, there naturally exists a healthy investor skepticism. Generally, at this stage of the economic cycle characterized by growing employment, steady business growth, and healthy consumer spending, interest rates should be rising. Instead, they are trending lower and real money costs are virtually nil. As a result, low interest rates are compounding the relative attraction of seasoned common stocks and solid dividend-payers in particular.

We believe this extraordinary low interest rate environment partially explains the breadth and longevity of the present equity bull market. Accordingly, we offer two simplistic observations:

- The lower that interest rates descend, the lower the discount factor investors will utilize to arrive at the net present value of a common stock investment. By extension, the lower the discount factor, the greater the price or price earnings ratio an investor will be willing to pay for a stock.

- During the present low interest rate environment, common stocks with sustainable dividend payouts and the prospect of dividend and capital growth have become increasingly attractive compared to low or negative yielding bonds. We believe appealing investment sectors include: Canadian banks, energy infrastructure stocks, and selective industrials.

In summation, the current abnormally low interest rate environment remains an important positive influence on common stock performance. It is our opinion that interest rates will remain lower for longer and this factor should prolong the present stock market run well into 2020.

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ABCFunds™

INVEST YOUR MONEY
WHERE WE INVEST OURS

Economic Perspectives

Extending The American Economic Cycle

Despite the past year's ongoing investor anxiety and pessimism with regard to recession worries, the American economy has just entered its eleventh year of economic growth – the longest economic expansion in modern history.

Although the U.S. economy is experiencing decelerating growth within a 2% – 3% range, we believe the risk of a near term U.S. recession is very low. Consequently, we expect this American economic growth cycle to extend well into 2020.

Our confidence is supported by a 50-year low unemployment rate combined with high labour productivity, strong consumer spending, muted inflation, an accommodating U.S. Federal Reserve, and record low interest rates. Given this positive economic setting, we expect common stock prices to trend higher.

Investment Perspectives

Bond Proxies: Solid Dividend Paying Stocks

With the preponderance of low and negative yielding bonds, the relative attraction of sustainable dividend paying common stocks with capital gains potential have become increasingly important to achieving incremental portfolio returns.

Bond proxies yielding 3% – 5% in our portfolios include the Canadian banks, energy infrastructure companies, and select U.S. and Canadian industrials. We believe these liquid, high quality, and dividend paying securities are appealing options to excessively low yielding fixed income securities in a record low interest rate environment.

Portfolio Perspectives

Still Fully Invested

Given our optimistic equity market outlook, our five ABC Funds' portfolios remain fully invested. Our investments are mainly composed of mid to large capitalization dividend paying U.S. and Canadian common stocks with favourable earnings and growth prospects.

Our portfolios are well-diversified within a number of key sectors, including: Information Technology, Consumer Discretionary, Financial Services, Industrials, and Health Care. At this point, we intend to adhere to our present investment stance for at least the next 6 -12 months.

Visa & Mastercard: Core Common Stock Holdings

Visa and **Mastercard** are core holdings in all ABC Funds, as they represent a combination of quality, stability, and growth. Both companies operate payment networks that link consumers, merchants and banks. The companies make money by charging a 0.15% fee on each transaction, essentially operating as a toll booth for global consumer and business purchase transactions. Their competitive advantage is having enormous scale, with trillions of dollars of commercial transactions producing huge free cash flows. Although network fees are relatively small, it takes vast scale to replicate these businesses and a well-developed administrative system to deal with government regulation, security, and fraud protection. Both companies possess enhanced economies of scale and a formidable moat discouraging new competition.

Visa and Mastercard's main growth driver is the continued shift to electronic payments and the decline of cash usage. Interestingly, the CEOs of both companies consider cash to be their main competitor. In many countries including the United States, cash is still the dominant method of payment, indicating a long runway for future growth.

With the rising penetration of digital payments, Visa and Mastercard are expected to grow EPS in the high teens over the next five years, highlighting the stocks' relative value against the broad market. Finally, with consistent strong earnings growth, a powerful economic moat, and the ascent of the digital economy, we believe that Visa and Mastercard represent excellent long term investments.

Administrative Information

- There are units of the ABC North American Equity Fund & ABC Global Equity Fund available for purchase. Contact our office for more information.

- Purchase requests must reach our office by the last business day of the month and redemption requests (for our open funds) must reach our office no later than ten business days before the last business day of the month.

- Clients that are invested in our close-end funds are able to redeem their reinvested distribution units on a monthly basis. Also, you can participate in the annual 10% redemption right if you provide the completed form by November 30 for a December 31 transaction date. If you need assistance with either of these options, please do not hesitate to call our office.

- All cheques are to be made payable to RBC Investor Services.

- All client requests are to be directed to ABC Funds.

- We continue to request that clients assist in updating their "Know Your Client" forms. This information is a regulatory requirement to assess the suitability of our various ABC Funds to individual client needs.

- RBCITS is the custodian of the ABC Funds and is responsible for providing our clients with account statements, tax slips and requested funds. We ask that you retain all statements for your records as there may be additional costs for retrieving historical data.

- Please contact our office to inform us of any changes in mailing or email addresses. If we do not have your current contact information, you may not receive the information we are sending out.

This newsletter is published by I.A. Michael Investment Counsel Ltd. and the ABC Funds
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