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Where Canadian interest rates, China, and fintech are headed

An interview with Economist, Sébastien Mc Mahon

While there's no surefire way to make economic predictions, peering into the mind of Sébastien Mc Mahon might be the next best thing.

In his position as senior portfolio manager, diversified funds and economist at Industrial Alliance Financial Group, Sébastien has written numerous articles on economic issues affecting Canadians. So we asked him to provide some insights on where he thinks the economy is headed in the next five to 10 years with respect to recession risks, interest rates, and investing trends. Here's what he had to say.

1. What compelled you to pursue a career in economics, and how do you see this profession evolving in the digital age?

Growing up, I always sought a deeper understanding of the world. I wanted to know why humans behave as they do and how society, as whole, manages to work cohesively when it's often hard to cooperate - even with your loved ones! Economics kind of crept up on me, as I saw it as a field where I could at least understand the way the world works a little better. The heavy use of mathematics also became very important to me, because of the math geek that I am.

Editor's note

Bob Dylan famously sings *The Times They Are A-Changin'* and nothing could be truer when it comes to the future of finance. Many speculate on what the global economy will look like in the next five to 10 years, and at the rate fintech is growing, it can be hard to predict where we might end up. But we've taken a stab at it anyway. As you peruse this edition of *Strategies*, remember that no matter where the world takes us, we've got you covered.

Lucy Conte, Editor-in-chief

INSIDE

In my opinion, the field of economics, like other social sciences, is undergoing a very profound and positive transformation with the advent of "big data." Social sciences aim to explain the behaviour of human beings, which is one of the most complex things to narrow down in the known universe. I always joke with my friends working in so-called "hard" sciences that while water boils at 100 degrees Celsius, not every human being will react the same under a set of circumstances. Economics did its best in previous centuries to build models and theories which can help us understand how the masses are behaving, and we finally have the data to test these hypotheses at the micro level. Important new discoveries are being made, and for us financial economists, a better understanding of human behaviour helps us be better investors.

Sébastien Mc Mahon, iA Financial Group

2. What recent developments have been the most influential in shaping your current perspective on the economy?

No question, the rise of populism, which led to the election of a president like Donald Trump in the U.S. and the trade tensions that came with it.

The recent history of economic growth is actually quite simple.

In the last 70 years, growth came from three sources: first, a booming demography, second, the rise of important new technologies that tremendously changed our daily lives and how goods are produced and transported, and third, globalization.

The first two engines of growth are now contributing less and less, as demographic growth in the developed world is slowing to a crawl and the low-hanging fruit that dramatically raised our productivity has been reaped.

Globalization, meaning the specialization of the production of goods and services and a deep reliance on trade, has now started to move in reverse. Globalization led to stronger growth, yes, but also to a rise in inequalities and unethical production, which in turn led to populism rising in the developed world.

As a human first, and economist second, I completely understand the root of populism and how everyone needs to benefit from growth. But I am worried about populism leading to nationalism, and the old wounds that are resurfacing (the relationship between Japan and Korea particularly comes to mind) worries me. The economic consequences could become deeper and deeper if collaboration between nations turns to conflict, if trust is deeply damaged and, consequently, this third former engine becomes a headwind to growth.

3. What are the recession risks for Canada, the U.S. and Europe in the near future? What would a new recession look like?

A recession in the near future is not our base case, but the risks are rising. We do expect Germany to soon confirm being in a technical recession, with output contracting in both Q2 and Q3.

It's always risky to say this, but I still don't feel that some sort of profound financial imbalance, which could lead to a repeat of 2008, is building right now. We are now in a slower growth world, meaning that the boom-bust pattern we saw in decades past is not how the current world operates. This means risks of seeing the economy overheating, leading to a deep contraction, are pretty low. I expect the next recession to be a soft one (if there is such a thing), and not one that will leave a trace in the history books like the previous one.

4. What role do you see China playing in the global economy over the next decade, regardless of how the trade war with the U.S. plays out?

Over the next ten years, China will become the world's largest economy. This means that, like it or not, it will take over global leadership. I expect China to slowly bring about a different world order, with a different vision than what us westerners are used to. China operates a controlled economy, with less emphasis on the short-term.

Expect China to take a more pronounced leadership role on geopolitical issues, and try to extend the influence it already has over Asia to the rest of the world.

5. How much could the central banks lower interest rates, and what would it look like if rates went too low or started climbing too quickly?

Hard to tell where the bottom is, but it looks like a consensus is building about a "reversal rate," meaning a rate below which harm would be done to the economy, being somewhere not too far below current

levels. So it's becoming more and more accepted that central banks might be relatively out of ammunition at these levels.

If interest rates started to rise in a disordered way, the impact on markets would probably be negative, as it would hurt investor psychology. Investors would have to review their valuation models for every asset class, including equities, and the risk premium could become overwhelming. So a rise to more sustainable levels could be a good thing, but it needs to happen in an ordered fashion.

6. Which top investment trends do you think will shape global markets in the next decade?

The rise of ETFs and other passive vehicles is here to stay. This means that only managers that can offer sustainable outperformance will last.

Our job as managers is to make the best asset allocation decisions and implement them in the most efficient, cost effective ways. So don't be surprised if you see managers like us using more and more derivatives in our funds.

7. We hear a lot about Trump affecting the economy. To what extent do politicians really influence what happens in the markets?

Trumpism is creating uncertainty. When uncertainty is rising, entrepreneurs become less willing to invest and hire, leading to real damage being done over time to the economy. As investors, you're always probably five minutes away from a market-moving tweet, so you have to be doubly careful about the trades you put in place.

8. To what extent does the U.S. economy affect Canadian markets?

A lot! The U.S. is still Canada's most important trading partner, and it's true that when the U.S. sneezes, Canada catches a cold. The Canadian stock market is still heavily weighted in energy and financials, two sectors that are sensitive to the state of the global economic cycle. The S&P/TSX is a very risk-on/risk-off index, and the strength of the U.S. economy is even more important than Canadian data.

9. Where is energy investing headed, and what are your views on oil?

With the importance set on ESG, the sector might be under-owned structurally. Especially Canadian oil sands, which are perceived as being dirtier than other global producers.

With the rise of shale oil production, the oil market is more likely to be oversupplied than undersupplied in years to come, meaning prices are likely to stay at or below current levels. Add to that the rise of electric cars and legitimate questions can be asked about the terminal value of an investment in the energy sector.

10. What should investors keep an eye on in the tech sector?

Many themes are driving the tech sector right now. In my opinion, there are four major ones to watch.

First, the "software is eating the world" theme is a very important one, as big players like IBM are moving towards services rather than hardware. Second, the 5G cycle should be a big driver of capex and investor interest next year. Third, fintechs are an important theme right now, as they're slowly taking away profits from large banks. Fourth, semi conductors and the rise of the electric cars is a theme that should have legs for years to come.

Sébastien Mc Mahon is senior portfolio manager, diversified funds and economist at Industrial Alliance Financial Group. He also acts as a senior economist and is a member of the firm's asset allocation committee. Additionally, he is a member of the board for Quebec's association of economists and other local financial organizations.

Are you ready for healthcare costs in retirement?

Canada is often looked to as a country that's getting things right when it comes to public healthcare. In many ways, we live up to that reputation. But it turns out that government funding for retirees isn't quite as generous as the average Canadian believes. Because of this, many of them aren't aware of – or prepared for – the out-of-pocket expenses they'll incur in retirement. The good news is, you can do something about it before it's too late.

There's a growing trend with employers to axe retiree health benefits to their retired employees. This means most people will need to plan for healthcare expenses in their retirement well in advance of their final work date. But few people do.

A Leger Marketing survey conducted on behalf of the Canadian Life and Health Insurance Association (CLHIA) says that 74 per cent of Canadians admit they have no financial plan to pay for long-term care when they get older. This is because many people assume that full-time care in a long-term care facility will be fully paid by government health care programs. But such programs may cover only a small portion – if anything at all – of nursing home or other specialized residential care facility costs.

Here are a few other expenses that are often overlooked when considering healthcare needs in retirement.

If you retire before age 65

While employed and under a company health benefit plan, the cost of your prescription drugs is partially, or fully, reimbursed and the cost to you is minimal. But if you retire before age 65 and need to purchase medication that's not over-the-counter, you'll have to pay for 100% of the cost of the prescription out of your own pocket.

Although you can claim these prescription costs as medical expenses on your tax return, you have to reach a certain threshold first and, even then, you'll only receive a 15% tax credit.

Dental and other expenses

If you're a resident of Ontario, you'll qualify for the Ontario Drug Benefit program at age 65 and the majority of the cost of your prescriptions will be covered by the plan. However, if you need dental work after you turn 65 and don't have private health insurance, you'll only qualify for the Ontario Seniors Dental Care Program if you're single with an income of $19,300 or less, or if you're part of a couple with an income of less than $32,300.

Then, there are all of the other medical services that you may need to use in retirement that the government will not pay for such as physiotherapy, massage therapy or podiatry, to name a few.

Assisted living

Although we're now living longer, we're not necessarily living healthier as we age. This means that, at some point, we'll need to avail ourselves of attendant care services either at home or in an assisted living facility. The government is not prepared to subsidize all of these costs, so if you want a certain level of care you'll have to pay for it yourself.

According to the company LifestageCare, the cost of a long-term care facility in Canada ranges from $800 a month for a private room in New Brunswick to $8,000 for a month in a one-bedroom suite in Ontario. If you're in need of private home care, the cost ranges from $3 an hour for in-home meal preparation in Quebec to $85 an hour for skilled nursing in Quebec.

Long Term Care insurance

In Ontario, there are currently just a few insurance companies that sell Long Term Care Insurance. And they have certain criteria that have to be met before they will pay out a claim. Most plans will not pay out unless two of the following activities cannot be performed without substantial help: bathing, dressing, transferring, maintaining continence and eating. Or, if you require substantial supervision because of cognitive impairment, they will also pay out a benefit.

> **"You need to know what assistance will be available to you."**

However, as our population ages and more people put in claims for Long Term Care insurance, there's a good chance that the insurance companies will increase their premiums or their exclusions, or they may decide that they cannot make a business case for this type of insurance anymore.

The majority of Ontarians do not own Long Term Care Insurance because they assume that if they ever need to move into an assisted living facility, they'll be able to pay for the cost with the proceeds of the sale of their home. This can work for a single individual, but in the scenario where only one member of a couple must move to an assisted living facility this isn't a perfect solution. The healthy spouse still needs somewhere to live, so this must be taken into account when planning for attendant care costs in the future.

As you review your expected expenses during retirement, keep in mind that healthcare costs could be a significant portion of them. To plan accordingly, you need to know what assistance will be available to you, and what you'll need to cover on your own. You can find a list of the healthcare services that are covered by the government in each province and territory at the Special Benefits Services website. Also, learn more about how to budget for retirement at Canada.ca, or speak to a financial advisor who can help you create – and stick to – a sound retirement strategy.

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Bash the cash: the future of currency

I remember growing up and trading games, toys and Pokémon cards with my friends, not realizing that I had just bartered. Bartering, used in early civilizations, eventually gave way to different forms of currency such as shells, stones, beads, fur and coins. Over the past millennium, cash has been king, but in the 21st century, digital may dominate.

Cash and the dark economy

In the current climate of increased surveillance, the case against cash has become more pronounced. Cash facilitates transactions in the dark economy, where people can underreport their income since it can't be tracked by tax investigators. It's also the default mode of payment for individuals or organizations conducting illegal activities, because it's difficult to detect and trace.

According to a study conducted by the Justice and Criminology department at Georgia State University, research shows a strong correlation between cash and street crime. For instance, there was a 10% decline in total crime in neighbourhoods that transitioned from federal welfare benefits in cashable cheques to preloaded debit cards.

Furthermore, it costs money to make money, which is why Canada eliminated the penny from circulation. What will be eliminated next?

Digital expansion

Our world is becoming increasingly digitized. For instance, music, mail, movies and money have all gone digital. Global electronic payment systems are revolutionizing the way we pay for these, and other, services. As a result, buyers are saying sayonara to carrying cards and turning to a more tech savvy solution – the digital wallet.

TrendForce, a global market research firm based in Taiwan forecasts that mobile payment volume will rise from $620 billion in 2016 to surpassing $1 trillion in 2019.

Mobile smartphones are used by more than half the global population, and it's no surprise that banks are partnering with technology developers to create payment applications for a cashless future. As mobile phones become more of a necessity than a luxury world wide, experts predict a rising trend for digital wallets.

David Wolman, author of *The End of Money* suggests in his book that the single most impactful contribution from the invention of smartphones is the applications that transform the device into a seamless digital wallet. Although credit and debit card transactions still account for the majority of electronic payments globally today, digital wallet usage has risen to a clear next step in the e-payment evolution. A survey conducted by Oxford Economics and Charney Research states that 72% of executives claim that accepting mobile payments can boost their sales, and failure to adapt and do so will place them at a competitive disadvantage.

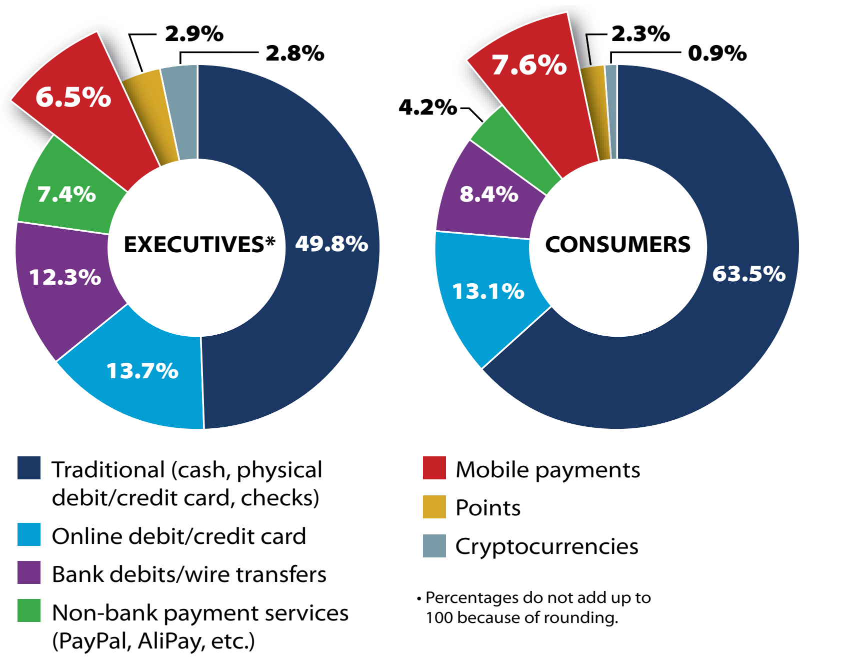

Figure 1: Oxford Economics and Charney Research March 2017

China and WeChat Pay / Alipay

Today, you no longer need a wallet while visiting China – a smartphone can easily accomplish transactions for any product or service. Online payments have dethroned cash as king in a digital revolution that's being led by two players: WeChat and Alipay. These have put China lightyears ahead in tapping into the digital pay revolution.

The fast penetration of smartphones and mobile internet, coupled with a sizeable young population of avid gadget-lovers and early technology adopters, makes this revolution possible. The dominance of mobile transactions lends itself to greater data collection by the Chinese government, which in turn feeds the rapidity of transactions only to double its volume. The growth of mobile pay in China comes off a solid base of smartphone users where WeChat has reached 963 million active users and Alipay has over 520 million. Even panhandlers will refuse your cash donation and insist on receiving money via Alipay or WeChat.

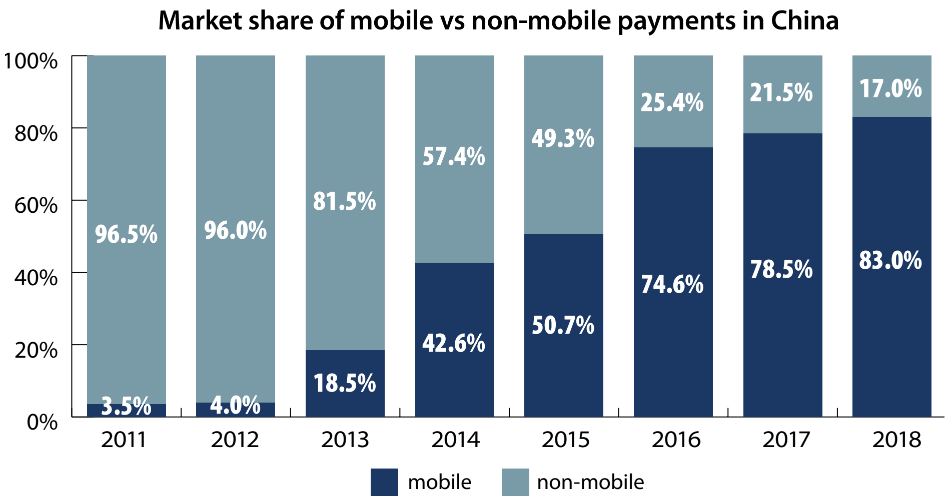

Figure 2: Daxue Consulting 2019

Cashing in on cash-less-ness

Consumer demand for the smart phone payment option has compelled most retailers, and even street vendors, to "cash in" on the opportunity. According to iResearch Consulting Group, which measures online audiences in China, the gross merchandise volume (GMV) of online payments in the country reached 57.7 trillion Yuan in 2016. This amounts to approximately 50 times the GMV of similar transactions in the United States. The U.S. GMV is estimated by market research firm Forrester Research at $112 billion USD.

iResearch also predicts that annual online transactions in China will reach 116 trillion Yuan by end of 2019. Unlike Apple pay, where sellers have to buy technology to receive a payment, in China, a simple piece of paper printed with the QR code is enough to initiate a transaction for an exchange of goods or services.

Risky business

It's easy to see how digital wallets will become more attractive as technology evolves, but there are some risks, such as data security breaches and fraud. If your phone is lost or stolen, there's a lot of financial – and personal – information that could be jeopardized.

However, digital wallets have a level of protection that debit and credit cards lack. With a physical wallet, cards can be stolen and quickly used before you're even aware that your account has been compromised. One way to quickly catch any unauthorized activity is to sign up for automatic alerts to your phone and/or email account whenever your credit or debit card has been used. Most banks and credit card providers offer this service. Because a digital wallet is locked with a pin code in addition to the code on your smart phone, credit and banking details are heavily encrypted. This makes it much more difficult to access the information.

> "There's a false perception that digital wallet technology is less safe than traditional transactions."

There's a false perception by many that digital wallet technology is less safe than traditional debit and credit card transactions, so most major retailers are still on the fence about accepting digital wallet payments. Companies such as Starbucks are teaming up with Square, and Home Depot with PayPal, to change this perspective by accepting digital payments via smartphone applications.

One of the main impediments to more mainstream use of digital wallets is the fact that there's no central application accepted everywhere. But as more consumers begin to demand the convenience that a digital wallet affords, more merchants will begin to upgrade their payment systems. When that happens, it will ultimately lead to more security and protection for the end user.

Cryptocurrency – why we're not there yet

Cryptocurrency has some fundamental differences from digital currency. For instance, digital currencies are centralized: there's a central point of control that regulates the state of the transactions in the network. Cryptocurrencies, however, are decentralized and the regulations are made by the majority of the community using blockchain technology, combined with a decentralized ledger. Consequently, cryptocurrency is lagging in comparison to digital currency because it's predominantly used in peer-to-peer payments, and requires a drastic increase in usage before it will be accepted as payment for real world goods and services.

There's also a dark side to cryptocurrency. Although it's considered secure and reliable, it's paved the way for illegal activity via the dark web, because any transaction processed in the blockchain does not require a third party to audit and approve. The dark web requires specific software, configurations, or authorization to access, and is typically used by those buying or selling illegal products or services. Silk Road, infamously known as the original dark web market that became notorious for enabling individuals to sell illegal items such as drugs or weapons, would use Bitcoin as a method of payment due to its quasi-anonymous characteristics.

Cryptocurrency is still in its infancy, so it's hard to know where it's headed. But until it becomes more centralized and used as a mainstay in retail, digital wallets are ready to reign.

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The value of connection

In late September, our firm held its annual Wealth Management Conference. This year, it was titled, Energy Exchange: The Power of Relationships. With a focus on recognizing the value of client and colleague connections, the conference brought together about 70 of our firm's national financial experts to expand their knowledge on a number of topics, as well as help keep them current in attaining ongoing industry accreditation requirements. Some of the topics covered were privacy and transparency, Socially Responsible Investing (SRI), dispelling myths about aging and the latest on digital wealth solutions. It was also a chance for our people to share their best practices and learn new ways of providing value to their clients.

During the conference's three-day run, we introduced a fundraising challenge to see how much money attendees could raise for the Canadian-based charity Live Different. In total, the conference raised over $18,000 for the cause. We'd also like to acknowledge the generosity of our business partners who sponsored the conference: PPI Advisory, Infinite Investment Systems, National Bank Independent Network and Purefacts.

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