Portfolio Managers Commentary – Q2 2017

"The real key to making money in stocks is not to get scared out of them" – Peter Lynch, Fidelity Magellan Fund Manager

Ignore the Distractions

The steady diet of headlines pouring out of the Trump administration has been unsettling for most investors, regardless of where they sit on the political spectrum.

We know equity markets loathe heightened uncertainty. What is happening in Washington is generating an enormous amount of political uncertainty. Yes, the word “impeachment” has even been bandied about in conventional circles. It was responsible for a one-day sell-off last month that cost the Dow 373 points. There hadn’t been much downside action in the major indexes recently, so talk of impeachment jarred the short-term crowd.

However the political as well as international uncertainty has yet to generate any economic uncertainty and very little downside in stocks as it's really all about the economy.

Given the comparisons to Nixon/Watergate, let’s take a high-level look at what was happening economically in the early 1970s and compare it to today.

Then vs. Now:

1973-74	2017
Inflation rose to double-digit levels, peaking at over 12%	Inflation remains low
Interest rates were spiking higher; prime loan rate hit 12%	Interest rates remain low
OPEC oil embargo roils economy, oil prices rise four-fold	A glut of oil exists today and prices are well below levels of recent years
The unemployment rate jumped as the economy fell into a steep recession	Employment is rising, the unemployment rate is at a cyclical low, and the economy is expanding

Source: St. Louis Federal Reserve, U.S. State Dept.

As above table illustrates, the fundamentals are radically different today than they were over 40 years ago.

Too Sanguine?

In our Q1 2017 commentary, I touched on the failure by the U.S. house of representatives to pass a so-called "repeal and replace" for Obamacare. It had little impact on share prices as many investors were anticipating the outcome.

The crown jewel for investors, however, has always been a cut in the U.S. corporate tax rate. Well, what seemed like a certainty immediately following the election has become murky. In fact, a late May article in the *Wall Street Journal* entitled "*GOP's Proposed Tax Changes Are No Match for Status Quo--Republican lawmakers' boldest ideas for changes are on political life support…,*" summed up the dilemma the party is facing.

We were told by the pundits that political gridlock and any unraveling of Trump's tax cut and infrastructure agenda would pound stocks. It's not yet unraveled but bold economic changes from Washington are at risk.

Yet, stocks in the U.S. are near all-time highs! Why?

I think what we are beginning to see is the passing of the baton. An investor-friendly agenda in the post-election climate that fueled market gains has been replaced by stronger economic fundamentals.

For the very first time in this century, all of the major economies of the world are growing at an accelerating pace. We are in a period of coordinated global growth with restrained inflation that appears to be responsible for rising equity values, globally, over the past six months.

The U.S. unemployment rate in April 2017 was 4.4%, down from 9.9% in April 2010 as part-time workers are now finding full-time work and the labor force participation rate is edging up since the end of 2015 meaning that more people are in the work force and contributing to the economy.

In terms of net worth, Americans are richer than they have ever been with the healthiest personal balance sheets seen in many, many years. Household net worth in Q1 2017 was above $95 trillion with home values and financial assets reaching all-time highs. In addition, the debt service levels as a percentage of personal disposable income was as low as 10%, a level not seen since 1980!

Corporations are also in a very strong financial position with cash as a percentage of current assets around 30%, twice the level they had heading into the market collapse back in 2000. While corporate earnings and stock prices have also been surging lately, there has also been an upsurge in cash dividends. Coming out of the Great Recession the dividend of the S&P 500 still managed to post a new all-time high of $30.44 in 2012. But in 2016 the dividend had risen by 50% to $45.03. In the long run, increasing earnings, cash flows and dividends will continue to propel stock prices higher.

Never in American economic history have the balance sheets and financial conditions of banks, corporations and households been as strong. On the other hand the balance sheets here in Canada, on all levels, are not quite as rosy. A topic we'll save for another day...

Market Valuation

In terms of valuation, there has been a lot of talk in the media about the high level of stock prices and how overvalued they are relative to historical levels. Stock values are generally measured in terms of their share price as a multiple of their earnings per share. This formula is called the Price to Earnings ratio or P/E for short. Since the market looks forwards, not backwards, analysts try and estimate what those earnings will be 12 months into the future. As of the time of this writing, the estimated forward P/E ratio is just over 17x versus the 25-year average of 16x.

Earnings multiples relative to the low level of interest rates indicates that the market does not appear to be as overvalued as the media would scare us into thinking.

Growth or Value Stocks

When we talk of overall market valuation it's painting a pretty broad picture, as there are thousands of stocks that make up the market. Some companies are overvalued while some are undervalued. Therefore the market can be broken down by companies displaying certain characteristics and can be classified as either growth stocks or value stocks. Growth investors seek companies that offer strong earnings growth while value investors seek stocks that appear to be undervalued by the marketplace.

Research has shown that over the long-term "value" stocks tend to offer higher returns than "growth" stocks. However over shorter periods there are times when growth outperforms value and value outperforms growth as the picture below illustrates. According to research produced by BNY Mellon, since 2007 growth stocks have posted stronger returns but it appears that the tide is about to turn in favor of value stocks. Value stocks are at their most attractive levels we've seen in over a decade, and we believe now is an opportune time to embrace value once again.

With the investment strategies in our managed accounts focused on the value investing approach, we are optimistic that even if the general market declines, the companies we own for our clients will continue to do well. In the year 2000, during the dot.com era, growth stocks outperformed but after the tech bubble burst, investors fled to value stocks. Current market conditions appear similar to this past period.

For What It's Worth

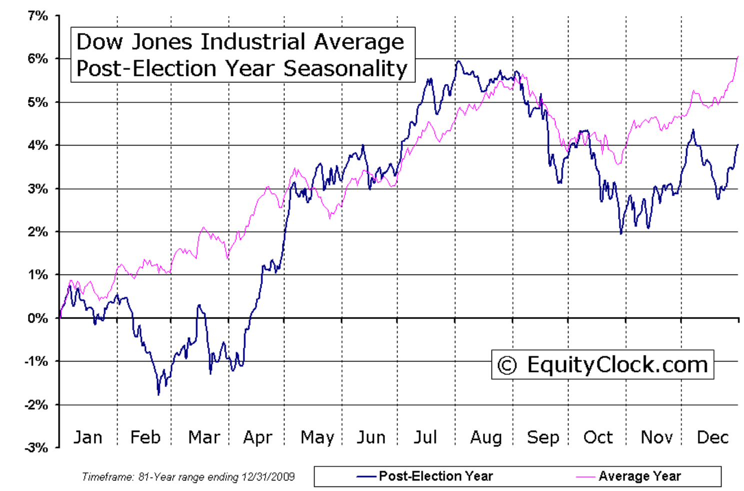
With summer now upon us it's usually a time to relax and enjoy the nice weather, go on a vacation, spend time with family and friends and take in the best that life has to offer. For a lot of people, during the summer months most couldn't be bothered to pay attention to their investment portfolios as there are much better things to do.

However, as passionate market watchers, we are always intrigued by some peculiar seasonal anomalies that occur in the stock market.

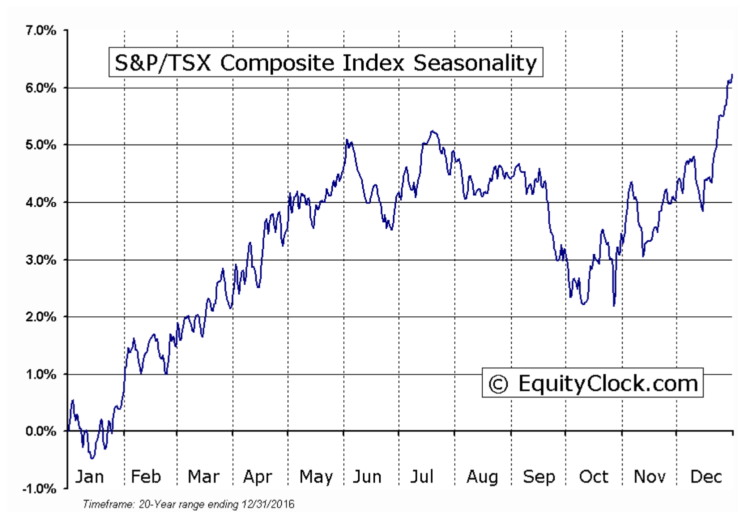
Discovered by Yale Hirsch, founder of the Stock Trader's Almanac, there is a six month bullish cycle running from November to April and a bearish cycle running from May to October. This is where the phrase “sell in May and go away” comes from. While this cycle is certainly not infallible, statistics from the Stock Trader's Almanac show the stock market seriously outperforming during the bullish six month period and underperforming during the bearish six month period. Over the past 50 years, the average gain for the Dow was less than 1% from May to October. In contrast, the average gain was more than 7% from November to April.

Market Commentary

In addition, there is another quirk in the U.S. market depending on where we are in the presidential cycle? 2017 is a post-election year which is slightly different than the average year. The accompanying chart illustrates the seasonal tendency of the Dow Jones Industrial Average in a post-election year. What you'll notice is that the market shows continued strength until the end of July before entering a period of weakness into the end of October. Although this pattern doesn't occur exactly as shown every year, it simply provides us with a glimpse into the probability of experiencing a correction into the fall. So far the U.S. market has been making new highs, tracking the seasonal pattern with the Dow trading near the 21,400 level.



In the Canadian stock market there is also a seasonal tendency for prices to rise into July and decline into the fall. However, in 2017 so far, the historical pattern has not held up as well. The S&P/TSX Composite peaked in late February and has been struggling ever since. Year-to-date the Canadian market has gained less than 1%, mainly due to weakness in the Financial and Energy sectors.



Based on the seasonal pattern we would expect to see this weakness continue into the fall unless we begin to see some improvement in oil and gas prices and the rest of the commodities that Canada produces.

I hope you've found this review to be educational and helpful. If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.

Thank you very much for the trust and confidence you've placed in my team and my firm.

Sincerely,

Brent Woyat, CIM, CMT
Portfolio Manager/Investment Advisor
Canaccord Genuity Wealth Management

www.brentwoyat.com

P.S. - I don't often ask for referrals, but during these unsettling times you might have a friend, relative, or co-worker who is in need of level-headed counsel on investing. Give me a call if you think I can help.