Portfolio Managers Commentary – Q3 2017

"A smooth sea never made a good sailor" – Franklin D. Roosevelt

The Boring Bull

The U.S. stock market, as represented by the S&P 500 Index, finished the quarter at a record high. Notably, the closely followed gauge of the 500 largest U.S. companies ran up its quarterly winning streak to eight consecutive quarters.

Surprisingly, it's done so in the face of three devastating hurricanes—Harvey, Irma and Maria, dysfunction in Washington, unsettling news from North Korea, and gridlock in Washington. But in many respects, it shouldn't be all that surprising.

As I've mentioned several times in previous commentaries, one common theme is a focus on the economic fundamentals. Stocks take their longer-term marching orders from corporate profit growth. And profits are driven primarily by economic growth at home and abroad. Currently, we're in the midst of a synchronized global expansion, which has created a strong tailwind for earnings.

Moreover, interest rates remain near historic lows, and the Federal Reserve hasn't been shy about signaling that any rate hikes are expected to come at a gradual pace.

If I had to concoct a recipe for a bull market, I'd go heavy on profits, economic growth, and low interest rates, *that's today's environment!*

Now, I understand the hurricanes have changed lives and wrecked property in Texas, Florida, and Puerto Rico therefore in the short term, the economic data is taking a hit from the storms. However, longer term it's unlikely to have much impact on the economic trajectory.

While North Korea's quest for an ICBM that can strike the U.S. is very unsettling, short-term investors seem to be pricing in the unpredictability of the rogue regime. More importantly—speaking strictly from an investment perspective—investors aren't anticipating a disruption in the economic cycle.

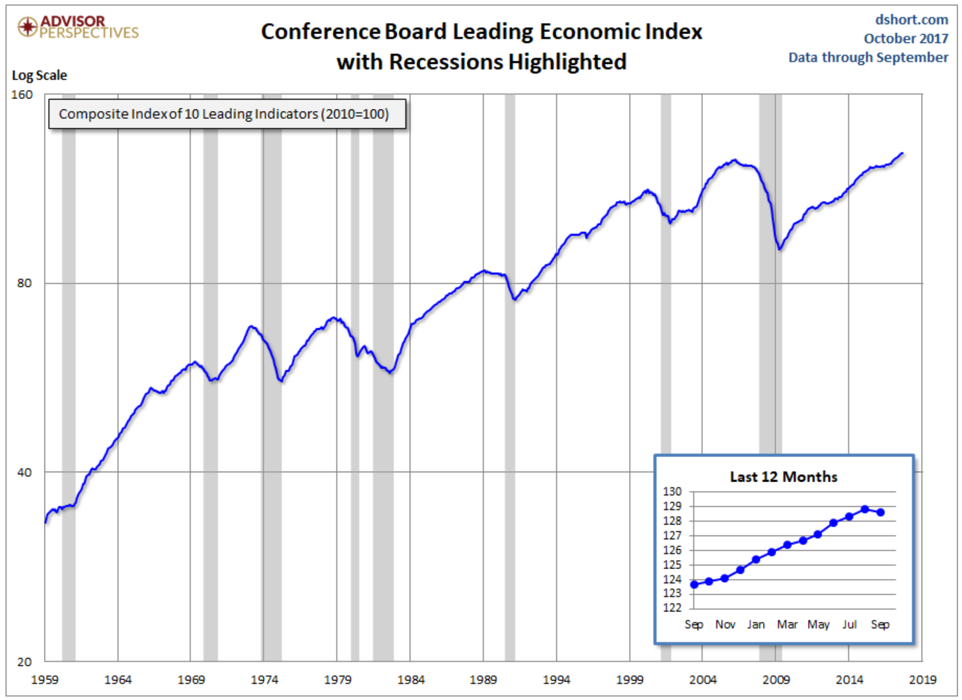
So, while you should be prepared for more troubling news, it simply isn't affecting U.S. economic activity.

Recession Risk

Although the global stock market has been roaring ahead this year, during the summer months the media headlines were screaming about endless economic fears and the potential for a market crash. Studies have shown that the mainstream media and professional forecasters' predictions are wildly useless.

It's understandable why investors fear the dreaded "R" word since most bear markets in the U.S. have coincided with a recession over the past 50 years. Most recessions in the U.S. have occurred as a result of an overtightening of interest rate policy by the central bank.

Since 1966 there have been 7 major bear markets in the U.S. stock market, with an average decline of -35% and the average duration was 18 months. All of these declines were accompanied by an economic recession except for 1966 and 1987. These two episodes were marked by periods of excessive speculation that resolved themselves rather quickly by a sharp drop but a quick recovery in stock prices.



In 2017 we've seen the U.S. Federal Reserve raise short-term rates resulting in a flattening of the yield curve. While this may indicate a possible slowdown in the economy going forward, we're not really that concerned until the yield curve inverts. This occurs when the yield on 90-day treasury bills is higher than the yield on a 10-year treasury bond. However, even when this event happens there is still a significant lead time before the economy and the markets begin to deteriorate.

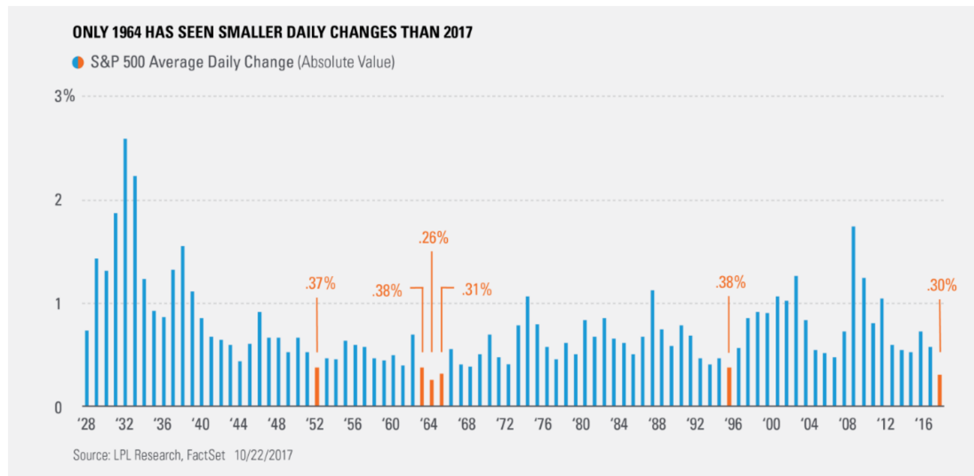
One of our favorite indicators for gauging the health of the U.S. economy is the Conference Board's Leading Economic Indicator (LEI). No U.S. recession has ever started while the LEI was high and rising. The LEI always declined for several months first before troubles began to appear in the markets. The chart of the LEI is shown along with the greyed-out areas indicating recessions as documented by the National Bureau of Economic Research (NBER).

Throughout the current cycle, the LEI has been rising continuously and still looks favorable. The US LEI has a solid track record of forecasting turning points in the economy, and the message we're receiving in the most recent report is that everything is humming along just fine.

Market Volatility

Although 2017 has produced some unsettling events around the world, the stock market has been quietly producing some remarkable statistics. As of this writing, the S&P 500 Index has gone 242 days (11.5 months) without a 3% correction, topping the record of 241 days set in 1995! This is a bit worrisome in the short-term as streaks like this will eventually come to an end so we should expect at least a 3-5% correction once the current buying frenzy comes to an end.

2017 has been one of the least volatile years in history. LPL Financial Research produced this chart which measures the average daily change in stock prices going back to the 1920's. We would have to go all the way back to 1964 to see another year showing less volatility than this year.



What this chart implies is that it would be extremely rare for the market to continue in this manner suggesting that we should expect something to give and begin to see volatility increase. This doesn't mean that we are about to enter a bear market in the long-term but in the short-term we would expect a market correction and a better buying opportunity towards the end of the year.

Tax reform

"Don't tax you, don't tax me, tax that man behind the tree," was attributed to the late Louisiana Senator Russell Long, who chaired the powerful Senate Finance Committee from 1966 to 1981 *(NYT).* He assisted with tax reform in 1986, and the U.S. Congress is now considering the first major rewrite of the tax code since then.

The initiative that's been proposed by the President and the Congressional Republican leadership is simply a blueprint. It must clear many hurdles before becoming law. The framework is silent on how dividends and capital gains will be treated, and no mention has been made of the 3.8% surtax on investment income for high-income Americans. The outline calls for special treatment for retirement accounts, but no other details were provided.

Therefore, anticipating and positioning for changes becomes very difficult given the uncertainty surrounding the bill. Meanwhile, a 20% top corporate rate has been proposed, down from 35%. It's roughly in-line with most developed nations, and is expected to be supportive of stocks. But it's early in the game and any discussion of the final points is purely speculative.

With the U.S. market posting strong gains this year, a lot of the gains are relying on lower taxes to support the high valuation multiples that are being discounted by the market. A failure to reform the current tax laws will likely result in lower stock prices and higher volatility.

NAFTA

A major risk to the Canadian economy is an unfavorable outcome to the current NAFTA negotiations. The U.S. administration has tabled several demands that will be very difficult for Canada and Mexico to agree to. The U.S. is demanding U.S. specific content in auto production, a 'five-year sunset clause' and limits on Canadian and Mexican companies bidding on U.S. government contracts.

Canadian exports to the U.S. account for almost one-fifth of Canadian GDP, and 75% of total exports. However, U.S. exports to Canada account for just 1.4% of their GDP putting the Canadian negotiators in a tough spot. If negotiations break down and the U.S. backs out of the deal then the most likely outcome would be a depreciating Canadian Dollar to maintain its competitiveness.

While we don't know what the outcome of the negotiations will be, there will ultimately be winners and losers of this process, but that won't be known until the talks conclude early in 2018.

Market Commentary

I hope you've found this review to be educational and of value. Once again, let me emphasize that it is my job to assist you! 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,

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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.

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