Investment Notes

December 31, 2016

GLOBEINVEST
CAPITAL MANAGEMENT INC.

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Overview

In last year-end Notes, I said that in my 54 years in the investment industry, I had never before seen the severity of and challenges from trying to make meaningful forecasts. While those words are applicable again this year-end, unlike last year there is a relatively more positive tone and higher hopes than we have seen in many years. As for reviewing our year-end comments for 2014 and 2015, for the most part they worked out well. However, last year I won two "Egg On My Face" awards: (1) putting a low probability on a Brexit and (2) the likelihood of a US fringe candidate (aka then candidate Trump) being elected. Both results suggest a major flaw in polling – people don't tell pollsters what they really think.

For the year, statistically there were some surprises. For example, the TSX (price return not total) at + 17.5% was the best among most major world markets with the exception of Brazil (+38.9%) and Russia (+52.2%), both in local currencies. In Canadian and US government bond markets, yields for the 2 to 30 year maturities fluctuated in a range until making year lows for the week ended July 8th. From then on, long before a Trump election was a given, they started to rise as the data below shows. We think that rising inflation (US CPI) and signs of an accelerating improvement in the US economy were the main drivers.

Maturity	July 8/16	November 4/16	December 30/16
2 YR: Canada	0.47%	0.53%	0.76%
US:	0.61%	0.78%	1.19%
5 YR: Canada	0.52%	0.78%	1.12%
US:	0.95%	1.23%	1.93%
10 YR: Canada	0.96%	1.16%	1.72%
US:	1.36%	1.78%	2.44%
30 YR: Canada	1.55%	1.82%	2.31%
US:	2.10%	2.56%	3.07%

In currency markets, the Canadian dollar rose 2.97% versus the US dollar, partially attributable to oil's price recovery. The US dollar relative to other currencies rose 3.7% from 98.68 (as measured by the DX/Y) to 102.37, driven by relative global interest rate differentials and a flight to the perceived safety of the US dollar. For example, 10 year government rates as of December 30th were: US 2.44%; Germany 0.21%; France 0.69%; UK 1.10% and Japan 0.04%. If either of these trends continues, it could take some of the shine off 2017.

There were some surprises in the commodities markets. Gold started the year at US $1,060 an ounce. It peaked at US $1,367.40 as of July 8th (the same week interest rates bottomed) and then declined to US $1,152 by year-end. Zinc was the big winner with a gain of 64.4%. Other winners included: oil (+45.4%), natural gas (+57.4%) and lumber (+27.2%).

Commentary

For purposes of looking ahead, discussion will be divided into three parts: (1) the US economy and equity markets prior to the US election; (2) what has changed since the election and what might happen once President-Elect Trump assumes office on January 20th; (3) possible geo-political-economic events that may occur no matter who occupies the White House.

1: US Economy and Equity Markets Up to the Election

As we have repeatedly opined, the 2008/09 economic crash was so severe that it would take longer than normal for the US economy to fully recover. In our view, it also severely damaged the American Psyche not only because of job losses, but in particular the decline in value of Americans' homes. As of today, the picture has improved dramatically.
Based on the latest Fed data, the total value of Household real estate has recovered to 2006/07 levels.

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Homeowners' equity has more than doubled and mortgage debt as a percent of Households' real estate values has plunged from about 64% to about 43%. This, plus the improving outlook for jobs and disposable income should support a further increase in consumer confidence, which is at record highs. Housing continues to be a growth engine and US factory growth as measured by the manufacturing ISM index is now back to its historic median. The point is that before taking into account any potential scenarios post the inauguration date of January 20th, US stock markets were already being supported by improving fundamentals.

We note that equity markets' performance from Jan 1/16 to Nov 4/16 were: TSX +11.5%; S&P 500 +2.0%; DJIA +2.7%; and the NASD Composite +0.8%. The price-earnings ratios (PER) based on consensus forecast of operating 2017 EPS were for the TSX 15.9x and for the S&P500 15.7x. There are many who consider the valuation level for the S&P 500 as "too high". We would counter by observing that perhaps it may seem so relative to the long-term average (1978 – 2016) of 13.8x, but that average does not take into account the extremely low current interest rates and in the past, much higher interest rates. Therefore, 15.7x does not seem to be excessive, especially in an environment of a growing economy and upward revisions to reported corporate earnings.

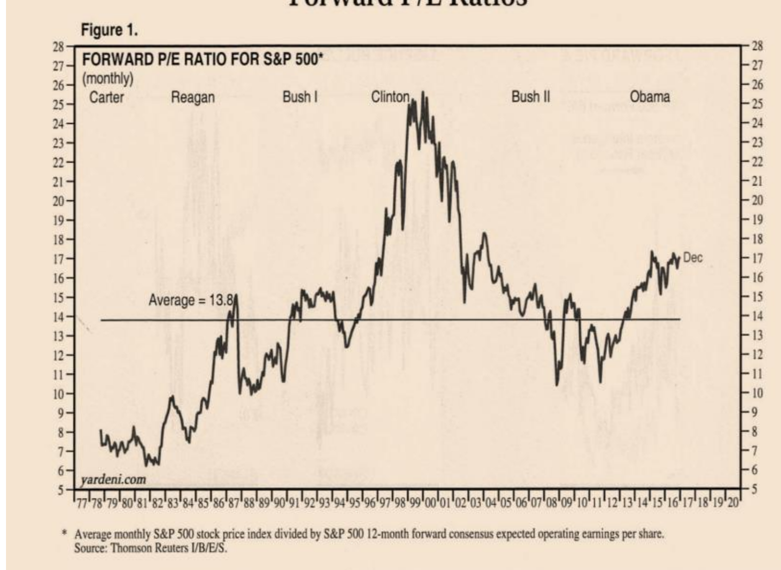
2: Since the Election

Since November 4, the equity market rise has been remarkable. From November 4 to December 30 price increases were: for the TSX +5.4%, the S&P 500 +7.4%, the DJIA +10.5% and the Nasdaq Comp + 6.7%. Price-earnings ratios based on consensus 2017 EPS estimates rose from 15.9x to 16.8x for the TSX and from 15.7x to 16.9x for the S&P 500, over the same time period.

Have valuations gone too far too fast? The answer is it likely depends on how much of the Trump's agenda is actually approved by both Houses of Congress, notwithstanding the Republican majority in both houses. There are two great quotes that show the difference in opinion about the potential for the US economy and equity markets.

The first is from one of our key advisors, Ed Yardeni of Yardeni Research Inc., who suggests that "It would be wrong to dismiss the possibility that President Trump will succeed beyond the wildest dreams of anyone with the exception of Kellyanne Conway". As for the S&P 500, Ed suggests that should legislation be passed which reduces corporate tax rates from the currently estimated 27.5% effective rate to 15%, it could add a one-time boost in operating earnings of about $13.00 per share to each of his current 2017 and 2018 EPS estimates. Should that scenario come to pass, it would reduce his estimated PER for 2017 from 17.4x to 15.8x and for 2018 from 16.4x to 14.9x. Looking at the chart of Forward PER from 1978 – 2016 and the recent 18.3x level in 2003/2004, market valuation looks relatively less stretched. Ed states that "those (current) valuations may not be too high if the President-Elect can deliver on the supply side magic of personal and corporate tax cuts". While the complete proposed package is important, we think the corporate tax cuts are key.

Forward P/E Ratios



The second quote comes from David Rosenberg of Gluskin Sheff, who in a recent note, suggests that "Chasing this rally is akin to picking up nickels in front of a steamroller". He further pines that, "It is all based on expectations and very little is fundamentally based even if GDP growth has improved and forward earnings estimates revised moderately higher." He goes on to suggest that the recent rise in the US dollar will hurt exports and that higher house prices and interest rates will negatively impact the economy. Finally, he suggests that it is too late in the economic cycle to hope for renewed growth. Also, he thinks that the debt to GDP is too high for anything except mediocre growth.

"So where does that leave us?" There is no question that if President Trump stumbles badly, a significant part of the faith that spurred this equity market rally will fade and likely, markets with it. At this point, we think the jury is out and have no doubt that Murphy's Law will re-emerge, which may cause some market hiccups. That Law may also manifest itself in other areas, i.e. geo-political-economic events.

Geo-Political-Economic Events

While we are aware of and try to follow and assess risks related to just what Russia, China, North Korea and Iran might be up to, it is virtually impossible to assign a probability to any particular event including ISIS attacks in Europe/Middle East and possibly North America. Also, Brexit negotiations will likely start this year. The stability of Europe's banks is a question mark. And finally, in the first half of the year there are elections in France, Germany, Italy, Holland and Iran. No shortage of potential negatives that could roil markets.

Summary

Going forward, we are cognizant of the potential difficulties and uncertainties, as well as the potential positives should there be a sea-change in the American Psyche combined with the possibility that President Trump may succeed if only partially. As suggested there will undoubtedly be bumps in the road that will cause market corrections, possibly in the 5% to 10% area. Until we are persuaded that a more severe correction may be at hand, we remain positive.

Peter Brieger, HBA, CFA
Christine Poole, MBA, CFA
Wendy Sanita, CFP, CIM

BNN Dates:

January 11 @ 1:00 pm – Christine

February 17 @ 6:00 pm – Christine

March 22 @ 6:00 pm – Christine

April 12 @ 1:00 pm – Christine

April 24 @ 6:00 pm - Peter

May 12 @ 6:00 pm – Christine

June 13 @ 1:00 pm – Christine

June 26 @ 6:00 pm - Peter

July 12 @ 1:00 pm – Christine

August 15 @ 1:00 pm – Christine

September 12 @ 6:00 pm – Christine

September 25 @ 6:00 pm - Peter

October 11 @ 1:00 pm – Christine

November 14 @ 6:00 pm – Christine

December 12 @ 1:00 pm – Christine

December 28 @ 6:00 pm – Peter

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