Investment Notes

March 31, 2017

GLOBEINVEST
CAPITAL MANAGEMENT INC.

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Overview

For the quarter ended March 31, 2017, in currency markets the $CDN rose 1.2% relative to the $US which rose a modest 0.3% against the Euro. Relative to world currencies the $US slipped 1.8% as measured by the DX/Y Index, which was a surprise. One would have expected an opposite move given the reported increase in the US CPI and given a further expected rise in interest rates. In commodities markets, most "hards" i.e. metals and lumber rose. For example, prices were for: gold + 8.6%, silver + 14.2%, copper + 6.0%, lead + 16.6%, zinc + 7.7% and lumber + 15.3%. "Softs" such as corn, soybeans and wheat were essentially flat. In Canada and the US, nominal government bond yields were mainly unchanged. Finally, in price terms and in local currencies, the TSX rose 1.7%, the DJIA rose 4.6%, the S&P 500 5.5%, the NASDAQ Comp 9.8% and NASDAQ 100 + 11.8%. Globally, in local currency and price terms, Mumbai was + 11.2% and the Hang Seng + 10.6%.

Commentary

The major question facing investors is "Can the US economy and stock markets maintain their positive momentum should President Trump's proposed legislative program come to nothing, as compared to how both might fare if the proposed tax reductions legislation covering repatriation of foreign based US corporate cash hoards is passed and efforts at deregulation are successful?"

Even without any positive impact from President Trump's election, the US economy was well on its way to an increasingly strong recovery based on improving house prices, employment, corporate earnings and a recovery in oil prices.

Behind that and in our view, overlooked by many, was the sea change in Americans' attitudes and confidence. We suggest a key contributing reason was a 180 degree shift in the American consumer psyche resulting primarily from the full recovery in home prices from pre 2007 – 2008 levels. While the rise in the stock market also helped some, more Americans own homes than stocks and so this recovery in housing values impacted a broader consumer base. Also, the rise in employment and wages to record levels played and likely will continue to play an increasingly significant part. Given that the US is in a full blown recovery, we think that even if President Trump's legislative agenda falls apart, the economy will continue to grow albeit at a lower rate. The next question is "For how long?" At this point there is a plethora of estimates but one of our advisors suggests it could last into the first quarter of 2019. Time will tell. As for the US stock markets, in a total meltdown of the Trump agenda it would be naïve not to expect a negative reaction of some sort.

US and Global Economic Review

Along with the US, the Canadian and European economies are starting to show signs of life but at this point, are lagging the US. As the US recovery continues, we expect the same in Canada and Europe. Some areas that are contributing to the US growth are:

Consumer Confidence: Surveys of current conditions and expectations have recently shown sharp increases as has the Consumer Optimism Index. Consumers are finding jobs are more plentiful and the number of jobs hard to find is declining sharply. Also, nominal and real incomes per capita are at record levels.

Purchasing Managers Indexes: Both manufacturing and non-manufacturing indexes continue to show strength.

Small Business: Small Business Optimism and the NFIB Outlook for Business Conditions have increased exponentially as have the NFIB Net Percent who expect rising sales during the next six months. Also the outlook for expansion is very positive.

CEOs: Their outlook on the economy has improved dramatically. The outlook for capital spending in real GDP terms usually follows and in fact, is just turning up.

Housing Activity and Prices: While there can be modest monthly fluctuations, the trends for the major indexes continue to increase.

S & P Forward Earnings: The estimates for 2017 and 2018 continue to increase.

As mentioned, we think everything is in place for continued economic growth in the US with Canada and Europe following. "What could cause that view to change?" A sharper rise in interest rates than currently expected and/or a flattening of the yield curve. At the moment we don't see 10 year US interest rates rising much beyond 3.50% this year and doubt that the Fed will allow a significant flattening of the yield curve. A sharper than expected rise in rates could negatively impact forward earnings estimates but more likely would negatively impact the price earnings' ratios investors would be prepared to pay. (See discussion below)

Markets Review

Commodities and Inflation

We note some interesting trend changes on Q1 commodities price performance which may be nothing more than a short-term anomaly and therefore, meaningless in the longer term. At this point, we will simply make the observations and carefully monitor future reported data before jumping to any conclusions.

For example, from about February 10th through the 24th, the price of many "hards" and "softs" peaked and declined from then until quarter-end, e.g. gold (0.5%), silver (0.9%), copper (4.3%), zinc (5.5%), WTI oil (5.9%), corn (2.9%), soybeans (10.7%) and wheat (8.6%). Two inflation indexes we follow: TRI/CC/CRB and the Rogers International declined from their highs by 4.5% and 4.4% respectively. The Q/Q declines were 3.4% and 1.7% respectively. Interestingly in the US, the latest CPI was + 2.7% Y/Y, up from+ 1.7% Y/Y at year-end. We find that data somewhat contradictory given the increasing strength of the economy. We further note that food, which was 13.7% of the CPI was flat Y/Y as of February 28th and Energy, which was 7.2% of the CPI was + 15.2%. Our analysis shows that the main cause of the increase in CPI came from higher energy prices.

So the key to future inflation may be changes in the outlook for oil prices. While many think OPEC members will extend the agreed upon production cuts beyond June, at this point, that is far from certain especially if US shale producers continue to accelerate their drilling and production. That could lead to an early demise of OPEC discipline and a return to lower prices than currently expected. For example, many analysts are forecasting oil prices in the $55.00 to $65.00 level for 2017 through to 2019. If these prices do not materialize, it may well put a lid on inflationary expectations. We were estimating a US CPI of 2.5% to 3.0% in 2017 and 3.0% to 3.5% in 2018. We would have to review and possibly reduce those forecasts if energy prices stagnate and/or even decline. As for the consumer and the economy, both should benefit.

Bond Markets

Not surprisingly, given improving business conditions in the US and Canada along with rising inflation, Government bond yields increased from year-end through March 10th. However, and perhaps as an unrelated coincidence with the price change in many commodities, from March 10th until quarter-end rates declined as shown.

Maturity & Yields

Maturity	% as of 12/31/16	% as of 03/10/17	% as of 03/31/17
2 Yrs. CAN	0.76	0.84	0.76
US	1.19	1.35	1.25
5 Yrs. CAN	1.09	1.27	1.12
US	1.93	2.10	1.92
10 Yrs. CAN	1.72	1.81	1.63
US	2.44	2.57	2.37
30 Yrs. CAN	2.31	2.48	2.31
US	3.07	3.16	3.01

We don't want to jump to any premature conclusions and will carefully monitor the incoming data to see whether the coincident pricings continue. On a different point, at year-end, real rates for 2 year Canada and US government bonds were negative as they were for the 5 year Canadas. By quarter-end, given the increase in the CPI in both countries, real rates were negative for the 2 year through the 10 year maturities. They were positive only for the 30 year maturities. At some point, that may put some upward pressure on rates.

Stock Markets

For the TSX, consensus 2017 earnings per share (EPS) are forecast to increase 23%, led by a rebound in Energy and Materials and 13% in 2018. The 2017 price earnings ratio (PER) as of March was 16.8x versus a historical average of 15.2x. With valuations above the historical average earnings growth will be a key to support higher stock prices.

For the S&P500, Thomson Reuters consensus forecast 2017 EPS to rise 10.7% and 12.2% in 2018. The corresponding PER is 18.0x and 16.1x, respectively.

To put PERs (forward and projected full year) into perspective, since 2000, the highest forward PER for the S&P 500 was 18.4x in 2004. So if there is no boost to operating earnings from a Trump tax cut or any other positive catalyst, arguably the S&P is fully valued and could be subject a correction.

However, if President Trump's tax cuts go through as planned, forecast corporate earnings would increase and estimated PER for 2017 and 2018 would decline, somewhat easing valuation concerns. That said, if the proposed tax cuts are not enacted, we still think the US economy has sufficient momentum to continue its growth, perhaps to March 2019 as previously mentioned. The stock market's upward momentum would continue albeit at likely a lower growth rate. Investors would also have to reconsider what multiple they would pay for possibly a lower earnings growth rate.

Geo-political Events

They are unpredictable but cannot be ignored. In the short-term, we have elections in France, Italy, Germany and Iran. So far, the EU for the most part escaped the wrath of Dutch voters. In a different geography, it will be interesting whether the recent demonstrations in Russia against Putin will have any lasting impact and can influence the 2018 Russian elections.

And finally there is Brexit. As we have stated in the past, it is far too early to make any definitive comments or jump to any investment decisions. For the next two years or so, we will no doubt be besieged by a wide range of controversial opinions. However, there are two key factors that the EU must consider. The first is that in 2020, it will have to structure a new budget. If the UK leaves, it takes with it about 10% of the EU's current revenues. The second is that the EU cannot know what its political structure will look like after a series of elections and depending on the outcomes, may have bigger issues to deal with than a Brexit.

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Summary

At the moment, the economic and markets' outlook remains positive. While we are somewhat cautious in the very short-term (a 5% to 10% correction wouldn't surprise us), we remain constructive longer term and continue to make purchases where we see value.

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

BNN Dates:

April 12 @ 1:00 pm – Christine

April 24 @ 6:00 pm - Peter

May 12 @ 6:00 pm – Christine

June 15 @ 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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