Investment Notes

June 29, 2018

GLOBEINVEST
CAPITAL MANAGEMENT INC.

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Overview

We continue to focus on the underlying fundamentals when assessing our outlook for markets. The economy, corporate profit growth and stock market valuations are topics for review. We recognize that geopolitical factors particularly the "Trump Tariffs" (TT) could have a major negative impact on economies and markets. The key question is whether stocks can continue to remain impervious to what may be continuing rising tariffs.

Commentary

The US economy continues to show strength and to outperform other developed world economies. In the short-term, autos and housing are suffering a little indigestion and the former may get worse depending on how the tariff issue plays out. However, in general, we suggest that given the length of the current cycle, there have been and will continue to be ebbs and flows in certain sectors of the economy and while unsettling, have yet to lead the economy into a recession.

For example, U.S. housing activity has slowed due to a lack of inventory of houses for sale, rising mortgage rates and rising house prices. (That's what a first half 25.8% increase in lumber prices courtesy of TT will do to house prices). The consensus view has interest and mortgage rates rising and in so doing, forcing potential buyers out of the market. We think that the rise in interest rates will be contained. And while mortgage rates are trending upwards, so is job growth and income growth, thus supporting affordability and offsetting higher home prices.

The U.S. is now in the 9th year of the economic recovery. The bear's argument is that things are so good they can't get much better and given the length of the recovery, will roll over and take the US economy into recession. As we have opined in the past, the economy's modest recovery growth rate during this current cycle suggest a prolonged recovery is sustainable, augmented by last year's tax reform package.

Continued corporate profit growth is the key driver for higher stock prices. At the beginning of this year, 12 month forward EPS for the S&P500 companies was $147 and the Index was trading at a forward price to earnings ratio of 18.7x. As of June 29th, the comparable numbers were $168 and 16.1x, respectively. Forward EPS has risen 14.5% while the Index rose only 1.7%; the stock market is reflecting some of the concerns we have discussed and valuation has contracted since the start of the year.

Given our expectations that EPS can rise by 19% in 2018 and continue into 2019 albeit at a lower rate, ongoing corporate profits should provide fundamental support for stock prices. Much has been made of the fact that the Dow and the S&P 500 peaked on January 26th and have gone sideways since then with many individual stocks in the Index having sold off more than the general Index. The suggestion is that this is a typical topping action and it is only a matter of time before a major decline takes place. We would counter that many stocks/sectors are going through what might be called a rolling correction. While individual stock price volatility may cause angst, collectively they may not cause much damage to the general market.

Aside from any TT surprises, what could cause a major downward revaluation for stocks? Our answer would be a flattened if not inverted yield curve and/or a faster increase in interest rates to levels not currently expected. As for yield curves, the Canadian and US government curves continue to flatten, but the spread between the 10 year and 2 Year Treasury Bond rates remains positive (please refer to chart). As for the potential level to which 10 year US rates could go there are numerous machinations one could go through to reach an estimate. Our best estimate that

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during the next year or so, the 10 year rate could reach 4.00% – 4.25%.

And that takes us to the 800 pound gorilla in the room – the TT. We fully admit that should Trump stick with current and proposed tariff rates, it would at a minimum create headwinds for equity markets and possibly something more serious. We make two points. The first is that as the US approaches its midterm elections political pressure on him by Republican candidates in vulnerable states may cause him to shift his position and that includes his position on NAFTA. The second, which is foremost in his mind (alleged) is his fixation with preserving his legacy and future image. That may take precedence over his stated policies, including trade protectionism.

While we remain positive we are acutely aware of some other geo-political issues. They include:

- US midterm elections in November;
- Canada's next federal election in 2019 unless Trudeau calls a snap election on the basis the country needs him to provide anti-Trump leadership;
- No Brexit resolution;
- Immigration issues in the US and particularly Europe if the German coalition falls apart;
- Future relations with China, Russia and North Korea.

Summary

As indicated, we remain constructive even though we acknowledge potential disruptions. Happy Canada day to you all!

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

2018 BNN Dates for Christine Poole

July 10 @ 12.00 pm
July 25 @ 7.00 a.m.
August 8 @ 6.00 pm
September 11@ 12.00 p.m.
October 10 @ 6.00 pm
November 13 @ 12.00 pm
December 11 @ 12:00 pm

June 29, 2018 Statistical Summary

STOCK MARKETS	YTD	1 Year
S&P TSX Composite Total Return (CAD)	1.9%	10.4%
S&P 500 Total Return (CAD)	7.2%	15.8%
S&P 500 Total Return (USD)	2.6%	14.4%
DJIA Total Return (USD)	-0.7%	16.3%
NASDAQ Composite Price Return (USD)	8.8%	22.3%
MSCI World Index Price Return (USD)	0.7%	9.0%
COMMODITIES		
GOLD	-3.7%	1.1%
SILVER	-6.7%	-1.5%
COPPER	-9.5%	10.5%
NATURAL GAS (NYMEX)	-1.0%	-4.1%
WTI	22.7%	61.1%
BRENT	18.8%	65.8%

TREASURY BONDS	06/29/18	12/29/17
2 Year Maturity (CAD)	1.91%	1.69%
(US)	2.53%	1.89%
5 Year Maturity (CAD)	2.06%	1.86%%
(US)	2.74%	2.20%
10 Year Maturity (CAD)	2.1%	2.03%
(US)	2.86%	2.40%
30 Year Maturity (CAD)	2.20%	2.24%
(US)	2.99%	2.74%
Inflation		
CPI (CAD)	2.2%	2.1%
(US)	2.2%	2.2%

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