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The Goodreid Gauge

Summer 2018

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After a tumultuous first quarter, equity markets in Canada and the United States regained their footing and turned in strong gains during the second quarter, as did Canadian corporate bond and preferred share markets. The S&P TSX Composite Index earned a total return of 6.8% during the quarter and the S&P 500 Index managed a total return of 3.4%. The FTSE TMX Canada Short Term Overall Bond Index mustered a total return of 0.7% and the Solactive Laddered Canadian Preferred Share Index rang up a total return of 0.9%. Bonds and preferred shares took more or less a round-trip ride in terms of price movement this quarter, with interest rates rising and their prices falling amidst economic optimism and rising risk appetites generally during the first half of the quarter, only to reverse those moves during the second half. The end result was negligible overall price appreciation, with all of the return stemming from dividends and interest, which in our view is a reasonable going-forward expectation for these two asset classes, which serve primarily as income vehicles.

The relative rank of each of these four asset classes was exactly opposite the ranking we saw in the first quarter, but notably, all four of them are now in the black with modest gains for the year to date. We don't know which asset class will be the hero and which will trail in any given quarter, but we do know they all have a role to play in managing risk, in capturing gains and in earning income, and each in turn will have its time in the sun.

Currency is a further diversifier in a balanced portfolio and was an important variable to consider this quarter. The loonie depreciated by 2% against the greenback, bringing the return on U.S. stocks to 5.5% when measured in Canadian dollars. This currency tailwind may persist for some time, albeit in a choppy fashion, with a faster pace of interest rate hikes expected in the United States vs. Canada, and with more stimulative fiscal policy (tax cuts) helping to drive faster economic growth south of the border.

Probably the most impactful variable in explaining the reversal of fortunes this quarter for Canadian stocks was the strength in crude oil prices, with West Texas Intermediate (WTI) oil prices up nearly 12% during the quarter, and Brent blend oil prices on the international markets up 11% as OPEC production increases announced during the cartel's June meeting were modest and should keep inventories manageable and the global supply/demand balance fairly tight. Moreover, the much discussed Permian basin production miracle in west Texas ran into a logistical roadblock this quarter with insufficient pipeline capacity to carry supplies to market, and this too helped to firm up pricing for crude oil. This is a problem Canadians are no strangers to, as our own oil producers have faced similar pipeline constraints over the last few years, with NIMBY obstructionists and a cumbersome and slow regulatory process making it increasingly difficult to build new pipelines to carry the growing oil sands production to market. This dysfunctional business and competitive environment for energy producers was showcased as front-page news in a way that was globally embarrassing for Canada. As a nasty spat developed between Alberta and British Columbia over the proposed (and previously approved) Trans Mountain Express pipeline expansion, the federal government was compelled to nationalize the pipeline in order to ensure the project's completion when its foreign owners threatened to walk away amidst the interprovincial brouhaha. Nevertheless, for better or worse, taxpayers now own the asset and the oil patch has been assured by the Prime Minister that the pipeline will be built.

Further relief came in late June when the Minnesota Public Utilities Commission gave the green light for Enbridge to build its Line 3 replacement through that state, which will double capacity on the line,

providing further relief for western Canadian producers whose oil has been deeply discounted vs. WTI pricing for a very long time due to lack of egress capacity. With the energy sector finally seeing light at the end of the tunnel (or shall we say, pipeline?), and with it holding a 20% sector weighting in the S&P/TSX Composite Index, the energy sector's return of 10% during the quarter went a long way towards propelling the Canadian market higher.

We believe the oil price rally to be sustainable and entirely consistent with strong global growth and rising energy demand, and, accordingly, we added Parex Resources, a rapidly growing, mid-sized energy producer trading on the TSX, but operating in Columbia, to the portfolio early in the quarter.

While energy stocks were most impactful in propelling the S&P/TSX Composite higher, it's important to also note that the rally this quarter was very broad based with 70% of index constituents moving higher, and with ten of eleven market sectors making gains, led by the headline grabbing but otherwise fairly small and narrow "healthcare" sector, which is comprised of Valeant Pharmaceuticals, several assisted living facilities and several market darling marijuana producers.

In the United States, stock prices continued to climb the proverbial wall of worry, shaking off erratic communication from the White House, legislative impasse on numerous key files and most notably the degradation of hostile trade rhetoric into outright hostile trade action with the executive branch invoking "national security concerns" to justify the imposition of duties on Canadian, European and Chinese imports….a scenario we warned about last spring in our piece entitled Trade Protectionism & The Principle of Comparative Advantage.

Many pundits and casual observers of the markets are scratching their heads wondering how the S&P 500 Index can continue to push higher amid these emerging risks. We've said it before, and we'll say it again: the United States is singularly and by far the most dynamic wealth-creating country on Earth, and the well-oiled gears of its entrepreneurial economy are not easily fouled up by even the most inept political leadership. The most powerful illustration of this is the fact that S&P 500 Index earnings of $132 are up 15.2% during the latest twelve months and are forecast by analysts to rise to $159 for 2018 and to $175 in 2019, for a whopping gain of 54% in just two and half years. Skeptics will point to the fact that earnings are being goosed by the benefits of the recently enacted, deficit financed corporate tax cuts, and this is indeed true, with about 40% of the anticipated earnings growth being driven by these tax cuts. The remainder of the growth is the product of an economy that is firing on all cylinders with full employment, rising housing starts, excellent consumer confidence and retail sales and corporate enthusiasm for business prospects as measured by the Institute of Supply Management purchasing manager surveys.

It's axiomatic to say so, but shareholders own the profits in the economy…this is the very premise upon which we invest in stocks, and rapidly rising corporate profits economy-wide support rising share prices. However, selectivity was also important this quarter, as the rising tide of a strong economy failed to lift all boats, as it did during 2017, for instance. A respectable, but not sensational, 55% of S&P 500 Index members made gains during the quarter, and in what is undoubtedly a sign of the times, the leader of the pack was Twitter, which gained admission to this venerable club of 500 in early June and rose 52% during the quarter.

Sector positioning was key as well with just seven of the eleven market sectors marking positive returns, led by energy, which was driven by some of the same factors that pushed Canadian energy stocks higher. Industrials, a sector which we reduced our exposure to during the quarter in the U.S. Small Cap portfolio, served as investors' favourite whipping boy when trade tensions flared up and thus was the notable laggard these past three months.

Among investors' leading fears is interest rate hikes - and with good reason, given the history of interest rate hikes triggering recessions. The U.S. Federal Reserve, under its new Chair, Jerome Powell, has shown continued resolve to normalize monetary policy, and the bond markets continue to expect two more interest rate hikes in 2018, which has prompted a flattening of the yield curve, with two-year U.S. Treasury yields rising more rapidly than ten-year Treasuries. This situation has attracted a lot of attention both from economists who view an inverted yield curve as an ominous harbinger of impending recession as well as from investors who subscribe to the popular but incorrect investment folklore that a flattening yield curve is kryptonite for bank profits…a myth which we recently debunked in a piece entitled Banks and Rising Interest Rates.

So, while we remain constructive on the outlook for banks on both sides of the border, and indeed recently increased our exposure to the group with two additions to the U.S. Small Cap portfolio, the flattening yield curve and the signals it sends about the stage of the economic cycle we are in is something we continue to monitor, along with a bevy of other macroeconomic variables. We also continue to monitor trade policy and trade actions very closely, as it is well understood and accepted by economists that trade protectionism and tariffs exacerbated the world's economic woes during the Great Depression. Today, with most of the world under a flexible exchange rate regime as opposed to the gold standard (as was the case during the Great Depression), tariffs, while still a blunt instrument, are not as potent as they once were. Exchange rates in theory adjust to compensate for them, with the "victim" of an American tariff likely to experience a depreciation of their currency vs. the U.S. dollar, helping to restore the competitiveness of their goods in the U.S. market. Nevertheless, globalization in reverse is not an outcome we would expect to be investor friendly, relative to

the status quo of free trade, but in our estimation the impetus behind the recent trade hostilities is political more so than economic, and cooler, more sensible heads may well prevail post the mid-term elections in November.

Drawing it all together, we recognize the economy is in the late stages of expansion but shows no signs of rolling over into recession. Significant capital gains on bonds and preferred shares are unlikely in the current interest rate regime, but safe and stable income prospects remain attractive in both of these asset classes, which furthermore provide important balance and diversification to an otherwise equity-oriented portfolio. Valuations are fair to full across broad swaths of both the Canadian and U.S. equity markets, but we continue to find compelling opportunities and undervalued stocks in quieter and less followed corners of both markets, and as such our portfolios are in a process of slow evolution. Calm, rational decision-making, backed up by significant research and deep qualitative and quantitative analysis is a lasting hallmark of our practice, and we are more convinced than ever that it will serve our clients very well in this oftentimes manic and hyperbolic market regime where a tweet, a press conference or a rumour sets off a tempest in teapot, triggering knee jerk responses from less disciplined, hyperactive traders…only to be negated or contradicted within a matter of days.