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“By The Way”

July 2018

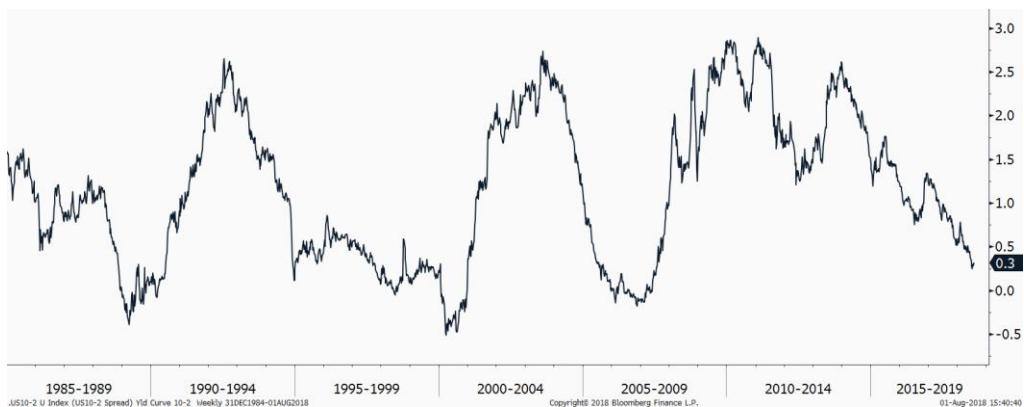
“it has been my experience that when everyone “knows” something will happen, it often doesn’t.”

Over half the year is gone and the summer doldrums are upon us. The Hamptons and Muskoka are filled with financial types trying unsuccessfully to relax. It seems a good time to briefly list and review the issues we think are meaningful and try to assess where we are today.

Global Economies: The U.S. is by far the strongest as second quarter real GDP came in at 4.1%. Canada also recorded a robust recovery; after a weak April, May GDP was up 0.5%. Europe on the other hand, is weaker, reporting a moderate 0.4% in the first quarter. China remains positive but also continues to slow. Overall, there is no reason for alarm, but we are almost certainly past the point of peak growth rates.

Central Banks: The Fed remains on course to raise rates gradually and slowly reduce the huge balance sheet that was built up during the period of quantitative easing. The European Central Bank would like to tighten policy, but the weak GDP growth keeps it from moving ahead. Japan still has the most aggressive program, and China has recently injected more liquidity into the system to offset the slower GDP growth. While monetary expansion is much lower than during the post-crisis period, there is no reason to believe we have reached the point that a lack of liquidity would have a negative impact on markets. That day however remains on the horizon. There is currently a lot being written about the likelihood of “an inverted yield curve”, when short term interest rates (which are regulated by the Fed) are higher than longer term rates (which are market based). Such an occurrence has taken place one year before each of the last three recessions. Certainly such evidence requires one to pay attention, although it has been my experience that when everyone “knows” something will happen, it often doesn’t.

US Yield Curve
 (10 Year – 2 Year)



Geopolitics: Tariffs and trade are no longer just fuel for theoretical discussions but are having a real effect on the economy and earnings. Over 40% of S&P corporate revenues come from outside the U.S., and over 40% of S&P companies mentioned in their quarterly reports the negative impact of tariffs on costs. More problematic is the risk of an escalation into a real trade war and the serious long-term implications of such an eventuality. The consensus, as well as my own opinion is that NAFTA and Europe negotiations will come to some laborious resolution, but the U.S. dispute with China has the potential for a more unfavourable outcome. The mid-term U.S. elections and the resulting infighting and name calling leading up to them will also provide reasons to be observant. As long as Mr. Trump is President, we will continue to experience volatility caused by his outbursts.

The Market: While the S&P 500 has not made new all-time highs, it is a positive that it broke out above the 2800 level that had been resistance since February. We have previously stated that it was important that market bellwethers, the financial and industrial sectors, acted better and such is the case, although not to the extent one can relax. Market breadth remains tepid, but not negative. It is of some concern that small-cap stocks are underperforming, which suggests a risk-off mindset by investors. So far it is only a short-term observation, but value stocks are outperforming growth stocks which is another sign of an aversion to risk. A contrarian would say these are positives since markets flame out not when everyone is worried but when euphoria is at its highest level. There are many more market factors to consider and it can't be said definitely that the S&P is now clear to resume its march higher. I am seeing more reasons to expect a bullish outcome, but selecting the right sectors and individual stocks will be more and more important.

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