VERITAS

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DID YOU KNOW...

- There are over 1 billion websites online worldwide, and this year global internet traffic is set to exceed 1 zettabyte, or 1 trillion GB, equivalent to 157,000 years of HD video.
- In a sign of the continued thawing of relations between the two countries, US wireless carriers are now permitted to offer roaming services in Cuba.
- According to CCSP-JP, a Mexican non-government organisation (NGO), Acapulco is the fourth most violent city in the world (Caracas is first), bad news for a country that derives 15% of its economic activity from tourism.
- For the first time since 1999, the three major US stock indices, the S&P 500, DJIA and NASDAQ, all reached new record highs on the same day on August 15.
- Oil is trading at roughly $50 per barrel today: in February, it was below $27; one year ago it was at $47; two years ago, $82; and three years ago, it was well over $100.
- No new runways have been built in SE England since WWII, and Heathrow's two are operating at 99% capacity.

CURRENT SITUATION

In large part as a response to the sustained increase in energy prices, the TSX gained a very respectable 5.5% in the quarter, for a total gain of 15.8% for the year to September 30th. By this point, it should not come as any surprise to our readers that what happens to energy and materials prices has a significant effect on our market, and this last quarter again shows just how this is so. The energy sector accounts for 21% of the TSX by weight, and materials another 13%. While the weightings are not as heavy as they were a couple of years ago, even at a combined 33% weighting, with the two sectors moving 27% and 51% respectively year to date, they accounted for a full 68% of the positive performance of the TSX. As we have mentioned before, an implication of this is that using the TSX as a proxy, or performance benchmark, for any portfolio that does not track the index can be misleading. To illustrate this further, we look at the performance of the S&P500, which has gained "only" 7.8% for the year, despite the US economy being measurably stronger than ours. But the raw performance does not tell the whole story because the S&P500 is a much more broadly diversified index, and lacks the energy and resource concentration of the TSX. For comparative purposes, without this concentration, the TSX would be up a much more modest 5.1%.

The International Monetary Fund (IMF) issued its forecast for global growth of 3.4% for 2017, up modestly from 3.1% this year, with the majority of growth coming from developing economies, and commented that the global economy has essentially "moved sideways" in the last year. This condition is not new, and reflects what one might expect in a maturing, more integrated global economy, and one that is past its period of greatest growth. Coincidently, it also reflects a comment made recently by the Bank of Canada to the effect that we need to "consider the possibility that the rapid pace of trade growth that prevailed for the two decades before the [financial] crisis was the exception, not the rule." This struck a chord because it makes sense to us that any economy, absent some form of technological disruption or unusual increase in population, can grow only so quickly before it reaches a level of stasis where no manner of stimulus will ignite growth beyond some natural long term sustainable rate. An analogy for this might be adding salt to water: after a period of rapid absorption, no more salt can be added unless the balance is structurally altered, such as by adding more water. When this economic "saturation" point is reached, which arguably it has by many western economies, growth expectations need to be adjusted, and central banks must amend policy accordingly, focussing on the over-

all long-term health of their economy, not just its immediate growth.

Related to this is the recent policy decision made by our Department of Finance to further tighten up mortgage lending practices, particularly for first time home buyers. In a nutshell, a mortgage applicant who does not have a 20% down payment, and thus requires mortgage insurance through CMHC, must qualify for the desired mortgage at the "posted" or advertised rate, not the negotiated lower rate they would realistically receive. The implication for the borrower is that their income must be able to support the mortgage at the higher rate, otherwise they will qualify for less, or, for some, not qualify at all and be forced out of the market. As bad as this sounds, we think it is good policy in this era of ultra-low interest rates. In one stroke, it takes significant risk out of the Canadian mortgage market, and also reduces the likelihood of heartache for some first time homebuyers. The reason is this: if a financially stretched potential borrower barely qualifies for a mortgage at a discounted rate of say 2%, and after five years has to renew their loan and rates have moved to 3%, with no change in their financial status, that 50% increase in borrowing costs could be financially devastating. The new policy reduces the possibility of this happening, thereby reducing the strain on both the borrower and CMHC. It should be noted that for the most part, the effects of this new policy will be felt more in major and high cost centres such as Vancouver and Toronto, where, as has been widely reported, coming up with the 20% down payment is already a challenge.

OUTLOOK

Reprising a portion of our outlook from the last edition of *Veritas*, while we remain convinced that the longer term outlook remains favourable for stocks, and distinctly unfavourable for bonds, given that equity markets put up such a strong showing in the last quarter, we are less optimistic that fourth quarter equity performance will be positive, or even flat. Year end returns should remain positive, but between what has to be one of the most bizarre political contests in the history of the US, and an environment that makes it almost impossible for the US Federal Reserve not to raise interest rates, we would not be surprised to see markets retrace some of their 2016 advances. We also expect market volatility to increase in response to the mounting policy uncertainty that is being created in the final weeks before the US presidential election in November. Looking beyond this, the expected December rate hike, and until we start to get more detail on how the UK will exit the EU, markets are expected to shift their focus back to the reasons why the Fed should increase rates, which stem from a fundamentally strong US economy, based on one of the healthiest labour markets experienced by that country in generations. This condition should provide for domestic economic strength for years to come, so long as 2008-09 conditions do not repeat themselves.

STRATEGY

Given our outlook, and third quarter gains in North American stock markets, our previously articulated asset mix policy shift will remain in place for the interim. We continue to maintain cash weightings in client portfolios that are higher than the minimum prescribed by portfolio investment policies, a position we do not foresee altering in the next several months. We remain committed to the companies that comprise our clients' portfolios, but we are somewhat sceptical of the overall market, and because of the correlation between individual stocks and the market, especially when the market weakens, clients' cash positions serve as a form of insurance against the declines. That said, if markets continue to appreciate, the cash will be a drag on performance, but experience tells us that the present environment argues for a more conservative positioning of portfolios. And assuming we do experience a pullback, this positioning will permit us to add to our clients' holdings of strong, sound companies at discounted prices in anticipation of their inevitable price recovery. Please do not hesitate to call for further discussion.

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