VERITAS

Spring 2017

DID YOU KNOW...

- Marking the end of an era, Sears has sold its iconic Craftsman line of tools to Stanley Black & Decker.
- Ending a time-honoured tradition, Labatt no longer provides retirees with free beer for life, a coveted perk of working for the former Canadian brewer.
- After being the weakest Western currency in 2016, the Mexican peso was the strongest last quarter, recovering its post-US election losses.
- Sales of vinyl records hit a 25 year high of 13 million in the US in 2016.
- In related news, American consumers listened to 431 billion songs via streaming, exceeding sales of direct downloads for the first time ever.
- 2017 is Canada's 150th birthday, but it also marks the 150th anniversary of Russia's sale of Alaska to the US — for US $7.1 million, or $123 million today.
- March 31st was "World Backup Day", established in 2011 to highlight the importance of backing up computer data, something Pixar Studios wished they had done in 1999 when 90% of *Toy Story 2* was accidently deleted just prior to its scheduled release.

CURRENT SITUATION

With seemingly minimal regard for the global headlines that at one time would have sent them into a tailspin, North American equity markets continued their relentless march upwards in the first quarter, setting record high after record high, especially in the US. There, the broad S&P 500 posted a 6.1% return, handily outperforming Canada's more modest, but still perfectly acceptable, and perhaps more reasonable 2.4% quarterly return. Our performance reflected the pullback in the energy sector as oil prices weakened briefly, and a more modest showing by our banks as compared to their US peers. A reminder to our readers that 68% of the Canadian stock index is still comprised of just three sectors: energy, materials and financials, and shifts in these sectors can have a significant impact on the overall market. But to put the short term moves of our two markets in context, and to demonstrate why investors should have a long term perspective, since the beginning of 2000, the TSX has generated an annual return of 6.2%, and the S&P 500 4.8%. This reminds us of the axiom that returns are generated by time in the markets, not by timing them.

Much of the gain in US equities over the past six months has been attributed to the anticipated positive economic impact of the new administration's campaign policy promises, a.k.a. the "Trump Bump". If it is true, we hope it is only partially so because it is becoming increasingly evident that many of the promised changes are going to take much longer to implement than alluded to during the campaign, if they can be implemented at all. Promised tax and health care reforms are two issues that are garnering a great deal of attention in this regard. We believe it is more appropriate to look back to the months before campaigning began in earnest, and focus on the positive data that were already emerging in support of stronger equity markets, and higher interest rates. As we discuss below, this data has continued to improve, despite relatively static US economic policies, suggesting that recent market strength is broadly fundamentally supported.

An example of the positive data relates to the continued improvement in the US labour market. We have written about this several times recently, but it is important to note that if a country's labour market is not healthy, sooner or later the overall economy of that country will suffer as consumer confidence erodes. As it does, consumers tend to reduce their spending in all areas, but especially on discretionary items. This usually negatively impacts both business and investor confidence, resulting in a reduction in business spend-

ing, including hiring, in response to the lower demand. Layoffs follow, creating the type of cycle we experienced in 2008. As at the end of March however, US jobless claims have been below the level that represents a healthy labour market for 109 weeks, the longest duration experienced since 1970. This, combined with an unemployment rate of 4.5%, real wage growth of just over 2%, and businesses reporting challenges in filling vacancies, points to a labour market at or near full employment. Interestingly, this has transpired without the return of "lost" manufacturing jobs, which in fact may never come back. Although some of those jobs indeed were lost to overseas production, many more were lost to enhanced domestic manufacturing processes, primarily via robotics. And contrary to what headlines are suggesting, improved manufacturing efficiency has resulted in this US industry operating at reportedly generation highs.

Shifting our focus North, our economy, while slowly diversifying in terms of composition and trade, remains very dependant on the export of raw materials, so it is welcome news that energy prices have remained relatively stable. The sustained recovery in energy prices has lead to more spending in the industries that support energy production, including engineering and transportation, which has a broader economic reach than just the oil patch itself. There is slack in the Canadian economy, but the recent pickup in hiring, especially in Alberta, is bringing our economy closer to full output. We see this supported by recent positive GDP growth numbers, the best that Canada has experienced since energy prices collapsed two years ago.

OUTLOOK

The US Fed raised interest rates this past quarter, and is expected to do so at least twice more before year end. We feel the Bank of Canada should follow a similar path, but it has indicated that despite the recent positive data, it sees too much economic uncertainty to risk a rate hike. This decision will continue to keep our dollar weak relative to the US, which we believe is one of the goals of the BoC, as the weaker dollar benefits our exporters, important given the above comments. Traditionally, higher interest rates are negative for stocks, partly because investors will begin to sell stocks, and notionally lowering their investment risk, in order to buy the new, higher interest bonds. But because rates are rising from such low levels, and the increases are in response to strong economic fundamentals, not to inflation, this dynamic is unlikely to materialise meaningfully until interest rates get to more "normal" levels. Then, perhaps, the historical relationship between the two asset classes will reassert itself. In the interim, stocks are expected to continue to outperform bonds. The outperformance, however, will be more modest and volatile as markets digest economic data. But as long as the data remains positive, the volatility, and any associated pullback, is not expected to lead to a full scale correction.

STRATEGY

Despite what we have experienced recently, we have to remind ourselves that markets do not rise in a straight line. In keeping with this reminder, and our expectation for increased market volatility and potential pullback, our strategy continues to be focussed on ensuring that there is no excess concentration in any of our clients' portfolio holdings. We are rebalancing portfolios regularly, and perhaps more frequently than normal, to ensure that profits are being taken in stronger names, and that we are adhering to policy asset weights. And as there is room in our clients' portfolios for additional investment opportunities, we continue the search for a company or two that will complement existing holdings, principally by further reducing the variability of portfolio returns. Our oft espoused criteria for inclusion still apply, and we will not be chasing trends or reacting to headlines suggesting that we are on the brink of a "paradigm shift". If a business or industry does not make sense to us, it has no business being in our clients' portfolios, and we will shift our attention to another candidate.
Have a happy Spring.

R. Guy Amighetti, CFA, TEP
Portfolio Manager

Tel: 604-632-4081
Email: rga@vici.ca
www.vici.ca