VERITAS

Summer 2016

DID YOU KNOW...

- V The US government can now revoke the passports of US persons who owe the IRS more than $50,000.
- V Toronto and Vancouver account for 25% of all jobs, and accounted for all of the net jobs growth, in Canada over the past year.
- V According to a Gallup poll, happiness is maximised at a household income of USD75,000: incremental income above that level does not result in a commensurate increase in happiness.
- V Chances of having a stroke are 33% higher for a person working 55 hours a week than for one working the traditional 35—40 hours.
- V Starbucks reported that it had $1.2 billion loaded on its customer cards and mobile app as at the end of the last quarter, more than many US banks have on deposit.
- V The Toronto Real Estate Board reports that owners of detached homes or condos in that city are seeing their net worth increase by $550 and $79 per day respectively.
- V BC is the only remaining province to retain a AAA credit rating, the highest rating available to institutional borrowers, from all the major debt rating firms.

CURRENT SITUATION

If an investor had gone into hibernation on April 1, 2016, and woken up on June 30, they would have seen that their Canadian equity index portfolio was up a healthy 5.1%, and their US equity index portfolio a more modest 2.5%. A quick examination of the relative returns would show that oil had recovered to $50 per barrel in the quarter, and gold producers were up almost 100% on the year. All in, a fairly normal set of performance numbers for the indices given their composition. What our hibernating investor would not have experienced was the intra-period gut wrenching swings in the markets caused by exogenous events such as the "Brexit" vote, ongoing concerns about Chinese economic growth and increasing government intervention in their financial markets, and a single outlying weak US jobs number. Yet despite all this, and the S&P having tested correction territory twice in the last 12 months, the S&P is up 3.8% on the year, and at the time of writing is even higher and has breached its previous record high. The TSX, although posting a much higher year to date return of 9.8%, and having corrected only once in the last year, is still some 1,000 points away from setting a new record high, which likely will not happen while oil prices remain at current levels.

Moving away from markets, a piece of US macro-economic data caught our interest, coincidently published on the day of the Brexit vote. There are 137 million US workers covered by unemployment insurance, and of those, only two million, or 1.5%, are actually collecting benefits. Furthermore, initial benefits claims are tracking 40 year lows, indicating that companies are reluctant to cut workers. This, combined with several other data points including the labour force participation rate, which is historically high, suggests that the US labour market is tight, a challenge for companies but a benefit for employees, healthy, and generally supportive of wage growth. All this, in turn, is expected to provide support to consumer spending, and more importantly, should help alleviate concerns that rising US personal debt levels is leading to a repeat of conditions that precipitated the 2008 credit market meltdown. Given that the majority of the US economy is consumer driven, and being mindful that the US is still our largest trading partner, their labour market and consumer spending strength will be of benefit and support to our economy through rising exports of finished goods, such as automobiles, serving as a partial offset to the weakness we are experiencing in the resource sector.

Given the potential enormity of its consequences, a comment on the "surprise" outcome of the Brexit vote is warranted. In short, as communicated by the major global stock markets' reaction to the vote of an immediate sharp decline followed by largely a full recovery, except in the UK, the decision by the UK to leave the EU is going to be a bigger challenge for the UK than for the EU and the rest of the world. Initial estimates are for a very slight 0.1% decline in global GDP in 2016-2017 as adjustments are made for an independent UK, but a more significant and prolonged contraction in the UK economy as it adjusts to its independence. Consider that not only will the UK be required to negotiate new trade agreements with the EU, but also will be required to do so with substantially all the countries with which the EU has agreements in place already, and to which the UK no longer has the privilege of free access. There will be many challenges facing Britons as they move down the path of extricating their country from a community to which they have belonged since the mid-1970s, and there are questions as to whether the challenges will be worth the yet to be determined benefits of independence. Regardless, and of some comfort to Canada, as the UK represents only 2% of global GDP, and 2.5% of our trade, their decision is expected to have little long term impact on our economy. And, as one commentator observed, just because the UK is going it alone does not mean that their economy is shutting down. As an aside, $2.08 trillion was wiped off global stock markets the day after the Brexit vote, more than either of the 2008 Lehman bankruptcy or the 1987 "Black Monday" crash, but represented only a 4.7% valuation decline. By comparison, the October 15, 2008 decline precipitated by the Lehman bankruptcy was 6.9%, and remains the single largest one day global decline to date.

OUTLOOK

The combination of the UK's decision to leave the EU, the return of what has been referred to as central bank dithering, particularly in the US, and the recent gains in North American equity markets has caused us to temper our outlook for stock returns for the balance of the year. Our expectation remains for positive equity returns, and outperformance of stocks relative to bonds, but given the gains already registered by the TSX, unless there is another substantial increase in the price of oil, we are assuming volatile but relatively flat returns for the TSX to year end. The S&P 500 is lagging the TSX, but assuming US economic data continues to be strong on balance, we expect at least a portion of that performance gap will close. In large part due to strong demand for bonds, and a limited supply of them, yields continue to decline the world over, and have gone negative in Japan, Switzerland and Germany. But strong demand notwithstanding, bond prices in North America will respond negatively when the US central bank returns to the "rate normalisation" policy that was suspended, hopefully temporarily, in the last few months, and starts raising rates again.

STRATEGY

With US equity markets trading at new all time highs, overall stock valuations being at the higher end of historical ranges, and bond prices as high as they are, we are implementing a modest and temporary asset mix policy shift. Merger-related portfolio activity has left client portfolios with a surplus of cash, and has presented us with an opportunity to take steps to further reduce the risk profile of those portfolios. Although there is no change in the strategy and discipline we employ to determine suitable replacements for the companies that are no longer part of client portfolios, for the interim we are contemplating reducing the overall capital allocated to those names. The net result will be higher than normal cash balances in our clients' portfolios, allowing us to take advantage of the previously mentioned expected market volatility, and any significant market declines emanating therefrom. The temporarily higher cash balances will also serve to partially insulate client portfolios from the same volatility and declines, should they materialise.

Have a pleasant summer, and please do not hesitate to call.

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