Veritas

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Did You Know...

- Sears Canada, following its retail brethren, Eaton's and Woodward's, has filed for bankruptcy protection.
- In related news, excluding items such as gasoline and cars, 25% of US retail activity is conducted online, and the proportion is rising.
- Auto sales in Canada, often overlooked because we are dwarfed by the US statistic, hit their highest level ever in May, surging 11.2% from last year.
- Despite smoking less than ever, because of price increases Americans spent more on cigarettes in 2016 than they did on soda and beer combined.
- After 146 years, the Greatest Show On Earth, the Ringling Brothers and Barnum & Bailey Circus, folded its tents for the final time on May 21st.
- The value, or market capitalisation of all global markets has surpassed $50 trillion, of which almost half is the US S&P 500.
- The proportion of US workers who only worked remotely rose to 20% in 2016, up from 15% in 2012.
- A pilot project in Waterloo, ON is aiming to turn dog waste into renewable biogas energy and fertiliser.

Current Situation

North American equity performance diverged in the first half of this year, with the broad US S&P500 posting strong returns of 9.3% to June 30th, despite growing expectations that many of the campaign promises made last year by the President cannot be fulfilled, potentially leading to slower US economic growth. Canada's equity performance, on the other hand, was flat for the first six months, and the worst in the G7, due to the combination of the recent decline in oil prices, and weakness in the financial sector in reaction to government intervention in the BC and Ontario housing markets, and the contagion effect of the near collapse of Home Capital Group. Home Capital is a "non-traditional" mortgage lender that serves a segment of borrowers who, for many reasons, would not qualify for credit with the big banks. Under normal circumstances, the Home Capital news would not have had the impact that it did, but in the current environment where so much attention is being paid to the Canadian housing market, and given the significance of domestic mortgage lending to Canadian banks' business, some saw Home Capital as the canary in the coal mine, suggesting that its imminent failure was going to spell the collapse of the domestic housing market, and cause a run on the Canadian banks. Ultimately, Home Capital did not fail, thanks in large part to an investment in it by Warren Buffett, which we see not only as a vote of confidence in the company, but in the Canadian housing market and economy as well, and there was no run on our banks.

Speaking of banks, at long last, the Bank of Canada recently raised interest rates by 25 basis points (0.25%), the first hike since 2010. The increase is symbolic because not only is it the first in a very long time, but it also confirms our argument that the Canadian economy is doing more than just recovering, and is strong enough to withstand higher rates. This observation flies in the face of recent headlines, especially regarding the ongoing travails of the energy sector, and their impact on equity markets, but although the resource sector as a whole represents some 30% of the TSX, it represents only 10% or so of Canadian GDP. The implication is that the remaining 90% of our economy is doing well. Furthermore, with the robust economic data and positive future economic indicators coming out of the US, still our largest trading partner, our economy should continue to do well.

On related trade matters, NAFTA is very much in the news, creating the fear that big changes in trade, mostly detrimental to Canada, are coming. We remain skeptical of the extreme view, believing instead that negotiations will result in minor revisions to the agreement. Our rationale is that Canada, in addition to being the principal destination for all US exports, perhaps more importantly is the export destination for 32 individual states. We doubt that their fortunes will be put at risk simply for a symbolical reform of NAFTA. And this ignores the fact that although the US does have a $13 billion trade deficit with us, it is dwarfed by the $344 billion deficit it has with China.

A recent Bloomberg article reported that the number of market indexes now exceeds the number of listed US stocks. This article struck us as important because for every index that exists, exchange traded funds, or ETFs, are created to track it in some manner, and every ETF created then buys the underlying shares of that index. Where it gets interesting is that despite that ETFs trade like shares of a stock, the underlying holdings do not trade, unless there is a change in the components of the reference index. This means that once the ETF buys the shares in the reference index, the shares become a permanent holding of the ETF, notionally reducing market liquidity, and potentially distorting pricing, in those stocks. But when the reference index changes its composition, which happens periodically, the ETF, assuming it tracks the index in lockstep, must immediately transact to reflect the index change, thus creating a “liquidity event” in the affected shares, and potentially further distorting their pricing. Because of this, for some portfolio managers who have “catalyst” based mandates, index rebalancing events are important, creating profit opportunities from the short term pricing anomalies that can arise from the rebalancing.

OUTLOOK

Partly because of the flat performance to June 30, we expect a stronger second half of the year for the TSX. Two factors play heavily in our expectations: the expected recovery in crude prices, which we are witnessing now, and the recent increase in our interest rates. BOC interest rate policy tends to be forward looking, and the recent increase, along with the commentary that accompanied it, suggests that the BOC sees enough momentum in our economy that the economic stimulus that has been created by the ultra low interest rates of the last decade is no longer required. The BOC has said that our economy is over the 2014—15 oil shock and is growing, implying that the recent hike will not be a one-off move, and that rates will gradually continue to move higher. We expect this will support the Canadian dollar as foreign investors and currency traders buy it to take advantage of the rising rates. The rate hikes here and in the US notwithstanding, conditions still favour stocks over bonds As rates rise, prices for existing bonds decline, and the longer the maturity of the bond, the more pronounced the decline. Consequently, we expect the current cycle will create opportunities to buy bonds, but not quite yet. Conversely, the reasons for the hikes remain a supportive of stocks, at least for now.

STRATEGY

With both North American central banks having articulated that, absent another period of prolonged economic weakness, they will continue to remove stimulus from the system, we will be keeping a close eye on the impact of the higher rates on our clients' portfolios. There will come a time when the prevailing level of interest rates will warrant a shift in asset allocation to one modestly less exposed to equities. We would consider this change when we see bonds providing returns that are close to those we would expect from our stocks. The logic for making the move is that when bond returns, which are considered lower risk than those of stocks, come close to expected stock returns, we are able to generate comparable returns and also lower overall portfolio risk. This environment, however, is not imminent inasmuch as we feel rates would have to double from here for it to be. In the interim, we continue searching for suitable companies to include in our clients' portfolios, but remain comfortable with the long-term prospects of the companies, and the industries in which they operate, that comprise them currently.

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