VERITAS

Summer 2018

DID YOU KNOW...

- Approximately 30 billion gallons of lava have poured out of the Kilauea volcano in Hawaii since it erupted on May 3.
- In sad news for "axemen" everywhere, after 116 years of making guitars, among them the storied "Les Paul", the Gibson Guitar Co. is bankrupt.
- If California was an independent country, its economy would be the fifth largest in the world, even ahead of Britain's.
- Brothers Fidel and Raul Castro ruled Cuba for a combined 60 years, and although Raul has "retired", he will remain head of the Cuban Communist party until 2021.
- Canada is the world's third largest blueberry producer, behind Chile and the US.
- One billion gallons of sewage are dumped into oceans every year by the global cruise industry, but in fairness, it is partially treated onboard first.
- North Americans spent USD 53.3 billion on marijuana and derivatives in 2016, more than what the US spent at Starbucks and McDonalds combined.
- For the first time in 110 years, GE will not be part of the DJIA, of which it was an original member.

CURRENT SITUATION

North American equity markets reversed first quarter losses with both the broad US S&P 500 and our TSX ending the second quarter higher. The S&P 500 posted a total return, including dividends, of 2.65% and the TSX 1.95%. Very little changed fundamentally over the last quarter to account for the shift in market sentiment. Instead, it appears that the challenges of the first quarter were overcome, overlooked, or simply recognised as being less of an issue than originally thought, allowing markets to advance as they did.

Investors have experienced a more challenging market so far this year than they did in 2017 (and for several more years prior to that) in terms of volatility, questionable news flow and real economic data. There is no question that current posturing between international trading partners is presenting a danger to all economies, but of note, if the "spats" become all out trade wars, the largest negative impact is expected to be felt by the US because of the size of its economy and how integrated it is with the rest of the world. There is much more to this, but suffice it to say that a return to protectionist trade practices will be financially painful, especially for consumers worldwide.

The market volatility we experienced in the first quarter has not completely abated. Generally speaking, some volatility is welcomed, not just for the trading and investing opportunities it might provide, but also, and perhaps more importantly, because it helps temper investors' return expectations. When markets rise year after year in benign conditions, investors, particularly those who go it alone, tend to lose sight of the fact that the market is not a thing that can be viewed in isolation. It is a composite of companies, and an arena in which those companies are judged and valued. When investors are reminded of this, and their focus returns to the factors that affect the prospects of those individual companies, asset repricing follows, particularly if the factors are viewed as potentially challenging to a company's prospects. This disrupts what is perceived as the perpetual stability of a constantly rising market, and volatility ensues.

The foregoing is not intended to be alarmist: we see overall economic fundamentals as healthy. For example, we look to statistics relating to the US jobs market, because if people are not working, not only do they not participate meaningfully in a consumer based economy, but they also become a cost to the government, further reducing economic activity. It was therefore heartening to see that, despite all the political and economic rhetoric, the US added 215,000 new jobs in June. This is a good number on its own, but made better by the fact that the number outpaced the growth in the labour force itself in the same

period. Ironically, there are risks to a very strong labour market, including a higher unemployment rate as more people are enticed by the strong market to seek jobs, thereby increasing the workforce. But the risk we watch for is inflation as rising demand for goods strains supply of these goods, putting upward pressure on prices. Fiscal policy response to inflation is higher interest rates, which we have been experiencing over the past year. The fact that rates have been rising ahead of inflation suggests that North American central banks are anticipating the inflation risk, and are taking steps to mitigate some of it.

Looking abroad, we see signs of continuing economic strength in the Eurozone, in spite of the uncertainties surrounding Brexit. The fact is that any negative impact of Brexit will be felt less by the EU than by the UK itself. Given the small size of the UK economy relative to the rest of the EU, even if the UK economy slows significantly, as it probably will in the early days post Brexit, the rest of the region is expected to fare well because of its economic integration. We commented in the last edition of *Veritas* that Greece was exiting the final phase of its financial bailout. Since then it has seen its economy expand, giving us further comfort that if even the heretofore weakest economy in the EU is growing, overall economic conditions in the region are good.

OUTLOOK

Given the presence of other factors that influence it, including rising interest rates, shifting political landscapes domestically and abroad, and trade tensions, we expect market volatility will be with us for some time, but do not see it getting to levels where most investors will be unwilling to participate in the markets. What we do see is the possibility of returning to an environment in which historical asset return expectations, upon which traditional investment management discipline is based, will prevail. One of the first concrete steps we have seen towards this shift in thinking is the recent interest rate increases. More important, however, is the central banks' language accompanying the hikes which is essentially stating, not suggesting, as was previously the case, that more hikes are imminent. As we have mentioned in the past, we expect that the higher rates will moderate further price gains in bonds and equities, but at this juncture, given the returns investors have received over the past ten years from both asset classes, we view any moderation in price gains as part of a process towards the normalisation of returns. Future normalised expected returns will be lower than what we have experienced in recent years, and that will prove to be challenging for some, especially those individuals and institutions who have based their financial expectations on aggressive return assumptions. In the long run, however, the expectations "reset" will benefit those of us who rely on realistic, conservative return assumptions when establishing long term investment strategies that have a reasonable chance of being successful.

STRATEGY

There has been increased media coverage recently on the relative merits of active and passive investment strategies, with pundits commenting that we are now in an environment where active management will outperform passive, or index, investing. We acknowledge that as portfolio managers we are biased, but we believe active management will always outperform over time for our clients. Granted, our clients are long term investors, so we do not subscribe to trading for the sake of trading, but this is not the same as being passive investors. Investing is a constantly evolving process, and if investment goals are to be met, one that requires monitoring and adjusting. This is particularly so when investing on behalf of others, as we do for our clients, inasmuch as the investing process must adapt to a client's own changing circumstance. Thus, active management for us is not just simply trading, but rather establishing and applying a discipline to the building, monitoring and rebalancing of each one of our clients' portfolios in anticipation and response to their evolving investment needs and goals. Please free to call to discuss.

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