VERITAS

Winter 2018

DID YOU KNOW...

- Uber has overtaken the ubiquitous Yellow Cabs in New York City in ridership numbers.
- Approximately US $1.8 million of gold passes through Switzerland's wastewater system every year.
- China and India, the two most populous countries in the world, represent 37% of the global population, and India is expected to be the most populous country within 10 years, overtaking China.
- Honolulu has made "distracted walking" illegal, prohibiting pedestrians from crossing the road while looking at their phones.
- It is estimated that Amazon captures 40% of every shopping dollar spent online, and this before it bought Whole Foods last August.
- Mars Inc., the maker of, amongst others, the candy bar bearing the same name, is not a public company, and is actually the sixth largest privately held company in the US.
- According to the UN, the global population of people over 60 will double to 2.1 billion by 2050, and rise to 3.1 billion by 2100.

CURRENT SITUATION

North American stock markets ended 2017 strongly, with the broad US S&P 500 gaining 22% for the year, and the TSX gaining a lesser, but still respectable 9.1%, both numbers including dividends. Canadian market underperformance can be attributed to its poor showing in the first half of the year, but comparing the TSX to the S&P 500 in the second half, and especially the fourth quarter, performance was almost neck and neck. We had expected the TSX to make up lost ground as the year came to a close, largely as a result of a pick up in commodity prices, specifically energy, and a recovery in the financial services sector. But because the Canadian dollar strengthened at the same time as energy prices surged, the price increase did not translate to share price appreciation sufficient to bring the energy sector to breakeven for the year. Energy share prices were pressured further by the pricing differential between Canadian oil and the North American benchmark, West Texas Intermediate, referred to as WTI. The differential reflects the type of oil Canada produces, which tends to be heavier than WTI, and requires more refining, making it less valuable than lighter oil, and hence it trades at a lower price.

Cryptocurrencies and cannabis: just by mentioning these two words, the value of this newsletter should double, if not quadruple. All joking aside, these two "industries" not only grabbed the lion's share of headlines in the latter half of the year, but saw a meteoric rise in the share prices of any company that was barely proximal to them. As an example, cannabis stocks are grouped in with health care in Canada, and that sector was up a remarkable 34% for the year, but a staggering 47% in the fourth quarter (this is not a typo—it had been flat to negative for the rest of the year). Or, in the US, take Kodak, which recently announced it was launching a cryptocurrency called KodakCoin: the company's stock increased fourfold in a day in response. Investor behaviour and market reaction to the crypto and cannabis stocks remind us of the heady days of the dot-com era in 2000, and what happened in the next year when the bubble burst. The crypto and cannabis markets are not only not regulated, but in many cases, not even legal as yet, leading us to ask what people think they are buying when they acquire shares in companies involved in these businesses. We encourage our readers to read about the Dutch tulip craze of 1634: we may be witnessing a modern day repeat, and if so, the ending will not be pleasant for those who are participating in it without knowing just what it is in which they are participating.

Turning our attention to more mundane fundamental matters that truly affect the long term prospects of economies, stocks and markets, a big piece of news out of the US was the passage of long anticipated tax reform proposals which, among other things, lowers US corporate tax rates by 40%. This is very good for corporate America, but not so good for Canada in the long run because the US now has become a more corporate tax friendly jurisdiction than Canada, turning the tables on a distinction from which we have benefitted for more than 15 years. As a consequence, the now lower US taxes are expected to draw future corporate investments to the US, and away from Canada. There could be an impact on existing Canadian operations of US corporations as well, depending on their tax sensitivity. It will be some time, if ever, before the anticipated additional investment in the US can make up for the forecasted loss of current tax revenue resulting from the change. In the near term, however, the new policies and reduced revenues are expected to add to the US budget deficit, and, more importantly, reduce government spending on social programs.

NAFTA negotiations continue, but evidently so poorly that some prominent Canadian business leaders are opining that there is a 75% possibility that the US will terminate the agreement. But despite the rhetoric that suggests otherwise, NAFTA is not "bad" for the US, and the trade between our two countries is not as imbalanced as is being implied. Consider that the US imports four times the value of goods from China than it exports to them, creating a $360 billion trade deficit with China, representing 50% of the *total* US trade gap. Canada, on the other hand, exports only 1.07 times more to the US than we import from them, making our trade relationship very close to balanced. Interestingly, the rest of the world's trade balance with the US, including Mexico, is only 1.3 times, which makes it a curiosity as to why NAFTA is the focal point of current trade negotiations.

OUTLOOK

With the IMF forecasting that every major economy in the world will expand in 2018, the OECD saying global economic growth will reach a seven year high, and the strong employment data being reported in Canada and the US, we are optimistic that this will be another rewarding year for investors. We expect that North American equities will continue to outperform bonds, but perhaps not quite as dramatically as 2017, especially in the US, given their performance in the last two years. Interest rates will continue to rise on both sides of the border. Provided the Bank of Canada does not hold back on rate increases, and oil prices do not collapse, our dollar is expected to remain near the US 80 cent level, and stronger against the euro, GBP and peso. There are risks to our outlook, but absent a global economic shock, current macroeconomic conditions appear to be strong enough to mitigate them. As an aside, the relatively strong CAD sets up 2018 to be another good year for Canadians to travel outside North America.

STRATEGY

Looking back at previous editions of Veritas, the majority of our strategy comments remain as valid today as when they were first written. We have commented in the past that establishing an investment discipline, and adhering to it, means that there is very little need to alter course period to period, and any alterations should be based on fundamental considerations, not in response to a trend shift. Our clients' portfolios remain invested for the long term, defined by us as at least five to eight years, and generally are invested so as to avoid being overly impacted by swings in business and economic sentiment. This discipline tends to have its best results during volatile and declining markets, which will return sometime. But it also serves our clients by reducing or eliminating their risk of being exposed to torpedo stocks that can materialise quickly when a hot trend goes cold. We view this as being particularly important in the current market environment, and while we must look at the drivers of the trend of the day, unless we can make sense of them from a ten year perspective, we give them wide berth.

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