THE COERENTE VIEW

2ND QUARTER 2017

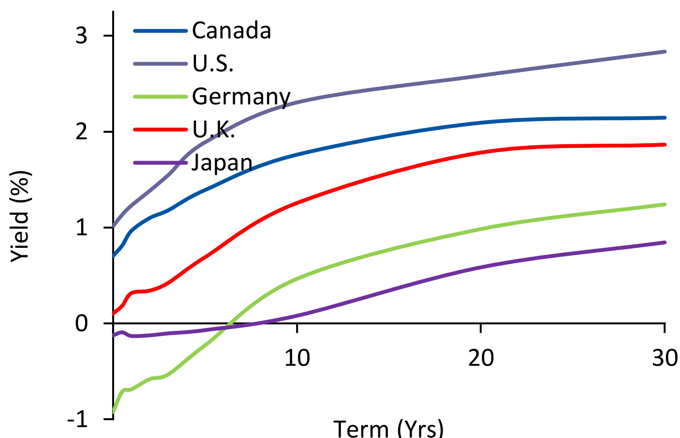
Market Statistics

	Jun/17	Mar/17	Dec/16	Jun/16
Yields (%)				
90 Day T-Bill	0.71	0.52	0.46	0.49
10 Yr. Canada Bond	1.77	1.62	1.72	1.13
30 Yr. Canada Bond	2.15	2.30	2.31	1.77
Rates (%)				
C.P.I. (annual)	1.32	1.56	1.50	1.49
US$/C$	0.77	0.75	0.74	0.77
Euro/C$	0.67	0.70	0.71	0.69
Prices (US$)				
Crude Oil (bbl.)	46	51	54	48
Natural Gas (mm)	3.04	3.19	3.72	2.92
Gold (oz.)	1,241	1,250	1,152	1,321

Market Returns

	Periods Ending Jun. 30/17			
			Annualized	
	3 Mo.	1 Yr.	5 Yrs.	10 Yrs.
S&P/TSX	-1.6	11.1	8.7	3.9
S&P 500 (C$)	0.5	17.6	20.3	9.3
S&P 500 (US$)	3.1	17.9	14.6	7.2
MSCI EAFE Net (C$)	3.5	20.0	14.1	3.1
MSCI EAFE Net (US$)	6.1	20.3	8.7	1.0
MSCI World Net (C$)	1.4	17.9	16.9	6.1
MSCI World Net (US$)	4.0	18.2	11.4	4.0
FTSE Universe Bond	1.1	0.0	3.3	5.1
FTSE 91 Day T-Bill	0.1	0.5	0.8	1.2

Yield Curves



The Economy

For the past four years we have suggested global economic growth would be slow and inflation rates low relative to previous economic cycles. This forecast remains in place but subtle changes are beginning to surface. Inflation rates were at one point decreasing to the extent that central bankers in a number of the developed economies feared deflation despite having reduced interest rates to near zero. As a result, “quantitative easing” policies which entailed buying long term securities (bonds) in order to help lower long-term interest rates were also implemented. In these economies, particularly in North America, the fear of deflation abated and inflation appears to have settled in around the 2% range. The U.S. continues to lead in terms of sustainable economic growth and unemployment now sits at 4.4%. At near full employment the expectation is that at some point we should see accelerating inflation. So far this has not happened.

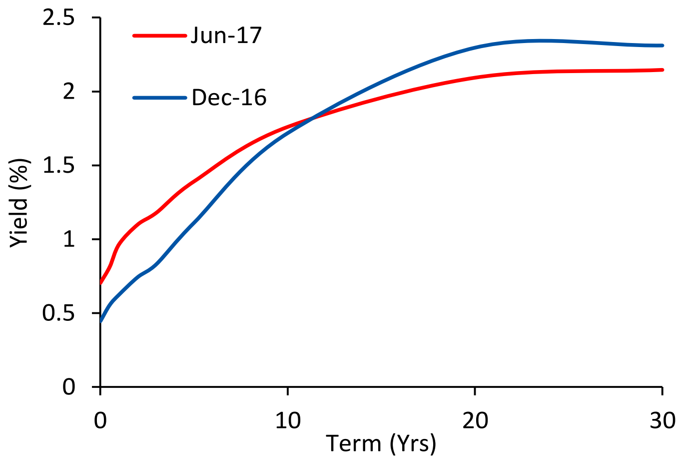
In anticipation of rising inflation rates and facing asset valuations that have been increasing and are, as Janet Yellen the U.S. Federal Reserve Chair stated, “somewhat rich” the Federal Reserve continues to hike rates. The very low interest rate policy of recent years has certainly buoyed real estate prices but stock markets have also benefited as competitive dividend yields (relative to bonds) have drawn funds into equities and in turn raised share prices.

The top two charts on page two illustrate that while North American central bankers have raised short-term interest rates, long-term interest rates have not followed. Instead, long-term rates have fallen, partially because bond purchasers are not yet anticipating robust growth or inflation. Also a factor is the global flow of funds. Despite low yields in the U.S., yields in Europe and Japan are even lower (see yield curves at bottom left) meaning funds flow into the higher yielding North American securities.

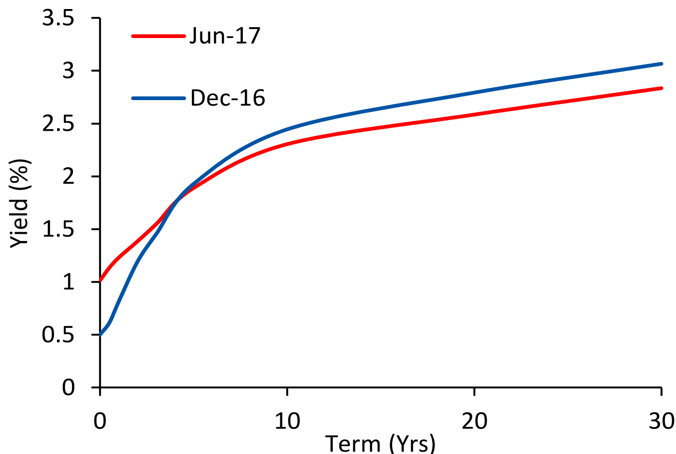
Normally longer-term interest rates exceed short-term rates. A flattening of the yield curve (when short-term and long-term rates converge toward each other) has usually been the precursor to a recession. The bottom chart on page two shows that in the U.S., over the last sixty years, virtually every time the ratio of T-bill interest rates to long-term bond rates hit 1.0 (i.e. T-bill rates = long-term bond rates) a recession occurred. Many economic prognosticators are currently suggesting caution for this reason.

The repercussions of a flat yield curve appear irrefutable. In the past, however, interest rates were raised aggressively to combat rapid economic growth or inflation. As mentioned, neither is yet occurring. Asset bubbles can also wreak economic havoc as we experienced with real estate during the 2008-09 period. If central bankers fear similar extended asset valuations and raise short term rates rapidly, then we may indeed experience a recession.

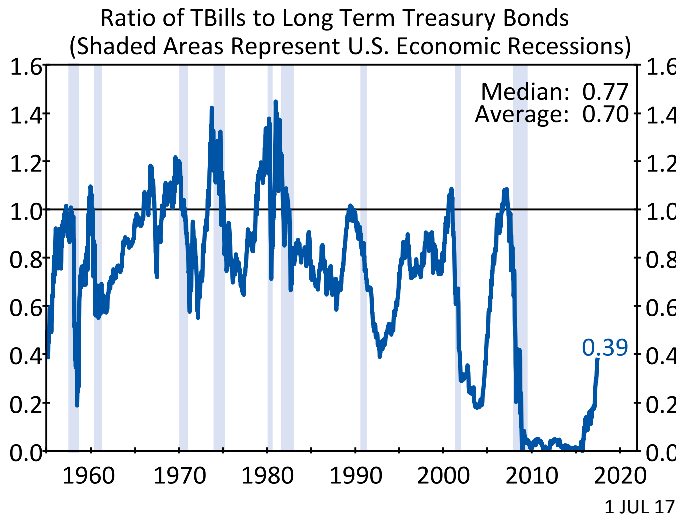
Canada Yield Curve



U.S. Yield Curve



Steepness of U.S. Yield Curve



We have suggested that slow growth and low inflation can provide for a decent investment environment but there certainly may be some specific areas of concern today. So far none of the world's major central bankers have given any indication that an aggressive move toward higher interest rates or an unwinding of quantitative easing is on the horizon.

The Markets

The upward move in interest rates held back returns in North America this quarter. The more dovish stance toward higher interest rates taken by central banks in Europe and Japan, along with indications of positive economic growth (versus zero growth a year ago) has resulted in these regions providing the greatest stock market gains lately. For the second quarter the S&P/TSX slipped 1.6%, the S&P 500 gained a modest 0.5%, and the MSCI EAFE index returned 3.5%. The FTSE Universe Bond index rose 1.1% as the aforementioned flattening of the yield curve has led to continued decent bond returns.

For Canadians, returns on foreign assets were reduced by the strength in the Canadian dollar. Despite the price of oil falling from $51 to $46 per barrel (most other commodities the C$ normally follows also saw prices slide) the Loonie rallied from 75 to 77 cents U.S. The unusual move higher was spurred by comments from the Bank of Canada of possible interest rate hikes. In our view, the price of oil remains range bound around $40-$60 per barrel as this is where U.S. shale oil is profitable thus mitigating the effect of any supply cuts by OPEC nations.

Technology related stocks have led the global markets for the past twelve months with some weakness appearing late in June. They have provided nearly 40% of the S&P 500 return and now comprise 24% of the index. The top five stocks alone (Apple, Microsoft, Amazon, Facebook and Alphabet-Google) make up 12% of the index. In terms of valuation, Microsoft, Alphabet and Apple have significant earnings supporting their share prices and thus do not have the same characteristics of the others.

Our investment philosophy emphasizes shares of companies with consistent earnings. Consequently, many of the technology stocks that arguably have stretched valuations are excluded from our portfolios. Also central to our approach is protecting portfolios from any permanent declines. With the expectation that interest rates will soon rise we have avoided real estate related companies, and where fixed income is owned only short maturities are held. While European and Japanese stocks have led of late, we are not motivated to chase equities in these regions. Economic growth in these areas is historically slower relative to the U.S., and the banks in these overseas markets remain fragile and mostly undercapitalized.

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Sources: TD Securities Inc., Scotia McLeod, Bloomberg