THE COERENTE VIEW

4TH QUARTER 2017

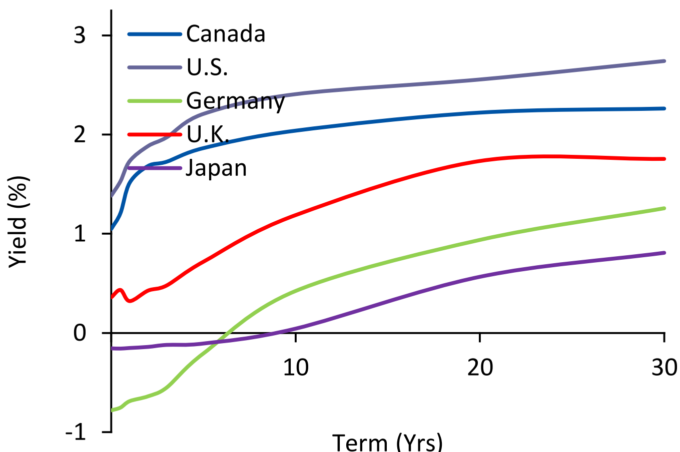
Market Statistics

	Dec/17	Sep/17	Jun/17	Dec/16
Yields (%)				
90 Day T-Bill	1.06	1.00	0.71	0.46
10 Yr. Canada Bond	2.04	2.10	1.77	1.72
30 Yr. Canada Bond	2.26	2.47	2.15	2.31
Rates (%)				
C.P.I. (annual)	2.10	1.55	1.32	1.50
US$/C$	0.80	0.80	0.77	0.74
Euro/C$	0.66	0.68	0.67	0.71
Prices (US$)				
Crude Oil (bbl.)	60	52	46	54
Natural Gas (mm)	2.95	3.01	3.04	3.72
Gold (oz.)	1,306	1,282	1,241	1,152

Market Returns

	Periods Ending Dec. 31/17			
			Annualized	
	3 Mo.	1 Yr.	5 Yrs.	10 Yrs.
S&P/TSX	4.5	9.1	8.6	4.6
S&P 500 (C$)	7.2	13.8	21.3	11.1
S&P 500 (US$)	6.6	21.8	15.8	8.5
MSCI EAFE Net (C$)	4.8	16.8	13.0	4.4
MSCI EAFE Net (US$)	4.2	25.0	7.9	1.9
MSCI World Net (C$)	6.1	14.4	16.9	7.6
MSCI World Net (US$)	5.5	22.4	11.6	5.0
FTSE Universe Bond	2.0	2.5	3.0	4.7
FTSE 91 Day T-Bill	0.2	0.6	0.7	1.0

Yield Curves



The Economy

Economic growth has continued to improve globally while inflation, much to the surprise of most central banks, remains subdued. This has allowed a dovish approach to the normalization of interest rates. Short-term interest rates have certainly moved up in North America and now exceed the 1% level. Elsewhere they remain close to zero, if not negative as illustrated on the Yield Curve chart at the bottom of this page. Of particular note is the "flatness" of the curve in the U.S. That is, you are not significantly rewarded for buying longer term maturities.

Long-term interest rates are largely affected by the low inflation rates. The shaded areas in the top chart on page two indicate that when short-term interest rates equal long-term rates a recession occurs. As more funds move into attractive, high yielding short-term notes, less long-term investment takes place and an economic slowdown occurs. The U.S. Federal Reserve (Fed) has raised rates three times in 2017 and recently forecast three more hikes in 2018, and two in 2019. With each rate increase typically being 0.25% we can quickly surmise that short-term interest rates could equal long rates (assuming no change in long rates) by the 1st quarter of 2019.

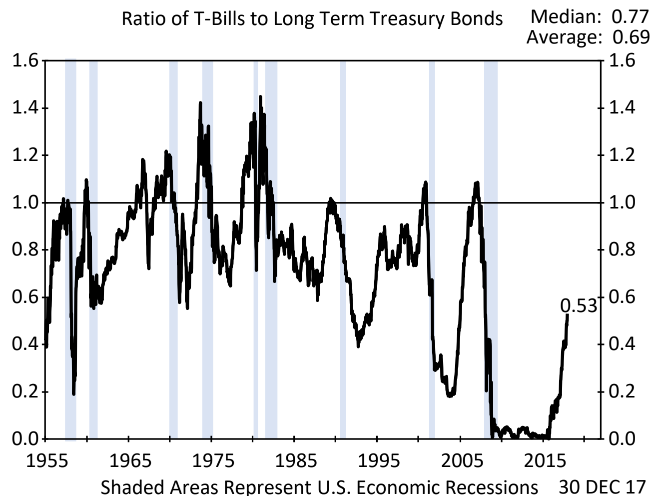
The Fed has no intention of purposely triggering a recession. Rather, they believe containing overall inflation rates and normalizing interest rates will avoid speculative asset pricing in areas such as real estate and excessive debt accumulation. The current low unemployment rate in the U.S., combined with expansionary fiscal policy will most likely lead to higher inflation rates. As well, if the Trump administration follows through in withdrawing from trade agreements, higher-cost American made products will replace previously imported low-cost goods sourced from China and elsewhere. Finally, the decline of the U.S. dollar versus most of its trading partners (see second chart on page 2) will also result in imported goods becoming more expensive.

The Markets

In 2017, returns exceeded expectations in both the stock and bond markets. The existing business environment is conducive to even further gains given President Trump's recently passed tax policy to reduce the corporate tax rate from 35% to 21% over the next decade. Nonetheless, there are some "red flags" appearing.

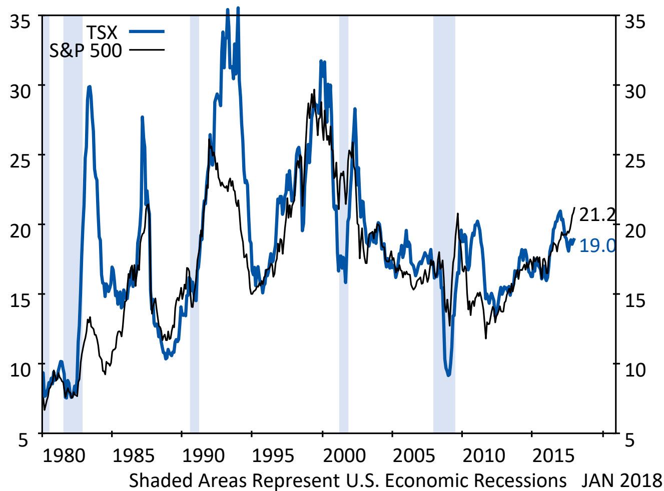
The foreign equity markets were exceptionally strong in the fourth quarter led by the U.S. where the S&P 500 returned 7.2%. The overseas EAFE index returned 4.8% and the Canadian based TSX 4.5% for the same period. Perhaps most surprising, however, was the performance of bonds. After a decisively negative third quarter of 2017 as long-term interest rates rose, bond yields reversed course in the fourth quarter and the FTSE Universe Bond index returned 2.0% on the indication

Steepness of U.S. Yield Curve



Trade Weighted U.S. Dollar Index

Price-Earnings Multiples



indication of subdued inflation rates. It is difficult to envisage a yield much lower than the existing 2.26% level for a government of Canada 30-year bond when economic growth remains increasingly positive. **In fact, we would suggest the probability of realizing losses in holding bonds with long maturities is high.**

For the year, equities demonstrated the same trend apparent in the fourth quarter but foreign equity returns were held back in Canadian dollar terms by the 8% increase in the value of our dollar which reached the $0.80 U.S. level.

Share prices have increased faster than earnings recently. As a result, share price multiples have expanded and now exceed the 21 times level in the U.S. (see last chart). The major contributor to this increase has been the performance of technology stocks which now comprise one quarter of the S&P 500 index. **In fact, 42% of the S&P 500 return in 2017 was derived from the performance of the technology sector (including the closely related shares of Netflix and Amazon).** We are not comfortable with the valuations of many of the major technology stocks, where in some cases earnings are virtually non-existent. As a result of not owning them, the performance of our foreign stocks did not match the major indices. The largest, most notable and newsworthy companies now go by the acronym of "FAANGM" (**F**acebook, **A**mazon, **A**pple, **N**etflix, **G**oogle and **M**icrosoft).

	Facebook	Amazon	Apple	Netflix	Google	Microsoft	S&P 500
P/E	32x	297x	18x	194x	26x	21x	21x
2017 Stock Price Change	53%	56%	48%	55%	33%	38%	19%

Cash adjusted P/E; 2017 Stock Price Change in US$; Google = Alphabet

We prefer the consistency of the Google and Microsoft businesses and are prepared to accept paying a premium multiple, however, we find most of the other stocks too expensive or risky. While valuations have not reached levels similar to the "dot-com" era in 2000, the risks of a share price correction are significant.

We primarily own the shares of reasonably priced companies that generate consistent cash flow and earnings, regardless of the economic environment. In fixed income, we expect a rise in long-term bond yields and have therefore kept our average bond term below the 3-year level. While low yields are normally a characteristic of bonds with short maturities, we have enhanced the yield of our fixed income sections by owning investment grade corporate bonds and preferred shares (with variable tax advantaged dividend rates) that provide minimum yields in the 5.0% range or will exceed T-bill rates by approximately 2.0%.

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