THE COERENTE VIEW

1ST QUARTER 2018

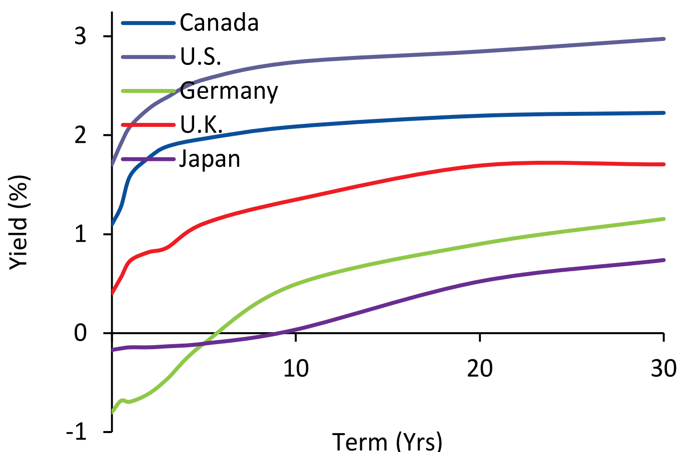
Market Statistics

	Mar/18	Dec/17	Sep/17	Mar/17
Yields (%)				
90 Day T-Bill	0.87	1.06	1.00	0.52
10 Yr. Canada Bond	2.09	2.04	2.10	1.62
30 Yr. Canada Bond	2.23	2.26	2.47	2.30
Rates (%)				
C.P.I. (annual)	2.16	1.87	1.55	1.56
US$/C$	0.78	0.80	0.80	0.75
Euro/C$	0.63	0.66	0.68	0.70
Prices (US$)				
Crude Oil (bbl.)	65	60	52	51
Natural Gas (mm)	2.73	2.95	3.01	3.19
Gold (oz.)	1,323	1,306	1,282	1,250

Market Returns

	Periods Ending Mar. 31/18			
			Annualized	
	3 Mo.	1 Yr.	5 Yrs.	10 Yrs.
S&P/TSX	-4.5	1.7	6.9	4.5
S&P 500 (C$)	2.0	10.4	18.8	12.0
S&P 500 (US$)	-0.8	14.0	13.3	9.5
MSCI EAFE Net (C$)	1.2	11.2	11.7	5.1
MSCI EAFE Net (US$)	-1.5	14.8	6.5	2.7
MSCI World Net (C$)	1.5	10.0	15.1	8.3
MSCI World Net (US$)	-1.3	13.6	9.7	5.9
FTSE Universe Bond	0.1	1.4	2.9	4.4
FTSE 91 Day T-Bill	0.3	0.8	0.7	0.9

Yield Curves



The Economy

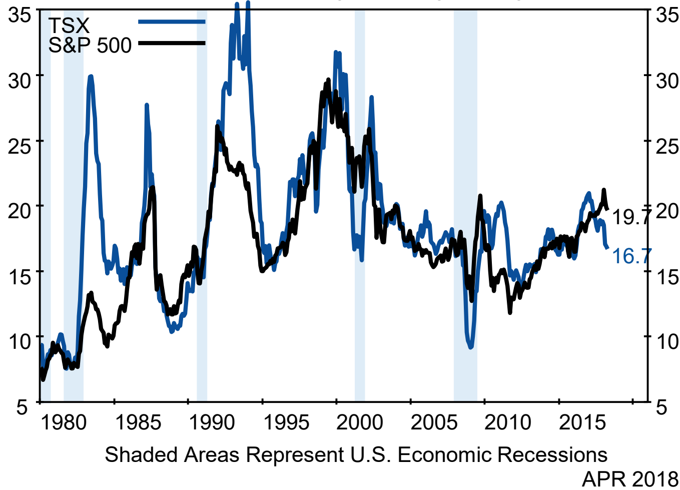
After almost ten years of growth the U.S. economy is demonstrating signs that it is finally in the later stages of an economic cycle. Growth remains strong, the unemployment rate is low and short-term interest rates are rising. Inflation is the one indicator that has, so far, been constrained and as a result long-term interest rates have not moved up significantly. The Canadian economy has mostly followed along with its southern neighbour except for the drag caused by our government's poorly conceived approach to energy policy. The table on the immediate left illustrates the rise in Canadian T-bill rates, CPI and ten-year Canada Bond yields over the last twelve months.

While North American gross domestic product growth is reaching the 3.0% level, Europe continues to hover in the 2.0% range, Japan and the UK at 1.5%. China leads with a reported GDP growth rate of 6.0-7.0%. The yield charts at the bottom of this page reflect the higher interest rates in place within the faster growing economies. Negative interest rates are still prevalent in the more fragile economies of Europe and Japan. The charts also indicate the relative flatness of the curves in North America. This flatness means investors are not significantly rewarded for buying longer-term bonds. Some prognosticators suggest that continued low inflation will suppress long-term interest rates and also contain further increases in short-term interest rates. This could prolong an already long economic cycle or at least delay any recession.

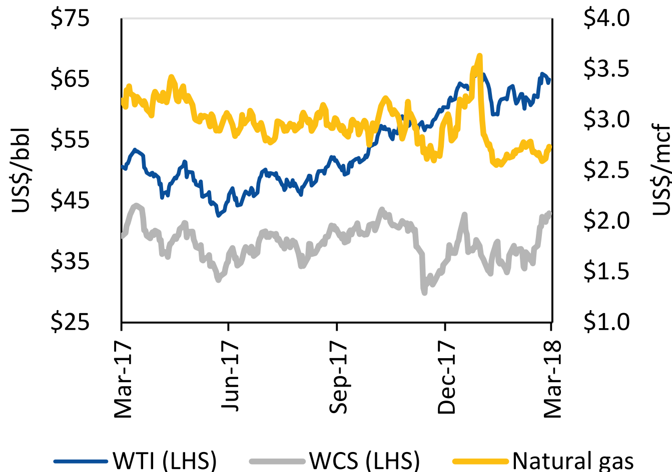
As mentioned in our last Coerente View, it is our opinion that central bankers in the faster growing North American economies are intent on raising short-term interest rates, not just to contain inflation, but also to prevent any excesses building in the form of inflated asset prices or increasing levels of personal debt. The lessons learned from the dramatic rise in real estate prices and debt levels in the U.S. that triggered the great recession a decade ago have not been forgotten. Central bankers now focus on more than just inflation and growth. They also recognize the importance of asset pricing and debt levels within an economy.

The Trump administration inherited a relatively healthy economy in the U.S. and has further fueled its progress with significant corporate tax cuts. As a result, the U.S. Federal Reserve is now telegraphing another four short-term interest rate increases in 2018, along with a continued unwinding of quantitative easing (the sale of long term bonds originally purchased to help lower long-term interest rates). The only potential obstacle preventing this more aggressive action by the Federal Reserve would be negative outcomes resulting from trade disputes or the implementation of tariffs.

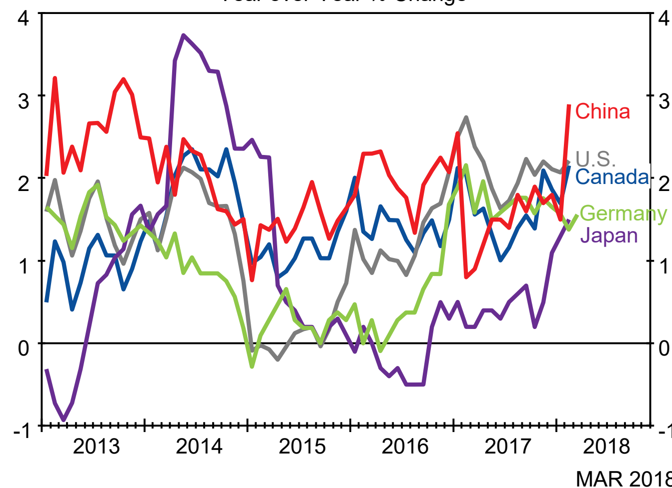
Price-Earnings Multiples



Energy Prices



Global CPI Inflation



The Markets

Equity markets globally were volatile during the first quarter and declined despite continued positive earnings surprises. The rise in interest rates appears to finally be taking its toll on the valuation of stocks as investors now perceive that increases in interest rates, particularly by the U.S. Federal Reserve, will be more frequent. The price-earnings chart opposite indicates valuations have indeed come down.

The Canadian stock market was one of the worst performers globally despite rising oil prices. The price of Western Canadian Select (WCS), which is the price received by oil sands companies, is normally lower than global oil price benchmarks such as WTI (Western Texas Intermediate) due to additional refining required for heavy oil and the added shipping costs associated with it. Heavy oil supply has increased as Canadian producers have expanded production and new capacity has hit the market in recent quarters. Unfortunately, pipeline capacity has not kept up as rebuilding and expansions have been held back by flailing government policy. There have also been ruptures in existing lines that have reduced operating rates. The differential between WCS and WTI has increased from $11 per barrel one year ago to $22 per barrel today thereby reducing earnings to oil sand producers and pipeline companies. As well, the price of North American natural gas has not followed the global price of oil higher as the market remains in significant oversupply with shale related gas production increasing. The prices of WTI oil, WCS oil and natural gas are reflected on the middle chart of this page. The Canadian TSX Energy sub index has declined -10.9% over the last year and -9.4% over the last quarter despite global oil prices rising 28.3% and 7.5% for the same periods.

The transportation issues related to heavy oil are expected to be alleviated by pipeline capacity improvements and increased railway use as we get closer to year end. Natural gas prices will most likely remain low for a number of years as producers have not yet given any indication they intend to reduce production.

Higher interest rates will slow the North American economies and if central bankers are too aggressive a recession could develop. We expect share price multiples to remain constrained by the rise in interest rates with the better performing stocks being those of companies operating globally that continue to report increases in earnings despite any economic slowdown. Bonds are relatively unattractive as interest rates are rising and inflation rates, while relatively steady today are still expected to increase, albeit at a moderate rate. Accordingly, only bonds with short-term maturities will be held in accounts.

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Sources: TD Securities Inc., Scotia McLeod, Bloomberg