THE COERENTE VIEW

2ND QUARTER 2018

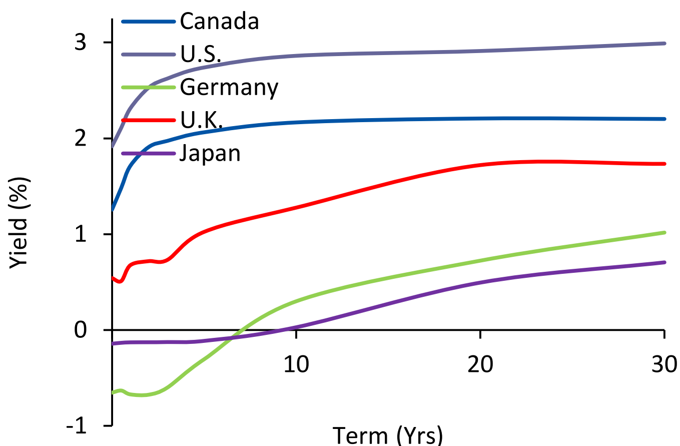
Market Statistics

	Jun/18	Mar/18	Dec/17	Jun/17
Yields (%)				
90 Day T-Bill	1.26	0.87	1.06	0.71
10 Yr. Canada Bond	2.17	2.09	2.04	1.77
30 Yr. Canada Bond	2.21	2.23	2.26	2.15
Rates (%)				
C.P.I. (annual)	2.22	2.31	1.87	1.01
US$/C$	0.76	0.78	0.80	0.77
Euro/C$	0.65	0.63	0.66	0.67
Prices (US$)				
Crude Oil (bbl.)	74	65	60	46
Natural Gas (mm)	2.92	2.73	2.95	3.04
Gold (oz.)	1,251	1,323	1,306	1,241

Market Returns

	Periods Ending Jun. 30/18			
			Annualized	
	3 Mo.	1 Yr.	5 Yrs.	10 Yrs.
S&P/TSX	6.8	10.4	9.2	4.2
S&P 500 (C$)	5.6	16.1	18.6	13.0
S&P 500 (US$)	3.4	14.4	13.4	10.2
MSCI EAFE Net (C$)	0.9	8.4	11.3	5.5
MSCI EAFE Net (US$)	-1.2	6.8	6.4	2.8
MSCI World Net (C$)	3.9	12.7	15.0	9.0
MSCI World Net (US$)	1.7	11.1	9.9	6.3
FTSE Universe Bond	0.5	0.8	3.5	4.5
FTSE 91 Day T-Bill	0.3	1.0	0.8	0.9

Yield Curves



The Economy

The global economies have demonstrated reasonable economic growth with the U.S. and China expected to continue to lead. Equally impressive have been the restrained rates of inflation experienced. Below are the latest forecasts from the OECD (Organization for Economic Cooperation and Development).

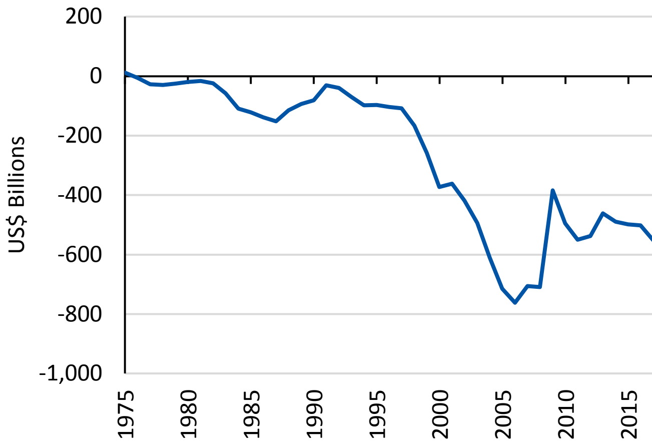
	Real GDP Growth (%)		Inflation Forecast (%)
	2018	2019	2019
Canada	2.1	2.2	2.2
U.S.	2.9	2.8	2.3
Euro Area	2.2	2.1	1.8
Japan	1.2	1.2	1.5
U.K.	1.4	1.3	2.2
China	6.7	6.4	2.0

The economic strength has allowed central bankers globally to reduce liquidity this past year by raising short-term interest rates and eliminating "quantitative easing" programs (the purchase of long-term securities in order to reduce long-term interest rates). Tightening measures have nevertheless been modest and slowly implemented as a lack of inflation has kept long-term interest rates essentially unchanged. Of late there has been further hesitation as a result of the trade wars instigated by the Trump administration. So far there has been a flattening of yield curves (illustrated in the bottom chart on this page) meaning investors are not significantly rewarded for investing in longer-term versus shorter-term maturities. This has raised concerns of a potential recession.

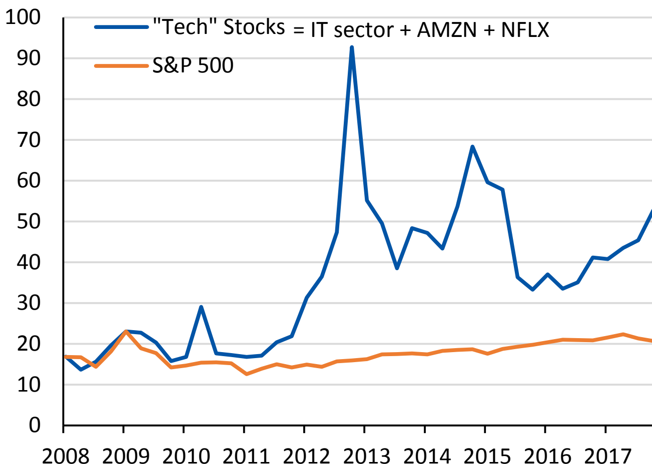
The U.S. has had a trade deficit since the mid-1970s (see first chart on next page). They purchase more than they sell because not all goods consumed by Americans are necessarily available in the U.S. or they can be produced at a lower cost elsewhere. Trade deficits longer term have been viewed negatively by some economists. More recent thinking has dismissed this theory when taking into consideration the length of time the U.S. has experienced a trade deficit, the sheer size of the U.S. economy and the fact that most of the world is willing to hold U.S. dollars and views it as the "global currency."

Beyond the politics of an "America first" platform it is difficult to understand the reasons for Trump embarking on a trade war. Freer trade is beneficial for all countries in terms of sustainable growth and it results in lower cost of goods for consumers. The consequences of the current U.S. trade path will inevitably lead to slower near-term growth for the U.S. economy and rising inflation as overseas goods become more expensive with tariffs applied or as higher priced U.S. produced goods are purchased in replacement.

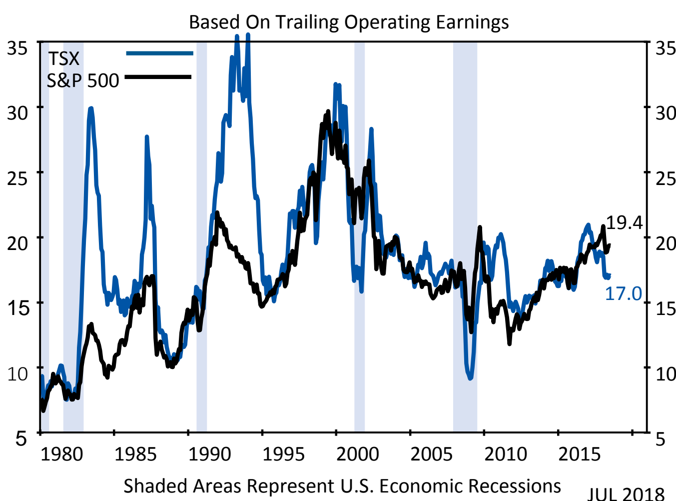
U.S. Annual Balance of Trade



Price-Earnings of "Tech" Stocks vs. S&P 500



Price-Earnings Multiples



The Markets

After a difficult first quarter in 2018, where most equity markets corrected in reaction to rising interest rates, the second quarter provided decent returns across most asset classes. However, equity market returns continue to be largely driven by technology-related companies with some assist from oil stocks. **Technology-related stocks (the technology subsector plus Amazon and Netflix) now make up almost 30% of the S&P 500 and contributed 8.9%, or 62% of the 14.4% return achieved by the index (U.S. dollar terms) over the recent twelve-month period ended June 30, 2018. Year-to-date, the S&P 500 returned 2.7% and the technology-related stocks contributed 3.9% implying that most other sectors in fact declined in price.**

While technology-related companies have certainly generated strong revenue growth, profitability has lagged for some of the largest gainers. As a result, valuation levels have now become stretched, reminiscent of the "dot-com" era in 2000. The chart on the left illustrates the premium trading valuation for the sector as a whole. The table below indicates the range of premiums for the shares of the largest companies. Some may be justified, others are simply extraordinary.

	Facebook	Amazon	Apple	Netflix	Google	Microsoft	S&P 500
Trailing P/E (adj. ex-cash)	27x	272x	15x	258x	27x	25x	21x
2018 YTD Total Return	10%	45%	10%	104%	7%	16%	3%

Despite share prices declining in most non technology-related sectors in 2018, corporate earnings have continued to increase and as result overall price/earnings valuations have fallen to more reasonable levels. We remain comfortable with the shares held in our portfolios but certainly understand the contagion effect that a major correction in technology stocks would have. We could experience initial declines in all stocks but would expect those with earnings support to recover relatively quickly. There also remains the risk to earnings of escalating trade wars on companies that rely on exports or foreign investments. Common sense and history would dictate that poor reactionary policies will eventually be reversed or placated.

A flat yield curve provides little reward for the purchase of longer-term securities. Current low yields and the general direction of interest rates suggest that any fixed income owned should remain short in maturity and be held primarily for the protection of capital with little return expected. Our portfolio weightings continue to favour equities in this environment.

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Sources: TD Securities Inc., Scotia McLeod, Bloomberg, O.E.C.D., U.S. Census Bureau