THE COERENTE VIEW

3RD QUARTER 2018

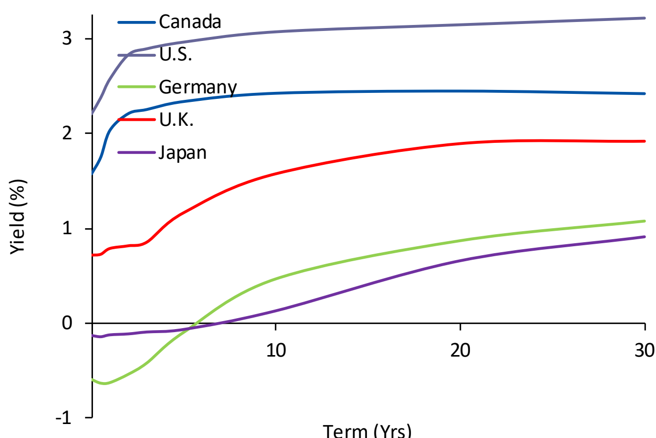
Market Statistics

	Sep/18	Jun/18	Mar/18	Sep/17
Yields (%)				
90 Day T-Bill	1.59	1.26	0.87	1.00
10 Yr. Canada Bond	2.43	2.17	2.09	2.10
30 Yr. Canada Bond	2.42	2.21	2.23	2.47
Rates (%)				
C.P.I. (annual)	2.84	2.45	2.31	1.55
US$/C$	0.77	0.76	0.78	0.80
Euro/C$	0.67	0.65	0.63	0.68
Prices (US$)				
Crude Oil (bbl.)	73	74	65	52
Natural Gas (mm)	3.01	2.92	2.73	3.01
Gold (oz.)	1,192	1,251	1,323	1,113

Market Returns

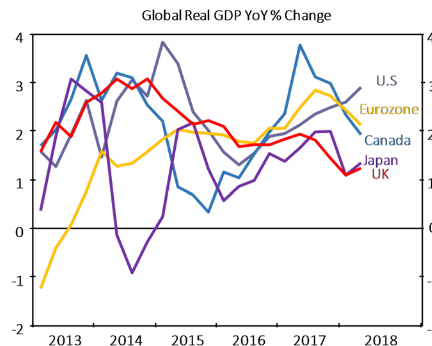
	Periods Ending Sept. 30/18			
			Annualized	
	3 Mo.	1 Yr.	5 Yrs.	10 Yrs.
S&P/TSX	-0.6	5.9	7.8	6.3
S&P 500 (C$)	5.9	22.3	19.3	14.2
S&P 500 (US$)	7.7	17.9	13.9	10.2
MSCI EAFE Net (C$)	-0.4	6.6	9.3	7.5
MSCI EAFE Net (US$)	1.4	2.7	4.4	5.4
MSCI World Net (C$)	3.9	12.7	15.0	9.0
MSCI World Net (US$)	5.0	11.2	9.3	8.6
FTSE Universe Bond	-1.0	1.7	3.3	4.4
FTSE 91 Day T-Bill	0.3	1.2	0.8	0.8

Yield Curves



The Economy

So far in 2018, equity market returns have tracked the economy as the U.S. has experienced strong economic growth and double-digit S&P 500 market returns while most other regions have languished.

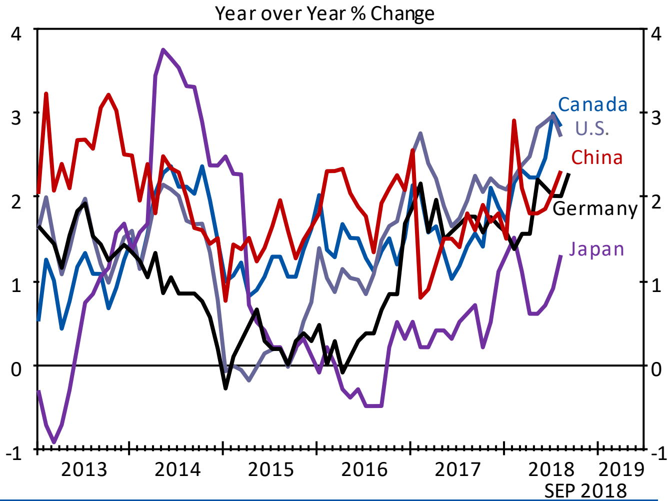


The U.S. economy continues to expand with consumer confidence at an eighteen-year high. This is reflective of real GDP growth exceeding 3% while the unemployment rate has declined to the 3.9% level. The U.S. consumer remains ebullient despite recent increases in interest rates.

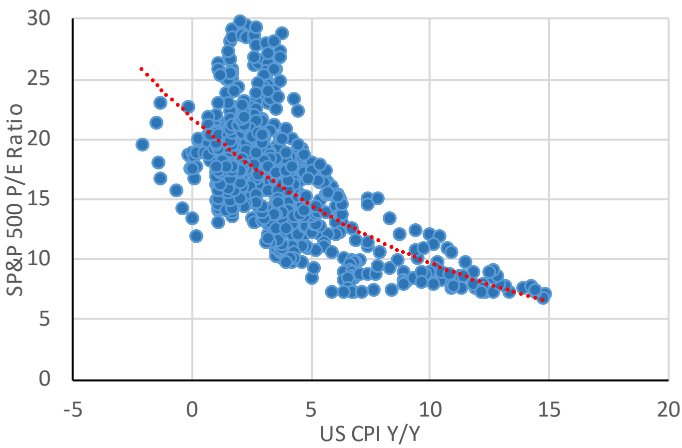
In Canada, the mismanagement of the energy sector has restrained GDP as our companies are landlocked and not able to get their product to market, realizing only $35-40 dollars per barrel of oil when the world price ranges from $70-80. The threat of tariffs by the U.S. also held back spending. At the time of this writing, a new trade deal with the U.S. and Mexico has been reached which only slightly dampens our auto sector but harms dairy farmers. This is a better overall outcome than originally expected. The implementation of tariffs by the U.S. has most definitely hurt the economies of Europe, China and Japan. Europe has also had to deal with the uncertainty regarding Brexit, a debt laden Italian economy and a Turkish economy which most likely will need rescuing by its larger geographical neighbors.

It was decisive U.S. policy during the great recession of 2008 that has fuelled almost a decade of modest but steady growth. Financial institutions were forced to accept loan losses and some went out of business but this allowed for an unencumbered recovery unlike the timid approach taken by most other countries. The Trump administration's unprecedented corporate tax cut has elongated the cycle. The additional after-tax profits were shared and disbursed to employees in the form of higher wages, passed along to shareholders via dividend increases and share buybacks and a sizable portion was retained to strengthen balance sheets or further capital investments. Economic growth remains strong for our southern neighbor. Canada will most likely continue to benefit given our proximity and integrated economies.

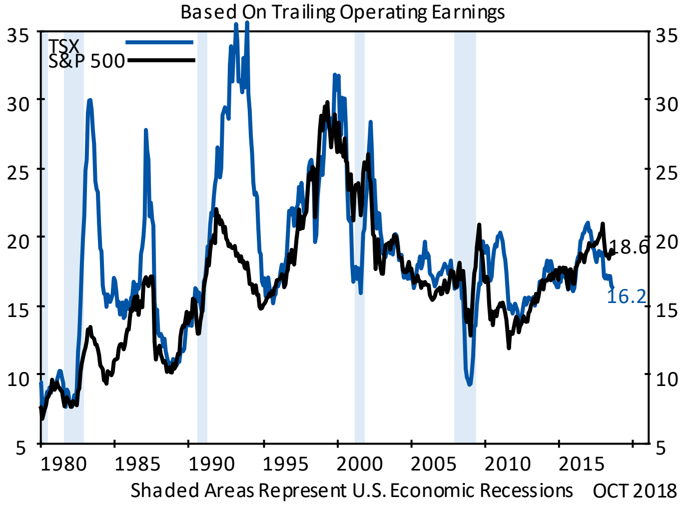
Global CPI Inflation



Inflation Drives Stock Market Valuation



Price-Earnings Multiples



The Markets

U.S equity market returns have far out distanced other regions in recent years but it has been particularly pronounced this year. Year-to-date, the S&P 500 returned 14.1% while the overseas MSCI EAFE came in at 1.7% and the Canadian based S&P/TSX 1.4%. Inflation however, has accelerated in the U.S., beyond the Federal Reserve 2.0% target, as shown in the chart opposite. It is no surprise that interest rates were increased three times in 2018 with the latest pronouncement in September indicating that further increases should be expected in 2019.

Canadian inflation rates have also been increasing but the Bank of Canada has been reluctant to follow the recent U.S. increase due to the uncertainty regarding trade and tariffs. With the new U.S.-Mexico-Canada trade agreement we would now expect the Bank of Canada to be more aggressive.

Central bankers view their main role as controlling inflation via increases/decreases in interest rates. In turn, interest rates have a significant effect on stock prices as valuations (price/earnings ratios) adjust accordingly. When interest rates rise and higher yields attract funds toward fixed income, stock valuations decline as they become relatively less appealing.

The middle chart on this page demonstrates that at today's inflation rate of 3%, historically the price/earnings ratio would range between 15-20 times which is very much in line with today's level. Our view is that certain sectors of the market represent reasonable value. The consumer, health care and financial sectors reflect valuations at the lower end while technology related stocks are today trading significantly above 20 times earnings with some at triple digit levels (i.e. Netflix and Amazon).

The U.S. stock market has certainly been fuelled by the strong economy. However, technology related sectors have provided more than half the S&P 500's return of late. They have done so more through price/earnings multiple expansion (valuation) than through increases in earnings. While we are comfortable with what we own in client accounts, we recognize the risks prevalent in the area of technology stocks and thus remain cautious and underweighted owning only those with a sizable and more stable earnings stream.

In a rising interest rate environment any fixed income owned will be short in term. We have also been able to add certain preferred securities that will benefit from rising interest rates as they have mechanisms that result in their dividends resetting to higher levels in the case of an increase in interest rates.

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Sources: TD Securities Inc., Scotia McLeod, Bloomberg