The Stan Clark Financial Team's

PERSPECTIVES

Mid-Year REVIEW

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Mid-Year Review: Positive returns despite escalating trade disputes and rising interest rates

By Stan Clark - Senior Investment Advisor and Michael Chu - Investment Advisor

It's summer already. Being mid-year, this seems like a good time to review what has been happening so far in 2018 – and what we might expect in the future.

For the first half of the year, almost every major stock market was up. The only exception was Emerging Markets, which started off strong, but ended down slightly. The World Equity Index, a measure of stock markets around the world, was up 4.6% (in C$) for the first six months. At home, the TSX was up 1.9%.

The chart below shows the returns of major stock markets around the world. Note that these returns are in Canadian dollars, so the currency effects are included.

Markets around the world were more volatile in the first half of the year as U.S earnings enthusiasm met multiple headwinds: a strong U.S. dollar; rising interest rates; higher inflation; and a brewing trade war. Strong earnings should continue, but remember that the markets are easily distracted.

Valuations

Compared to the beginning of the year, U.S. stocks are a tad cheaper on a trailing price-to-earnings basis. Although prices are higher, earnings over the last 12 months are even higher; hence a slightly lower P/E ratio. Forward earnings over the next 12 months for the U.S. S&P 500 are expected to be about $168 per share, a record high. Barring an all-out trade war, this should be achievable – and, at the June 30, 2018 level of the S&P 500, would result in a P/E of only 16.

Comparing the dividend rate to bonds, U.S. stocks are not as attractive. Interest rates have come up, providing options for investors seeking income.

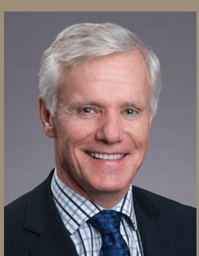
In Canada, stocks are also a little bit cheaper, using the trailing P/E ratio compared to six months ago. And Canadian stocks are still looking relatively cheap compared to bonds, as dividend yields remain much higher than the 10-year interest rate. As well, Canadian stocks are relatively cheap compared to the U.S.

More buybacks

Stock buybacks continue to grow, up 42% this year. According to top economist Ed Yardeni, the end of 2018's first quarter saw stock buybacks annualized to a record high at $756 billion. The previous record was $688 billion in 2007. Repatriated earnings following the U.S. tax cuts boosted buyback activity. S&P 500 companies also paid out a record amount of dividends at $436 billion. Together, this works out to over $1 trillion

	Q1 2018	Q2 2018	H1 2018
Canada (S&P/TSX)	-4.5%	6.8%	1.9%
U.S. (S&P 500)	1.8%	5.3%	7.2%
Europe	-0.2%	0.4%	0.2%
Japan	3.3%	1.7%	5.0%
EAFE (Europe, Australia, Far East)	1.0%	0.5%	1.6%
Emerging Markets	4.1%	-6.3%	-2.5%
World	1.3%	3.6%	4.9%

Source: Bloomberg



Stan Clark
Senior Investment Advisor

Welcome to our 2018 mid-year review issue

Michael Chu and I have collaborated on a mid-year review of how Canadian, U.S. and international markets performed in the first half of 2018 – and what the major influences were over the last six months.

We hope you find this review both informative and useful in understanding the current economic context – and how we're keeping your portfolio firmly on course.

Enjoy your summer!

Stan

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paid back to shareholders in the last 12 months.

	Trailing P/E	Trailing Earnings Yield	Dividend Yield	10 Year Bonds
Canada	17.8	5.6%	3.0%	2.1%
U.S.	22.6	4.4%	1.9%	2.8%
Austria	10.4	9.6%	3.2%	0.6%
Italy	13.3	7.5%	3.8%	2.7%
Japan	13.9	7.2%	2.1%	0.0%
Singapore	13.6	7.3%	3.7%	2.4%
China	14.8	6.8%	2.0%	3.5%
Brazil	16.4	6.1%	3.5%	11.3%
Korea	9.3	10.8%	2.1%	2.6%
Taiwan	14.3	7.0%	3.9%	0.9%
Europe	16.9	5.9%	3.5%	
Asia	13.6	7.3%	2.3%	
Emerging Markets	13.8	7.2%	2.6%	

Source: Bloomberg

This second longest expansion should soon be #1

The current U.S. economic expansion has reached 107 months, making it the second longest expansion in American history. This eclipses the 1961-1969 recovery, which lasted 106 months. The record recovery was exactly 10 years, from 1991 to 2001. So if the current expansion lasts until July 2019, we'll have a new record.

How likely is this to happen? It's pretty likely, as the current expansion started from the low point of the "Great Recession" and is moving at such a moderate pace. It doesn't really matter how long the expansion is; the pace is more important. It's like running a marathon. If you pace yourself, you can last a long time – unlike a sprint, where you burn out quickly. The U.S. economy has not appeared overheated in the past nine years. The latest U.S. GDP estimate is 4.8% growth. This is a bit high and could be interpreted as overheated; however, estimates often come down as quarters advance.

Low unemployment

Another indicator of economic health is that U.S. unemployment is at 3.8%, the lowest level in the last 49 years. A low unemployment rate can be a concern because: it's hard to fall much further; it increases the risk of inflation; and it may become a drag on growth.

In terms of inflation, the good news is that wage growth is below average and does not show signs yet of increasing. Things can change, but wage pressure should not be a major concern for at least another year.

At such a low unemployment rate, is there room for the economy to grow? There are a couple of factors to consider. Firstly, productivity can increase to grow the economy without more people working. Secondly, the participation rate can increase. For example, if someone stops looking for work they no longer count as unemployed, according to the statistics.

The current participation rate – that is, the percentage of people working or looking for work over people who can work – is 63%. Since 1950, participation rates have ranged from 58% in the 1950s (when a much smaller percentage of women worked outside the home) to a high of about 67% in 2000 with a long-term average of 63%. The participation rate was 66% before the financial crisis. If more people come back into the workforce, say to the level before the financial crisis, the unemployment rate would be adjusted to about 8.5%. That would give us plenty of room to grow without putting a huge pressure on wages.

Is the bull market getting old?

Is the bull market nine years old? Not officially. A bear market is defined as a 20% drop from the peak. There have been two short bear markets (in 2011 and 2015) that were just over 20%. That means the current bull market is not nine years old; rather, it's closer to three years old. Those who fear an end of the bull market based solely on time might wish to reconsider.

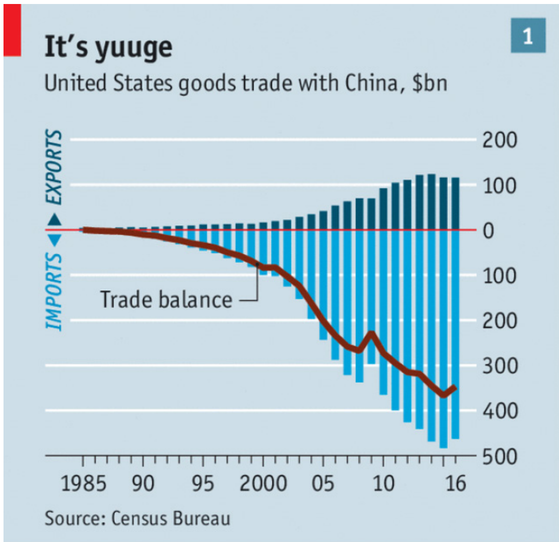
It's also important to note that economic expansions in other countries are not as old as in the U.S. For example, Japan's expansion began in 2012, making it only six years old. Granted, that is one of the longest post-war expansions for Japan. The Eurozone's expansion started in 2013, making it only five years old. Both regions are experiencing low inflation, enabling their central banks to be flexible with accommodative monetary policy. Emerging Markets also have a wide range of expansion ages, though none as long as the one in the U.S.

Reasons to worry

In addition to an escalation of trade issues, there are a few risks to the market in the short term: rising interest rates; the strong U.S. dollar; and rising oil prices. All three of these factors are normal in a growing economy, combined with the Fed's unwinding its near-decade of fiscal stimulus. While the market can transition through these headwinds, increased volatility is likely to occur as well.

What started the trade issues, anyway?

China is attracting a great deal of interest because of the current U.S. administration and the gaping trade imbalance. A trade imbalance occurs when one country imports more than it exports. In this case, the U.S. imports $500 billion of goods from China, but only exports $130 billion back to China. This works out to a $370 billion trade deficit – and the deficit has been growing consistently over the last few decades. The big-picture problem is that with the deficit, wealth is being transferred from the U.S. to China. There will probably always be some trade deficit, as the U.S. is a consumer-driven economy and China has a cheap labour pool. But the issue is that the trade deficit has been growing significantly.



Economist.com

China is less vulnerable to a trade war today than it was a decade ago because of more domestic consumption. But China is still no match for the U.S., as it still relies heavily on U.S. demand and its retaliation arsenal is lighter.

The current landscape is tit-for-tat tariffs by both countries. But subsequent threats from the U.S. suggest that the scale of tariffs could hit $500 billion, basically covering all of the goods that China exports to the U.S. China doesn't have the depth to match the U.S. dollar-for-dollar on tariffs. So China may come up with more creative

The worst-case scenario is a long-term, full-on trade war involving a wide range of products and affecting many countries. This would have a negative economic effect on all involved countries.

ways of retaliating, such as a boycott or devaluing its currency to make their goods cheaper.

Trade war will likely end with fewer tariffs

The trade tariff situation might look different in the weeks after this article was written. At this point, it is important to note that these threatened tariffs are not intended to be permanent; rather, they are tactics to negotiate a more favourable trade balance. One key leverage for the U.S. is the strength of its economy. Meanwhile, the rest of the world is becoming more dependent on the U.S. buying its products.

Multiple scenarios abound

The base case is likely a mild drag on the world economy. But, depending on how things develop, it could range from a lot worse to slightly better.

The worst-case scenario is a long-term, full-on trade war involving a wide range of products and affecting many countries. This would have a negative economic effect on all involved countries. It could also put a damper on company profits and hence the stock market. On the other hand, the best-case scenario occurs if the U.S. tactics result in fewer trade barriers, which would likely increase trade.

Although many disagree with Donald Trump's other policies, the president seems partially in the right on the subject of trade with China. The issue isn't just a lack of reciprocity and market access, but also the absence of a level playing field when it comes to U.S. intellectual property rights. For example, a U.S. company offering cloud-computing services in China must store the data in China and also partner up with a Chinese company. Furthermore, many sectors in China, such as telecom, technology and healthcare, are off limits to U.S. companies.

While Trump's approach is filled with uncertainties and with China in a vulnerable position, we would expect the most likely scenario to be a mediated truce addressing some of the big U.S. concerns.

Tax cut effects

Just before Congress passed the tax cuts in December 2017, S&P 500 companies were expected to grow 11.2% this year – which would have been pretty good. Now, after the tax cuts, analysts are expecting 21.3% growth, almost double. This should help push the stock market higher.

It's not just earnings. Revenue growth is also significant, with growth expected to be 7.4% this year and 3.4% next year. Profit margins are also expanding, topping 12% – a first in decades.

Mid-term elections

U.S. mid-term elections are in November 2018, and have the ability to change the distribution of political power. If the Democrats win the House of Representatives, as the betting markets are anticipating, many Republican initiatives relating to immigration, deregulation and the North American Free Trade Agreement will become less likely to survive Congress. Nevertheless, the president still has considerable sway over foreign policy and tariffs.

Oil prices

Oil prices are up more than 40% since the beginning of the year. There are two main reasons for this. First, the inventory glut has finally been worked off. Additionally, insufficient investment in the industry in the last few years during the doldrums is now resulting in a production shortfall, despite U.S. shale efforts.

Second, geopolitical risks have changed. The U.S. decision to re-apply sanctions to Iran, Venezuela's free-falling economy and internal conflicts within Libya and Nigeria, all threaten to reduce oil supply. Still, OPEC could boost output to smooth these concerns.

Over the medium term, oil prices should have some downward pressure. U.S. shale producers are now the true swing producers, able to quickly change production to limit big changes in prices. U.S. firms report that the break-even cost to motivate extra production is around $50 per barrel. That's a good guess as to where oil prices could gravitate over the medium to long run.

Rising interest rates

The U.S. Fed raised interest rates by 0.25% for the second time this year, pointing to the continued strength of the economy and labour market. Canada's economy was also strong, resulting in the Bank of Canada electing to raise rates in January and again in July 2018. U.S. 10-year rates exceeded the 3% psychological barrier, the highest in seven years. However, this was just temporary and market concerns caused it to come back down below the 3% level.

Three misconceptions about rising interest rates

People have been concerned about interest rates rising for the last 10 years. After all that time, we're finally in a rising-interest-rate period. But like the stock market, no one knows where interest rates are going to go. Ben Carlson of Ritholtz Wealth Management provides some context about rising interest rates and discusses some misconceptions:

Misconception #1: Rising short-term rates are bad for the stock market. It's true that stock market returns tend to be lower when rates are rising than when they are falling. Annualized returns were 10.3% when rates were falling and 8.4% when rates were rising. So it seems like stocks prefer falling rates, all else being equal. But it doesn't mean that stocks automatically lose when short-term rates go up. Over the long term, stocks perform better than short-term bonds even when rates have been rising.

Misconception #2: Things were better for bond investors when rates were higher. It seems like a good thing if we could buy government bonds that yielded 10%, as in the supposed good old days. But higher rates don't necessarily mean things were better. That's because we need to factor in inflation and look at real rates of return. Back in the 1970s and 1980s, double-digit interest rates were common. Yet, after taxes and inflation, investors would actually end up losing money on bonds. Rates were high because inflation was out of control. After inflation, higher rates can actually work against you.

Misconception #3: Rising interest rates are bad for the housing market. Mortgage rates are rising both in Canada and the U.S. While this makes affordability harder, there are many other factors that come into play, such as demographics, income, family and perhaps most importantly, emotions. Over the last 30 years in the U.S., there doesn't seem to be a significant relationship between mortgage rates and housing prices.

Yield curve about to invert?

In our previous review, we discussed the flattening yield curve. To recap, the yield curve is a graphical representation of interest rates across different maturities. A typical comparison would be the difference between the two- and 10-year interest rates. Usually, the 10-year rate is higher than the two-year rate. This signals that the economy is healthy. It's also good for banks' profitability and their willingness to lend, which affects other companies.

The significance is that historically, when the curve inverts – that is, when the two-year rate is higher than the 10-year rate – it signals an upcoming recession. The curve is currently not inverted, but is close to being flat, causing some concern. The current spread is about 0.3%, the lowest point since 2007. Keep in mind: A flat curve that does not actually invert has historically been a precursor to good equity returns.

Yield curve bearish for stocks?

Recessions cause bear markets for stocks. Yield-curve inversions have often been followed by recessions, which is why they have been useful in predicting bear markets. But top economist Ed Yardeni has made an argument that if the yield curve inverts, this time it might be wrong in predicting a recession. Here are a few of Yardeni's points:

1. Yield-curve spread is only one component of the Index of Leading Economic Indicators, which is deemed to provide a recession warning. The 10 components, which include the stock market, unemployment claims and consumer and business confidence, collectively pushed the LEI to a record high despite the yield curve. So the LEI certainly isn't sounding an alarm.
2. The economy is performing well and inflation is subdued. There are few signs of an inflationary boom or speculative excesses that would require a more forceful normalization of monetary policy (rapidly raising interest rates).
3. Globalization of bonds. The U.S. bond market has become more globalized and is no longer exclusively driven by the domestic business cycle and Fed policies. U.S. bonds are currently attractive to foreign investors. Their actions can cause U.S. rates to come down, resulting in a flatter yield curve that is somewhat detached from the U.S. economy compared to before.

No boom, no bust

The current economic recovery, while long, hasn't been marked by excess. It's been *long*, but not *strong*. If a recession were to occur, it wouldn't have to be extremely bad, either. In short, no boom means no bust. The current economic cycle has to end eventually; this is normal and a new cycle will begin.

Thinking small

A lot of the issues we've discussed are at the macro level, that is, large-scale events such as the overall economy, interest rates or trade. The effects of macro events are hard to predict. But on the micro level of individual companies, we can see that companies can be nimble. They can adjust production and supply and adapt to new rules such as trade tariffs. By investing in companies with strong characteristics of doing well, we should be able to mitigate some of the potential negative effects from the macro level.

Central bank activity

In the developed world, central banks around the world are generally raising interest rates, reducing an accommodative policy in place since 2009. Central banks have been very supportive in the past decade, but for the most part stimulus is no longer needed because of solid economic growth and low inflation. The U.S. Fed has probably been the most aggressive in reducing stimulus. Canada is doing the same, though at a slower pace. There is a risk of raising rates too much or too fast. The good news is that, given the current economic data, the central banks can be patient.

Contrarian indicators

It's been a while since we last discussed the *Sell Side Indicator*. If you recall, the Indicator started as a survey of the recommended equity allocations of Wall Street strategists. Interestingly – and counterintuitively – this stock sentiment survey turned out to be an excellent contrarian indicator. That means you should do the opposite of what the strategists suggest! Subsequent 12-month returns would usually be high when strategists were pessimistic. And vice versa, returns would be low when strategists were optimistic.

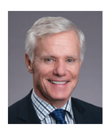
Usually anything below 52% is considered bearish; anything above 62%, bullish. The current reading is 57%, which means the strategists are about neutral. That could be interpreted as good news, as a high reading (above 62%) would be regarded as extreme bullishness. And as a contrarian indicator, a high reading would potentially mean bad news for stocks.

Another contrarian indicator is the American Association of Individual Investors' measure of investors' outlook for stocks. The current reading is 43%. Historically, when investors were overly optimistic (greater than 50%), subsequent stock returns were low. When investors were overly pessimistic (less than 30%), returns were high. So this contrarian indicator is somewhat neutral/positive, too.

Looking ahead

Corporate earnings growth is expected to continue, which provides good support for the stock market. But earnings could grow less than expected, depending on the outcome of several issues surrounding trade and rising interest rates. Less-than-expected growth would put downward pressure on stock prices. While these issues are important, they are even more difficult to predict.

Instead, our philosophy is to focus on determining an appropriate mix for you through resilient financial planning and owning a well-diversified portfolio of companies with strong characteristics. ■



Stan Clark is First Vice-President, Portfolio Manager and Senior Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Michael Chu is a Portfolio Manager and Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

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Phone: (604) 641-4361   Toll free: 1 (800) 661-9442   Fax: (604) 608-5211   Email: StanClarkFinancialTeam@cibc.ca   www.stanclark.ca