The Stan Clark Financial Team's

# PERSPECTIVES

# Year-end REVIEW

Volume 9 - Issue 1 January 2018

Stan Clark
*Senior Investment Advisor*

**Welcome to our special year-end review**

How were the stock markets in 2017? Michael Chu and I have put together this concise review of what went on in Canada, the United States and other important economies around the world – and how it affected stock markets. We also look ahead to the rest of 2018 and beyond.

We hope you find this review informative and useful.

Enjoy!

Stan

CIBC Wood Gundy

## Year-end Review:

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

**With a new year beginning, we thought it would be useful to review the events of 2017, then look at what 2018 and beyond may hold for us.**

A lot happened in 2017. The most noteworthy event, a new U.S. president, who would be controversial and heavily scrutinized. Whatever you may think of him, one major constructive takeaway from Trump's first year was the passing of the tax reform bill.

The economic landscape in North America continued to improve as unemployment fell and consumer confidence grew. For the first time since the financial crisis in 2008, economies around the world began heading in the same direction as we witnessed synchronized global growth. In 2017, the U.S. Federal Reserve and the Bank of Canada both made moves to begin normalizing interest rates with three and two rate hikes, respectively.

As each new year begins, it's customary to make predictions. But if there's one thing we learned, it is not to rely on predictions. That won't be news for our clients and other readers of *Perspectives*. Our constant message is: Instead of focusing on making or listening to predictions, it's better have a plan and be prepared for a range of outcomes. Preparation trumps prediction. Preparation helps build resilience into your financial future.

**Stocks in 2017**

Major stock markets around the world did well in 2017. The World Equity Index, a gauge of stock markets around the world, was up 14.5% (in C$). The largest weighting in that index was the U.S., which was up 13.9% (in C$). At home, the TSX was up 9.1%.

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

**How did we do?**

Our strategies did well last year. They each outperformed the market except for one which slightly underperformed.

Our Canadian stock strategies (Disciplined Canadian Stock), returned 9.4%, outperforming the TSX by 0.3%. Our U.S. stock strategies (Disciplined U.S. stock), returned 24.1%, outperforming the S&P 500 by 2.3% (in U.S. dollars).

We also have 2 global portfolios made up of all 12 of our stock strategies. The Disciplined World Equity composite returned 15.4%, outperforming its benchmark by 1.3%. This portfolio is 40% Canada, 40% U.S. and 20% international.

Our second global portfolio, the Dividend Select World Equity composite, returned 13.2%, underperforming the benchmark by 0.2%. This portfolio has a slightly higher weighting in Canada and dividend payers. It is 50% Canada, 35% U.S. and 15% international.

We also have a North American composite which returned 14.4%, outperforming its benchmark by 2.4%. This portfolio is invested 40% in Canada and 60% in the U.S.

Note: These returns are just for stocks. Clients with

| | Q1 | Q2 | Q3 | Q4 | 2017 |
|---|---|---|---|---|---|
| **Canada** (S&P/TSX) | 2.4% | -1.6% | 3.7% | 4.5% | 9.1% |
| **U.S.** (S&P 500) | 5.1% | 0.3% | 0.5% | 7.5% | 13.9% |
| **Europe** | 6.1% | 5.0% | 1.4% | 3.3% | 16.7% |
| **Japan** | 3.7% | 2.3% | -1.7% | 12.7% | 17.4% |
| **EAFE** (Europe, Australia, Far East) | 6.3% | 3.3% | 1.4% | 5.1% | 16.9% |
| **Emerging Markets** | 10.4% | 3.4% | 3.8% | 8.3% | 28.4% |
| **World** | 5.4% | 1.3% | 0.9% | 6.3% | 14.5% |

*Source: Bloomberg*

**Stan Clark Financial Team Strategy Returns**

| Composite | 2017 Strategy | 2017 Benchmark | 2017 Outperformance | 5 year Strategy | 5 year Benchmark | 5 year Outperformance |
|---|---|---|---|---|---|---|
| Disciplined Canadian Stock | 9.4% | 9.1% | 0.3% | 15.9% | 8.6% | 7.3% |
| Disciplined U.S. Stock (in US$) | 24.1% | 21.8% | 2.3% | 18.0% | 15.8% | 2.2% |
| Disciplined World Equity | 15.4% | 14.1% | 1.3% | 18.4% | 13.6% | 4.8% |
| Disciplined Select World Equity | 13.2% | 13.4% | -0.2% | 16.7% | 12.4% | 4.3% |
| Disciplined North America Equity | 14.4% | 12.0% | 2.4% | | | |

less than 100% in stocks will have proportionately less returns. These returns are also before fees.

To summarize, 2017 was another good year for stocks and our strategies. All our strategies have good long-term track records which is important to know as down periods will happen from time to time. The past informs the future – when it comes to evaluating strategies, the long-term performance is what gives us the information we need to make good decisions.

**Records and valuations**

A year ago, we were writing about the Dow Jones Index hitting the 20,000 milestone. Fast-forward to today, we've just seen the Dow break 25,000! The stock market has done well. But keep in mind that as the numbers get larger, future milestones will come more often, so they lose a bit of their shine. Adding 5,000 points to 10,000 (a 50% gain) is a lot harder than going the same 5,000 points from 20,000 (a 25% gain).

Should we be scared with markets hitting new records? To answer, it's important to look at valuations, not just the price. Prices can go up and still be reasonable – as long as they are supported by growth in company earnings, which has largely been the case.

| | Trailing P/E | Trailing Earnings Yield | Dividend Yield | 10-Year Bonds |
|---|---|---|---|---|
| Canada | 18.8 | 5.3% | 2.8% | 2.2% |
| U.S. | 24.4 | 4.1% | 1.9% | 2.6% |
| Austria | 13.9 | 7.2% | 2.2% | 0.6% |
| Italy | 31.0 | 3.2% | 3.4% | 2.0% |
| Singapore | 14.8 | 6.8% | 3.2% | 2.1% |
| Spain | 15.4 | 6.5% | 4.0% | 1.5% |
| China | 16.7 | 6.0% | 1.6% | 3.9% |
| Brazil | 17.0 | 5.9% | 2.7% | 10.0% |
| Korea | 11.0 | 9.1% | 1.5% | 2.6% |
| Taiwan | 14.6 | 6.8% | 3.7% | 1.1% |
| Europe | 20.3 | 4.9% | 3.2% | |
| Asia | 16.0 | 6.3% | 2.5% | |
| Emerging Markets | 15.1 | 6.6% | 2.2% | |

*Source: Bloomberg*

We've previously discussed how U.S. stocks were cheap, as the dividend yield on stocks was higher than the 10-year bond rate. As prices moved up, this is no longer the case because interest rates are now slightly higher than the dividend yield. While still in line with each other, based on this measure, stocks are no longer cheap. Fortunately, in Canada, stocks are still cheap, as the dividend yield is still well above the interest rate.

Price-to-earnings (P/E) ratios are another simple way of looking at valuations. Using last year's (trailing) earnings, U.S. stocks are currently trading at 24 times. This seems expensive based on historical averages. However, earnings are expected to grow over the next year, bringing the forward looking average down to more reasonable levels. The forward looking average is around 18 times, which is not cheap but more palatable.

Stocks are also relatively cheaper in parts of Europe, Asia and the emerging markets, so there are opportunities overseas.

**Earnings driving returns**

Valuations are only one part of the equation affecting stock market returns. For the S&P 500, approximately 2/3 of last year's returns were due to earnings growth. The remaining 1/3 came from an expansion in P/E ratios. This split is not constant. Last year, the returns were mostly from higher earnings, but for the preceding five years most of the returns came from P/E expansion.

Normally, analysts start out the year too optimistic in projecting earnings estimates. As the year progresses, they are forced to temper their expectations. But this year, estimates have repeatedly moved up. Yet a higher than usual number of companies still beat these expectations. This is unusual in the latter stages of an economic cycle, suggesting that analysts have been too pessimistic and that earnings can further accelerate.

**What does the CAPE ratio say?**

In previous articles, we've discussed Robert Shiller's cyclically adjusted price to earnings (CAPE) ratio. This compares current stock prices to an average of the past 10 years of earnings. The CAPE ratio is significantly higher than the long-term average, suggesting that the U.S. stock market is expensive. But there are many arguments to adjust the way CAPE is calculated. That's because of structural differences that exist today such as changes in accounting rules, growth rates and interest rates. These adjustments make the CAPE ratio more reasonable compared to the historical averages, but still on the expensive side. What does this mean? While CAPE is not useful for signaling market turning points, it is useful for predicting long-term future returns. A high CAPE ratio indicates lower future long-term returns while a low CAPE indicates higher returns. Based on an adjusted CAPE, future long-term returns are expected to be around 2% to 4%, after inflation.

**Business cycle length**

It is now 8½ years since the current economic recovery began. While no growth cycle has lasted for more than 10 years, records are meant to be broken. The 10-year recovery from 1991 to 2001 broke the previous record of 9 years (1961 to 1969), which also broke the previous record of 6 years (1938 to 1945) and that broke the previous record of 5 years.

It is reasonable that the current recovery can go beyond 10 years because growth rates from 2009 to 2016 have been so slow. Growth rates in the current expansion were mostly sub 2% until 2017, when it rose to 3%. A goldilocks economy, one that is neither too hot or too cold, can last a lot longer than an overheated economy.

**Catching up from a lost decade**

According to Professor Charles Jones of North Carolina State University, from 2000 to 2009, the U.S. stock market suffered its worse decade in history, even worse than in the 1930s. From 2000 to 2009, the S&P 500 lost 3.3% per year (after inflation) compared to a 1.8% gain during the 1930s Great Depression.

The U.S. suffered what we might call a "lost decade" between 2000 and 2009. During the financial crisis (2008 and 2009), America lost 100% of the private sector jobs it had created in the previous 8 years. In addition, the unemployment rate reached over 10%. Although the stock market has more than recovered, it lost so much ground in the previous 9 years that it is still trailing the historical 20th century norms. For example, in the 18 years ending in 1999, the S&P 500 grew 1100%. However, in the 18 years from 1999 to 2017, the S&P 500 is only up 80%, hardly a runaway bull market. It's true the markets and economy have recovered, but this is more of a "makeup" recovery than a bubble.

**Tax reform: less is more**

President Trump finally signed the tax overhaul bill at the end of 2017, delivering a major tax cut to U.S. corporations along with some temporary cuts for other businesses and most individuals. The bill cuts the corporate tax rate to 21% from 35% and individual tax rates across the board. Overall, this bill is projected to decrease federal revenue by $1.5 trillion over the next decade, but the expectation is that the tax cuts will spur enough economic growth to make up for the revenue loss. Many "experts" say that it will not. What does history say?

There have been four tax cuts in the past century: in the 1920s and 1960s; in the 1980s with President Reagan; and in 2003 with President Bush. In each case, tax collections actually rose over the next several years and usually quite dramatically. No one knows exactly what will happen this time, but history shows that previous tax cuts have resulted in more tax revenue.

**Bitcoins**

We're all aware of the frenzy behind bitcoins. The rapid ascent of cryptocurrencies seems to have captured many minds, hearts and wallets. To some, this is the beginning of a story with much room to grow. These proponents argue that "this is the future" while others argue that the currency has no substance.

People seem to be buying bitcoins, not necessarily to use them as intended, but only because the price keeps going up. The reason bitcoin prices are rising is that there is a fixed limited quantity. As long as more money is flowing in than out, the price will rise. But buyers are chasing a line of code that they barely understand. What happens when the price trends down? No one knows when this might happen, but there's a big difference compared to a stock price going down. A stock represents a business that has sales, earnings and assets. How much sales or earnings will a bitcoin ever have? None. A business can recover, whereas a bitcoin is just a digital version of a tulip bulb.

Tulip bulb mania was, in fact, a period in Dutch history. The prices for newly introduced and fashionable tulips reached extraordinary prices and then dramatically collapsed. Yes, we're talking about flowers! Tulip bulb mania is generally considered the first recorded speculative bubble.

No one can predict the prices of bitcoins, but you certainly don't want to be the one who is swimming without a bathing suit when the tide goes out! The price may still go a lot higher, but according to Warren Buffett, "I can say almost with certainty that cryptocurrencies will come to a bad end."

The technology behind bitcoins is another story. Blockchain is a method of recording transactions between two parties. Theoretically, blockchain is efficient, verifiable and permanent. Think of it as an automatically notarized ledger. There's lots of potential to change the way business is done. But it's still early and we will have to see how it unfolds.

**Stability begets volatility**

Economist Hyman Minsky grew up during the Depression. Perhaps not surprisingly, Minsky became fascinated with the why and how of financial disaster. He came up with the "financial instability hypotheses." Basically, long stretches of prosperity sow the seeds of the next crisis. He believed investors get comfortable and then take on extra risks, pushing things too far. This, he warned, leads to the formation of an asset bubble, which eventually bursts. Subsequently, the opposite happens: a race for safety and lower risk-taking/deleveraging, which completes the cycle towards low volatility. Sound familiar? We witnessed this recently with the financial crisis. We saw a bursting of bubbles and high volatility, followed by financial deleveraging and a rush to safety.

There currently doesn't seem to be any major financial imbalances, which would otherwise be worrisome as bubbles tend to occur in mature bull markets. However, there is some evidence of higher risk taking lately, such as with bitcoins, so we could be in the early stages of a bubble.

On the other hand, volatility in the stock market has been trending down. In fact it is at its lowest level since the volatility index started in 1985. But as we've seen, things can change quickly. Perhaps we should prepare for more volatility going forward.

**Flattening yield curve = bumpier times ahead?**

The yield curve is getting flatter. The yield curve is a graphical representation of interest rates across various bond maturities. A typical comparison would be the difference between the 2 and 10-year interest rate. What's the big deal? Historically, inverted yield curves, where the 2-year rate is higher than the 10-year rate, often preceded recessions. The current difference is only 0.5% which while is not inverted, is at a 10-year low and causing some concern.

Why has the yield curve been flattening? The Federal Reserve controls short-term rates and has been raising them lately because they are optimistic about the economy and less worried about deflation. And long-term rates, which in the past were based more on inflation forecasts, have not been rising as much.

This time, the Fed actually does have more control on long-term rates because of their quantitative easing program, which involved buying huge amounts of long-term bonds. As they unwind these holdings, they can help long-term rates to rise in sync with short-term rates, preventing the curve from inverting. Long-term rates have also been kept low due to high international demand for long-term U.S. bonds. This demand could fall in the future, helping long-term rates to rise.

Contrary to popular belief, a flattening yield curve that does not actually invert has historically been a precursor to very strong equity returns.

**Continuation of the bull market?**

We will never know in advance when a bull market ends. There's no timer or buzzer that goes off like at the end of a hockey game. But there are some key fundamentals suggesting a continuation of the bull market in 2018:

1. Earnings projections are high and rising.
2. The number of shares is shrinking. Stock buybacks and privatizations have reduced the number of shares available to buy.
3. Global growth is accelerating.
4. Tax reform should boost earnings and growth.
5. Oil prices are recovering, helping energy company earnings recover.

All these factors help the stock market rise. Market corrections will occur along the way; this is inevitable. Still, there's a good case that the current bull market can continue.

**Possible melt-up**

Value investor Jeremy Grantham of GMO recently discussed being prepared for a near- term melt-up or end phase. Grantham based his argument on a combination of statistical and psychological factors from previous eras. While previous bubbles are all different and not easily comparable, we should study the past to help prepare for the future.

Grantham says that stocks are expensive, based on the long-term Shiller CAPE ratio. But price alone is not a sufficient sign of an impending bubble break. Bubbles are also accompanied by euphoria and excess. For a bubble to burst, it must first form, and in the current bull market that has been slow to happen.

So is a stock market bubble forming? Historically, this means an acceleration in rising prices. For the last few years, the market has been clawing its way steadily higher. But in the last few months, there has been some modest acceleration. Stocks would still have to go a lot higher over the next couple of years to reach a classic bubble scenario.

Grantham predicts a melt-up within the next two years with gains of over 50%, followed by a bubble break with a significant decline of 50%. As you know, we're not big on predictions. But we should be prepared.

According to top economist Ed Yardeni, as the stock market continues to go up, it attracts more money. That too, is referred to as a melt-up and Yardeni thinks we might be in the early stages of one. Regardless of what the stock market does, earnings continue to rise, providing fundamental support for the stock market. A cut in corporate taxes, more deregulation and a continuation of a global synchronized boom should continue to bolster profits. Analysts are currently predicting earnings growth of approximately 10% in each of the following three years, though this might not fully factor in tax cuts.

### U.S. mid-term elections

Mid-term elections in the U.S. are less than 10 months away. Betting markets indicate that the Democrats have a decent chance of picking up the House of Representatives. This would eliminate the Republican triple control (White House, Senate and House of Representatives), thus limiting their agenda.

### Canada

The strength of Canada's economy prompted higher interest rates. The Bank of Canada raised interest rates twice in 2017 amid higher growth, lower unemployment and low inflation. They also raised rates again in January 2018, but future rate hikes should come at a more cautious pace amid uncertainties surrounding NAFTA.

NAFTA negotiations are ongoing with the continued threat of a U.S. withdrawal. Note that a withdrawal notice requires 6 months, but can be rescinded, so a country can give notice, but then not actually leave.

Historically, the U.S. has never terminated a free-trade agreement. While the Constitution gives the president the authority to negotiate treaties, Congress shares responsibility regarding trade. We could see a bigger mess if President Trump wants one thing but Congress doesn't.

### China more balanced

In China, for the last 10 years, credit growth was outpacing GDP growth by a huge amount. This was not a good situation as economic growth was unsustainably being funded by more debt. Fortunately, the gap has narrowed considerably with the year to year growth of debt slower and GDP a bit faster, to the extent that they are now growing around the same rate. There's still a huge amount of debt accumulated from before, but we can say that they have slowed down the rate of leveraging which is a good first step.

The amount of shadow banking growth is lower too, compared to the last few years. This shows that the government is reigning in this unregulated debt market.

### Wild Cards for 2018

As you know, we're not big on making predictions, especially for the short-term. But a few wild cards could have a big impact on 2018:

1. Mueller investigation. The investigation seems to be gaining momentum. Who knows how high it will reach, but it could go all the way.
2. Kim Jong-un. In testing ever more powerful missiles, this seems to be leaning towards a military confrontation. While it's fairly certain who would win, wars usually aren't good for the stock market.
3. New leadership at the U.S. Federal Reserve. Janet Yellen's term as Fed chairman ends in February 2018. Taking over is Jeremy Powell, a very accomplished lawyer and financial services industry executive. Oddly though, he does not have a PhD in economics. There are also two other top people at the Fed who are leaving. How to unwind the Fed balance sheet was already a monumental task.
4. China credit. The Chinese economy has grown 12 times since the turn of the century. Including the infamous shadow banking, debt has grown 40 times in that same period. Given the size of the economy, the credit bubble could have far reaching consequences.

### More worries

Howard Marks of Oaktree Capital, recently discussed a few of his worries. Using P/E ratios, stocks can be seen as expensive, they were only higher in in 1929 and in 1999. These high valuations preceded huge market crashes. But that doesn't mean valuations can't go higher. In 1999, valuations were much higher than they are today. And don't forget interest rates are much lower today, which partially justifies higher P/E ratios.

Another of his big worries is what's going to happen as central banks begin to unwind their balance sheets (bonds accumulated from quantitative easing). There is no historical precedent for the recent unconventional actions used to boost economies. If quantitative easing was stimulative, then should unwinding be the opposite? Hard to say what will happen to interest rates and inflation.

### Looking ahead

In summary, the stock markets and economy are doing well. There are many positive forces such as increasing earnings, synchronized global growth, still-low interest rates and mild inflation. But valuations are not as good as they were, raising the risks of a potential downturn. This doesn't mean some major negative event is imminent. It just serves as a reminder that anything can happen in the short-term, so we should be prepared for a variety of outcomes. It also doesn't mean we should start timing the market. We do not believe in market timing because its track record is poor given that markets are complex and adaptive. Instead, we believe the best way to grow your wealth is to stay disciplined, sticking to your targets determined by your needs and risk tolerance from your financial plan.

As we noted at the outset, a lot happened in 2017. Chances are that a lot will happen in 2018 as well. One thing we are certain of is that there will be many headlines and predictions. A handful might come true, but as we've learned in the past, the best thing to do is to be prepared for a range of possibilities because only time will tell what really does end up happening. ■

CIBC Wood Gundy | The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

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