May 28-18

Good Afternoon to All Clients

Successful investing like most things in life often involves a large amount of luck and good timing!

Yes I know the counter argument is that if you "buy and hold" to the bitter end through the ups and down's (i.e. with zero Tactical timing applied) you will achieve the market average return and this is the main "logic behind" the current index investing craze.

But the reality is that we humans are not wired to hold through the severe ups and down's! It's simply too emotional for 95% of us and the famous Dalbar Study over the last 20 + years confirms that we are wired to "buy high and sell low" and that is surely what will happen again in 2018 (or 2019) to the vast majority of investors!

One of the ways to improve your investing success (and to minimize these inherent investing flaws) is to find ways to improve your timing of the markets so as to avoid these large drawdowns that we historically see every 5-6 years.

Of course, this Tactical call must be approached in a prudent and calculated way. I have covered this in prior communications but the main theme is to keep 75-85% of the portfolio on AUTO PILOT (i.e. Invested) and depending upon the client apply a tactical over lay with the other 15-25%. I believe that this is paramount towards the end of ALL CYCLES such as this one!

There are many reasons to believe that now is a good TIME to be tactical and with any luck we will get a fabulous buying opportunity in the very near future!

I think the simple fact that ALL equity markets are flat for 2018 (and down 5% from the January highs) despite the US first quarter outstanding/record numbers on earnings, revenues and profit margins speaks volumes as to where we are in this cycle!

We are VERY late and yes the music is still playing but I fear what will happen when the music stops playing in this very old and weak cycle.

History tells me that it will not be pretty as the emotional lizard brain takes over your portfolio so why do I want to tempt fate here when I know that it is fickle human emotions that we are betting on this late in the cycle??

As always I like to list both the BEAR and BULL story and then conclude on where I think we are on the ever moving RISK vs REWARD pendulum.

THE BEAR STORY

#1 INFLATION or STAGFLATION is a CONCERN

-in the short term it is very likely that we will see more “surprising” inflation data (but mid-term it will be deflation) and this could be problematic for the economy, markets and the FED
-buss cycles always end with some inflation over simple supply and demand issues and frequently we see asset bubbles and “irrational exuberance” as everything is going UP. Think FAANG, Bitcoin and housing.

-the worry with inflation in this cycle is twofold for me #1. Tax Reform has NEVER occurred this late in a buss cycle which means inflation is coming and will be a “surprise” and #2. Very weak GDP growth at a time of rising inflation implies a risk of STAGFLATION…expensive markets do NOT do well under these conditions…

#2 HIGHER RATES MUST FOLLOW

-we will see the next US rate hike in June and I think that is when equity markets will start to worry about the effects this will have on the excessive consumer and buss debt that has accumulated over the last decade with close to zero interest rates…
-with higher rates the 10 year Treasury is now at 3%+ and offers a good alternative to equities. This is especially true when we are this LATE in the cycle so it is an easier-attractive transition for older nervous investors which will pull money out of equities in 2018 I suspect

-but the real risk with higher rates is the additional PAIN that will be felt by many borrowers e.g. those rolling mortgages now at much higher rates, those looking for new mortgages, student debt now at $1.5 T, record high auto loans and of course the biggest risk in this cycle is US Corporate debt esp. the huge JUNK and “near” junk market…my expectations are for soaring defaults in this sector and this will start in 2018

-higher rates hand cuff an already over indebted consumer resulting in limited future spending and the recent earnings and outlook reports from Target, Lowes and Home Deport reflects this consumer weakness

-historically it is well known that rising rates (in addition to Quantitative Tightening (QT)) are a big challenge for expensive markets and this time will be no different

#3 HOUSING WILL NOW WEAKEN?

-housing is crucial to the wellbeing of the general economy because of the spin-off benefits….carpenters, plumbers, lawyers, carpet layers, appliance etc
-unfortunately all the evidence points to a housing peak in 2017 and the more recent data reveals that a continued slowdown is underway

-this is because of higher mortgage rates (highest in 7 years) , expensive housing prices (lumber prices are at record levels) , poor housing supply and the biggest problem is a middle class that is struggling with weak wage growth BUT esp. the millennials who are the future buyers of these homes

-Canada has a much bigger housing problem than the US—50% of all residential Cdn mortgages will roll over in the next 12 months!!! That is going to hurt as most of these were at 2.5-2.8% and they will NOT be getting that rate going forward…hence my caution on Cdn Banks. The recent data reveal that nationwide existing home sales are down 14% yoy and this has got to be a worry for our Bof Canada S Poloz. Overall housing economic activity is over two standard deviations above its historic contribution to the economy so one has to wonder what happens when this corrects…

#4 TRADE ISSUES A CONTINUED WORRY

-we are still uncertain as to how this will play out re China, Mexico and Canada…this could/will add to our inflation problem…

#5 THE GLOBAL ECONOMY IS SLOWING

-the majority of the global Purchasing Managers Indexes (PMI) for April point to a continued slowdown in global growth and the equity markets track the global PMI very closely in direction fyi
-the US recent data was better on the manufacturing side BUT the fact that COPPER is down 7.5% ytd is a BIG worry (Dr Copper with the PhD in economics)!!!

-also the Citigroup Economic Surprise index is telling me that there is slow down ahead in the economy
-oil prices are not helping as they are up 50% yoy and in the US for every 1 cent per gallon increase in gasoline we see a corresponding DECLINE of $1 bill in spending-consumption so this is a negative for the economy in 2018

-the global bellwether Caterpillar suggested last month that the first ¼ was the peak of this cycle!

-potentially the biggest risk for the markets in 2018 centers around the EU with Italy and its new populist government which is a HUGE risk e.g. Italy's massive debt and membership in the EU are two areas that the populists want to change….I will be following this carefully

-and remember all these countries are either already tightening (raising rates + QT) or tapering their QEs (EU and Japan) and so the punch bowl is being removed at a time of global weakening…caution is the course for me

-I think the markets also see this as despite great US earning numbers for the first quarter global markets are flat to negative thus far in 2018!!

#6 MUTIPLE BUBBLES INDICATE it is LATE CYCLE

-I have mentioned this before but human nature is such that it ALWAYS goes overboard on greed towards the end of the cycle and valuations on FAANG and Bitcoin are indications of this "irrational exuberance" in my mind

-the TECH sector now makes up almost a 1/3 of all large cap US mutual funds which is similar to the dotcom era…

#7 A REPEAT FED POLICY ERROR?

-these are UNCHARTED economic and political waters on MANY fronts and it is my bet that the FED will once again raise rates too aggressively and invert the yield curve and inflict a recession in the next year!

-escalating oil prices support my suspicion as higher oil prices are often the second last nail in the consumer coffin (draining consumer retail spending) and then higher rate hikes being the last nail that kills consumer spending

-I am an avid follower of Dr Lacy Hunt and it is worth pulling up his last quarterly report (Hoisington Investment Management) where he explains in great detail how Quantitative Tightening is a form or monetary tightening which is killing the money supply and liquidity and will soon result in a yield curve inversion followed by a recession…I will try and find this report again and send it out later

#8 MID-TERM ELECTION

-markets drop an average of 16-17% in these years over uncertainty on the election outcome so expect more volatility over the summer and perhaps a buying opportunity…if we are lucky…

#9 PREM WATSA—our Canadian W Buffett

-a report last week revealed that Mr. Watsa has now raised his cash level from 39% in 2017 to 50% in 2018!!!! GULP!!

-I am smart enough to follow these exceptional (older) value guys actions (Buffett has over $100 Bil in cash) and right now they are saying SHORT TERM PAIN for LONG TERM GAIN….cash and short bonds suck BUT they won't when the markets drop….

#10 OTHER ISSUES

-There are many other reasons to be bearish right now but I will leave these for a later discussion e.g. Sell In May and Go Away, credit card growth has been negative two months in a row which is rare outside recessions…

THE BULL STORY

It is important that I review the BULL story if for nothing else than to revisit and question my own biases .

I will send out a couple of very bullish reports after this report that will allow you all to counter my bearish-defensive stance!

Here are some of the main points for the bulls:

#1 The TRUMP TAX REFORM

-this is allowing for a boom in share buybacks and Merger and Acquisitions…but this benefit is front loaded and mostly transient I believe or at least baked into the markets

#2 US Regional manufacturing Surveys

- these were all very good in May and points to continued growth in the US and are a reflection of the Tax Reform

#3 RECESSION Risk is Minimal

-this is perhaps the biggest BULL argument…no recession means that any 10-15% dip is a buying opp….

CONCLUSION

My best guess is that late January 2018 was the peak for this cycle and I expect to see lower markets going forward along with more volatility like we saw in Feb!

The current environment of rising rates, 3%+ bond yields, soaring oil prices and rising inflation is just not a good back drop for expensive and tired markets (nor the consumer). That is a fact!

Of course I am hoping that luck is on my side (as nobody can predict the exact date of the decline-this is short term stuff with many-many influences) BUT my timing of being tactical and defensive in 2018 seems both logical and appropriate when I review similar scenarios in history!

AND If I am wrong, the back-up plan is that we are likely not leaving much on the table (i.e. we are very close to a peak) and we all have approximately 80% of our portfolios on auto pilot to take advantage of any further irrational exuberance!

This week and next will be important determinants of the markets short term direction as we head into another rate hike mid-June…fingers crossed!

Terry

PS—some great reads and graphs below—not mandatory but worth a look

PS—despite my cautious and defensive outlook I have been doing selective buying in some client accounts as there are now some decent valuations available with the recent 10% market decline e.g. Enbridge, TRP, Saputo, Brookfield Renewable, Fortis, Chartwell Retirement, Interpipeline etc.