Infomail
March 21,2017

Divergent Messages

"There have been 13 Fed rate hike cycles in the post-WWII era, and 10 landed the economy into recession. Soft landings are rare and when they occurred, they come in the third year of the expansion, not the eight"

Economist David Rosenberg, Gluskin Sheff

We're getting completely divergent messages from bond and stock markets. Bond prices are not suggesting much economic growth, and the recent decline in energy prices may have confirmed that. On the other hand, equities (in the USA anyway) are reaching new highs.

The economic environment is improving on a global basis, and I've mentioned in recent writings, we may be entering a phase of synchronized global growth not seen in over a decade. This is supported by economic date such as leading economic indicators, the PMI numbers, New Orders Index, etc…These are all improving from pretty low levels, but are still not back at historical growth rates.

The fundamentals are also improving. After seven consecutive quarters in a row of negative earnings growth, we're seeing improvements on the corporate earnings side, both on the top line (revenues) and the bottom line (earnings).

There is no doubt the markets may have come too far, too fast, and valuations are extended short-term on most metrics one can look at (price-to-book, price-to-earnings, price-to-cash flow, price to sales, etc). but at 18x earnings, neither are markets "crazy" expensive.

Expectations are high, much of it on the back of President Trump's policy proposals. Investor sentiment has gone from cautious, with more of the same expectations of grinding growth, to wide eyed optimism and belief that a 3% (or better) US GDP can once again exist.

Combined, rising equity prices and bond yields create a puzzle for investors. We are now almost 3 months into Trump's Presidency, and four months since the election. During that time, US equity prices have risen steadily, as have yields on US government bonds. The strength of equities have been puzzling for several reasons, and not a day goes by without many questioning when the so-called "Trump rally" will run out of steam.

There are two possible reasons that the stock and bond yields have been going up:

1) New policies in Washington has created optimistic expectations
2) Solid company fundamentals which are improving

I would argue that just as Brexit has not led to the dire effects feared, Trump's election was nowhere as negative as so many had predicted. A 10% rise in US equity prices since the election confirms that.

The current bull market celebrated its eighth birthday last week. After eight years of rising prices, many advisors will naturally push clients towards over-weights in asset classes that have done well recently (banks, utilities, bonds, real estate etc.) and recommend managers with great 3 year numbers. It's a natural human reaction to "chase" returns.

I read recently somewhere that "diversification only looks like a good idea AFTER mistakes are made". Having a little extra amount of cash weighting is probably prudent in the near term. The Investor's Intelligence survey of newsletter writers hit a 20 year high lately at a 63% bullish/17% bearish reading. That's contrarian.

Since many of the dollars invested in markets in recent years has come via the buying of passive indices and ETF's, a very crowded trade has developed. Stick with active managers with solid long term performance, ie: 5 to 10 years or better. We've been lucky so far, as bear markets usually happen every 5 to 7 years and trim 30% on average. One can argue that the 2008-09 cycle was one for the ages, and given the return on the S&P 500 from 2000 to 2010 was virtually zero, one can argue the "normal" cycles may have been jolted out of whack.

Either way, we are in markets of extremes, and misplaced enthusiasm and optimism in what has been hot will be replaced at some point with those names and sectors which have been ignored and despised. This applies not only to equity markets but real estate as well.

It always has been that way, always will be.

Stay tuned,

Vito Finucci, B.COMM, CIM, FCSI
Vice President and Director, Investment Advisor
Associate Portfolio Manager

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ®Registered trademarks of Royal Bank of Canada. Used under licence. © 2016 RBC Dominion Securities Inc. All rights reserved.