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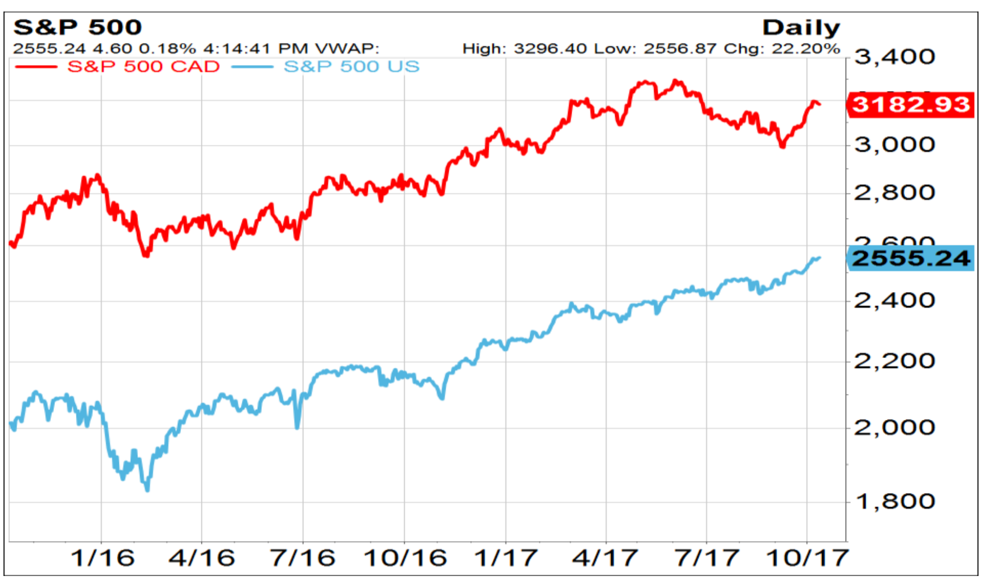
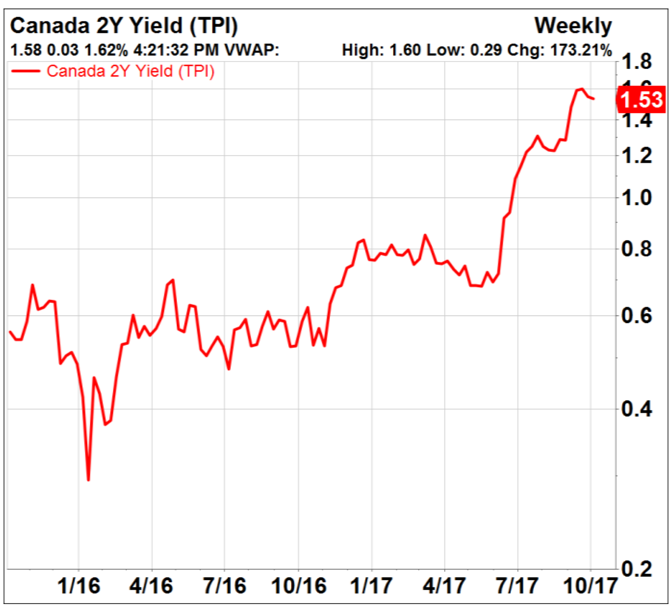
Third Quarter 2017

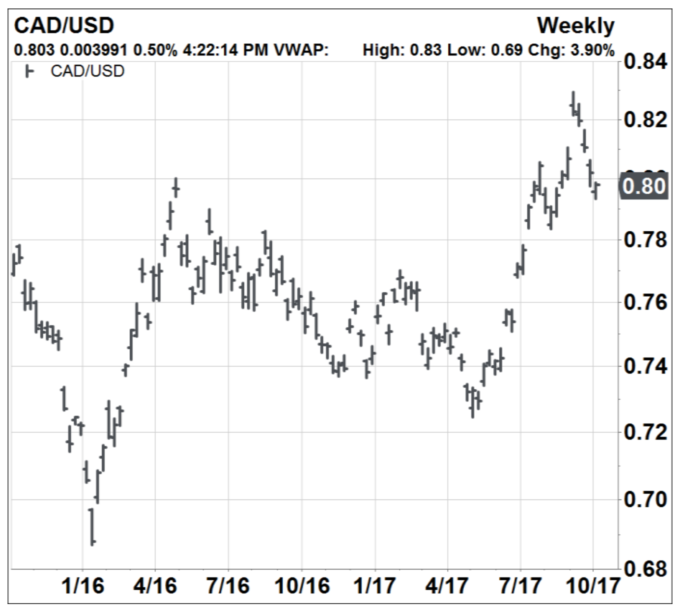
Of the three principal types of financial assets that we are concerned with, the price of cash (currencies), of debt (interest rates) and equities (stocks), it was the US/Canadian exchange rate that had what was for me the most surprising impact in the third quarter. For Canadian investors, the US dollar's -3.8% decline over the three months (and 7.3% decline in the first 9 months) all but offset the widely celebrated gains in the US stock market. In the three months to the end of September the S&P 500 had a Total Return of 4.5% in US dollars but that became only 0.5% when measured in Canadian dollars. This was a bit frustrating with all the media reports of record stock market highs.



In the previous chart, the top line shows the S&P 500 index in Canadian dollars. The bottom line shows the U.S. blue chip stock index in U.S. dollars.

It wasn't a surge in the price of oil that spurred the rise in the Loonie, which hasn't been acting much like a Petro Dollar at all these last few months. On September 6 the Bank of Canada raised the overnight interest rate 0.25% to 1%, saying "recent economic data have been stronger than expected". The 11% rise in the Canadian dollar from early May to the end of September seemed, to a certain extent, to anticipate the Bank's move. The value of the currency these days has more to do with interest rate differentials between Canada and the US, or, more accurately, perceptions about future interest rate differentials, than with the price of energy.





The chart above on the left displays the yield on the 2 year Government of Canada bond and the one on the right shows the price of the Canadian dollar in U.S. dollars. Note the synchronicity.

Currency effects aside, world stock markets were on a tear earlier this year as the globally synchronized economic expansion continued. Some might even call stock prices irrationally exuberant. This weekend I was pleased to hear that Richard Thaler had been awarded the Nobel Prize for economics for his work pioneering Behavioral Economics, the application of psychology to economic decision making. That is a topic I've written about before. BE is a challenge to the notion that markets are efficient and

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that investors are rational. As Thaler said Monday night in an interview on the PBS Newshour: "After the 87 crash, when the market fell 20 percent in a day, and the Internet bubble, when the Nasdaq went from 5000 to 1400, and the real estate bubble, which led to a financial crisis from which we're still trying to extricate ourselves, the idea that markets work perfectly is no longer tenable."

Gains in stock prices over the last few years make me wonder when again we'll be dealing with Behavioral Economic terms like "loss aversion", which is the unwillingness to let go of a valued possession, or "recency bias", the tendency to evaluate performance based on recent results and "herding instinct" which can cause people to act like the people around them. As Thaler said to Judy Woodruff in that same PBS interview: "As far as the stock market goes, personally, I'm a little worried about it." Me too, but then, I'm a worrier.

I hope to read Thaler's recent book, Nudge, but just now I'm busy reading a new book I was just given – Coaching Hockey for Dummies. Highly recommended. Hockey is a subject I can afford to be quite irrational about. Thank you for reading and for trusting us with your savings.

Sincerely,

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