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# “By The Way”

April 2018

*“It takes buying to move prices up, but markets can fall of their own weight.”*

The interday and intraday volatility of the S&P 500 and the Dow Jones Indices leaves one confused, if not bewildered. White House tweets or Mark Zuckerberg appearing before Congress while not meaningful in the long term, can send markets screaming off in one direction or another, only to reverse within days or even hours. The sentiment swings are hard on the nervous system, but still must be viewed as noise. In a word, we remain trendless. Until the markets breakout above the January high or breakdown below the February low, there is no definitive answer as to what direction the next major move will take. Despite the lack of a clear resolution, the market action during this consolidation has made “keeping the faith” more and more difficult. In particular, the lack of strong follow-through when the market rallies is disconcerting. Since the February lows, the S&P 500 has several times made a mini breakout from a small pattern and looked to be headed higher, but each time there has been an inability to sustain momentum and the market fell back below the breakout point. In the last letter, I voiced concern about the lack of breadth as markets rally, and that also continues to be a worry. The bulls need to become more aggressive; as the old adage says, “It takes buying to move prices up, but markets can fall of their own weight.”

I have long championed the belief that strong earnings growth would provide support for higher stock markets. That theory is being tested currently as we are seeing excellent earnings reports from a myriad of industries and companies, but these results have only produced a varied or weak response from the stocks involved. A part of the answer to this dichotomy is the recent popularity of the notion of “peak earnings” which argues we are currently seeing a topping out on the rate of earnings growth and that stocks will fall in response. I can’t disagree that the nearly 20% growth rate we are now experiencing is unsustainable, but I don’t think a drop to the still very strong consensus growth estimate of 10% for 2019 is a reason to sell stocks today. As Jason Trennert of Strategas Securities points out, “There has never been an economic recession when corporate profits were growing”. These impressive earnings reports are partly being fueled by the tax reform package passed by Congress last year, which has led to an argument about whether this is a one-off benefit, or will the positive effects be sustainable over time. The answer will come as we watch what corporations do with their increased wealth. In a perfect world the new-found wealth will be reinvested into the business and provide real growth and higher productivity. However, if executives chose as they have in the recent past to use the money to raise

dividends or buy back stock, the positive impact on the economy will be muted. The silver lining for investors is that while net earnings will not be improved by stock buybacks, earnings per share will be, and combined with higher dividends would be good for financial markets, but to the detriment of the real economy. Surveys suggest there is intent to use at least part of the proceeds for investment in plant and equipment. I will be watching actual capital equipment expenditure reports to get proof there will be follow-through. It is a very small sample size but it is promising to see that of the first 130 companies to report first quarter results capital spending increased by 39%.

Historically, mid-term election years have often not been kind to the S&P and this year provides the potential to be especially troublesome given President Trump's very poor approval rating and his knack for losing the narrative. A Democratic take-over of the House of Representatives seems almost assured at this point, but Senate results remain in question. Since it is the House that brings impeachment proceedings, such an event would become more probable. However, impeachment is only a charge. The Senate is the jury, if you will, and it is extremely unlikely the two-thirds majority needed to convict is at all possible. Nevertheless, such a disruption is sure to rattle markets should it come to pass.

I can't sign off without a brief comment on the Fed and higher interest rates and the possible effect on the stock market. We have all known for over a year that rates were going to rise, and that the Fed would be less accommodative. In short, I don't believe 3% on the 10-year Treasury Bond is a sufficient reason to shut down the economy and sell stocks. That day will come, I just don't think it is today. I continue to expect the Fed to be measured in the timing of rate increases, wary of the potential negative impact on the economy. There is much in the news about a flattening of the yield curve, which is the spread between 2-year rates and 10-year rates. The inversion of the two rates, when the short rate moves above the long is one of the most reliable predictors of a recession. As such, it is an important signal and deserves to be watched closely, but we haven't got there yet.

Finally, I have been spending more time musing about Canadian stock markets. Most of my time and energy, and the content of these letters, focuses on the U.S. To be honest, it's a case of studying the dog, not the tail; not to mention the long-time outperformance by U.S. markets. Despite the many negatives in the Canadian economy and geopolitics, my contrarian nature suggests I should investigate the possibility of a change in outlook and I intend to.

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