



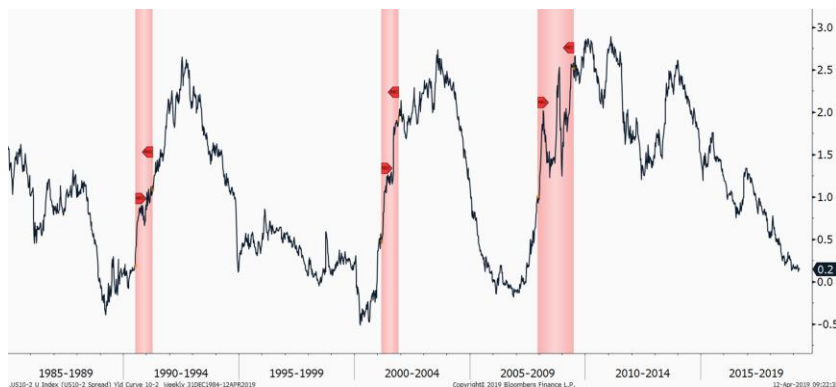
Jack Way
Vice President

“By The Way”

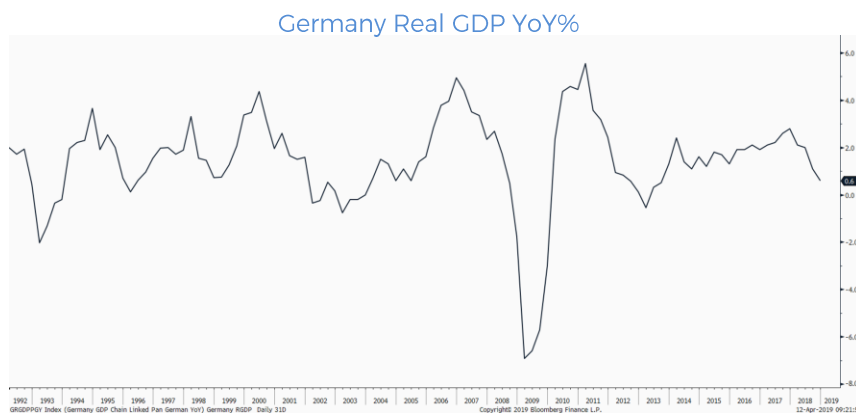
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The S&P 500 continues its inexorable climb higher. Areas of resistance around 2600 and 2800 that I thought were important were easily brushed aside leaving only the all-time high of last September at 2930 as the last level to be conquered. The internal strength of the market remains very solid, such that on a technical basis there appear to be no reasons for concern. Of course, as usual, it is my nature to be concerned anyway. The yield curve did in fact invert with the 10-year Treasury Bond yield trading lower than the 3 month T-Bill yield. Much has been written that such an event historically has presaged a recession and bear market. Lately, however, numerous arguments have been raised to try to establish why “this time is different”, but those four words have lost investors more money than one can imagine. Therefore, although many of the arguments are compelling, I will wait for further confirmation. I am also seeing many mixed signals throughout financial markets. For instance, the stock market euphoria would suggest we will see renewed growth this year, the bond market has taken the opposite tack. The 10-year U.S. Treasury Bond yield dropped below 2.50% indicating that fixed income investors are expecting much lower growth, or at least are concerned enough about the outlook to seek a haven of safety. Even within the bond market, dichotomies are present. Despite the flight to safer government bonds, the riskier corporate and high yield areas have also performed extremely well. As these and other conflicts are resolved we should get more clarity on the direction of economies and markets. In addition, the rise in the S&P Index this year has been totally based on an increase in the P/E multiple not earnings, and analyst estimates are predicting a 3% earnings decline in the first quarter, with 200 of the 500 companies reporting less income than a year ago. Many are suggesting this is merely a “soft patch” and earnings growth will rally in the second half of the year. History tells us it is very unusual for an earnings decline to only last one quarter, but if global economic growth can be revitalized, such may well be the case. Even so, those forward earnings estimates put the S&P 500 multiple at 16.7x, a level not overvalued, but not cheap either.

US Yield Curve (10-2Yr)



I remain suspicious that global growth will rebound sufficiently to support meaningful earnings growth. The International Monetary Fund lowered estimates for 2019 GDP both globally and for the U.S., and while the Fund's forecasting record is not that great, I believe the direction is correct. European growth was also downgraded by the IMF and E.U. Central Bank President Draghi backed that up in his press conference by saying risks are "tilted to the downside". The weakness in Germany, the traditional driver of Eurozone growth, is particularly of concern. Although it is not surprising given the slowing growth in major trading partners such as China.



Modern Monetary Theory (MMT), which I have written about in the past, has in what seems like only a few months moved from a peripheral academic concept to become much more mainstream in both political and economic discourse. It is now an accepted fact that while the Fed's monetary stimulation of the past decade has had a sizeable impact on financial assets and income inequality, it has had little impact on the real economy. The FED policy known as QE, purchased bonds on the open market in the mistaken (it turns out) belief the money would be put to constructive use in the economy. It was not, and now a strong argument can be made that the next time the Central Bank needs to fight a recession or stimulate the economy, direct monetization of debt will be the new policy. That is where MMT comes in; the Central Bank will crank up the printing presses and the new currency will be loaned to the Government and then through fiscal spending, be directly invested into the economy. Even the rich and conservative, e.g. Ray Dalio recently on 60 Minutes and Stephen Moore, Trump's Fed nominee, are supportive of MMT or something very similar, assuming that future higher taxes will cover the debt incurred. I remain unconvinced, but that's not the point. No one cares what I think. However, it's going to take a lot of taxes if the U.S. heaps more debt on top of the \$22 trillion already on the books.

I was not aware until I read a piece this week from Goldman Sachs that legislation has already been introduced and hearings convened in the U.S. Senate to prevent companies from using stock buybacks. Repurchasing their own shares has been a major use of funds for many S&P 500 corporations, and eliminating the practice will have a significant impact on markets and the economy. The first effect would be on earnings per share since buybacks have reduced a company's number of shares outstanding and thus increased EPS. Goldman estimates that over the past 15 years on average EPS has exceeded reported earnings by 2% annually due to buybacks. Since valuation is often based on the market's P/E multiple, the ramification would be meaningful. Secondly, buybacks have been the largest source of net equity demand since at least 2010. In 2018

for example, according to the FED, net corporate repurchases totalled \$509 billion, versus the net sales of equities by pension funds and mutual funds of \$367 billion. Finally, what will companies do with the considerable cash that had previously been used for buybacks? From the perspective of the overall economy it would be most helpful if the funds were reinvested in capital expenditures that have the potential to provide real growth. Unfortunately, that eventuality seems unlikely since corporations haven't seen attractive opportunities for investment and some extra cash isn't going to change that thinking. More likely the money will be used to increase dividends, reduce debt, or make acquisitions.

It is impossible to predict when or if MMT or buyback legislation will become realities, but if democrats win the 2020 elections, the odds will rise dramatically. Both have the potential to be real game-changers for markets and the economy.

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