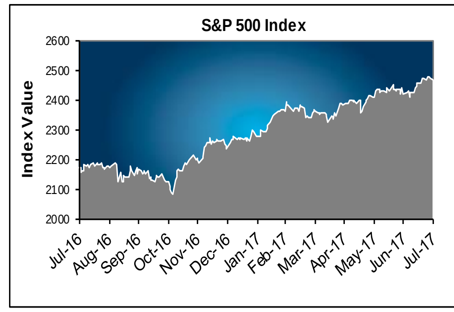
This Month in the Markets

July 2017

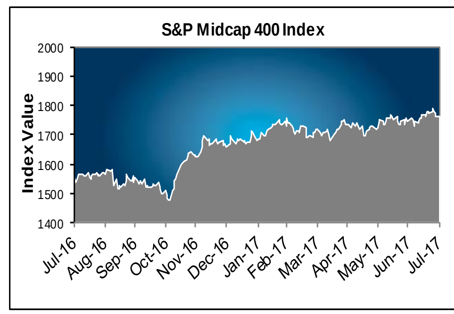
EQUITY COMMENTARY

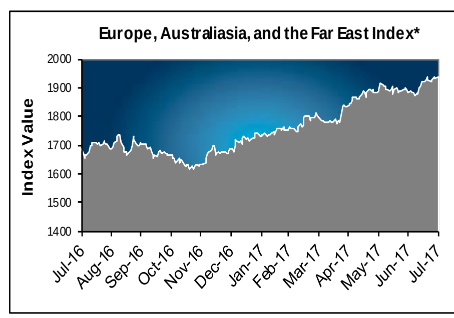
Fear of Heights

July was another strong month for global equities. Corporate earnings continued to surprise to the upside with S&P 500 sales growing 6% so far in the quarter and earnings +13%. Materials, technology and telecommunications companies were the big winners in the month returning 4.3%, 4.5% and 4.1% respectively. The only negative sector was healthcare, dropping 0.1%. Overall, the Morgan Stanley Composite Index (MSCI) closed the month up 2.3%. U.S. stocks underperformed international stocks with the Standard & Poor's 500 Index (S&P 500) rising 2% compared to the 2.6% gain of the MSCI Europe Asia Far East Index (EAFE). This difference was attributable to the weakness in the U.S. dollar which fell 2.5% during the month. The MSCI is up 11.9% year to date, with the S&P 500 up 10.4% and EAFE up 14.7% in U.S. dollar terms. The 4.3% outperformance of international markets, measured in dollars is mainly due to the recent decline in the dollar which has dropped 8.8% so far this year.

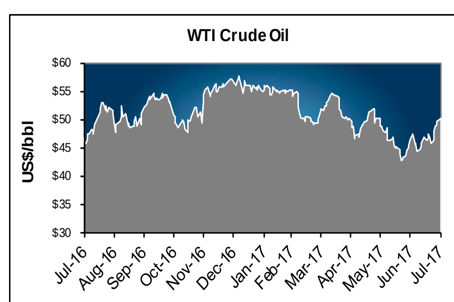


In clinical terms, the extreme or irrational fear of heights is known as acrophobia. It's derived from the Greek word meaning "peak, summit, and edge". In fact most of us suffer somewhat from a natural fear of heights especially when there is little support or protection. Investors these days seem to suffer from acrophobia as well. The recent "traumatic fall" in 2008 has led many investors to question the validity of the rally. Many point to the low interest rate environment as the key source of returns. They argue the market is artificially supported by low real rates. While this is surely the case to some degree, it does not appear to us to be the sole or even the key reason for the length and scope of the rally. If low interest rates were the key to stock market rallies, then why is Japan a serial underperformer? Here is a country where rates are virtually zero (and have been for decades) but its equity market is only performed in line with the world's developed markets over the past 5 and 10 year periods.   We would argue it's not simply rates or the Fed's quantitative easing program that is pushing stocks higher. In fact we think it's likely due to good old fashion earnings. Take one of the world's best developed markets, the S&P 500 as an example. Since the end of 2009 earnings for the index have compounded at roughly 10.6% per year and the market has returned 10.9% per year on a price basis alone.





When markets rally many people also feel there is little value but we would argue, again, that they fail to work harder. We do admit that opportunities are limited in nature and there are fewer attractive investment opportunities overall but that does not mean there are none. Recently we have taken advantage of "Amazon's Annihilation" of the retail sector and added some select names we believe have been unfairly punished. We suggest it is important to truly acknowledge what the company does and its value proposition. The qualitative factors and the story of the company should be weighted more heavily than historic multiples when factoring in the future value of the company or industry under pressure. In many cases, the industries being clobbered right now are in secular decline and Amazon's influence is only coincidental as there are some secular shifts in consumption patterns. Time will tell if our assessment on Dollar Tree bears fruit but we feel the company is attractive based on its expanding consumable offering and it's bargain price point leaves it somewhat insulated from Amazon's strategy. Trading at about 15 times earnings we see value in a franchise that could see earnings growth of 15% to 20% over the next several years as the company continues with store expansions and the Family Dollar integration.



*MSCI EAFE Index

FIXED INCOME COMMENTARY

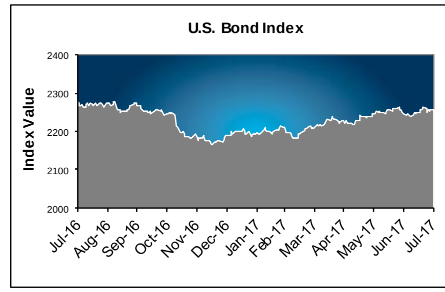
Slowing Reform Process

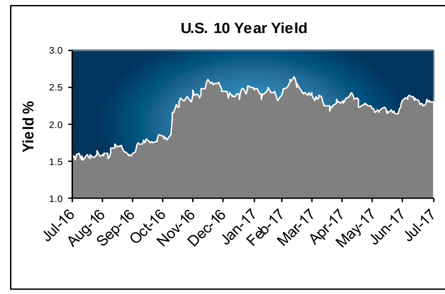
Corporate bonds and preferred securities outperformed government bonds by a good margin in July. The benign trading environment and another strong earnings season have supported risk assets. The capital markets have continued to shrug off any headline risks, even the inability of the U.S. Congress to get reforms passed and somewhat tighter monetary policy did not have any impact on asset price volatility. On the contrary, the VIX Index, a measure for near-term stock price volatility, hit an all-time low of 8.84 in June. The same is true for the MOVE Index, which is the bond market's equivalent of the VIX Index, has set a new record low. There was some movement in the foreign exchange market with the dollar losing ground versus most of it peers. The market has priced a slower monetary tightening pace for the U.S. at a time when other central banks have started to catch up. Like the Bank of Canada, which has increased its target rate from 0.50% to 0.75%, the first rate hike in 7 years.

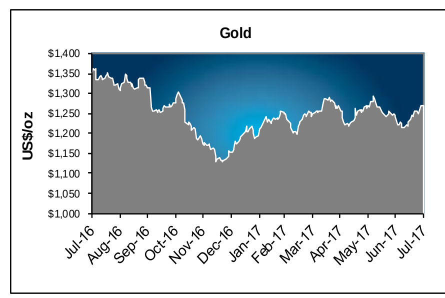
The underperformance of the U.S. dollar is not due to economic problems in the U.S. but rather a result of other economies improving at a slightly faster pace. In July, the International Monetary Fund (IMF) kept its global growth outlook unchanged at 3.5% for this year and 3.6% for next year. A closer look at the forecast reveals that the expectation for the U.S. economy was lowered to 2.1% in 2017 and 2018, from previously 2.3% and 2.5%, respectively. This shortfall is expected to be made up by stronger growth elsewhere, especially by China and some parts of Europe. Recently, the U.S. has endured several growth downgrades after reforms in the U.S. Congress have come to a near halt. The ongoing battle over the healthcare law seems to hold up efforts of reforming other parts of the country. On top of investors' mind is Trump's proposed tax reform which could potentially reduce corporate taxes materially, ignite a new capital expenditure cycle and consequently lift GDP. At the end of July we learned that the quarterly annualized growth rate in the U.S. was 2.6%, after 1.2% in the first three months of the year. While this result should be viewed as positive, it is down from expectations of near 4% just a few months ago. The U.S. economy is expected to grow by 2.2% this year according to consensus estimates.

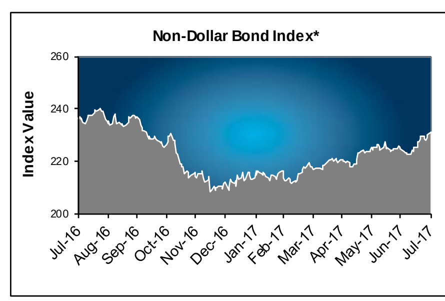
The relatively benign growth environment will also lead to a rather moderate monetary tightening path in the U.S. After two interest rate hikes in the first half of this year, the Federal Reserve (Fed) will likely pause in the third quarter and focus more on the unwinding of its massive balance sheet. According to the central bank this will happen in a gradual and well communicated way so that there should not be any surprises to the capital markets. While the Fed intends to hike the target rate once more in the fourth quarter, the most recent pricing of the Fed Fund futures does not support this outlook but expects the next rate hike in June 2018 at the earliest. Although the U.S. central bank has fulfilled its mandate of full employment, it is still undershooting its 2% inflation target. The personal consumption expenditure core price index stands at only 1.4% year-over-year and the trend has decelerated since the start of the year.

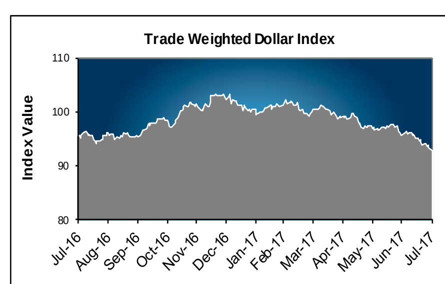
The Canadian dollar has been one of the star performers in July. The loonie was supported by its first rate hike since 2010 and a rebound in crude oil prices. Real estate prices and household indebtedness have soared in Canada and concerns about some dislocations have warranted tighter financial conditions. We acknowledge the risk that this leverage coupled with increasing rates may escalate risk at some stage for Canada.











*Merrill Lynch Global Broad Market, Ex US Dollar Index