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MARKET ETHOS

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Old, But Not Obsolete

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We have never been fans of price targets or specific numeric forecasts for the market, or any investment for that matter. The reason being that there are just too many moving parts. Maybe you could forecast dividends accurately, as they often don't move too much from year to year. Nailing index earnings is a lot more difficult, and even if you were able to accurately predict earnings, best of luck guessing what earnings multiple the market will support in six or twelve months time. The earnings multiple is often a function of investor sentiment or mood at a given point in time, and this can change on a whim. That being said, we do have a base case scenario on how we believe the market, and some of the key moving parts, play out over the next year.

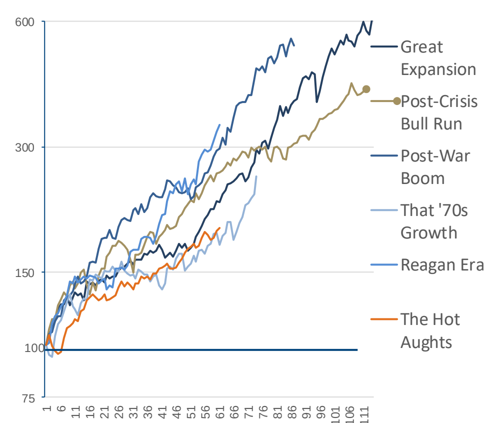
S&P 2,700 – where to from here?

The bull market is now the second longest in the past hundred plus years. However, that does not necessarily imply that it is going to end any time soon. Our market cycle clock favours a continuation of the rally. With 21 of the 30 indicators we monitor in the positive, we do not get too worried until that number falls below 10.

It is becoming increasingly evident that we are late in this cycle as seen by heightened volatility, monetary tightening, and full employment. The good thing for investors is that the late part of a business cycle is typically accompanied by strong earnings growth, a boon for equities. The problem is that it is not only earnings that drive stock prices. Multiples and dividends are two other factors you need to include to give you the full picture of the return on an index. In 2017, we had a great mix of all three, earnings grew by 12%, multiples expanded, and investors collected more than 2% in dividends. This year is off to a similar start with earnings growing by 14%, but the difference is that multiple contraction has nearly erased the gains.

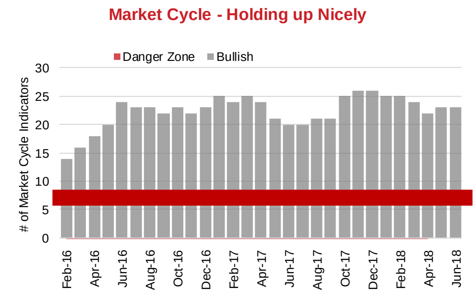
The market multiple is basically a function of aggregate sentiment, and sentiment has certainly become quite pessimistic. Bearishness, as measured by the AAII US Investor Sentiment reading, is nearing extreme levels and tends to be a good contrarian leading indicator. This leads us to believe there is asymmetrical risk that sentiment gets better versus worse from these levels. After a sizeable multiple contraction to start the year, we would expect some stability or even mild expansion in the 2nd half of 2018.

RANKING THE BULLS



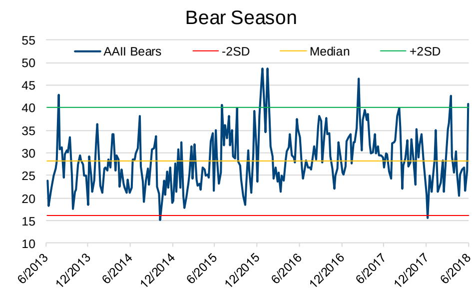
Earnings

Both consensus and our expectations are that earnings will continue to grow through the end of 2018. Tax cuts will continue to fuel growth for corporations and are percolating through the economy, providing a positive backdrop for consumer spending. Not only that, but the job market in the U.S. remains robust creating on average 223K jobs a month so far this year. This has pushed the unemployment rate to cycle lows and lead to higher wage growth. More money in your pocket, typically leads to more spending. Overall, the U.S. economy is doing very well. You couple this with our outlook for multiples, accompanied with another 1-1.5% in dividend payments, and that paints a nice picture for stocks. Our guess is that we breakthrough 2,900 by end of the year. Albeit, not in a straight line as increased volatility is likely here to stay. Long story short, buy the dip if the opportunity presents itself.

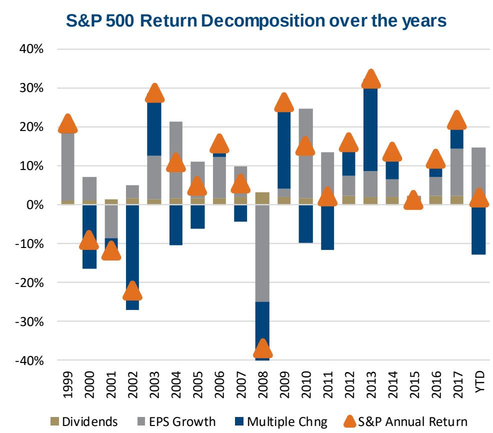


2019 and Beyond

Although the remainder of 2018 is setting up nicely, things look less favorable peering over the horizon to 2019. The biggest risk would be rising inflation leading to higher bond yields. Rising yields typically coincide with falling multiples. Our forecast is that we see higher bond yields in the next twelve months, which could pressure multiples and drive stocks lower in the first half of 2019. This could be caused by a few things. Higher wages, which we cited as a boon for this year, will likely cause companies to raise prices to offset the cost of labour. Oil prices have ballooned, rising over 20%. Oil is the feedstock for a variety of industrial applications, and gasoline needs to be used to move finished goods. Oil itself is often overlooked by most economists and central bankers because of its cyclical nature, but the flow through impact can have a real impact on prices. On the trade side with Trump slapping tariffs on almost everybody, we would expect continued retalioations, like we saw from Canada on Friday going “dollar for dollar”. This inevitably leads to higher priced goods and certainly adds to uncertainty, which is not good for multiples.

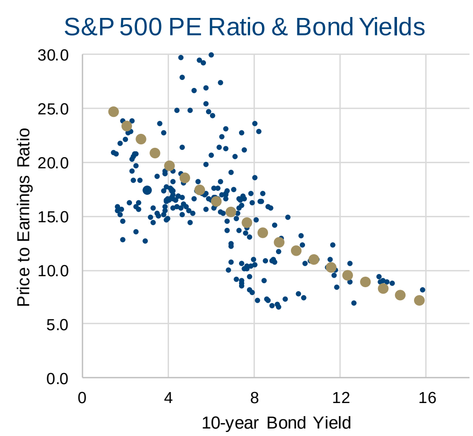


On the earnings side, the prolific growth in 2017 and 2018 will make it that much harder to outperform those same figures in 2019. So, we do not see earnings providing the type of backstop that they have provided so far in 2018. You can pretty much count on collecting your roughly 2.5% in dividends, but other than that, good luck.



What about Canadian Stocks??? Our guess is higher.

If you thought predicting the next 6-12 months for U.S. equities seemed challenging, predicting Canadian stocks is a colossus task. The reason being is that our market is more concentrated, and if you get one aspect wrong, your whole forecast could be completely off. Materials, Energy and Financials account for more than 65% of the S&P TSX composite index, all of which have vastly different driving forces. Our market is nicely positioned to fare well during the late stages of an economic expansion, but also vulnerable to underperform during the next recession. Canadians are generally over levered, our housing market made it through the last recession relatively unscathed, and the high GDP growth in emerging markets (which is already wavering) would slow and reduce demand for our natural resources. We did add to our Canadian equity weight back in February, which is working out nicely, but we remain underweight in our globally diverse asset allocation strategy. But for those that love a good forecast we think the TSX breaches 17,000 by the end of the year as



global growth continues, political rhetoric eases and the central bank remains relatively accommodative.

Portfolio Implications

For our funds we will continue to deploy cash during sell offs and let our cash weights build during updrafts. We remain overweight sectors that are cyclically oriented and underweight those that are negatively impacted by rising rates. We have been positioned this way for quite some time, and it has worked out rather well for out investors. Timing the pivot will be key, where we switch our positioning in anticipation of a correction / recession. We have already started to de-risk, but until we become less bullish on the near term (6 months), we will likely maintain this stance.

Charts are sourced to Bloomberg unless otherwise noted.