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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Policy “Trumps” Cycle

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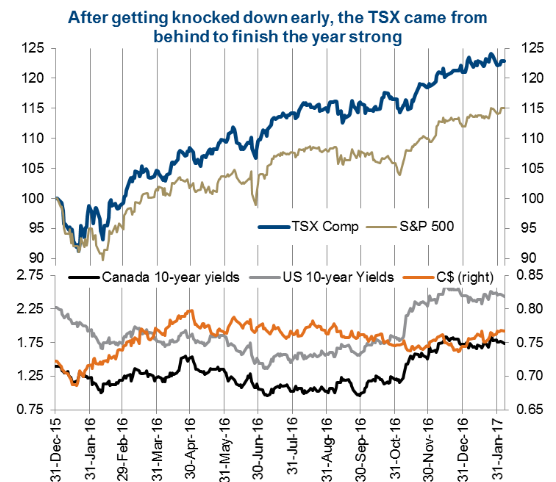
In this edition, we are providing an abbreviated synopsis of our Richardson GMP Market Outlook Quarterly which was published a few weeks ago. The full report is available on the Richardson GMP home page (here)

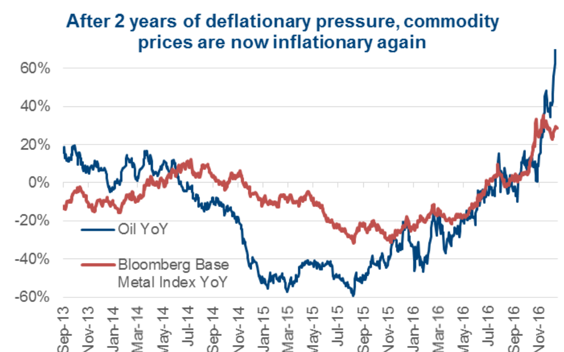
2016 - An American Classic



Looking back, the last year had many similarities to classic American novels and movies. We had the tumultuous beginning with a severe market correction, followed by the underdog (the TSX) coming from behind to end up being the strongest performing among develop markets. 2016 clearly had a happy ending for market participants.

The impressive performance by the TSX which rose over 20% (top chart) last year was fuelled most by the Financial, Materials and Energy sectors. It certainly helps when the highest weighted sectors turn in winning performances. Not to be forgotten, the S&P 500 did manage to rise to new highs, despite ‘only’ rising around 10% last year. Conversely for Canadian investors currency was a bit of drag, as the volatile C$ ended only a bit stronger than it began.

With the bull market turning eight years old in March, the classically late cycle sectors were some of the best performing. We also saw the Fed continuing down the tightening path and bond yields still rising. Thought the bull is getting long in the tooth, they don’t typically die of old age. Our market cycle model continues to favour a continuation of the current cycle. Economic and earnings growth have returned, the latter of which could very well drive the cycle forward for another year or two.



Deflation to reflation

The year finished with a strong push higher in bond yields. U.S. 10-year yields currently are just under 2.45%, so far in 2017 they seem to be consolidating the big move of the past six months. Investors have taken notice, punishing on a relative basis sectors with a high degree of interest rate sensitivity. We ask, what if 10-year U.S. Treasury yields were to rise to 3%?

It’s possible that this move was more of a normalization after yields were pushed artificially low following the Brexit vote, but investors

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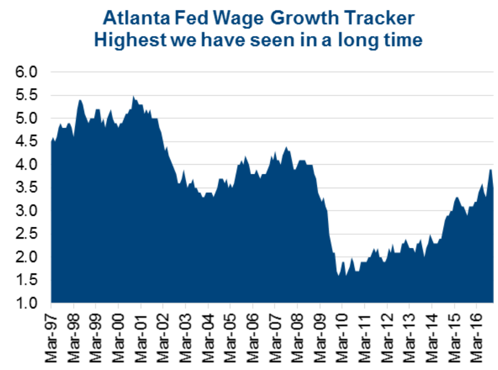
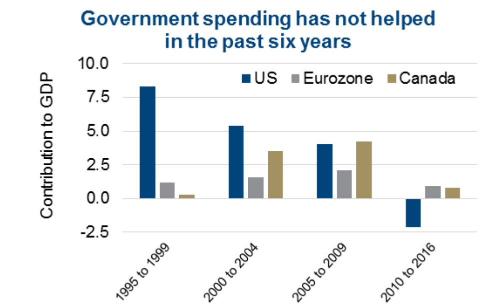
should take note of a number of factors which point to higher bond yields this year. We're seeing improving economic data across the globe. All seven CitiGroup Economic Surprise indices are in positive territory. Rising commodity prices are also spurning bets on inflationary pressures. (bottom chart previous page) Also to this point, rising wage pressures (top chart) are likely to follow considering the U.S. is at or at least very near full employment.

While we're not delusional enough to make a grandiose call about the end of the secular bond bull market—we'll leave that to the so-called 'guru's'—we do believe that we're at the point in the cycle where the path of least resistance for yields is higher in 2017.



Bring on the Big "G"

People want change, made evident by populist votes winning against the establishment recently. There has been a shift in attitudes towards 'austerity', with governments in Canada, the U.K., Japan and now the U.S. willing to spend big to drive growth.

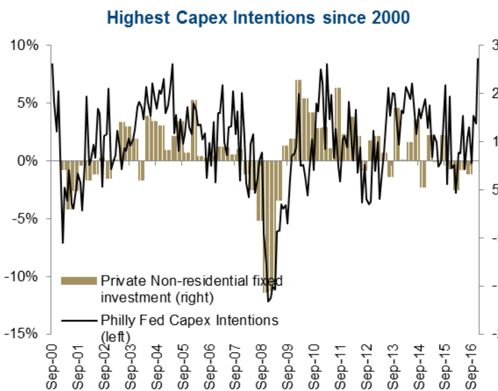


The chart on the right is the cumulative government contribution to GDP over five year periods. Since 2010, government spending has done very little to help foster economic growth and, in many of these years, was a drag on the economy. This is in stark contrast to previous periods in which the government was a positive contributor. If that does begin to change, as governments are beginning to pledge, this headwind could quickly become a tailwind for the various economies.

Okay, perhaps the word 'quickly' should not be used. It does take time to implement government spending, but it does appear to be coming.

The Return of Capex

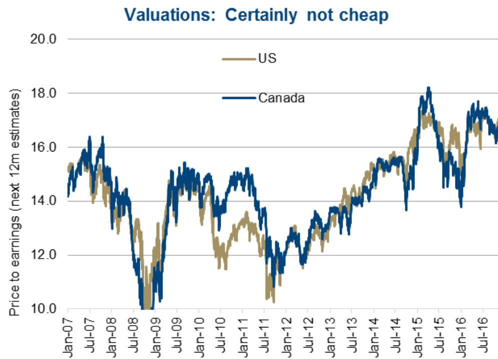
Corporate capital expenditures (capex) are an important line item in the quarterly GDP report. Capex has been weak over the past few of years, which has weighed on growth. The reluctance for corporations to spend is likely due to increased uncertainty as well as markets rewarding those who favoured increasing their dividends and corporate buybacks.



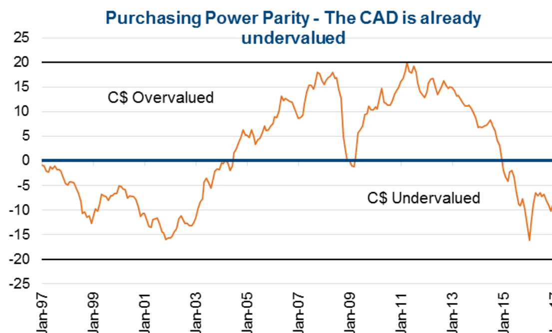
This looks to be changing in 2017. The Philly Fed Capex Intentions Index just reached its highest level in over 15 years (chart to the right). Coupled with Trump's pro-growth mandate, plan to lower corporate taxes, reduce regulations and repatriate cash held overseas, 2017 may very well see a surge in capex and possibly even M&A activity. Sectors to watch which are most sensitive to capex spending are Industrials as well as Technology.

2017 Earnings Tempest

Rejoice, the earnings recession is over. After seven consecutive quarters of negative earnings growth, it is fair to say that the trend has been broken. (bottom chart)



Now that the slowdown in global growth and the energy market collapse are behind us, we see a number of positives for corporate earnings going forward, especially in the United States. A reduction in corporate taxes as well as regulatory burden are at the top of our list. This is good news considering the market is trading at a somewhat elevated valuation (bottom chart previous page). At 17.6x 12-month forward earnings and 16.9x for the TSX we think it unlikely to see further multiple expansion. Markets will have to rely on earnings growth to drive future returns.



The Dollar

We remain bullish on the U.S. dollar vs. the Canadian dollar through 2017. The U.S. economy continues to chug along, while the Canadian economy is still working through some regional weakness. The Fed and the Bank of Canada also appear to be on different trajectories. While the Fed is expected to continue to hike though the year, the BoC has most recently mentioned a potential rate cut. Rate differentials have continue to widen, yet curiously the Canadian dollar has strengthened in January. The typical correlation between the two has broken down, but we expect this to correct itself in due time. Our bullish stance on the U.S. dollar is not without trepidation. The Canadian dollar is already slightly undervalued against the U.S. dollar (top chart) and the market already has a bullish posture towards the U.S. dollar in the futures markets. We believe the next bullish driver for the dollar could be U.S. tax reform. The last time the U.S. government provided a tax holiday to repatriate foreign cash holdings, the U.S. dollar climbed.

Final Thoughts

The bull market will turn eight years old in March, making it one of the longer runs in the past 100 years. We would say that many market characteristics appear to be late cycle: the Fed tightening, energy and materials leading, signs of inflation showing and the market abruptly swinging. While those are not good things, the vast majority of our indicators point to a continuation of the current bull cycle for some time. Earnings growth is returning and economic data continues to strengthen.

For now, we would view any sell-off as a buying opportunity and continue to recommend that investors be either market weight or mildly underweight equities.

Charts are sourced to Bloomberg unless otherwise noted.

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