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Navigating the Trade Winds

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Dear friends,

The year 2016 did not quite start the way we had hoped, but it sure did end the way we had foreseen. Like most experts, we had absolutely no clue that the Brexit victory was even possible. In just the same way, the political gurus were dismissing from the onset Trump's candidacy at the convention and to call him Mr President was not even the butt of jokes, it was inconceivable. Once again, experts are aiming at the knees; their posture is at best neutral. But in extreme cases they are bracing themselves for a catastrophic meltdown. Will Mr Trump surprise us in a good way? Hopefully, he will. But surely, he will instill controversy and provoke instability. Therein, several opportunities will arise.

		Closing	Change	
		31-Dec-16	Quarter	2016
Stock Indices				
S&P/TSX		15,288	3.8%	17.5%
S&P 500		2,239	3.3%	9.5%
MSCI EAFE*		1,037	6.7%	2.3%
Currencies				
CAN$ (US$ / C$)		0.7445	-2.3%	3.0%
Euro (US$ / EUR)		1.0516	-6.4%	-3.2%
Commodities				
Oil (WTI)	$	53.75	11.7%	44.8%
Gold	$	1,157	-12.4%	9.0%
Volatility index				
VIX		14.04	5.6%	-22.9%

** MSCI Europe, Australiasia and Far East*

In Canada, investors perceived a rising black tide as a good omen. The momentum of resource equities swept up and carried the entire index. Most of them were in rebound overdrive. The first semester was almost all golden; the Golds ended the year up 47%. Together, the energy and materials sectors both accounted for more than 9% of the S&P/TSX's 17.5% yearly return. Generally, portfolio managers were surprised by the depth of this massive rally. The S&P/TSX tilts heavily in commodities, but not many managers will take the bet to concentrate 33% of their holdings in energy and materials, which is the total weighting of these sectors in the index. In our portfolios, we had taken several positions at the start of the year and slowly increased our exposure. Just like many of our colleagues, we cannot place such a large portion of our holdings in those volatile sectors. When resource equities outperform, the moves are radical and distort the overall return of the S&P/TSX. The result is that many managers underperform. This is why we refer to this phenomenon as an illusion. Like most illusions, the reversal is normally not too far away. For 2017, we believe that the commodity play is still on and will be sustained by the overreaching economic growth in the world. Still, we will limit our exposure to 25% in order to buffer the cyclical nature of these sectors. Moreover, we are focusing in the large caps of the energy and materials sectors that are more stable and less unpredictable than the smaller names.

Down south, the S&P500, which is more homogeneous, managed to extract a 9.5% return for the year. Most of the propellant was furnished by the financial sector which was set on fire by the Trump's victory. Overseas, returns were disappointing, just like the 2% of the MSCI EAFE would attest.

The impact of Trump's presidency on markets

The first two years of a presidential cycle are generally not very positive for the stock market. Since 1928, the unfavourable slant led to a 2.5% return on average in year one, and to 4.2% in year two. Oddly enough, the recent exceptions were registered under the two Obama mandates. The unprecedented pace of the indices following Trump's victory is based on the strong belief that the Republicans stranglehold on the legislature, combined with a Trump White house will usher in a pro-business environment. A lot of hope and wishes are riding on the first 100 days of the Trump administration and the 115th congress. The new Republican tag team is promising a reduced regulatory framework, a substantial cut in the corporate rate from 35% to 15% and a tax holiday on repatriated overseas capital that will be extended over a ten year period. Also, the Republicans promised a torrent of public money for infrastructure projects. The party is officially on! All these wonderful market friendly promises have obviously contributed to a "climate change". The temperatures are rising and the market as projected itself way in front, contemplating the return of a healthy earnings growth environment. Any slipups on any of these fronts will be a pretext for a correction.

What's in store for 2017

It appears that the economic locomotive that is America will not be alone in towing our worldly prospects. For the first time in a long time we have a shot at a synchronized worldwide expansion in 2017 and the leading economic indicators are very positive. The IMF is looking for a 3.4% increase of the world GPD. To put things into perspective, the S&P500 is not cheap at 19x trailing earnings, but we have seen in the past that it often becomes pricier before an important correction occurs (P/E at 29x in 2000). Even though the S&P500 is close to full value based on 2017's earnings, it remains quite affordable in terms of forward earnings from 2018. The consensus among analysts is a 12% increase for both 2017 and 2018. In Canada, the S&P/TSX projections come in at 26% and 13% for the same periods. We must underline the fact that this index is still well below two times book value and all cyclical tops were reached after crossing that frontier. We are counting on a good 2017, but believe that a lot of overvalued stocks will limit index returns, which is especially true in some of the defensive sectors. Being in the right sector at the right time will be crucial. Our preference still leans towards economically sensitive equities like the techs, industrials, consumer discretionary and major resource names. We prefer value stocks over growth stocks.

Conclusions and perspectives

What lingers in our minds for 2016 is the end of the earnings recession, the end of the sideways correction in the major indices and most of all, the incredible resiliency of this leggy bull market. This market shook, trembled several times, but it never crumbled. Obviously, for 2017, the key point is that expected earnings will be there. The major road blocks are an uncontrolled rise in the US$, a blowout in long term US bond yields, the beginnings of a trade war with China, etc. Obviously, President Trump is the biggest question mark of all. The real surprise would be that he causes no surprises. But when he does, we will be there to buy the dips if earnings and the world economy are still strong. Finally, we believe the unexpected surprise might come from the emerging markets in 2017.

The Alizé Capital Team