alizé capital
Gestion de portefeuilles / Portfolio management

La voie des Alizés

Navigating the Trade Winds

July 2018

In this issue:

- ***A favorable quarter despite ongoing tensions***
- ***The commercial tariffs disputes***
- ***The history and the Fed***

Dear friends,

Despite growing commercial tensions, stock markets in the western world had a rather strong quarter. The S&P/TSX even reached an all time high of 16 450 points, on June 20th, to finish Q2 up 5.9%. We cannot ignore the amazing rebound we witnessed in crude oil. The Canadian oil patch went ballistic, going up 15% this last quarter. The S&P 500 finished slightly in the black for Q2, but registered a 4.9% return when expressed in Canadian dollars, thanks to a strong greenback. Our North American portfolio strategy continues doing well. Our decision to add some high-quality energy stocks contributed to the overall performance. On the other hand, emerging markets had a lackluster quarter. Is this a sign of fears related to the Trump-China tensions?

		Closing	Change**	
		30-Jun-18	Quarter	2018
Stock Indices *(% in C$)*				
S&P/TSX		16,278	5.9%	0.4%
S&P 500		2,718	4.9%	6.1%
MSCI EAFE*		1,959	-0.5%	-0.3%
Currencies				
CAN$ (US$/C$)		0.7615	-1.9%	-4.2%
Euro (US$/EUR)		1.1685	-5.0%	-2.6%
Commodities (US$)				
Oil (WTI)	$	74.13	14.3%	22.6%
Gold	$	1,251	-5.5%	-4.0%
Volatility Index				
VIX		16.09	-3.88	+5.05

** MSCI Europe, Australasia and Far East (US$)*
*** Changes are expressed in C$ for Stock Indices.*

Looking at President Trump's muscular behaviour, one question we must ask ourselves is: will he tone down before starting a full scale trade war? We still believe so, although time is quickly running out. If all these growing signs are worrisome for the world economy, the underlying fundamentals are still very sound. Worldwide, monetary policies are very accommodating and this is very encouraging for a strengthened and continuous growing economy. A persisting low inflation environment will slow the tightening cycle somewhat, here and elsewhere. That said, governments could also help by stimulating growth with fiscal packages. In the face of growing commercial tensions, we still believe that equity markets across the globe could progress gingerly for a few more quarters.

For all the bad blood spilled, company earnings projections are still holding strong. For the 500 companies that are included in the S&P 500, 43% of their revenues is generated overseas. We are still on track for a solid 20.7% earnings growth for Q2 and, ultimately, a remarkable 22.4% for the year. Thanks largely to an impressive 26.6% in Q1. In Canada, the expected growth in earnings for 2018 is 12.5%, spearheaded by the red-hot energy sector (27.5% projected). We continue thinking that the key to this strong bull market is a continued steady growth in earnings.

Navigating the Trade Winds

July 2018

The commercial tariffs disputes

President Trump is not turning his back on his electoral promises. He absolutely wants to prove to the entire world that trade disputes are winnable, even if it is against his economic allies. Mister Trump is not known for being a bluffer. He will not scamper from this game, even turning a defeat into a glorious victory. The numbers are plain for everyone who wants to assimilate them. For example, in terms of foreign trades share in the GDP, the US is substantially less exposed to trade retaliations than the European Union (12% for the US vs. 44% for EU). If tensions flare up and escalate into a grudge match of measures and countermeasures, the major losers would be the NAFTA partners, China, South Korea, Japan and of course the EU members.

At this point of the dispute, an all out auto trade war is also a distinct possibility, unless the Europeans cave in to American demands. Our interpretation of events is that President Trump is looking for a larger portion of foreign auto production on American soil, particularly from Germany. The same could be said about its NAFTA partners. Even though these accrued tensions could have consequences on market volatility, we do not believe that it will result in a significant correction. Although, we do believe that if the present confrontations get out of hand, that Canadian and international markets would be more susceptible to losses.

The history and the Fed

Must we remind everyone that this economic cycle is well advanced. However, it is resting on solid foundations and could become the longest one in history. Let us compare present market conditions to those observed before the previous two bear markets. We notice that the present forward P/E ratio is comparable to 2007, before the crisis, but well below the one in March 2000 during the tech bubble. Although the current market metrics have become less attractive, present investors are well compensated with a dividend yield that competes well, for the first time, with yields offered by 10-year T-Bonds. Therefore, investors remain in the market and this provides support for equities.

	March 2000	October 2007	June 2018
S&P 500	1 527	1 565	2 718
Forward P/E	27.2	15.7	16.1
Dividend Yield	1.1%	1.8%	2.1%
10-Yr US Treasury	6.2%	4.7%	2.9%

At the Federal Reserve, Governor Powell let it be known in June, that regarding interest rates, he was ready to move in either direction depending on ensuing events. We believe that the Fed is not really concerned with current inflation trends at this point, so the compass is still pointing true north. Consequently, the Fed will pursue in increasing rates at a measured pace. An accelerated pace in 2018 could harm earnings. To us this appears as a low probability outcome. In a longer time horizon, we believe the Fed will point the way for the 10-year T-Bonds to tend towards a 4.5% yield within 18 months.

Conclusions and perspectives

As we write this letter, China has retaliated tit for tat with the Trump administration. They are slapping a 25% duty on certain 'Made in the USA' imports worth $34 Billion. If Trump does go forth and replies forcefully with tariffs on $500 billion worth of Chinese goods, it will be war. Notwithstanding an open-end trade war, we foresee several good quarters for the equity market because of strong fundamentals in the economy and company earnings.