alizé capital

Gestion de portefeuilles / Portfolio management

La voie des Alizés

Navigating the Trade Winds

October 2016

In this edition:

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- ***The fading menace of the Donald;***
- ***Marking the end of the earnings recession.***

Dear friends,

		Closing 30-Sep-16	Change Quarter	2016
Stock Indices				
S&P/TSX		14,726	4.7%	13.2%
S&P 500		2,168	3.3%	6.1%
MSCI EAFE*		972	5.4%	-4.1%
Currencies				
CAN$ (US$ / C$)		0.7617	-1.6%	5.4%
Euro (US$ / EUR)		1.1241	1.2%	3.5%
Commodities				
Oil (WTI)	$	48.11	-0.3%	29.6%
Gold	$	1,322	0.0%	24.4%
Volatility index				
VIX		13.29	-15.0%	-27.0%

** MSCI Europe, Australiasia and Far East*

As we look back and close the books on these past summer months, the Canadian markets completed another positive quarter. The S&P/TSX finished up 4.7%, aided mostly by a reinvigorated energy sector that kept on barreling along despite, or, shall we say, reassured by a stabilization in oil prices around $48. The salient markers of this third quarter were the new all-time highs attained by most of the major indices in the US. In our previous edition we expected the crucial 2,135 level on the S&P 500 to be surpassed and it happened back in July. The real surprise is that this level was never seriously retested since then. Despite all these good news, the actual return for 2016 remains quite timid at 6.1%. In Canada, if we exclude most of the commodity complex and other cyclical stocks, the performance is also limited.

For a while, we have held the belief that the markets were navigating through a consolidation period. After a strong advance of all indices that started from the depths of 2009, most indices have held a pause that started in November 2014. Let us be blunt, two years is long time for a trading range type correction. Basically, the S&P 500 swayed from 1,865 to 2,135 points for almost two years, for a less than 15% range. In itself, a consolidation is beneficial and salutary after such major advance in the US. Generally, bull cycles, like the 2009-2014 episode, are resolved by either an abrupt 20% correction or a soft landing. The absence of the first leaves us with the second option. The question now seems to be, did the new highs of July mark the end of one consolidation and the beginning of a new upside leg. It is quite possible. Let us also underline that the NASDAQ joined the other indices in August by reaching a new all-time high as well. Almost 16 years after the tech bubble. This is a positive sign.

Unfortunately, there is always a flip side to good news. First, at an international level, the economic expansion will have to shake off its doldrums. Second, corporate earnings growth will have to resume. Third, we must put this Presidential election behind us with a favourable outcome. If these three difficulties were surmounted, then the markets could start a new upward cycle that could conceivably last for a few years. That said, a solid base is a prerequisite to start a new push upward.

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If we can consider the last two-year consolidation as a solid base for a renewed cycle, the fact remains that most investors apprehend the autumn. Even if this September was a bit shaky, we see a relative high level of confidence in the markets. Some experts would associate this with blindness, complacency and carelessness. We disagree. A good example is the way the VIX reacted after the Brexit result. After exploding in reaction to the shocking surprise, the VIX was beaten down to its median quarterly levels. Could we see another pullback in the stock market? If we do, this could set the stage for a proper start to a new bull leg. Otherwise, the spark needed could also come from one of the following factors:

The fading menace of the Donald

At the very least, the markets perceive the possibility of a Trump Presidency very unfavourably. The September mini correction coincided with a small surge in Mr Trump's polling numbers. That was enough for a grain of doubt to be planted in the investors psyche. The VIX surged but once again was well contained. Therefore, the questions must be asked: is a Trump victory even possible and even if it was, would it be catastrophic? Well, what happened in September and also following the Brexit are pretty good indicators. We believe his chances of winning are quickly vanishing and even if such a victory is possible, the impact on the markets will be limited to a knee jerk reaction. We believe that investors overestimate the Trump impact. A President cannot unilaterally abrogate an international treaty like NAFTA. It can surely initiate such a process and such a process would surely disrupt international capital markets, but it would have to be approved by both chambers at Capitol Hill. For now, Trumps support in recent polls is faltering and his fate could almost be sealed.

The end of the earnings recession

Earnings season for Q3 is starting and it will be interesting. Presently, we have an unusually high number of companies that went on the record with positive earnings pre-announcements. For now, a majority of analysts are calling for an end to the earnings slowdown. After five straight quarters of dismal reports, we should see a turnaround beginning this Q4 with earnings growth picking up. Despite currency grumblings, the consensus number for next year still stands at 11.4% growth for the S&P500. In Canada, due to a more stable environment in the commodity picture, analysts are now calling for a 22.7% growth rate in 2017 and 14.9% in 2018. These are pleasant numbers.

Conclusions and perspectives

A welcome return to a positive earnings growth environment goes a long way in explaining our subdued optimism for the long term. However, there is a strong probability that the markets will take a few steps backward before going forward. For this reason, we maintain an excess of 5% in cash equivalents and short term fixed income positions. In the face of climbing indices, our prudence explains our slight under performance for this quarter. We chose not to change our present stance as a potential pullback would represent an opportunity to plough back 5% to as much as 10% into equities. Recently, we were encouraged by healthy leading economic indicators coming out of the BRIC zone (Brazil, India, China and Russia), but we remain on the lookout following few unfavourable economic figures in the US, the normalization interest rate path of the Federal Reserve and the unwelcomed renewed bullishness of the USD.

The Alizé Capital Team