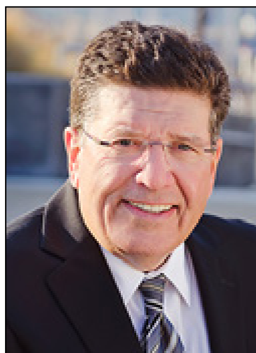
MARKET COMMENTARY



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Rate of Change

"If farming were to be organized like the stock market, a farmer would sell his farm in the morning when it was raining and buy it back in the afternoon when the sun came out"

- J.M. Keynes

John Maynard Keynes is known as the father of macroeconomics and is one of the most influential economists of all time. Keynesian theory reminds us to view markets with a wide lens and play the long game. *"Successful investing is anticipating the anticipation of others"* is my second favourite J.M.K quote.

You'll remember from previous newsletters that stock markets and to some degree bond markets are leading indicators of economic and business direction. That being the case the current volatility can be explained by the inefficiency of the market run up in January 2018. The 7.4% increase in valuation of the S&P 500 from December 29, 2017 to January 26, 2018 was just too much too fast to be sustained.

The stock market is an auction bringing buyers and sellers together to interact. Like all auctions if unrealistic buyers run up the bids a realistic group of sellers will take a profit.

The subsequent correction has given buyers a pause to reflect on the future of earnings. Earnings support stock prices. We are in the process of seeing first quarter earnings reports and they are very good, with increases averaging 20% +/- ahead of the first quarter in 2017. The market however has given all its January gains back and then some which makes me wonder if investors have it wrong and are selling the "sunny afternoon" in the hopes of buying back on a "rainy morning". It is tempting to attempt market timing however after 31 years of buying undervalued quality assets and exercising patience while the crowd changes its views on value has proven to achieve the required results.

"In the financial markets hind sight is forever 20/20 but foresight is legally blind, and thus for most investors market timing is a practical and emotional impossibility"

- Benjamin Graham.

So, if we're not smart to market time and we are smart to purchase "suitable securities at suitable prices", as per Ben Graham then currently here are a few examples of what I consider companies that we can accumulate for the rest of this business cycle.

- J.P. Morgan has reported earnings growth in excess of 20% year over year, a 19% return on equity and a capital spending program to expand earnings further.

- **Union Pacific Railway at $136.30 with a 2.1% dividend yield is poised to report earnings April 26, 2018. If we see weakness in the share price subsequent to the report, that would be an opportunity.**

- **Walmart reports May 17, 2018 and is making great strides in e-commerce. Share valuation is approximately 18% below its recent high and represents excellent value.**

- **Home Depot is another consumer discretionary stock with similar valuations to Walmart.**

Canadian companies begin reporting earnings in earnest in a few weeks and they are starting at lower valuations relative to U.S. companies. We have pipelines, banks, resources and real estate corporations that are valued well below their market peak of December 2017 and barely above valuations of 2007.

Determination of potential returns and hence the value of stocks is often measured against the rate of return on bonds. Recently the yield on 10-year bonds has been rising and has reached 3.03% in the U.S. and 2.37% in Canada. These rates are four times what they were in 2008 so we are getting back to a normalized relationship between debt and equities; however interest rates are not restrictive on economic growth at these levels. Bonds should be held in short durations as part of a portfolio allocation to provide liquidity and temper volatility. They still do not provide a real rate of return after taxes and inflation.

Most of us think of rising rates as the potential to receive higher returns on bond investments; however if you consider those rates as a higher cost of money for corporations and government's it becomes clear that the trajectory or *rate of change* **of our economies may begin to slow. That shouldn't come as a surprise as the stimulus of low interest rates begins to be reversed to more normal levels. The effect however is volatility in stock markets as investors try to anticipate the level of economic growth and corporate earnings over the next few years in a higher cost of money environment.**

I'm not sure when the current correction will be over and I wouldn't be surprised if our stock markets don't appreciate much until we digest a few more quarters of earnings. The fundamentals of stimulative economic policy globally and global GDP growth forecast by the IMF at 3.9% for 2018 and 2019 with persistently low inflation tells me to retain and add to good value companies to continue participation in this secular bull market.

The current market volatility is an adjustment to a lower rate of change in earnings and growth and in my opinion not an anticipation of a pending "bear market". Markets can perform very well for a long time at 3.9% global growth and 10-year bond rates below 4%.

All the best for spring,

Graham

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