Seymour Investment Management

January 15, 2018

Global equity markets rallied to a strong finish in December supported by favourable macro-economic conditions. The Canadian benchmark S&P/TSX Composite Total Return Index ('TSX') climbed 4.5% in the fourth quarter but underperformed the U.S. benchmark S&P 500 TR Index ('S&P 500')'s 7.5% return (6.6% in CAD dollar terms).

For the full year, the TSX produced a respectable 9.1% return but nevertheless lagged most major indices including the S&P 500, which returned 21.8% (13.9% in CAD dollar terms). The TSX's underperformance in part reflects the drag of Energy and Materials stocks, which together comprise more than 30% of the TSX. Of note, the Technology sector (+38.5% in 2017) contributed more than 40% of the S&P 500's gain, and the sector now comprises 23.8% of the S&P 500 Index. Following this period of underperformance, we view Canadian equities as more attractively valued relative to their U.S. counterparts.

Throughout 2017, investors expressed concerns related to political, geopolitical, and monetary uncertainty, stretched valuations, and the prolonged nature of the economic cycle and bull market. As we have written in previous commentaries, "the stock market climbs a wall of worry". This was clearly demonstrated once again in 2017 as global equity markets produced very strong returns in the face of these and other risks.

Global economy is now enjoying a synchronized economic recovery

The global economy found a very strong footing in 2017. Real GDP has accelerated in most countries and the global economy is now enjoying a synchronized economic recovery. According to Desjardins, "for the first time since 2007, all 45 countries surveyed by the Organisation for Economic Cooperation and Development (OECD) should post increased real GDP in 2017". The so-called 'Goldilocks economy' is running 'not too hot, not too cold, but just right'.

The U.S. Tax Cuts and Jobs Act is expected to further boost economic growth

At the end of the year, the U.S. passed the *Tax Cuts and Jobs Act (TCJA)*, which is expected to further boost economic growth. The merits of the legislation are debatable, particularly lowering personal income tax rates in light of a growing federal debt and deficit, but that is a subject for another letter. In our view, from an investment standpoint, the most significant aspect of the TCJA is the reduction in the U.S. corporate tax rate from 35% to 21%. This will bring U.S. rates in line with the rest of the developed world, including Canada. Most economists are predicting that GDP and corporate earnings will increase markedly as a result of the tax reform.

In addition to the lower corporate tax in the U.S., the TCJA has a provision to encourage (i.e. force) U.S. corporations to repatriate capital that currently resides in lower-tax, foreign jurisdictions (i.e. Ireland, Luxembourg, etc). It is estimated that some $2 trillion is held by U.S. corporations in such jurisdictions and it is highly probable that most of this capital will be repatriated and used for a

variety of activities including share buybacks, dividends, mergers and acquisitions and business investment. All of these activities will provide economic stimulus.

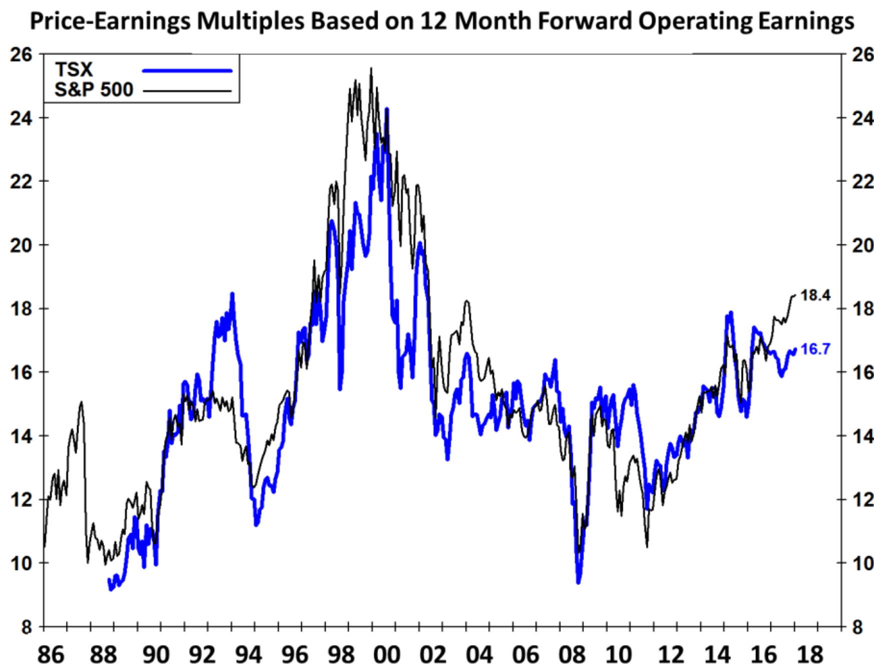
Canadian companies with significant U.S. revenues stand to benefit from U.S. tax reform

For Canadian corporations, the U.S. tax changes are somewhat of a mixed blessing. There is little question that Canada's competitive position has been materially altered by U.S. tax reform. Under the previous tax regime, Canadian companies enjoyed some competitive advantages vis-à-vis their U.S. counterparts (including a lower corporate tax rate). These advantages have been mitigated by the tax reform. On a positive note, many Canadian companies have significant revenues in the U.S. (and pay U.S. corporate taxes) and these companies stand to benefit from U.S. tax reform (at least in the short term).

Macro conditions provide a favourable backdrop for equity markets

Macro conditions continue to provide a favourable backdrop for equity markets. Strong economic growth, modest inflation, and the availability of credit at very low interest rates have contributed to strong profit margins and corporate earnings growth. That said, equity market returns are a function of both earnings growth and the price that investors are willing to pay for that earnings growth. It is true that valuation expansion has played a role in driving strong equity market returns, as demonstrated by the chart below which illustrates the expansion in forward Price-Earnings (P/E) multiples.

Exhibit 1:



Source: TD Securities

Valuations for most asset classes globally are now at the upper end of their historical range

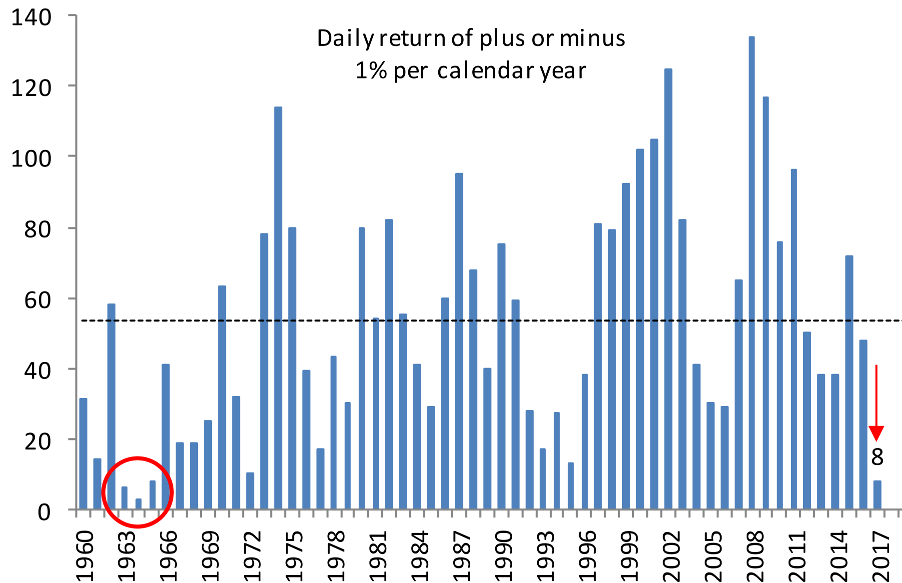
Broadly speaking, valuations for most asset classes globally are now at the upper end of their historical range, which can partially be explained by historically low interest rates. Valuations can remain above or below historical averages for long periods of time and historically, valuation has been a poor predictor of equity returns in the following 12 months. The predictive power of valuation multiples rises when one looks out longer-term (i.e. 10 years) and is one reason that we expect more modest equity returns over the next decade.

Volatility may be higher in 2018

Several strategists have suggested that stretched valuations, coupled with continued political, geopolitical, and monetary uncertainty, may contribute to higher volatility in the year ahead. We concur that volatility should be higher in 2018 largely because volatility was exceptionally low in 2017, as the chart below illustrates.

Exhibit 2:

Volatility (S&P 500) - # of Trading Days with Move Greater than 1%



Source: Scotiabank GBM Portfolio Strategy, Bloomberg

As we have written in past letters, volatility and market corrections are a normal part of equity investing that investors should not fear. For patient investors, market corrections create buying opportunities. They are also the reason why equity investing requires a long-term time horizon.

Secular bull markets typically span 15 years or longer

We believe we are in a secular bull market which began in 2009. Secular bull markets typically span 15 years or longer, and within a secular bull market there will be a number of shorter-term 'corrections'. This was true of the last secular bull markets of 1959 – 1966 and 1982 – 2000, and has been true of the current bull market that began in 2009.

Market corrections are very difficult to predict

We have also written in past letters on the topic of market timing. We believe it is extremely difficult to time market corrections, a view well-supported by academic research. Predicting market corrections is very difficult, in part because they are often triggered by unforeseen events.

Although examining historical market cycles can help understand the current economic and market cycle, no two cycles are the same. A common thread, however, is that secular bear markets tend to be triggered by recessions. As we noted previously, the economy remains very strong and the current macro environment remains supportive of equity returns. That said, there is little question that the economic cycle is maturing.

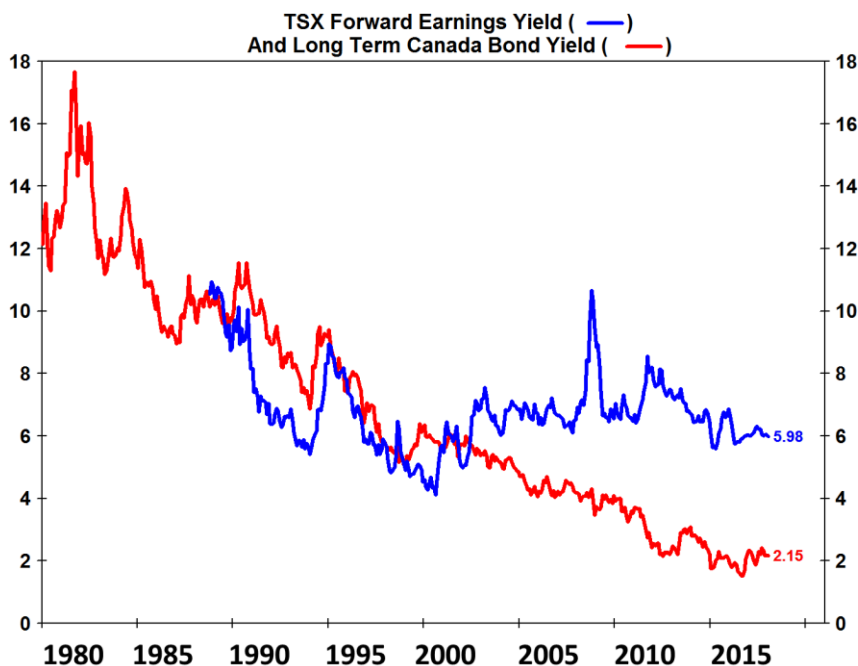
Inflationary pressures are starting to build

With both the U.S. and Canadian economies running close to full potential, there is evidence that inflationary pressures are starting to build. Following strong employment reports we anticipate that the U.S. Federal Reserve and the Bank of Canada will continue to hike interest rates, albeit at a measured pace. We expect the Bank of Canada will move cautiously with rate hikes given its

We expect bond yields will continue to move higher

concerns about high consumer debt levels, the housing market, trade uncertainty, and the strength of the Canadian dollar. With inflation expectations moving higher and continued monetary and quantitative tightening, we expect bond yields will continue to move higher. Higher interest rates will be somewhat of a headwind for asset prices broadly; however, in a rising rate environment equities are likely to outperform bonds. As the chart below illustrates, equities continue to look attractively valued relative to bonds.

Exhibit 3:



Source: TD Securities

We continue to encourage our clients to ignore the market noise and follow a buy-and-hold investment approach

The secular bull market that began in 2009 continues to evolve, and we can expect corrections along the way. Investors that attempt to time the market may find that they miss some of the solid equity returns that tend to characterize the later stages of the economic and market cycle. We continue to encourage our clients to ignore the market noise and follow a buy-and-hold investment approach by investing in high-quality companies that they can hold for the long term.

Market corrections are a normal part of investing and history suggests that we should expect a market decline of 10% or more every 12 – 18 months. In our view, the best way that investors can prepare themselves for a correction is to understand that corrections will inevitably occur and make sure that they have sufficient liquidity to meet ongoing obligations without having to liquidate investments in the event a correction does occur. Investors should maintain an appropriate asset mix, diversify, invest in high-quality, well-capitalized companies, and have the fortitude to remain invested through downturns.

As always, we welcome any feedback. We would like to take this opportunity to thank our clients for their continued support and wish you a happy and healthy year in 2018.

Warm regards,

The Seymour team