Seymour Investment Management

July 17, 2018

North American equities performed well in the second quarter of 2018 on the back of broad-based strength in the global economy and corporate earnings. The Canadian benchmark S&P/TSX Composite Total Return Index ('TSX') rose 6.8% in the quarter, led by a rally in resource stocks and cyclical equities. The U.S. benchmark S&P 500 TR Index ('S&P 500') climbed 3.4%, or 5.4% in Canadian dollar terms after adjusting for currency. Year-to-date, the TSX is up 1.9%, while the S&P 500 is up 2.6%, or 7.2% in Canadian dollar terms.

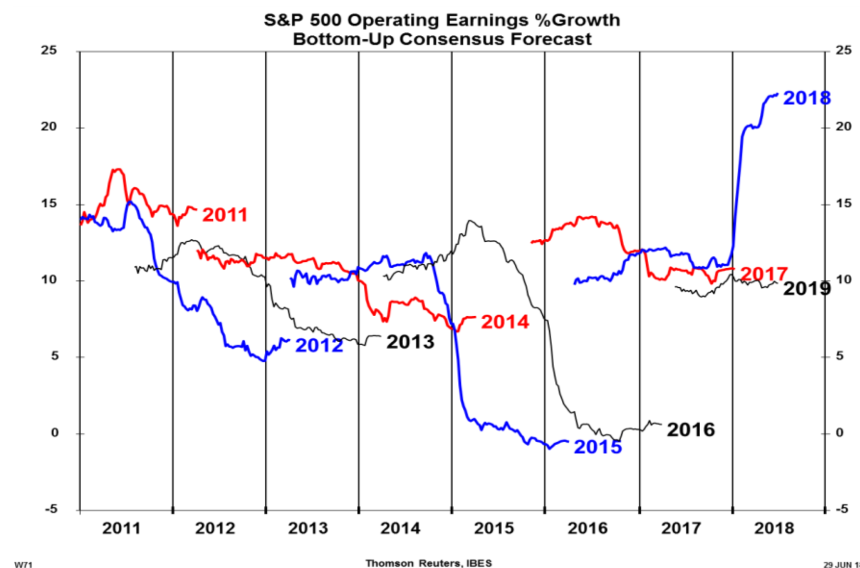
Historically-low interest rates have supported a prolonged economic cycle

For some time, the economy has been operating in a sweet spot where growth has been running 'not too hot, not too cold, but just right'. Historically-low interest rates have supported a prolonged economic cycle (8.5 years of uninterrupted growth following the *Great Financial Crisis*) and a remarkable recovery in employment. A strong economy, low inflation, and the availability of credit at low interest rates have created a favourable macro backdrop for corporate earnings growth. Companies in a wide variety of industries are growing revenues while maintaining attractive profit margins, and solid earnings growth has translated into attractive equity returns.

Reported earnings are exceeding expectations

U.S. economic growth has recently reaccelerated, boosted by tax reform and fiscal spending following the January 1 implementation of the *Tax Cuts and Jobs Act*. Reported earnings are exceeding expectations and analysts are raising estimates.

Figure 1: S&P 500 Earnings Growth Based on Analyst Consensus Estimates



Source: TD Securities Inc.

The current bull market has frequently been described as 'the most hated bull market in history'. Part of the reason for the subdued investor sentiment is that equity markets are forward looking, and there is little question that we are now in the later stages of the economic cycle.

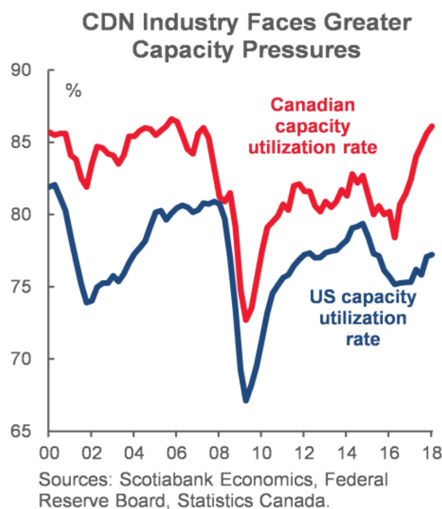
When we talk about 'late-cycle conditions', we are referring to the latter stages of the business cycle when the economy is operating close to its full economic capacity and inflationary pressures start to emerge. This phase of the cycle tends to be associated with the development of excesses; euphoric behavior; easy lending conditions and covenants for borrowers; and stretched asset valuations. At this stage in the cycle, central banks begin to gradually remove stimulus and raise interest rates in an attempt to slow the economy and stave off inflation to prevent the economy from overheating. At the same time, central banks hope to avoid slowing the economy so much that it enters a recession. Late-cycle monetary policy tends to be a delicate balancing act, ripe with potential for policy error.

The North American economy appears to be operating close to its economic potential

For several years, we have listened to management teams recount challenges in attracting and retaining talent. Labour is tight, as evidenced by unemployment rates that are hovering near multi-decade lows in both the U.S. and Canada. The North American economy appears to be operating close to its economic potential (Figure 2). After a prolonged period of sluggish pricing growth, inflationary pressures have started to emerge.

Inflationary pressures have started to emerge

Figure 2: North American Economy Facing Capacity Pressures



We always knew that historically-low levels of interest rates could not be sustained, although few predicted rates would remain as low as they have and for so long. The U.S. Federal Reserve began hiking its benchmark short-term interest rate in late 2015 in an effort to return interest rates to more normalized levels. Last month's quarter-point hike marked the seventh rate hike in the current tightening cycle. The Fed has indicated a likelihood of two more rate increases in the second half of 2018, followed by a continuation of gradual tightening in 2019.

As we have discussed in previous commentaries, valuations of risk assets tend to come under pressure during periods of rising interest rates. Whereas the impact of higher interest rates is relatively straightforward for bonds (i.e. higher interest rates will result in lower bond prices and returns), the impact on equity prices is more nuanced. If bond yields rise (i.e. interest rates rise), then investors will require a higher return from equities. This higher required return, or lower multiple, on equities can depress stock prices. The negative impact of higher interest rates will not be felt equally across all industry sectors. Low-growth, interest-sensitive stocks (i.e. utilities, telecom stocks, and REITs) tend to be more impacted.

In Canada and elsewhere around the world, central banks have been slower to hike rates than in the U.S. While economic data remains positive and supportive of the removal of stimulus, the Bank of Canada has cited concerns related to record levels of household debt, the housing market (following the implementation of new mortgage rules), and more recently, trade uncertainty for its cautious approach to interest rate hikes.

Diverging monetary policies and heightened risk aversion have contributed to a strong U.S. dollar relative to other global currencies. Broadly speaking, a weak Canadian dollar is positive for the Canadian economy (because it makes Canadian exports more competitive) and for corporate earnings of many Canadian-domiciled companies (that generate significant revenues in the U.S.).

Canada's reliance on trade with the U.S. has become a risk factor in the short term

Canada's reliance on trade with the U.S. has become a risk factor in the short term amid rising trade tensions. Following seven rounds of unsuccessful NAFTA negotiations, the U.S. announced tariffs on steel and aluminum imports and a host of Chinese goods. Retaliatory measures taken by the U.S.'s trading partners including China, Canada, Mexico, the EU, and Russia, have escalated trade frictions. Although the tariffs announced to date are only expected to make a modest dent in the economy, trade uncertainty will cause some companies to delay business investment decisions or make sub-optimal supply chain decisions. The U.S. is reportedly considering imposing import tariffs on auto imports, which some believe would lead to an escalation of retaliatory measures that could result in an all-out global trade war.

Global growth will continue in some form, and trade tensions will ultimately be resolved

A revised NAFTA agreement appears unlikely in the near term following the recent election of a new Mexican president and with midterm U.S. elections approaching. Unfortunately, the longer that protectionist measures prevail, the greater the likely economic impact. Although we don't know how the trade dilemma will play out, what we do know is that global growth will continue in some form, and trade tensions will ultimately be resolved. New trade agreements will eventually be signed and supply chains will adjust. We are confident that the senior executives managing our companies will remain nimble, be proactive where they can be, react when necessary, and adapt.

We have been asked what specific measures we are taking in client portfolios in response to heightened trade uncertainty. At the risk of sounding complacent, the truth is that we have made very few changes in recent months. While it might seem intuitive that our short-term macro outlook should drive our investment decisions, in reality it rarely does.

Risk management is an ongoing process at Seymour

As portfolio managers, we view our role as two-fold: to achieve attractive investment returns while managing risk. Risk management is an ongoing process at Seymour. We continue to advocate:

Appropriate asset mix – Clients with near-term liquidity needs should retain cash to fund required expenditures, rather than rely on equity investments.
Quality – We invest in high-quality companies with strong management teams that have attractive business models and are well-positioned to grow their earnings and cash flows on a sustained basis over the long term.

Monitoring valuation risk – We try to avoid areas of the market that we believe are overvalued and invest in stocks with reasonable valuations.

Diversification – We continue to monitor concentration risk in client portfolios, diversifying portfolios across holdings, industry sectors and geographies.

Limiting resource exposure – Commodity prices are inherently unpredictable. This can lead to weak financial results and poor capital allocation decisions by even the best management teams, as evidenced by industry's poor track record of generating appropriate returns on invested capital.

To be clear, economic indicators are in no way pointing to the likelihood of an imminent recession. While some investors have pointed to the flattening yield curve as cause for concern given inverted yield curves typically precede recessions, if the yield curve were in fact to invert (which it hasn't), there is some question whether this in fact would be a reliable indicator. Large-scale bond purchases by central banks have depressed bond yields in recent years. Moreover, in a scenario where risk aversion rises or U.S. growth remains strong while global growth falters, a flight to safe-haven Treasuries could push down long-term bond yields.

The current economic expansion could continue longer than most expect

The current economic expansion is the second-longest in history going back to 1855. As Macquarie economists note in a July 9, 2018 publication entitled *The Longest Most Durable Expansion in History*, "expansions do not die of old age [but] rather they come to an end as a consequence of a combination of imbalances in the economy and policy error". Furthermore, economic expansions have been increasing in length for several decades (Figure 4). It is entirely conceivable that the current expansion could continue longer than most expect. Fundamentals remain strong and economic data remain healthy.

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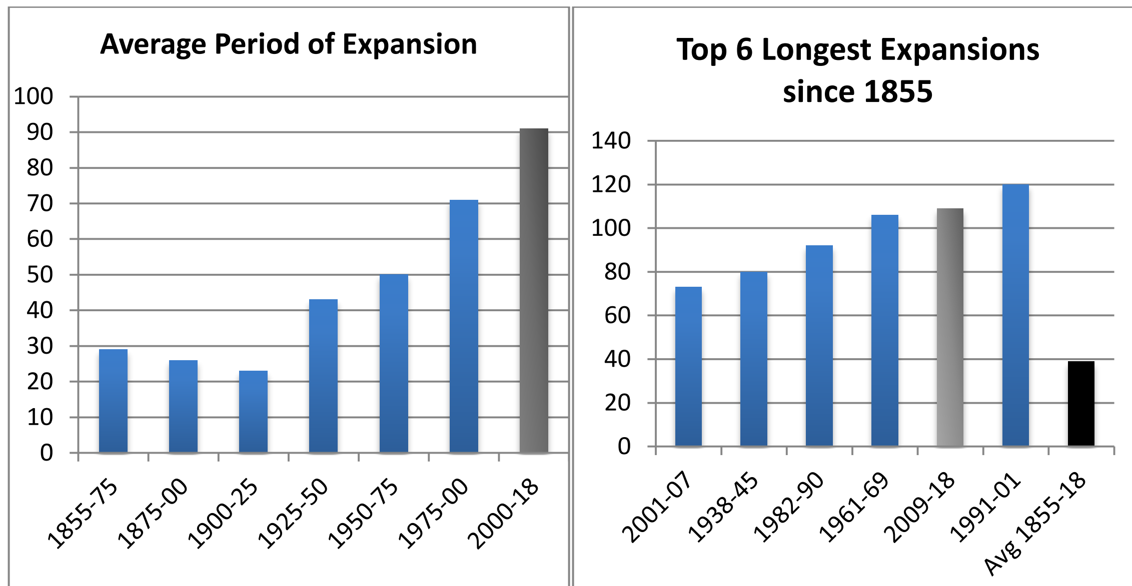
Figure 3 & 4: Historical Economic Expansions (in Months)



Source: NBER, Macquarie Research, July 2018, Seymour Investment Management

As we look forward, there are reasons for caution (i.e. household debt; the housing market; inflationary pressures; policy risk; trade uncertainty; and financial pressures in emerging markets and the Eurozone) but also reasons for optimism. If we look back at eight years' of quarterly client letters, we are reminded that there are always risks and uncertainties that come and go, intensify and lessen, and morph into new and unexpected challenges and opportunities. At Seymour, we have consistently strived to remain disciplined and avoid knee-jerk reactions, knowing that short-term economic and market predictions are likely to be wrong. As we have reiterated in past commentaries, it is extremely difficult to predict the outcome of macro events and the timing of market corrections.

Valuations have recently contracted because equity returns haven't kept pace with corporate earnings growth

We continue to focus on finding high-quality companies with strong management teams that have attractive business models and are well-positioned to grow their earnings and cash flows on a sustained basis over the long term. We are confident that over the long term the shareholder value that these companies create will ultimately be reflected in their share prices. We try to buy great companies at reasonable valuations, and notably, valuations have recently contracted because equity returns haven't kept pace with corporate earnings growth and now appear more attractive.

As always, please feel free to contact any member of the Seymour team with questions or feedback. We wish everyone a safe and happy summer.

Warm regards,

The Seymour team