Investing Wisely

A Newsletter from Mike Wise

May 2018

I will be in Calgary from May 16 until June 1. Please call me at 403-616-3434 or email me at mikewise@wiseword.ca to set up an appointment.

Our stay in Paradise is coming close to an end. Carmen and I will fly back to Costa Rica in early June to pack up all our belongings. We will return to Calgary late in the month, dog included, and re-establish our life in the Great White North. While there were some bittersweet moments, all in all it was quite an adventure, and I have no regrets that we tried to experience our dream.

I think the true regret would be if we hadn't tried it!

I thank you, and all my other clients, who had to put up with what were sometimes less-than-adequate lines of communication.

Where We Are

Table 1 shows how various asset classes are performing in 2018.

Monetary policy (actions of the central banks) dominates the financial world.

The interest rate on the US 10-year Treasury bond – the most widely-traded security in the world – moved from 2.46% at the start of 2018 to 2.74% at the end of April.

The DEX Universe bond index, which is Canada's best index of interest rates, started 2018 at 2.47%, and is now at 2.70%. Rising interest rates are bad for bond prices. The DEX Universe Bond Index, which includes both interest received and changes in capital value, is down -0.8% so far this year. The Canadian Prime Rate, which is the base for most variable-interest-rate loans, now sits at 3.45%.

Table 1
2018 Returns - Year to 30 April

	30 April Price	YTD Change
Equities		
TSX (CAD)	15668.93	-3.3%
S&P500 (USD)	2669.91	-0.1%
Commodities		
Oil (WTI; USD)	$68.10	12.7%
Gold (Comex; USD)	$1323.40	1.1%
Fixed Income		
DEX Universe Bond Index (CAD) - Total Return	1028.1	-0.8%
-Interest Rate	2.70%	0.23%
Best 5-yr GIC Rate (rate as of Mar 7)	3.12%	0.35%
Exchange Rates		
USD/CAD	$0.7797	-$0.0154
EURO/CAD	$0.6429	-$0.0196

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The Canadian dollar has weakened a bit this year. That will be the subject of a whole section later on in this newsletter.

The WTI oil price continues to show strength and is up 12.7% so far in 2018. Gold is also up this year.

The Toronto TSX Index reached its 2018 high on January 4. It is now trading down -3.3% on the year.

So far this year the German DAX index is down -2.6% (measured in Euros), and the London FTSE100 index is down -2.4% (measured in pounds). The Nikkei index in Japan is down -1.3% (measured in Yen).

Most client portfolios have a mixture of stocks and bonds. I use the Globe Canadian Neutral Balanced Peer Index as my primary performance benchmark. That benchmark was down -1.4% to the end of April. It is hard to get into positive territory when both Canadian stocks and Canadian bonds are down!

> The Globe Canadian Neutral Balanced Peer Index was up 5.5% last year, and is down -1.4% to the end of April. It is hard to get into positive territory when both Canadian stocks and Canadian bonds are down!

Where We're Heading

Nothing much has changed since my previous newsletter: the story this year will be the battle between strong economic growth, which should support stock market prices, and rising interest rates, which will dampen market prices.

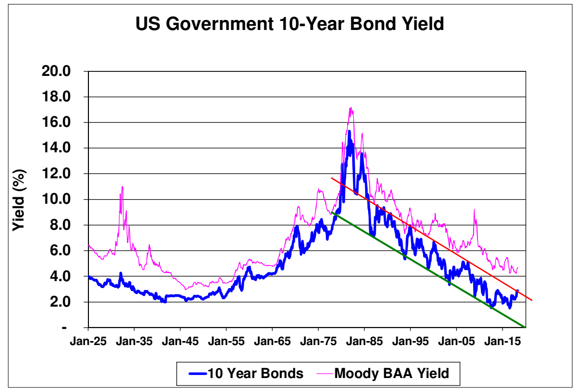
Recall that I consider Mr. Market to be manic depressive. We can expect violent swings in the market as his mood changes from optimism to pessimism and back again.

Let's look at these factors in more detail. I will focus on the US, because the US is the elephant, while Canada is an insignificant lemming that tags along. I use the term lemming because if the US stock market falls off a cliff, the Canadian market will fall off the cliff too!

Interest Rates

Chart 1 shows the path of the US 10-year Treasury Bond. As mentioned before, this is the most widely-

Chart 1
Source: US Federal Reserve



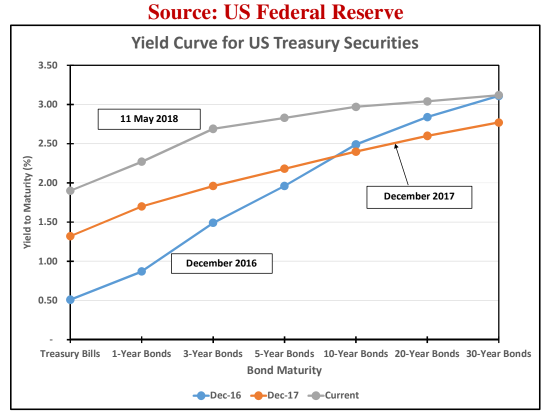
traded security in the world, and all other bond prices are set relative to this bond.

As is obvious from Chart 1, bond yields have been going down ever since 1982 – a 35-year span that encompasses the investing time horizon for most of us. It also encompasses the time horizon of every professional bond trader in the world: the pros have never seen an extended period of rising interest rates. This will have a profound effect, as what has worked for them in the past will no longer work.

Way over on the right side of the chart, the blue line of interest rate is touching the red trend line ("resistance" in technical analysis terms). Are we now in a long period of rising interest rates? Or is this another of the periodic bursts within a regime of ever-declining rates? We don't know.

It is well-known that the single best leading indicator of an approaching recession is the interest rate yield curve. A sharply-sloping curve, such as that shown

Chart 2
Source: US Federal Reserve



for December 2016 in Chart 2, is positive for business and the economy. The US Federal Reserve can control the short end of the curve, while market forces control the long-dated end of the curve. If the Fed wants to slow down an over-heated economy, it raises the short-end yields, thereby flattening the slope. In extreme cases the Fed can push short rates higher than long term rates; this inverted yield curve is the signal of an approaching recession.

Although the yield curve is taught in every economics class, it tends not to get a lot of attention. Not this year. I have never seen so much focus on the shape of the yield curve. As you know, professional traders try to anticipate trends, and try to get in front of the trend. This new-found focus on the yield curve could result in a self-fulfilling prophesy: if traders think that the yield curve may invert in the near future, they will act upon it now and cause the very reaction that they were anticipating!

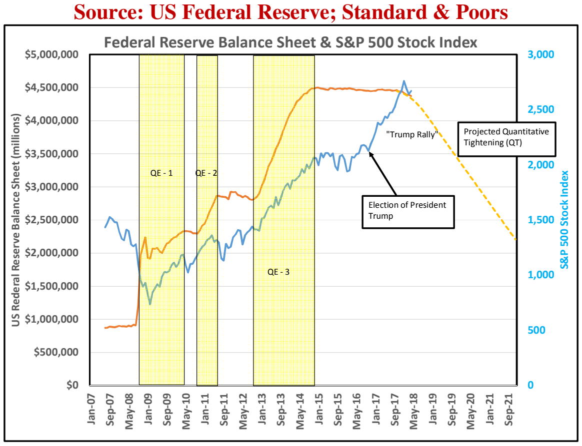
You can see on Chart 2 that the yield curve for December 2017 is flatter than that of a year earlier, and that the May curve is flatter still.

The Fed is on record as saying that it wants to raise short term rates by another ¾ % by the end of the year. If that happens, and short rates reach the 3% level, the curve will be flat. Dangerous times lie ahead!

My previous newsletter showed a chart that indicated a correspondence between the amount of securities purchased by the Fed during their successive rounds of "Quantitative Easing" (money-printing to you and me), and the return from the US stock market. Chart 3 updates that previous chart.

Chart 3

Source: US Federal Reserve; Standard & Poors



The Fed is now in a mode where they are planning to sell those securities bought during QE. This is the opposite of QE: By selling the bonds, they are removing the cash they receive from circulation in the economy. Chart 3 shows a dotted line that indicates the projected level of Quantitative Tightening (QT) over the next 4 years.

The correspondence between QE and stock market returns is not cut-and-dried. The Trump Rally kind of spoils what would otherwise have been a good story. We don't know yet how Mr. Market will react to having less cash washing around the financial system as a result of QT. My gut instinct says that he won't be pleased!

Economy

The US and Canadian economies are doing fine. I'll have a look at my usual favourites. Manufacturing overtime hours looks at blue collar workers. Management will prefer to boost overtime during good times rather than hire new permanent employees, and will prefer to reduce overtime when things get tight, rather than let good people go. Employment at temporary help agencies looks at much the same thing, but for white collar administrative staff. Both provide good leading indicators for economic conditions.

Chart 4 shows overtime in manufacturing industries. Overtime has shown a nice uptick over the past few months. Businesses must be doing well! I haven't shown it on this chart, but total private-sector

Chart 4

Source: US Bureau of Labor Statistics

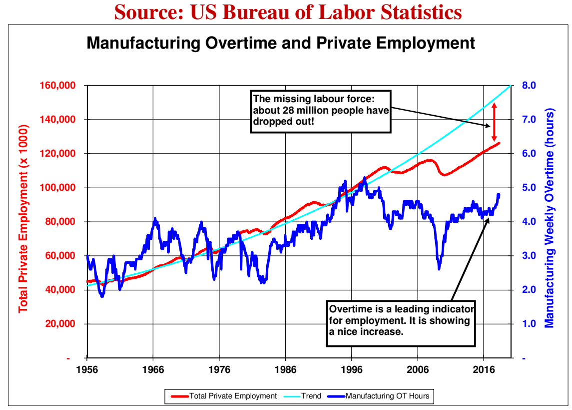
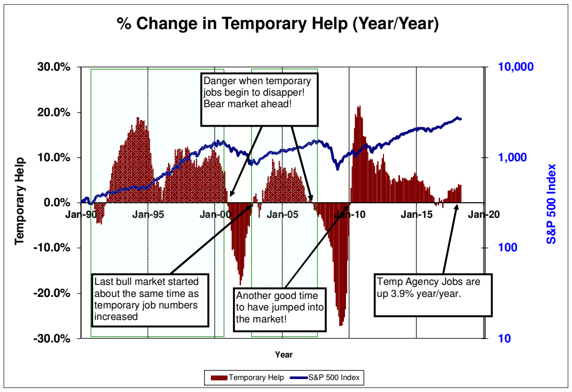


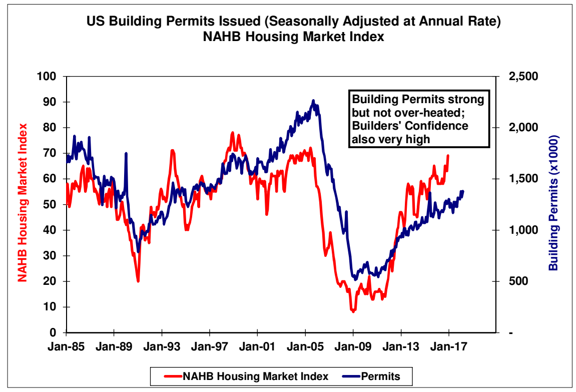
Chart 5
Source: US Bureau of Labor Statistics



employment in the US grew by 2.3 million over the past 12 months. (Employment by governments only increased by 3,000 in the same period.) The US is experiencing employment growth *and* increasing overtime for those employed. Definitely a good thing!

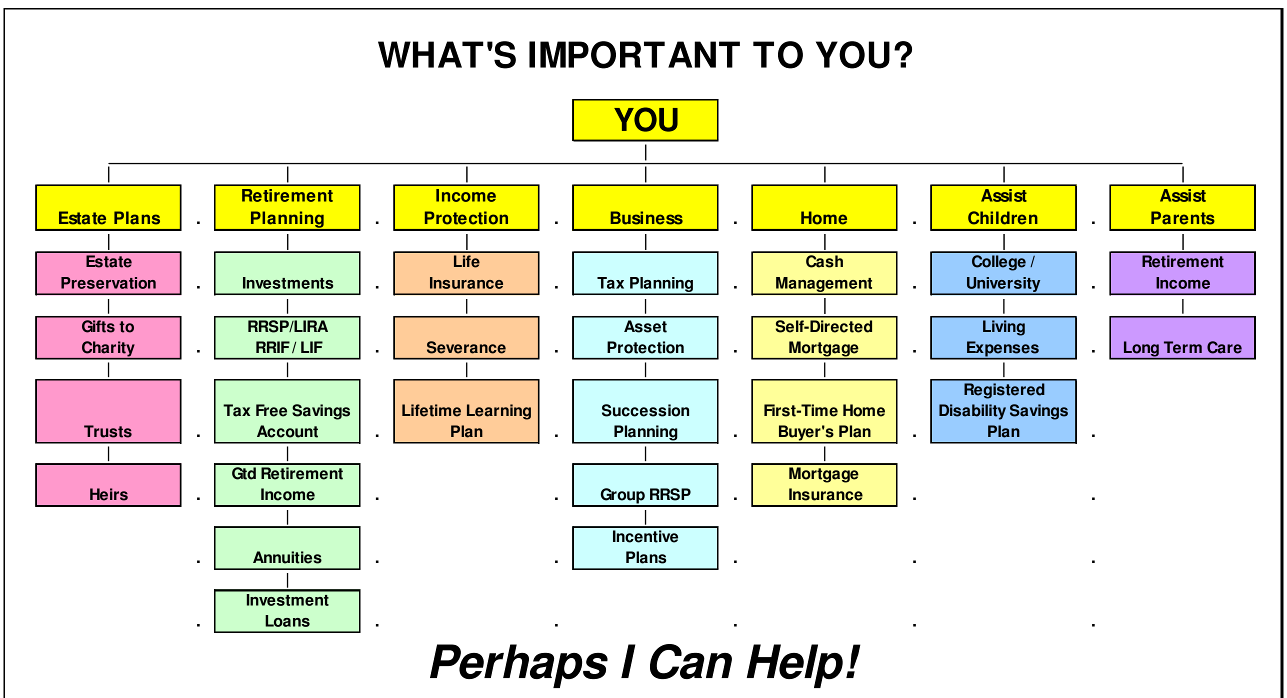
Chart 5 shows the year-over-year change in employment at temporary agencies. The latest data shows a 3.9% increase in employment versus April of 2017. This is another sign of an economy that is doing well.

Chart 6
Source: US Census Bureau; National Association of Home Builders



Finally, let's look at Housing. New home construction is important; its effects ripple throughout the economy. Anyone who has built or moved into a new home knows that the cost of the actual building is only the start of the expenses. A new home needs new appliances, new draperies, and probably new furniture. Almost certainly the yard needs to be landscaped.

Chart 6 shows data from 2 different sources. The red line shows the confidence of home builders. A reading of >50 indicates that builders are happy with the future outlook of their industry; below 50



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indicates that they are pessimistic about the future. The current reading is 70. Home builders are happy!

The blue line on Chart 6 shows new permits for home construction. Permits are a necessary precursor to actual construction, and are therefore a good leading indicator for future construction activity. What we see in Chart 6 is a robust, but not over-heated, level of home construction permits. I'd characterize this as kind of a goldilocks situation: neither too hot nor too cold.

Canadian Dollar Exchange Rate

Canada is a major oil producer. It is the 7th largest producer of oil in the world, with 2016 production averaging 3.7 million barrels per day. Much of this production is exported, primarily to the United States. Canada is the 4th largest oil exporting country (2015 data). Those exports are priced in US dollars.

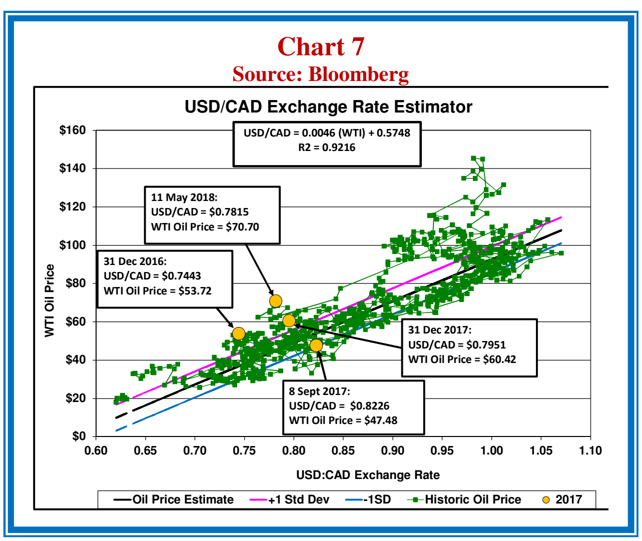
It is therefore no surprise that the world sees the Canadian dollar as a petro-currency. A simple 1-factor equation explains 92% of the fluctuations in the USD/CAD exchange rate:

$$USD/CAD = 0.0046 * WTI + 0.5748$$

Where:

USD/CAD is the US:Canada exchange rate;

WTI is the West Texas Intermediate oil price in US dollars



According to the formula, the looney will fluctuate by about ½ cent for every dollar that the WTI oil price moves up or down.

Chart 7 shows the history of the oil price and the USD/CAD exchange rate since 2002. The thick black line represents the equation, while the 2 parallel lines mark 1 standard error of estimation above and below the trend. If you remember your statistics, in a normal distribution roughly 2/3 of all outcomes will lie within 1 standard error of the trend.

I have highlighted 4 data points with gold circles. Two show the oil price/exchange rate position at year-end 2016 and 2017. Another gold dot shows that as recently as September 2017 the looney was trading at a premium relative to where the equation predicts it to be.

The last dot represents the most recent oil price and exchange rate: $70.70 per barrel and USD/CAD at 0.7815. You can see that this dot is well outside of the "expected" range of values. What has happened?

I think that 2 factors have come into play.

First, most Albertans already know that there is a significant discount between Western Canada Select crude oil and West Texas Intermediate crude oil. The May 11 WCS price was $50.38, while WTI was $70.70, for a discount of $20.32 per barrel. Canada exports around 3.2 million barrels per day, so that discount amounts to a loss in potential revenue of US$65 million dollars … money that never reaches the pockets of Canadians. Multiply that figure by 365 days a year, and pretty soon you are talking real money!

Why the discount? Refiners would say that WCS crude is heavier, and harder to process than the lighter WTI crude. There are also hefty transport charges to ship oil from the oil sands to refineries in Texas. (Let's not get into the obstacles that would be put up by regulators and environmentalists if anyone actually tried to build an oil refinery in Canada!)

The WCS discount is well-known, and up to now hasn't affected the equation of exchange rate.

The second factor I think is more important. I think that market players may have come to the conclusion that western Canada oil will NEVER make it to tidewater on either the east or west coasts. The western Canadian production will remain forever landlocked, with only one potential customer: the United States.

The looney is now being valued as if the oil price were $45 per barrel – not far off the actual WCS price of $50.38. This may become our new reality.

How does this affect you, me, and every other Canadian? Simple: it makes us all poorer. Everything that we import, either through buying the item at a store or indirectly through the supply chain, costs more when the currency is weak. Those who profess to like a weak dollar must also believe that Zimbabwe is rich and Switzerland is poor!

Were we to use the equation to predict where the looney should be, we find that the USD/CAD exchange rate should be 90c, not 78c.

According to Statistics Canada, last year Canadian imports amounted to CAD573.5 billion, or $16,000 for every Canadian. The opposition to pipelines is costing every man, woman and child in this country about $3,700 per year because the reduced value of the looney leads to higher prices in the store.

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Interest Rate Special

Do you have any cash sitting in a bank account earning next to no interest? Here's a great opportunity to put that money to work!

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Please call me at 587-329-1659, or email me at mikewise@wiseword.ca if you are interested.

Mike the Bartender