QUARTERLY COMMENTARY

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The China Syndrome

So the TSX has almost recovered back to its all-time high of last April and the US markets have just breached theirs and look to go higher – all during a very nasty trade war, with trouble brewing in the Persian Gulf, and political disarray just about everywhere. What is going on? I say that the recent move to new highs in the US might possibly end up being what's called a fake breakout. In order for the markets to continue to make meaningful gains, the trade war needs to be resolved and investors need to be convinced that the US is not about to fall into a recession. Here in Canada, the economy seems to be recovering from the recent slowdown. We've had a stronger-than-expected rebound from a slowdown that nearly brought the economy to a halt in late 2018 and early 2019. Falling mortgage rates, continued employment strength and growing business investment have pushed our economic growth rates higher than expected. Our central bank's updated projection is for annualized economic growth this year of 1.3 per cent, and an expansion of 1.9 per cent in 2020 so according to them there isn't any recession in sight.

The US and Canada are really in different places in the economic cycle – mostly because we were affected much more by the drop in energy prices (which have recovered quite a bit) and then there was Trump's take-no-prisoners trade tariffs and "negotiations". Now that the new NAFTA has been signed (although not yet approved by Congress) and the tariffs have been withdrawn there is much greater business certainty and confidence here in Canada.

Our central bank isn't planning on reducing interest rates right now, while the Fed has just indicated that it will. U.S. rates at 2.5 percent are well above Canada's 1.75 per cent. A combination of Fed easing, China stimulus and trade-war ceasefire (they're talking again at least) could make the recent yield curve inversion (lower long term rates than short term) a false recession signal.

In a recent economic insight piece, T. Rowe Price concludes that the risk of a recession is muted in the U.S. since key economic signals indicate an aging expansion rather than any imminent downturn. Indeed the current economic expansion is the longest in U.S. history – over 10 years. It's not really been the best one though because the pace of growth and the total growth in this cycle is not as great as in past cycles.

What's more, in past booms there were major shifts toward freer markets in some areas of public policy such as income tax cuts or capital gains tax cuts. In the 1990s policy makers held down government spending and increased free trade. By contrast the current expansion happened in spite of tax hikes and more regulation. These are the opposing factors that are at work now.

The good news is, in past rate cutting cycles going back to WWII, the S&P 500 has gained on average 10.3% in the first six months after the first interest rate cut and 14% a year later. The potential problem I see is that quarterly earnings reports will be coming out shortly and the forecast is for profits to decline. If they are worse than expected the US market could easily sell off even with rate cuts coming. The global trade war is no little matter. Trade war uncertainty has really affected business confidence badly which is why business spending in the US has basically come to a halt after healthy growth in 2018.

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Investors who blithely think that lower interest rates by themselves will always make stocks go higher may be mistaken this time. Although a rate cut in the US will help to lower the value of the dollar and thus help US exporters and more highly indebted companies (including many smaller firms) good news on the trade front will be necessary for this market going forward. And if interest rates aren’t cut three times this year like the markets are expecting, watch out.

With regard to how to invest at this stage, it's best to stick with high quality companies – those that are able to produce what we call stable free cash flow growth. Companies that do this can amongst other things increase their dividends, buy back shares and boost their earnings per share, reinvest in the business and pay down debt to maintain a healthy balance sheet.

If you have any questions about your portfolio or any changes you would like to discuss, please don’t hesitate to contact my office at any time.

Sincerely,

Richard