The Market in Review

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This week's articles and insights

1. *Back From the Brink*
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"Don't worry about the world coming to an end today. It's already tomorrow in Australia."

- ***Charles Schultz***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	21,675	-0.84%	+9.67%
S&P 500	2,477	-0.65%	+8.34% (+1.31% in $CDN)
TSX	15,258	-0.53%	- 2.19%

Back From the Brink

The world didn't end this week. As a result, markets went up.

Both North Korea and the US stepped back from the brink of war, which allowed the tensions to cool enough to consider a diplomatic solution to the current crisis. China has finally gotten serious about cutting off trade with its tiny neighbour, which likely played a part, as well.

Big declines in the markets are usually linked to central banks raising interest rates and the resulting recessions. Geopolitical tensions are just speedbumps causing temporary heartburn.

The Ned Davis Research group looked at world events going back to 1907 and the subsequent performance of US stocks. They found the decline and recovery period is quite short, on average:

- 6.6% Mean return of US markets during the crisis
+ 3.8% Average returns of the US market one month later
+14.2% Average return one year later

In other words, it has been a better strategy to "buy at the sound of cannons" when a crisis erupts.

On the domestic front, it seems backward that Canada, a country with a leader that is almost universally loved, has a stock market that is down for the year. Yet the US, with an increasingly isolated leader, is enjoying a strong year for stocks.

The reality is that many business sectors in the US are enjoying record profits and Washington is just a sideshow. The US economy is $18 trillion in size and what happens in Washington doesn't matter. At this point, anyway. Housing, aerospace, pharmaceuticals, and technology are all enjoying record profits down south, while energy and weak exports have hurt Canada. There may come a time when President Trump runs out of people to fire or criticize and then finds it impossible to get anything done. That will be the time when politics and markets collide.

For now, we have just passed an excellent earnings season and the risk of global recession is falling, not rising. Unemployment in France just hit a 5-year low, which suggests Europe is slowly putting the Greek disaster of a few years ago behind it. August and September are traditionally the weakest months of the year, though, so coupled with paralysis in the White House, there could be bumps in the weeks ahead.

Peak Oil or Peak Demand?

We seem to spend an inordinate amount of time discussing oil in these letters. Energy accounts for 20% of all Canadian exports, so what happens to oil and gas are a big deal up here. The world runs on oil, and the US is on the verge of becoming the world's largest oil producer, as well. Energy is meaningful to every country.

Oil and gas stocks have been very weak this year, despite oil's price stabilizing at close to US $50 per barrel. Many analysts say this is because US $50 is the cost of the average shale well, and unless prices go higher, these companies won't ever make much money. Both the shale and oil sands producers have been very clever about reducing costs, though, so they will find ways to be profitable eventually – even at these prices.

Another theory that is creeping into the popular consciousness is that of Peak Demand. This states that oil consumption is at the cusp of permanent decline due to advances in the technologies of electric cars. This idea is worth exploring further because it would be a very big deal if it is true.

In an article called "This Is How Big Oil Will Die", Seth Miller starts by pointing out that an internal combustion engine has approximately 2,000 parts compared to about 20 in an electric vehicle drivetrain. Electric and gasoline-powered cars were both developed at about the same time in the late 1800's but internal combustion engines won out because oil supplies were found in such abundance. As oil prices plummeted, it made gasoline engines far cheaper.

Electric cars have always had important advantages. They do not require oil changes, filters, timing belts, or other fluids. A well-maintained gasoline engine can achieve 200,000 miles over its lifetime and a diesel engine double that. Electric cars, on the other hand, are new and untested. However, some see them being on the road for as much as 1,000,000 miles over their lives because the most significant servicing they need is new tires.

This can result in significantly lower costs over the life of the vehicle. Taxis in New York charge approximately $2 per mile for an average fare. Seth Miller's article suggests an electric car's costs are only about $0.13 per mile. And take that to $0.10 or lower when we do away with drivers and go to self-driving cars. He sees economics dramatically changing the kind of cars we drive:

"By 2023, used car prices will crash as people give up their vehicles. By 2030, gasoline use for cars will have dropped to near zero, and total crude oil use will have dropped by 30% compared to today."

It is a pretty bearish argument, one that would cast a very dark cloud over Alberta oil, BC gas, and even the Canadian dollar.

But before we run out and sell every oil stock we own, let's remember that energy is already extremely out-of-favour. And this argument sounds almost as extreme as the "Peak Oil" theory introduced with much fanfare in 2005.

"Twilight in the Desert" was a book published in 2005 by Matt Simmons. It stated that Saudi Arabian reserves were inflated and the world would soon run out of oil. His arguments were well-reasoned and, for a while, Peak Oil appeared to be right. It certainly came to be well-believed as oil soared above US $140 per barrel in 2008.

What he did not foresee was that high oil prices caused many expensive deposits to become economic. New sources deemed too costly were suddenly feasible, such as oil and gas trapped in shale deposits. These enjoyed a tidal wave of research and suddenly, countries from the US to Canada and Argentina were found to have reserves that rivalled those in the Middle East. The result today is that OPEC has lost its monopoly power. With so many new fields and ways to get the stuff out, we are unlikely to see $140 oil again in our lifetimes.

Electric cars today make up a very small percentage of overall sales. And most of these are heavily subsidized, and when governments remove these (as happened recently in Hong Kong), sales vanish. Optimistic projections put electric vehicle sales overtaking internal combustion cars by 2025, and to this we say *hold on*. This ignores how businesses adjust to change, as well as the basic economics of batteries versus gasoline. Gasoline, for example, contains 50x the energy density of the same-sized battery, for example. A battery can be recharged, of course, but at what cost and from what source? Many electric vehicles today can trace their electricity back to coal plants. The idea that solar energy will supply enough power to an all-electric fleet ignores how much land would need to be covered by solar panels, as well as how we build better batteries.

Half of all oil ends up in lubricants, plastics, and jet fuel. These are unlikely to be replaced, so there will always be a market for a certain amount of oil and gas.

The conclusion of this long argument is that there will be an eventual "Peak Demand" for oil caused by electric vehicles. Eventually, they will just have too many advantages. But this point in time is probably further out than the 2025 year electrical optimists suggest – probably 2040. At that point, we may have hit

“Peak Oil” and see supplies running out. We may have large solar collectors in space beaming us back very cheap and clean electricity.

Meanwhile, we expect pipelines, producers, and refiners to be decent investments for some time to come.

We want to say thanks to our clients for introducing their friends and family members to us throughout the year. It’s a tremendous compliment and a huge responsibility, and something we never take lightly.

Making Money by Making Money

Say what you will about those crazy North Koreans, when their backs are against the wall, they become very resourceful.

The Hermit Kingdom, as it came to be known because of its almost-complete isolation from the rest of the world, defaulted on its debt in 1976. It was badly in need of foreign currency because its tiny economy consisted only of exporting natural resources, some fishing, and the building of large monuments for other dictators. The new leader, Kim Jong-il, issued the order that all of the country’s future covert operations would be conducted through the use of counterfeit US cash. This accomplished two objectives. First, funding became much easier, and second, it waged economic war on its great enemy.

It is hard to say how successful they were in their early years. They did not rise to fame – or infamy – until fifteen years later with the fall of the Berlin Wall in 1991. As East Germany collapsed, everything was for sale. It even sold its exclusive currency printing presses which were then smuggled into North Korea. Coincidentally, these were the same presses the US government used for its cash. North Korea also had access, as a national government, to the same inks, linen papers, and security threads as those sold to the US Mint.

By 1993, the first near-perfect US $100 notes were discovered circulating in Ireland. Dubbed “superdollars” because they were almost indistinguishable from real US cash, they propelled North Korea to the top of the world’s counterfeiters. The resultant $50 and $100 bills were so convincing and hard to trace that

Europol said “superdollars are just U.S. dollars not made by the U.S. government.”

How much they made is a bit of a guess, with sources suggesting somewhere between $25 million per year to as high as $1 billion per year. The US government changed the $100 note in 1998 and 2003 but revised copies had caught up by 2006. The US has since added 3D threads and holograms, as Canada has, in the 2013 iteration, causing counterfeit notes to drop off.

However, some in the US Secret Service – the agency in charge of policing counterfeit cash – believe the North Koreans have just gotten so good, we can no longer spot the fakes.

Not content with just one currency, China is now finding fake 100 yuan notes in circulation and have tracked them to North Korea. Of course, with credit and debit cards, usage of paper money is on the decline. Someday, technology will put the Hermit Kingdom out of business.

But wait…

The recent ‘Wannacry’ computer virus that paralyzed over 75,000 business computers was linked by Britain’s National Cyber Security Centre to a North Korean-affiliated hacking team. The virus demanded payment in Bitcoins, the new digital currency. To “launder” this digital currency, North Korea recently became a large Bitcoin “miner”, which is how Bitcoin is created. If someone accuses the country of embezzling millions in Bitcoins, they can just point to their new Bitcoin mining operation and say they earned it themselves.

North Korea dedicates almost all of its resources to illicit operations. Its recent success with long-range missiles is because they were able to obtain Russian missile engines made in the Ukraine, a country teetering on bankruptcy because of the Russian invasion. Government drug squads arrest drug dealers not to stop the trafficking of drugs, but to stop them from competing with the government’s own drug smuggling operations.

As their vast counterfeiting operations show, when faced with a need to make money, North Korea has learned to make money by…making money. Their resourcefulness points to the difficulty law-abiding nations have in policing such nations.

While we wish it were otherwise, there are no easy solutions to solving the Hermit Kingdom enigma.

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