The Market in Review

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This week's articles and insights

1. *Supply and Demand*
2. *How Long?*
3. *No Maybe's – We Need Babies*

"All I ever did was supply a demand that was pretty popular."

- *Al Capone*

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	24,463	+0.42%	- 1.04%
S&P 500	2,670	+0.52%	- 0.13% (+ 1.26% in $CDN)
TSX	15,484	+1.38%	- 4.47%

Supply and Demand

There are some laws that never change, such as gravity and entropy. There are others that are less obvious, but no less immutable. One that imposes itself on us time and time again is the Law of Supply and Demand. A rising demand for something inevitably leads to an increase in supply, and vice-versa.

We have seen this happen in every commodity from wool production to automobiles. Demand rises, leading to rising prices. More people jump in to take advantage of the high profits, then prices fall. This leads to consolidation and, eventually, a balanced market.

For those of you old enough think of all the computer companies that sprang up in the early 1980s. Commodore, Atari, Apple (**NASDAQ AAPL**), Compaq, Victor, Vector, Texas Instruments, Radio Shack, Packard-Bell, and Sinclair, to name a few.

For those younger, remember Blackberry (**TSX BB**), Nokia, Motorola, Palm Pilot, Ericcson, LG, and those from Sony and Siemens?

Both industries ran into the same market dynamic, where rising demand saw scores of new entrants. Then, scarcity changed to glut, followed by new innovations, and eventually competitors with much deeper pockets. Today, a handful of computer companies make most of the world’s laptops and desktops. Apple, Samsung, and several Chinese companies make just about all our phones. Prices dropped and few survived. It happens in every era to every market.

Why bring this up? Because it is happening today in the marijuana market in parts of the US. And what is happening there is likely to happen to Canada’s producers, as well. Today, it seems like the sky is the limit with new dispensaries popping up like mushrooms. There were 23 shops listed in Victoria in 2016 and approximately 31 either approved or at some stage of application by the end of 2017. It seems like a boom that will never end.

It has in Oregon. Marijuana officially became legal in Oregon in November of 2014, even as it remained illegal at the federal level. The Oregon Liquor Control Commission began handing out dozens of licenses to growers and dispensaries to meet the surging demand for legal weed. The state loves the new industry. It brought in US $68 million in cannabis sales taxes last year.

But like computers and cell-phones, more and more people got involved, and techniques became better and better. Outside investment flooded in when the state relaxed ownership rules in 2016, increasing the number of new farms under cultivation.

As of April 1st of this year, “Oregon had licensed 963 recreational cannabis grows, while another 910 awaited OLCC approval.” (source: Willamette Week).

Demand for marijuana in all its forms in Oregon is approximately 340,000 pounds. The problem is this: the state now reports that 1.1 million pounds of cannabis were produced last year. That’s three times as much as is consumed, and it is illegal to ship it outside the state. This has led to a halving in price from $1,500 per pound last summer to just $700 per pound by last October. One small grower reported he got just $100 per pound at auction in December. The same thing has happened in Colorado, another pot-legal state. Prices have declined by half since last October.

Canadian marijuana stocks have been in a gold rush of their own that began after the Liberal government was elected in 2015. Many are still well above their prices of just six months ago, but be warned: the winnowing is coming.

Just as with the early computer companies, it will be the largest players that survive. The smallest will be either bought out or put out of business. In fact, this may have already started. Canada’s largest publicly-listed marijuana companies have begun absorbing others, while the smaller players saw their share prices peak in January. Many have since been cut in half.

In time, marijuana will become a stable, boring, dividend-paying industry much like those in the alcohol and tobacco sectors. Until then, it will be a market share war, and many won’t survive. We are not involved in these stocks, but for those of you who are, the gold rush is over. Stick to the largest players or the ETF baskets.

How Long?

“How long has this been going on?
You've been acting so shady
I've been feeling it lately.”

- from the 1974 song “How Long” by the band Ace
-

The “correction” that began in February feels as interminable as Canada’s winter.

And yet, the Dow Jones Industrial Average has recovered almost a thousand points, or 3.4%, since its lows in early February. Canada's TSX has risen 200 points from its low for a gain of 1.3%. Both have experienced higher and higher lows, like a ball bouncing up the stairs. This is a healthy phenomenon. Fewer and fewer stocks are hitting 52-week lows, which is another healthy sign.

So why does this "recovery" feel so ragged and false?

The backdrop of unceasing tense news - bombs in Syria, standoffs over the pipeline in Canada, daily battles (and book launches) in Washington – hangs like a black cloud over the stock and bond markets.

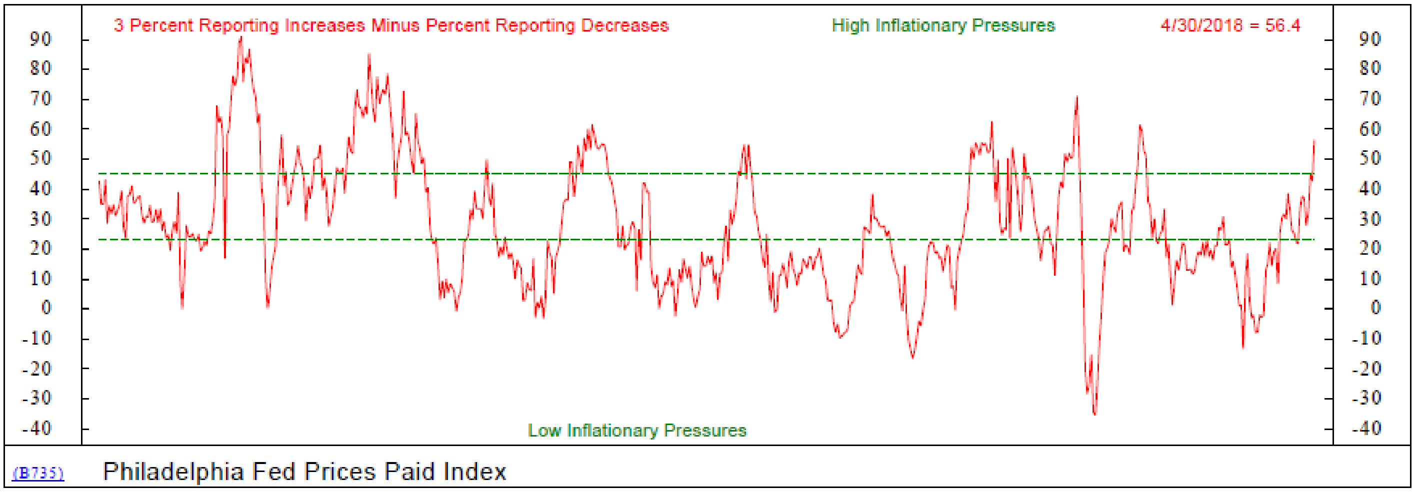
There is also the threat of trade restrictions with China through new tariffs and obstructions. After the US imposed tariffs on Chinese washing machines and solar panels, China levied its own 179% tariff on US sorghum – a grain used for animal feed in place of corn. The US's cancellation of the proposed takeover of US-based Qualcomm (**NASDAQ QCOM**) by Singapore-based Broadcom (**NASDAQ AVGO**) was followed by China's reconsideration of Qualcomm's buyout for chip firm NXPI (**NASDAQ NXPI**). Did either country win? Who knows? Certainly, the shareholders did not.

And yet, the markets have managed to grind higher. We are back in earnings season and earnings have been quite healthy. That is the biggest prop under stocks - a strong economy and growing earnings.

Stock market corrections often herald larger changes beneath the surface of the market averages. Like the churn sailors avoid during a tidal change, there can be a great deal of motion even as there is no locomotion.

The tidal forces today are rising interest rates pushing up against economies running at nearly full capacity. The economy wants to grow even more, but higher interest rates slow things down. Sometimes, you get the worst of both worlds – rising prices with no growth. Inflation is beginning to show up in the economic numbers through bottlenecks in both labour (too few workers) and materials (too much demand).

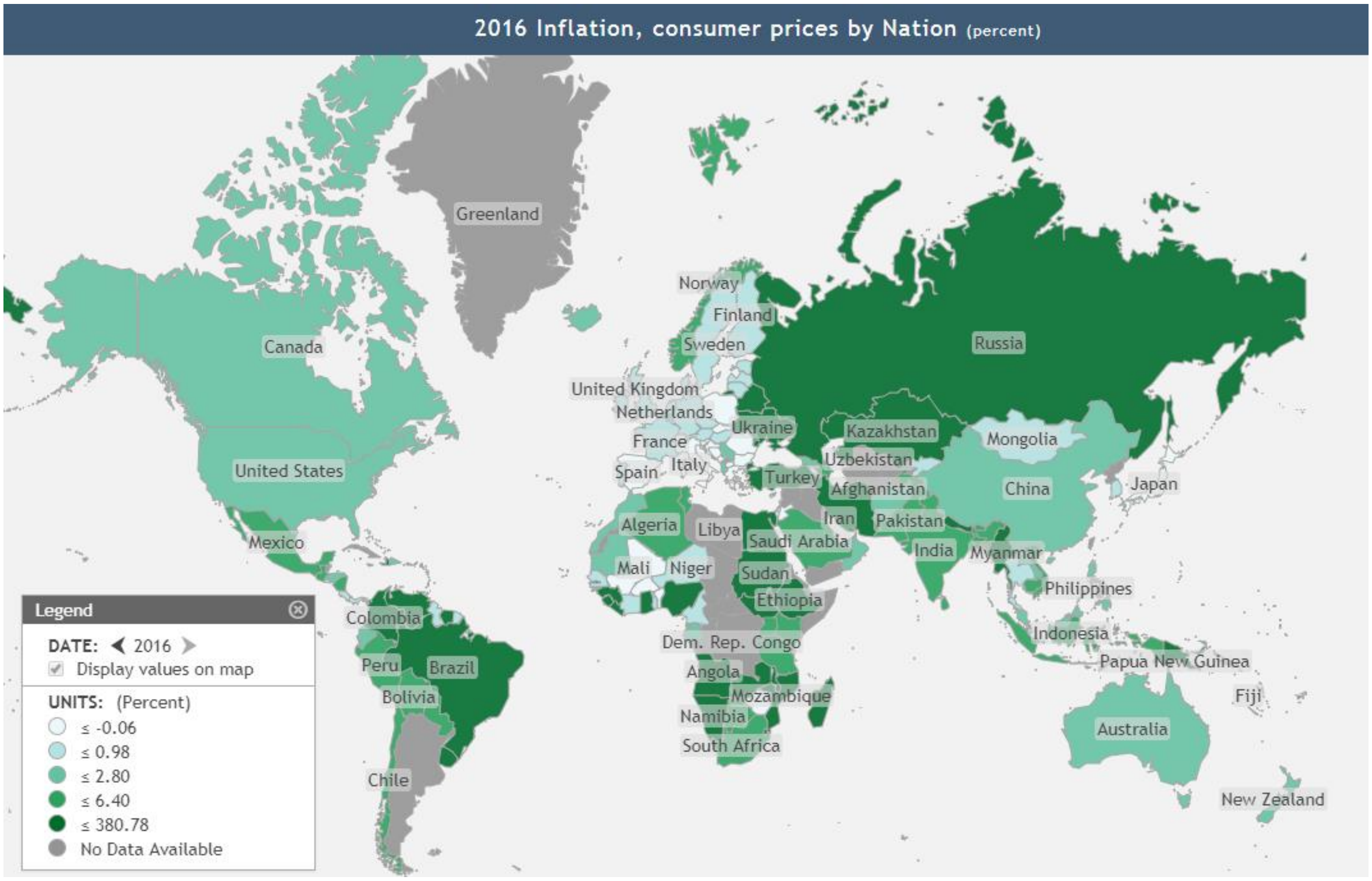
For example, the Philadelphia Prices Paid index (a measure of the cost of commodities that go into making stuff) jumped 14 points this month to 56.4, the highest level in seven years.



Inflation has long been sought by central banks as a way to devalue the vast debts built up by governments. It may be one of those "be careful what you wish for" desires. Inflation is pushing up prices everywhere and being passed on to you, the consumer.

As investors, where are we seeing it?

Where we're seeing the most inflation is in emerging markets, and it is creeping up here in North America. In particular, it is most notable in commodity-producing nations, and influencing higher prices in energy, base metals, and other industrial inputs. Oil stocks are now one of the strongest groups, followed by mining and materials stocks. Is the period of lower oil prices, interest rates, and disinflation over? The technological advances of automation, big data, etc, have disinflationary impacts – but have they been offset by over-eager quantitative easing? Time will tell. What is perhaps true is that future rate holds rather than rate cuts could have the same stimulative impact on our collective animal spirits.



Source: Economic Research, Federal Reserve Bank of St. Louis

Thank you for your referrals this month! They are always handled with great care and discretion.

No Maybe's – We Need Babies

A recent article in The Federalist by Glenn Stanton described the demise of Toys 'R' Us as being caused as much by the dearth of babies as by debt and poor management. The once-rising chain suffered from a heavy debt load forced on it after a leveraged buyout in 2005. Increased competition from Target (**NYSE TGT**) and Wal-Mart (**NYSE WMT**) also helped do the company in. Amazon (**NASDAQ AMZN**) and other on-line sellers haven't helped, either. The part about the shortage of babies was even more interesting. In particular, what countries around the world are doing about it.

As countries become more prosperous, an unintended side effect is a falling birth rate. Countries that industrialize need fewer farm workers, and richer lifestyles mean more focus can be placed on fewer offspring. Both result in the same thing: fewer babies.

The country that most epitomizes shrinking itself to greatness is Japan. The country's population has been shrinking since 2010 and is now losing a net 270,000 people per year. In the next two decades, Japan will lose the equivalent of almost 14 million people – an entire Tokyo.

The first effort of any country intent on growth is increased immigration. Japan is very choosy about the ethnicity of who it allows in, and focused on Peruvians (60,000 immigrants) and Brazilians (220,000 immigrants) of Japanese descent in the 1980s and 1990s. This was barely a drop in the bucket, and they did not integrate well. Japan even began a program during the financial crisis of 2009 where they paid these people to go back to South America!

Canada's birth rate of 1.60 babies per woman ranks ahead of China (1.57) and Japan (1.46) but is well behind that of the USA (1.84) and Mexico (2.21). To offset this, we have one of the highest per capita immigration programs in the world. Canada is aiming to absorb 310,000 new immigrants in 2018 (source: Statistics Canada). The US takes in about 1,000,000 per year, a rate one-third of ours.

Back to Japan for a moment. The country was one of the first to begin paying people to have more babies. This hardly moved the dial, so the country is getting even more creative (or desperate) by promoting a robotic baby to young couples. This is supposed to help them develop maternal urges, and then go on to the real thing.

Europe is also facing a "grey wall" of its own. In response, Denmark is promoting vacations because government data suggests more babies are conceived during holidays than at any other time. Successful couples even receive a chance to win baby supplies and a further discount on more vacations to have even more children. Russia now has an annual "Day of Conception" and Singapore a "National Night" when patriotic couples can do their part for the state.

A falling birth rate impacts everything from tax revenues to the size of a country's military. Immigration is one way to stem the tide, but babies are likely to become even more valuable in the years ahead. China, for example, once allowed almost anyone to adopt its unwanted girls. Now, the practise has virtually stopped. It is the same for other countries such as Romania and Russia. Now, they want to keep their precious children – even the orphans. Canada's thirst for immigrants has been met by global unrest in the Middle East and parts of Asia. Someday, peace will return and Canada may find its open door increasingly unused.

Meanwhile, expect to see more and more government focus on the promotion of babies and family size. Like Singapore's "National Night" and Russia's "Day of Conception, perhaps Canada's "Family Day" may take on a whole new meaning.

Here is the article mentioned:

http://thefederalist.com/2018/04/17/baby-shortage-downed-toys-r-us-coming-entire-tax-base/

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Prices shown are as of close April 20th, 2018.

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