The Market in Review

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This week's articles and insights

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"Politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies."

- Groucho Marx

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	25,965	+ 0.68%	+ 5.04%
S&P 500	2,902	+ 0.93%	+ 8.52% (+12.55% in $CDN)
TSX	16,263	- 0.57%	+ 0.33%

Politics and Profit

Just after the momentous US election in late 2016, we had the opportunity to hear a man named Stuart Sweet speak about the US political situation and what effect it could have on stock market returns. Stuart has been a Legislative Assistant in Congress, an expert witness for Social Security, a senior advisor for various Republican administrations and a lobbyist. While he leans Republican in his politics, he was to be able to cut through all the headlines and noise in his analysis. And he turned out to be very right in his predictions.

We thought it would be informative to share his insights on how current politics could shape stock market returns over the next year. It beats talking about interest rates!

When we spoke with him again this week, he said things are not as easy to predict as last year's passing of the new budget ("a slam dunk" he called it) because of the upcoming mid-term elections. Here were his main points:

- 20% of US voters are not affiliated with any party – they "vote their pocketbooks" and swing to the party who offers them the most. The Republicans need these voters, and the key to their support is jobs and a strong economy. Expect all Trump policies to be directed to these "Rust Belt" swing voters.

- "NAFTA 2.0" will get done. The agreement with Mexico had to be concluded quickly, so the incoming president could take the credit and the outgoing president could take the blame. He believes there is a 60% chance the Democrats will take the House of Representatives from President Trump's Republicans in November, which will complicate NAFTA talks. This means discussions could get very complicated after that, so the pressure is on Canada to make some concessions now to get a deal in place before then.

- Despite all the threats, Mr. Trump cannot freeze Canada out of the NAFTA negotiations. He has the authority to negotiate bilateral deals (i.e. with Mexico) but cannot change tri-lateral deals (NAFTA) without Congressional approval.

- President Trump has made it a priority to remove many federal regulations. One of the biggest beneficiaries will be the US banks, which have been forced to hold a great deal of cash in excess reserves. Rules preventing them from lending this money out, raising dividends, or buying back stock have been reduced in the last year. He particularly mentioned Citibank (**NYSE C**) as one of the biggest beneficiaries. Citi has raised its dividend almost 200% in the last 18 months, and is buying back US $17 of its shares with excess capital. Unlike other big US banks, it generates almost 40% of its revenues from outside the US, with a good portion coming from Mexico. The recent NAFTA agreement with Mexico is a big win for Citibank. Citibank is held in our Dividend Value portfolios.

- 90% of all pills Americans take are generic drugs. Despite this, many are still very expensive due to their having only one supplier ("sole-source"). The government is committed to approving 1,800 new generic applications in 2018 – 5 per day – to introduce more competition and lower pricing. The most visible example is the new generic Epipen, which is expected to cut the price from the ~$300 it now costs.

- Defense spending will rise worldwide. In 2017, only 6 of 29 NATO members met the 2% defense budget target while the US spent 3.6% of its budget. All are being pressured to spend more.

- A conflict with North Korea remains a bigger threat than most people realize. With both a hydrogen bomb, missiles that reach the US, and a reluctance to back down, Stuart says his sources in the Pentagon believe there remains a 30-40% risk that North Korea is attacked by the US and its Asian partners.

- It is no surprise to anyone that the US needs to upgrade its road, bridges, and dams. Up until now, Republican hawks have resisted any more deficit spending, so have stalled an infrastructure bill. If the Republicans lose their majority in Congress, we may see a compromise between Trump and the Democrats to pass a major infrastructure bill. Such talk may be fanciful now, but both Mr. Trump and the Democrats have voiced support for more spending inside America.

- Finally, Stuart mentioned that most politicians are thoroughly vetted by the time they reach high office. Past scrutiny in lower government jobs and the military means that most skeletons are already out of the closet before anyone hits the White House. Mr. Trump, who rose to power through none of these channels, is one of the least vetted presidents in US history. Expect to see more dirty laundry aired over the next two years, he says.

Returns This Week

The major US averages touched new highs this week. Canada set its own new high in July and has been consolidating since.

In the US, strength in Amazon (**NASDAQ AMZN**) and Apple (**NASDAQ AAPL**) – set to introduce three new phones – helped. In Canada, strong earnings from the Canadian banks propelled us higher. Bank of Montreal (TSX BMO) recorded the strongest "beat", TD Bank (**TSX TD**) and Royal (**TSX RY**) were good, with Bank of Nova Scotia (**TSX BNS**) the laggard.

Canada has 7 banks which control almost all lending and finance in the country. The US had over 14,000 commercial banks in 1984. This has shrunk to 4,805 today (source: Federal Reserve Bank of St. Louis) and appears to be headed towards our level of concentration.

Good for consumers? Unknown. Good for bank stock investors?

Absolutely.

Things We Learned This Week

When you read widely, you uncover some very interesting things. Here are two that caught our eye this week.

1. Too much water in Texas. Shale drilling typically reaches depth down to 10,000 feet or lower. A lot of water is used to fracture ("frack") these wells in order to crack open the shale to release oil and natural gas. Most people familiar with the technique are aware of the vast amounts of water used in the process. In thepast, this created water shortages until companies learned to recycle much of the water used. Since sand is also used in fracking it, too, was subject to shortages until new sand mines opened up.

   What is not widely known is that there is a great deal of water in reservoirs at these depths, and it is very salty. Up to four barrels of briny water is recovered with every barrel of oil, and companies are running out of places to put it. They cannot dump it on the surface because it poisons farmland, so they have been re-injecting it into old oil wells. Those are now full, however.

   The solution? A new industry centred around recycling both fresh and salty water is growing rapidly. Those Texans are very resourceful – don't be surprised to see Texas become a water exporter in future years due to the unexpected surplus of water from their oil shales.

2. Scientists at Sandia National Labs in New Mexico just discovered the most durable alloy ever invented. It is 90% platinum and 10% gold and incredibly resistant to heat – the prime cause of wear in materials. If you made a car tire of it, they say, you could skid for a mile and only lose a single layer of atoms. In fact, it would take skidding (not driving) around the earth 500 times before the tire gave out.

   Don’t expect platinum-gold tires anytime soon, but this alloy will no doubt appear in electronics, parts used in the space industry and possibly even your new knee or hip replacement in the years ahead.

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

Calling Out the Doomsayers

I have kept a personal journal for close to thirty years. It now stretches over nine volumes. As we approach September 2018, I thought it would be appropriate to share an entry from ten years ago that highlights the differences between then and now, and what despair we felt at that time:

Friday, September 19th, 2008:

“I am sitting in my closet, cluttered with shoes, a dry-cleaning bag, and a mirror. It’s cramped, but it is a private hole I can crawl into after a brutal week.

“On Monday, Lehman Brothers declared bankruptcy. The markets fell 400 points. On Tuesday, the U.S, government took over AIG (American International Insurance – the largest insurance company in the world) in what amounts to a delayed bankruptcy. Another 400 points down. Thursday, markets reversed mid-day and closed sharply higher. Friday, the government rolled out the big artillery and banned all short selling on financial stocks, and then outlined a new Resolution Trust to buy up Wall Street’s bad mortgage debts. Is China collapsing as well? The charts say yes.

“Every day begins with a rally then ends with a thud. So many people want out, we are all waiting for an up day to exit. Business has ground to a complete halt. I can’t sleep, and my back has ached for a month.

“I like the closet. There’s no phone in here.”

If anyone thought advisors have spines of iron and stiff upper lips, now you know the truth! We feel terror just like everyone else.

Now fast-forward to today.

- Record low unemployment. The four-week average of unemployment claims in the US fell to its lowest level since December *1969*.
- Record high corporate profits – now growing at their fastest pace in seven years.
- Household savings rates were just revised up, and U.S. median household income is at an all-time high.
- Consumer confidence is soaring.
- US markets have just broken out to new highs. Canada reached a new high in July.

Will we get another market crash, as so many doomsayers predict? Of course there will be another major decline someday – just not now or in the immediate future. How can we say this with any degree of certainty?

After the sickening decline of 2008, we decided we needed better “forward-looking radar” to help us see a storm before it hit. We subscribed to Lowry’s, one of the oldest stock market charting services in the world. They have been in business since 1938 and have data on every rally and crash in those 80 years. Lowry’s tracks how many stocks are rising and falling (market breadth) and how many shares trade (volume) to plot two key graphs: Buying Power and Selling Pressure.

When Selling Pressure exceeds Buying Power, it means more stocks are falling than rising. Like a tidal change, what happens under the water is not always apparent on the surface. Many small and medium stocks can be deteriorating as sales erode, but because the major indexes are dominated by global giants far more immune to early weakness, we miss the warning. It is like canaries in a coal mine – small creatures are more sensitive to change.

Selling Pressure moved above Buying Power in the summer of 2007, warning those who followed Lowry's that markets were becoming increasingly unhealthy. It took a year before the bottom fell out, but fall out it did in late 2008.

What is Lowry's saying today? Here is their comment from just a month ago:

July 13th, 2018

"So, how do deteriorating market conditions compare with conditions today? Actually, they don't. For example, rather than deteriorating, market breadth continues to expand, as the S&P Advance-Decline Line recorded a new all-time high this week. Buying Power remains in a long-term uptrend, climbing to within four points of its March rally high this week, while ***Selling Pressure fell to lows last seen over 70 years ago***. In addition, the percentage spread between the Buying Power and Selling Pressure Indexes reached its most positive level since 2004 this week."

"In summary, despite ongoing efforts by the bears to project a dire outlook and imminent arrival of the final market top, there are still many displays of strength, in terms of breadth and in the balance of Supply and Demand. This suggests a bull market that is still alive and well and that new buying rather than selling should remain the primary focus for investors."

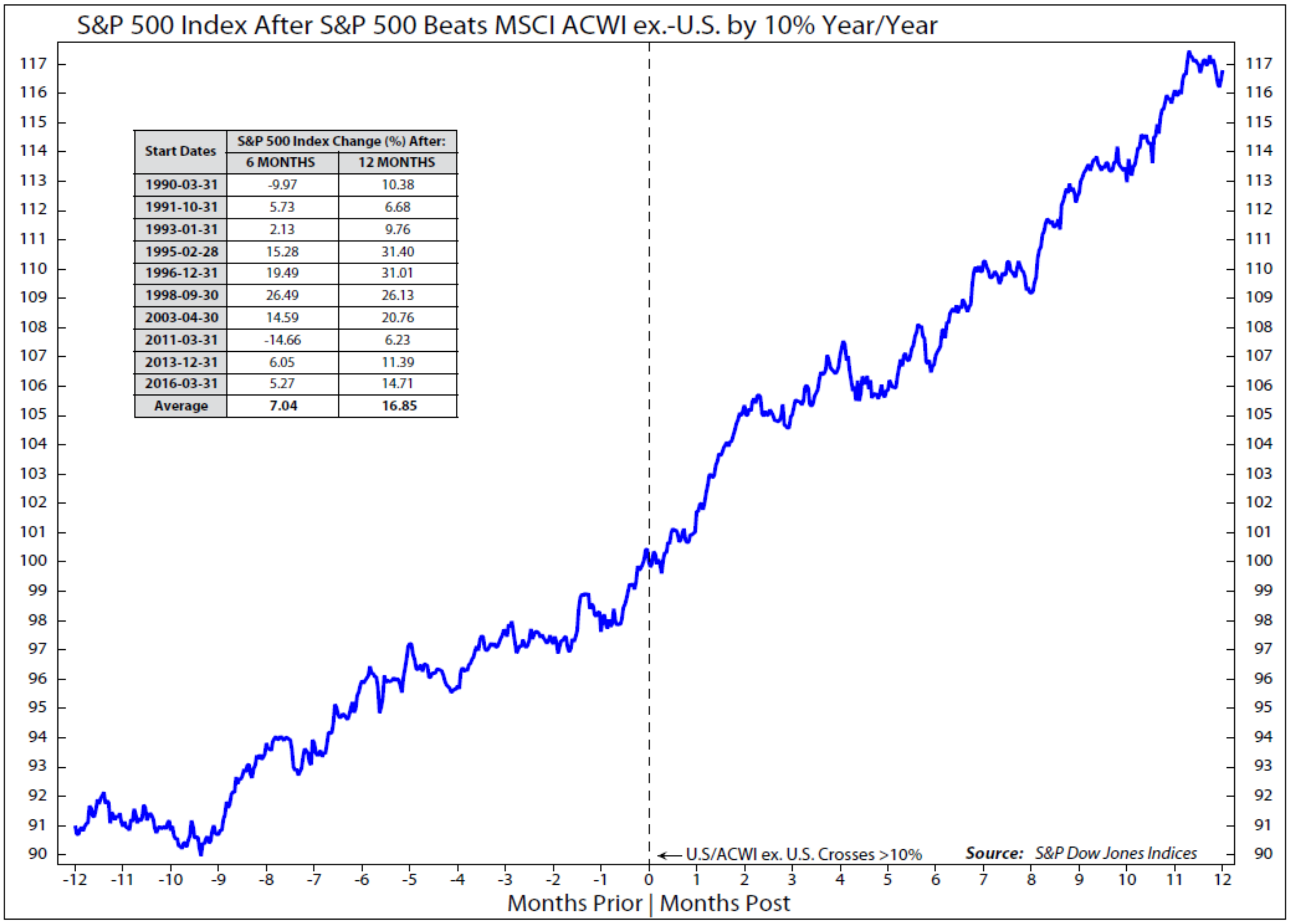
Further to this, another analysis of market conditions comes from the Ned Davis Research company, a service we pay dearly for. It is one of the most respected market analysis companies in existence.

The US market is the leading market in the world. It is the largest economy and contains the most dynamic companies. When the US market outperforms the rest of the world (when the S&P 500 outperforms the MSCI All-World ex-US Index) by over 10% in the 12 months up to August 31st, it has gone on to positive returns in every case over the past 31 years.

Since 1987, there have been ten instances where US stock performance exceeded world stocks by more than 10% over the previous 12 months. In most cases, stocks wobbled during the year, but ended up an average of +16.6% one year later. Ten samples in 31 years is not huge, but it does suggest that when the US market gets its mojo rolling, it continues rolling higher for many months.

Economic conditions are very strong today, suggesting we may be in a similar environment.

Now, stock valuations today are too high to declare this the start of a new bull market, but the underlying health of stocks suggests that this bull may have months – or years – left in it yet.



Start Dates	S&P 500 Index Change (%) After: 6 MONTHS	12 MONTHS
1990-03-31	-9.97	10.38
1991-10-31	5.73	6.68
1993-01-31	2.13	9.76
1995-02-28	15.28	31.40
1996-12-31	19.49	31.01
1998-09-30	26.49	26.13
2003-04-30	14.59	20.76
2011-03-31	-14.66	6.23
2013-12-31	6.05	11.39
2016-03-31	5.27	14.71
Average	**7.04**	**16.85**

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