The Market in Review

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This week's articles and insights

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"Know yourself and you will win all battles."

- ***Sun Tzu***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	24,597	- 1.40%	- 0.49%
S&P 500	2,651	- 1.68%	- 0.86% (+5.21% in $CDN)
TSX	14,750	- 1.25%	- 9.00%

Humbug Markets

When I first started with Prudential-Bache Securities in 1986, the head of training in New York was a grizzled veteran named Al Levy. Al had been a stockbroker for years then switched to the training department. We were a class of 50 people, but only a handful survived to make careers of it. That was how they trained brokers and insurance agents in those days: throw a lot of minnows into the ocean. Not a lot of us made it back as grown fish.

I remember one story Al told us about 1973. This was a very tough bear market when the Dow Jones Industrial Average fell 45%. You develop strange superstitions in this business to avoid bad luck, so he and his fellow brokers made a vow to have a drink every day the market went down. They figured that would stop the plunge.

They ended up drinking for 30 straight days before stocks finally turned.

While we have not fallen anywhere near that amount - Canada's S&P/TSX index is down 11% since its peak in July – but it has felt like a non-stop descent. Alcohol has been considered, and more than once.

This severe a correction, and one in such a short space of time, forces you to reconsider your stance. Are we headed towards a bear market? And if so, will it be a 'baby bear' or something as bad as 2008-2009?

Let's start with the bad news. There's plenty of it:

- Brexit. We have assumed that an orderly deal will get done. These are the British, after all - tea, milk, and straight corners. Teresa May survived a non-confidence vote this week, but any deal will be tough to pass.
- Manufacturing is weakening in almost every country. Call it a pause, but things are definitely slowing down.
- Oil prices have tanked. Blame it on surging US production, but there is also the problem of slowing consumption. We really need to see some stability in the oil price.
- Interest rates have been rising relentlessly, squeezing borrowers.
- And of course, the escalation in the US-China trade wars. Last week's shocking arrest of a Chinese executive in Vancouver has set American-Sino relations back years.

The internet makes sure we hear every bit of bad news, all of the time. The human brain is hardwired to focus on the shocking and horrific, and our 24/7 media delivers it to us on multiple screens.

Even if things are slowing down, it is not clear by how much, or if it is merely a pause or the beginning of a recession. It has led, however, to a surge in predictions of doom, even though predictions aren't worth the digital ink they are printed on. We know of two high profile "analysts" who have predicted worldwide collapse every single year since 2012.

Just how good are economic predictions, anyway?

What about the rest of them?

At the end of 2007, almost no economists predicted the global crash just a year away. In fact, a UK economist named Loungani claimed that "over three decades, of the 150 recessions recorded **only two** had been forecast," which implied a success rate of close to 0% for the calling of a recession. Our chief strategist Jeff Saut points out that searches for "recessions" on Google have spiked to their highest level since 2011, even surpassing the searches in 2016. That year was when China and oil nearly caused one. It is also near the panic levels of the European debt crisis in 2011.

More and more economists are calling for a recession to start in 2019. Perhaps their perfectly terrible record should give us comfort.

However, we have been around long enough to know when it is time to play a little defense. This is seasonally one of the best times of the year for stocks, and yet they are having a *very hard time* rallying. The old saying goes “If Santa fails to call, the bears will roam on Broad and Wall,” referring to the very predictable Santa Claus rally that occurs right after Christmas.

There have been very few places to hide this year, other than cash, so that also gives us pause.

We do invest more defensively in times like this.

- We buy more GICs and bonds, especially with rates improving.
- We raise a little more cash.
- We stagger our purchases and time them for “down” days.
- We never let up in our focus on dividends.

We also have to remember that annual declines are a regular occurrence – and they all feel terrible.

Also, more than 50% of stocks in the S&P 500 are already down 20%, but this has ***already happened***. Only 18% of investors today are bullish, while 49% are bearish (source: American Association of Individual Investors).

“Folks, bear markets do not begin without a euphoric conclusion to the bull market. The individual investor is not just cautious, but scared to death.”

- Jeff Saut

Are we likely to see further declines? It is entirely possible. A 2008-2009 decline is highly unlikely, however. Banks are so much better capitalized now, and mortgage loans are much stronger than they were then.

And central banks are beginning to pause their hikes. Canada, Switzerland, and the EU have all stopped raising rates because of the economic weakness.

Stocks fall 5-10% during the year almost 40% of the time. In other words, in 20 of all the years since 1967 (50 years), we have seen declines just like this one.

In fact, if your timeframe is more than 1-2 years, you should probably be a buyer here and not a seller.

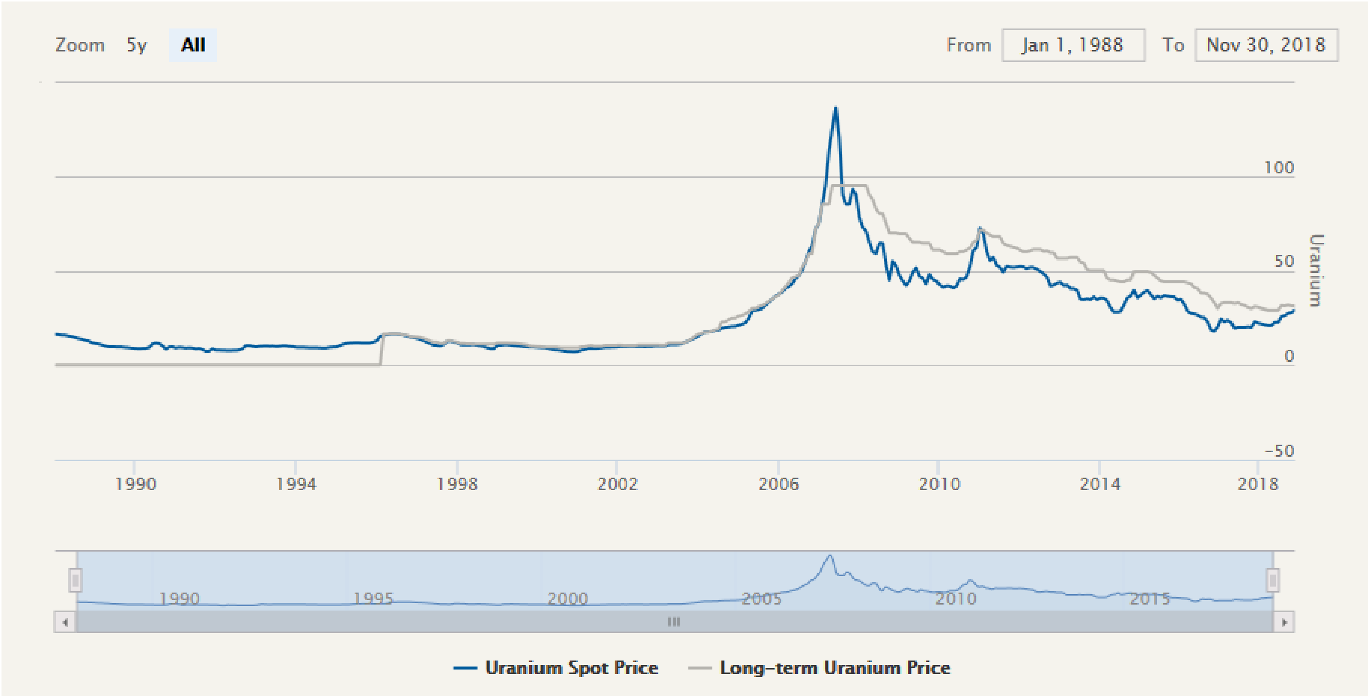
Even with corrections and recessions, stock returns have been as follows (source: TaxTips.ca):

9.0% Average Canadian annual return since 1979 of Canada's S&P/TSX index (38 years)
10.5% Average U.S. annual return since 1967 of the US S&P 500 index (50 years)

Scratching Our Craniums About Uranium

It has been 13 years since we last used that headline. In 2005, one of the greatest uranium booms was just beginning. The price of spot "yellowcake" rose from US $21 to $136 in just 2 ½ years. A second jump in 2011 proved to be the end of the party, for just after that was the Fukushima earthquake that led to the shutdown of 54 Japanese reactors. Uranium prices plummeted.

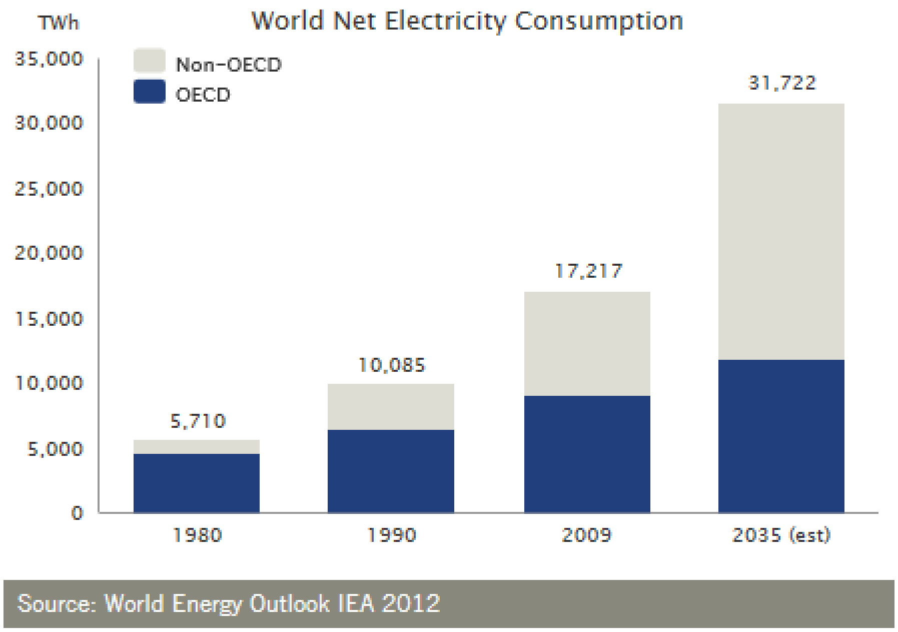
Countries from Germany to the US began mothballing older reactors. Cameco (**TSX CCO**) was probed for tax evasion by the Canada Revenue Agency. By 2017, Kazakhstan and Cameco had both closed mines and lowered production.



Source: Cameco website

A funny thing about reactors, though – you can't turn them off. That's their beauty – continuous, cheap power. And while the west was closing reactors, China and the rest of world continue to build them.

Why? The world needs the power.



There are 51 new reactors under construction or in the planning stages. Japan has also turned 9 of their 54 back on, with plans to add more next year. Uranium has quietly been the best-performing commodity in the world in 2018, and few investors know or care.

We added a small position in Cameco, the world's second-largest uranium producer, to our Dividend Value portfolios recently. At $16, the Raymond James official target is $18, but if uranium continues to rise, we think the target could be much higher.

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

The Art of War

Of all the events of the past few months, the most unexpected was the arrest of Meng Wanzhou, the Chinese executive of the Huawei corporation. She stands accused of directing Huawei to supply equipment to countries on the U.S. export banned list, including Iran.

Just days before, Presidents Trump and Xi had agreed to a 90-day truce on their tariff battle to negotiate the more contentious issues between the two nations. Huawei is the largest smartphone provider in the world now and one of China's national champions. The arrest in Vancouver came literally out of the blue.

How this plays out is anyone's guess. What has become more apparent in the last few years is that China has been quietly positioning itself to assume world leadership by the year 2049, and that the U.S. is now aware of this and is pushing back. The book **The Hundred-Year Marathon** by Michael Pillsbury details China's patient strategy.

While we hope for some sort of détente to emerge from the trade talks, what we are seeing is the surfacing of a new cold war – one that will likely last another 20-30 years. Before you run for the hills, remember that the world economy grew very nicely during the last cold war between the U.S. and the Soviet Union, but the free-wheeling globalization that the world has enjoyed since 1990 is over.

To understand the Chinese strategy, it is worthwhile to read Sun Tzu's **The Art of War,** a book written by a Chinese general 2,500 years ago. It shapes much of modern China's strategy.

For example, consider China's rise from a backward emerging market to the #2 economy in the world today. The country was classed as a developing nation when it joined the World Trade Organization in 1986, and rightly so. It was a very poor country. This status allowed China to restrict imports, favour its local companies, and subsidize exports. Even environmental emissions were more relaxed, and remain so today.

All warfare is based on deception. Appear weak when you are strong, and strong when you are weak.

At breakneck speed, China has now emerged as the world's #2 economy and military. It is now the second-largest filer of patents worldwide, with Huawei - the same company accused in Vancouver – issuing the most patents worldwide in 2017. Many of these patents are filed and paid for by Canadian researchers, then signed over to Huawei (source: The Globe & Mail).

Huawei has been sued by T-Mobile, Cisco (**NASDAQ CSCO**), and Motorola (**NYSE MSI**) for theft of intellectual property, and questions continue to swirl about how Nortel's technology ended up in Huawei products.

One bushel of the enemy's provisions are equal to twenty of yours.

Western companies and governments have been targets of cyberattacks for years now. In what appears to be one of the largest ever, the Marriott (**NASDAQ MAR**) hotel chain just revealed that it had been infiltrated for four years, with over 500 million customer records stolen, including passports, credit cards, and driver's licenses. The attack emanated from the Chinese government, according to intelligence sources. This is just another in a long list of cyber thefts in the world today. The West is particularly vulnerable in our area of greatest innovation: the internet.

Attack him where he is unprepared, appear where you are unexpected.

The arrest last week in Vancouver was completely unexpected by the Chinese authorities or Huawei. The U.S. giant, long tolerant of its companies being pilfered, has awakened. This may mark the opening salvo of an out-in-the-open great power struggle we will be witness to for the next several decades.

Meanwhile, China has quietly lowered tariffs on America cars and resumed purchases of North American soybeans. Perhaps U.S. trade officials have begun reading Sun Tzu themselves.

It is often possible to drive the enemy into the plight of making erroneous judgments and taking erroneous actions, thus depriving him of his superiority and initiative.

(all quotes from Sun Tzu's **The Art of War**)

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