The Market in Review

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This week's articles and insights

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To sin, or not to sin…
It's a quandary we've all been in,
Smoking, drinking, even pot
Such fun today, tomorrow not.

Hell was once, the preacher said
Where kissing, drinking, smoking led,
Lotteries are now considered nice
Encouraged just like every vice.

I worry, though, if I stay chaste
How will the taxes be replaced?

There’s nothing left from what we made
And debts demand that they be paid.

I don't smoke, perhaps I'll start
It's a way to do my part,
The tax I’ll pay will help impart
New ads to tell me not to start.

I’ll play some cards and roll the dice
A loss would be my civic price,
I’ll up the rate I do my drinking
It’ll help to slow my rate of thinking.

Now laws have changed, and I must heed
Our nation’s need to sell some weed,
It's safe, it's good, our northern pot
Now legal, too, in case you're caught!

The logic here is clear to see
We need to heed our leaders’ plea:
"Don't you start, but don't you quit!"
For who will pay the deficit?

- *"Don’t You Quit!" by Paul Siluch*

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	25,521	-4.12%	+ 3.24%
S&P 500	2,762	-3.85%	+ 3.31% (+ 2.10% in $CDN)
TSX	15,606	-3.90%	- 3.72%

Sin Taxes

The poem above was actually written about 15 years ago in response to the provincial government licensing gambling. We had institutionalized alcohol and tobacco and were now adding casinos to the taxation mix.

But legalized drugs? That was a bridge too far, even for revenue-hungry politicians.

Until today, that is. Come July of this year, marijuana will be legal in Canada. The government will begin raking in a 10% excise tax plus GST on every gram of marijuana sold. This will work out to about a 20% overall tax rate…for now. We know "sin taxes" started low on alcohol and tobacco, but now make up about 80% of the cost of a litre of both gasoline and wine. Marijuana will likely face the same fate.

The big issue for advisors is the investment potential of this “budding” new sector. Canada will be one of the first countries in the world to fully legalize cannabis and we may even become a global hub for the stuff.

Over time, every other nation will likely follow, driving the cost lower and lower. New Zealand was once the world leader in the production of kiwi fruit. Once seeds got out, they were grown everywhere, which drove down the price. New Zealand hardly exports kiwi fruit anymore.

Canada’s cannabis companies are now worth approximately $36 billion. The top three companies have sales of just $110 million today, which suggests the stocks are wildly overvalued. Marijuana Business Daily, an industry publication, suggests annual sales for Canada's recreational marijuana market could grow to $2.3 billion - $4.5 billion by 2021. This assumes a great number of new users and the complete elimination of illegal dealers. Even if this optimistic forecast comes true, it means the industry is trading at close to 10x sales. Not 10 times *earnings* – 10 times *sales.*

The old adage *buy the rumour, sell the news* suggests the excitement around this new industry should persist until legalization occurs in July, or thereabouts. Once reality hits, we should start to really see how many people are buying pot and how the industry reacts to new government regulations. In Ontario, cannabis products will only be sold in licensed liquor stores. This will limit overall sales, especially from the many small growers who cannot get licenses or shelf space.

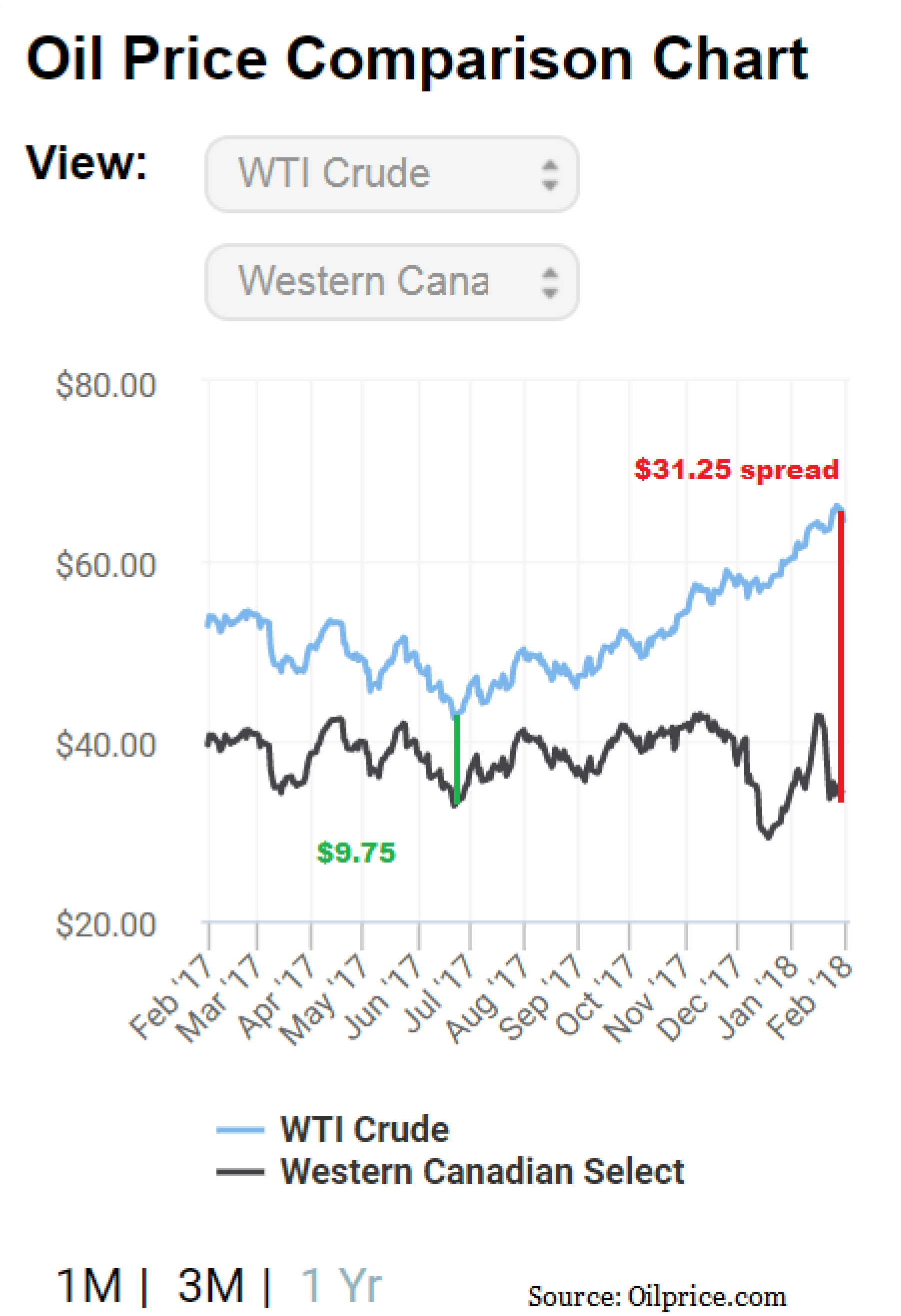
In the years ahead, the marijuana industry will come to look very much like the alcohol and tobacco industries: Regulated, slow-growing, highly profitable, but modestly valued.

In the meantime, traders can enjoy the ride. Until July.

No Soup for You!

In the classic Seinfeld comedy, a deli owner nicknamed the Soup Nazi decided who was worthy of his soup and who was not. His judgment was completely random and harsh.

In the world of oil, prices have been rising for months with West Teas Intermediate (WTI) touching close to $70 per barrel. Most oil is priced off this benchmark, except for the bulk of Canadian crude. Canadian heavy oil, called Western Canada Select (WCS), does not attract near this price. Our oil requires more processing and so is priced at a discount. Mexican and Venezuelan crude are equally heavy, but Canadian oil gets a much more severe haircut in today's markets.



Source: Oilprice.com

Historically, the discount has been about US $10-$15 per barrel. The large spread today is the result of pipeline outages and too few ways to ship it. We do not have the pipeline capacity and oil-by-rail has been slow to respond.

Canada produces 2.4 million barrel per day of WCS oil (source: Natural Resources Canada), and it is growing. As the chart above shows, Canada has missed out entirely on the recent jump in oil prices. While America's WTI is now at US $65 per barrel, ours is near the lows of the last year – around US $35 per barrel.

The losses to Canada's pocketbook are significant. An extra $15 per barrel discount on 2.4 million barrels is US $36 million per day, or about $13 billion per year. Who benefits? The American refineries get to buy our oil at a very cheap price and then sell the refined gasoline at market rates. No wonder most US refiners are at all-time highs.

Politics aside, this disparity also explains why Canada's oil sector has been so weak. We have simply become too good at producing oil while neglecting domestic refining capacity and transportation of it. It is even worse for the natural gas producers, where production has grown even more. Canada is blessed with huge reserves of natural gas but our biggest customer – the USA – is now our biggest competitor. US crude output in January was the highest in 47 years and just below the record set in November 1970 (source: EIA).

The discount between Canadian natural gas and US gas is 50%. At one point in December, Canada's price dipped almost to zero because we had too much in storage and nowhere to put it. New supplies became worthless for a short period of time.

In time, this will resolve itself. The railways are already gearing up to ship thousands of carloads per day and new pipelines are just a year away. But production continues to grow, meaning Canadian energy is likely to trade at a sizeable discount for the foreseeable future.

There are a few bright spots in the darkness of Canada's energy patch. Those companies with refineries – Suncor (**TSX SU**) and Imperial Oil (**TSX IMO**) have been able to offset losses on the production side with profits in refining. Some companies are producing the much lighter shale oil and liquids rich natural gas, both of which are in higher demand and command a better price. Many Canadian companies are now focusing on their US properties and ignoring Canada. The Canadian Association of Oilwell Drilling Contractors said only 107 more wells will be drilled in Canada in 2018 over 2017. Production is exploding in Texas and Oklahoma due to a decrease in regulations and the new tax cuts – exactly the opposite of the conditions in Canada.

In fact, many Canadian drills have been moved south to the US to be run by American workers.

Our conclusion? Canada's energy companies are a resilient lot. We may be staring at the absolute lows in the prices of many Canadian energy companies right now, but the recovery has taken – and is likely to take - much longer than we first thought. Stock purchases should focus on liquids-rich gas producers and light oil companies, or the integrated giants mentioned above which own refineries.

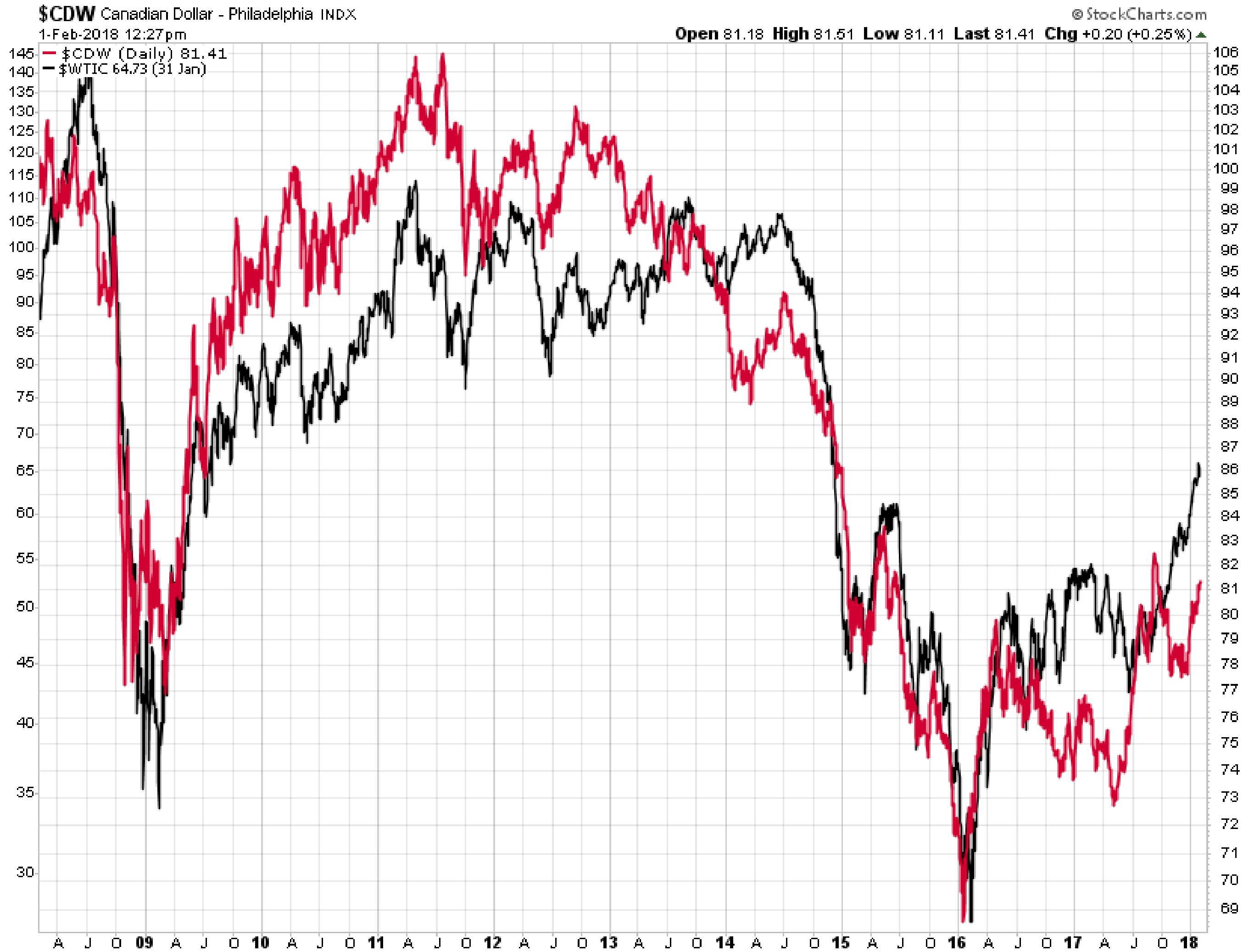
So What About the Dollar?

Perhaps the biggest frustration is the rise in the Canadian dollar from US $0.73 last April to $0.81 today. Canada is an exporting nation and a stronger dollar makes our oil, wood, and grain more expensive.

The chart below shows the lock-step trading relationship between the price of oil and the Canadian dollar. Close to 20% of our exports are energy, so it is not a surprise that our boat would float with the price of West Texas crude oil.

The problem is the one stated above. We don't receive the higher West Texas price - we receive the severely discounted Western Canada Select price. Our dollar is going up because world oil has gone up, yet we receive none of the benefits.

Common sense suggests the Canadian dollar should fall this year, but when has common sense mattered in today's markets?



Is There a Crash Coming?

There is a growing feeling of angst that a severe stock market decline is just around the corner. The US market has gone over a year since even a 3% decline, so investors are nervous that "the big one" is just around the corner.

The truth is this: Economic conditions are better than they have been in many years. The last crash in 2008 was preceded by a spike in oil prices to $140 per barrel and US mortgages being foreclosed at an accelerating rate. Oil today is half the price it was then, and the mortgage market down south is very healthy. Banks have more capital in reserve than they have had in decades and problem countries from Brazil to Russia to Italy are on the mend.

The biggest support for the stock market is rising earnings. We know US earnings are up sharply due to the recent tax cuts, but they are also rising quickly in Europe and Asia. Market declines usually happen when earnings are in decline, not when they are improving.

That said, the US market is due for a “corrective rest.” Fewer socks have been making new highs, which suggests we could see a 5-10% decline in this ongoing bull market. There is also a level of complacency among investors. After sunny skies for so long, some people are convinced it will never rain again.

It may feel like a crash after so long with no declines, but it won’t be. Our strategist, Jeff Saut, describes these declines as necessary to “rebuild the stock market’s internal energy.” He is calling for February to possibly be the month when we finally get that 5% decline. For those adding to retirement plans, it could be welcome news.

We have received several referrals this month.

Thank you!

Attention Management

Many years ago, the most productive person was the busiest. Whoever could squeeze more work into fewer hours was the one promoted and praised.

Busy equalled productivity.

Then along came the telephone and other forms of faster communication. Suddenly, you could be very busy answering the phone and yet get nothing done. Busy no long meant productive. In fact “busy work” became synonymous with wasted time.

This ushered in the era of *time management*. Whoever could control the phone or could keep the office door closed when there was a line-up outside was the new star to be promoted and praised.

Time management equalled productivity.

Today, we live in a world of email, texts, and constant internet connectivity. Our days have expanded to a full 24 hours. Many young people now sleep with their phones next to their pillows! Time now manages us, rather than the other way around.

In this new age of information bombardment, anyone can be busy. Managing time and energy are no longer enough. There is too much information to be consumed in the time available, which means what now has to be managed is our attention. Without attention management, it is far too easy to get distracted down the rabbit-hole of Facebook or click-throughs to new websites and chat rooms.

Some newly-productive people shut off their e-mail until they have accomplished an important task or planned their day. Many meetings are now phone-free to eliminate distractions, and even the White House is testing the idea of no phones allowed (although this may be an effort to prevent recordings of you-know-who in the Oval Office).

"Resisting the lure of busyness, having a plan for saying no, maintaining a relentless focus on self-directed goals that only you can achieve — these are the skills we need to cultivate in ourselves to succeed, both at work and in life."

- Ron Friedman, Harvard Business review

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