The Market in Review

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This week's articles and insights

1. *For Better or Worse*
2. *Another 2008 Meltdown? Not Likely*
3. *Marijuana – Not So 'High" Anymore*
4. *No Stock for You!*

"Dear Life: When I said "can my day get any worse?" it was a rhetorical question, not a challenge."

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	26,252	+ 2.63%	+ 12.54%
S&P 500	2,923	+ 2.65%	+ 16.60% (+13.65% in $CDN)
TSX	16,253	+ 1.50%	+ 13.48%

For Better or Worse

If there was a dominant theme in the Old Testament, it was Good versus Evil. God versus Satan, Eden and the serpent…you were on one side or the other. And there wasn't a lot of gray area in between.

The New Testament brought forth more of a theme of change. You could be better, or you could be worse. Even if you were a bad sinner, you could repent to find your way to a better path. You could also slide downward to a hotter fate, if you made the wrong choices.

(Disclaimer: My theology education ended at age 14 when I was confirmed to take communion in the Anglican Church, and then decided sleeping in was preferable to a hard pew.)

The economy and the stock market work in a similar fashion. When we listen to the daily news, it is either Good News or Bad News. Mostly Bad News, to be honest. We are then encouraged to panic one way or another based on this information. This is Old Testament thinking.

However, markets react far more to *change* as opposed to absolutes – New Testament thinking, if you will. Better or Worse has far more impact than Good or Bad.

Take, for example, Microsoft's earnings in the dot.com years. Revenues grew every year from 1994 through 2004 – decidedly Good News - and yet the stock fell more than 50% from 2000-2001. Overlaying the stock price movement with the growth rate in revenues shows how the worsening trend affected the share price:

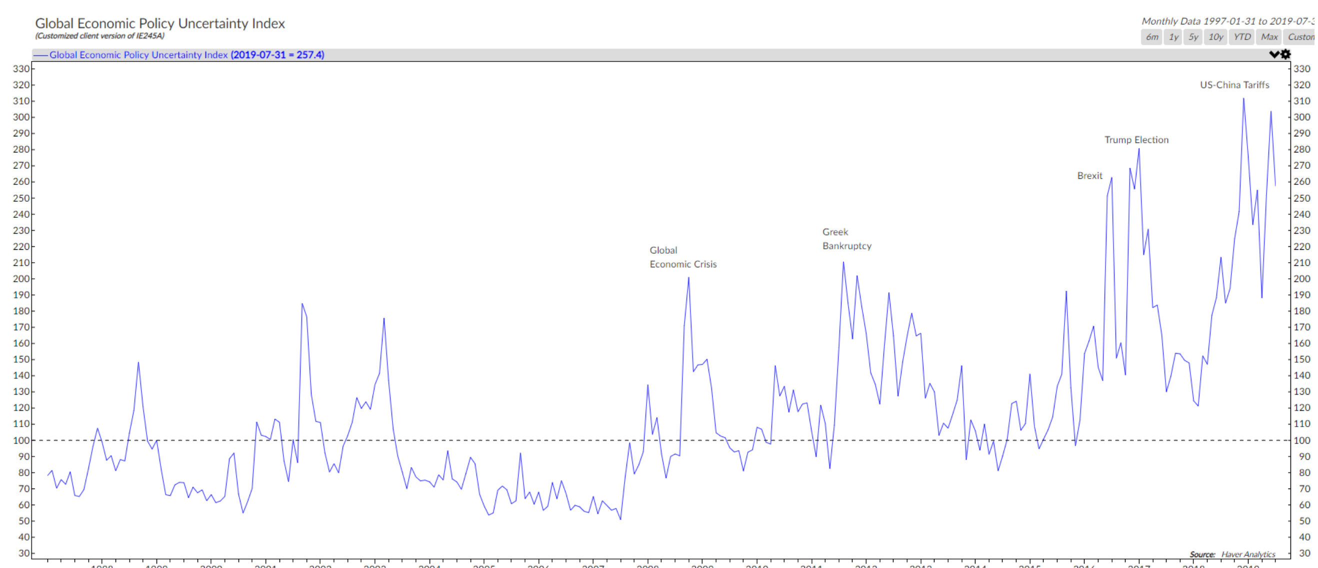
As growth slipped to 16% from 29% in 1999, the upward trajectory slowed to the slowest pace in five years. When earnings growth decelerated further to 10% in 2001, the shares plummeted.

Therefore, the question we try to answer is not "Are conditions *good* or are conditions *bad*?" but rather "are conditions getting *better* or *worse*?"

Looking at the world, things appear pretty bad. Conditions are as tense as they have been in many years:

- The U.S. trade war with China.
- Beijing and the pro-democracy demonstrators in Hong Kong.
- India stripping Kashmir of its autonomy.
- North Korea continuing its nuclear-weapons program.
- Iran and tensions in the Strait of Hormuz.

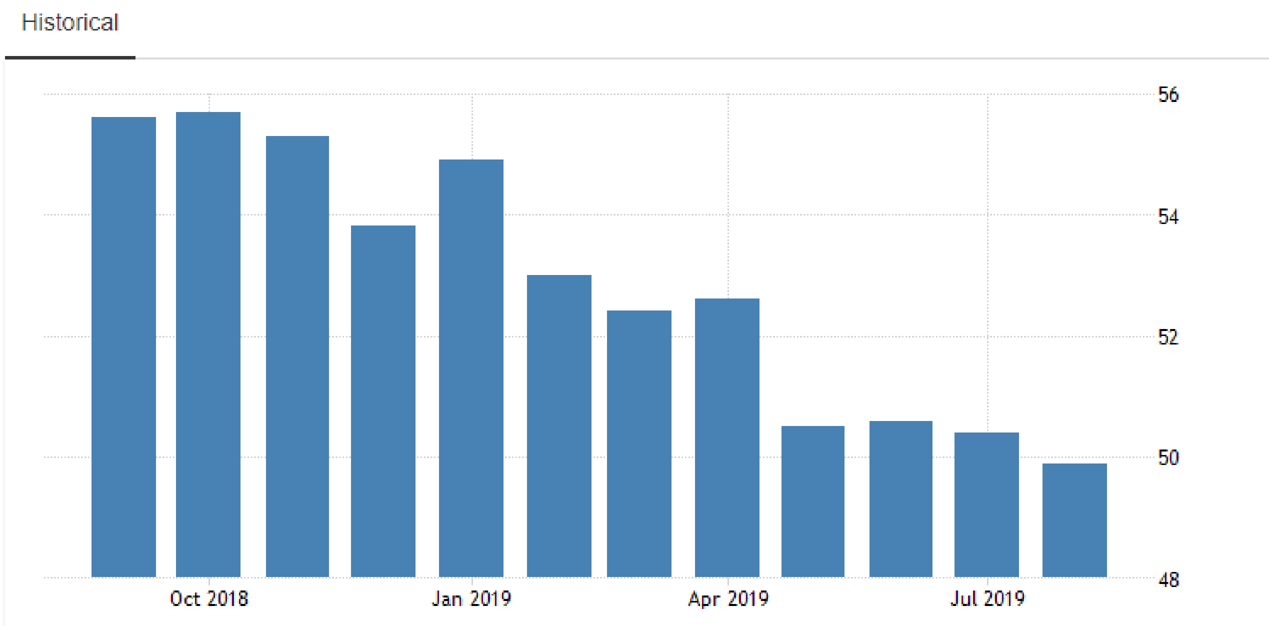
There is even an index that shows this:



As a result, economic conditions have deteriorated. No surprise – people spend and invest less when there is uncertainty.

The economy that has held up best of all in 2019 is the US economy. Its trend continues to worsen, unfortunately. The Manufacturing Purchasing Manager's Index (Markit Economics) showed the first month of contraction in manufacturing (a number below 50 is contraction) since September 2009, as new orders fell the most in ten years.

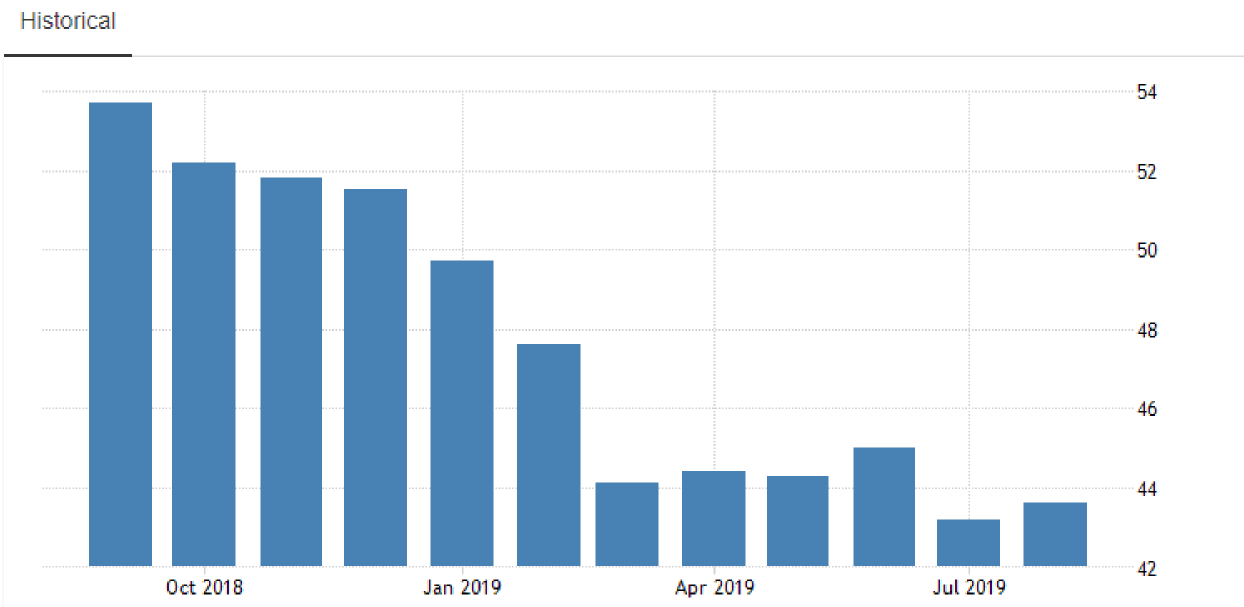
This plays into our expectations for flat-to-weaker markets over the next few months:



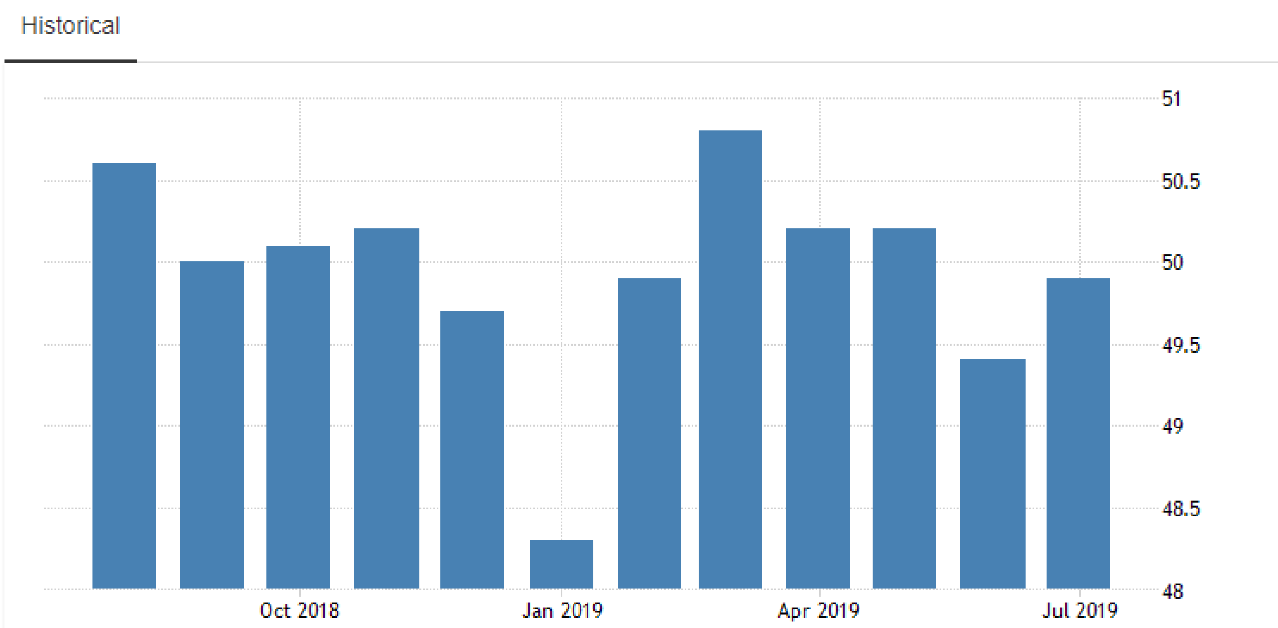
Overseas, where conditions have been worsening for almost a year, we may be seeing signs of bottoming.

Germany has been in contraction for almost a year, which everybody knows. Old Testament thinking tells us the German economy is *bad*.

However, it just reported a positive surprise. Its economy is still contracting, but at a *less-worse* pace:



China is also showing very tentative signs of improvement.



Source: Markit Economics

In truth, we may be grasping at straws here. There is a great deal of turmoil and weak economic numbers everywhere, and it will take time for world markets to work their way through them.

But we do know that even the worst economies eventually bottom and turn upwards.

Another 2008 Meltdown? Not Likely

Are we standing on the cliff of another 2008 meltdown? We look at the credit markets for early signs, and there are **none apparent**.

High yield bonds – the lowest grade credits (they are the “canaries in the coal mine” that die first) - show few signs of stress. Note the previous stress periods in 2011 and 2015 – we are not seeing that today:

High-yield bond spreads over the last 10 years

Source: RBC GAM, Bloomberg. Data as of July 31, 2019.

RBC Global Asset Management 16

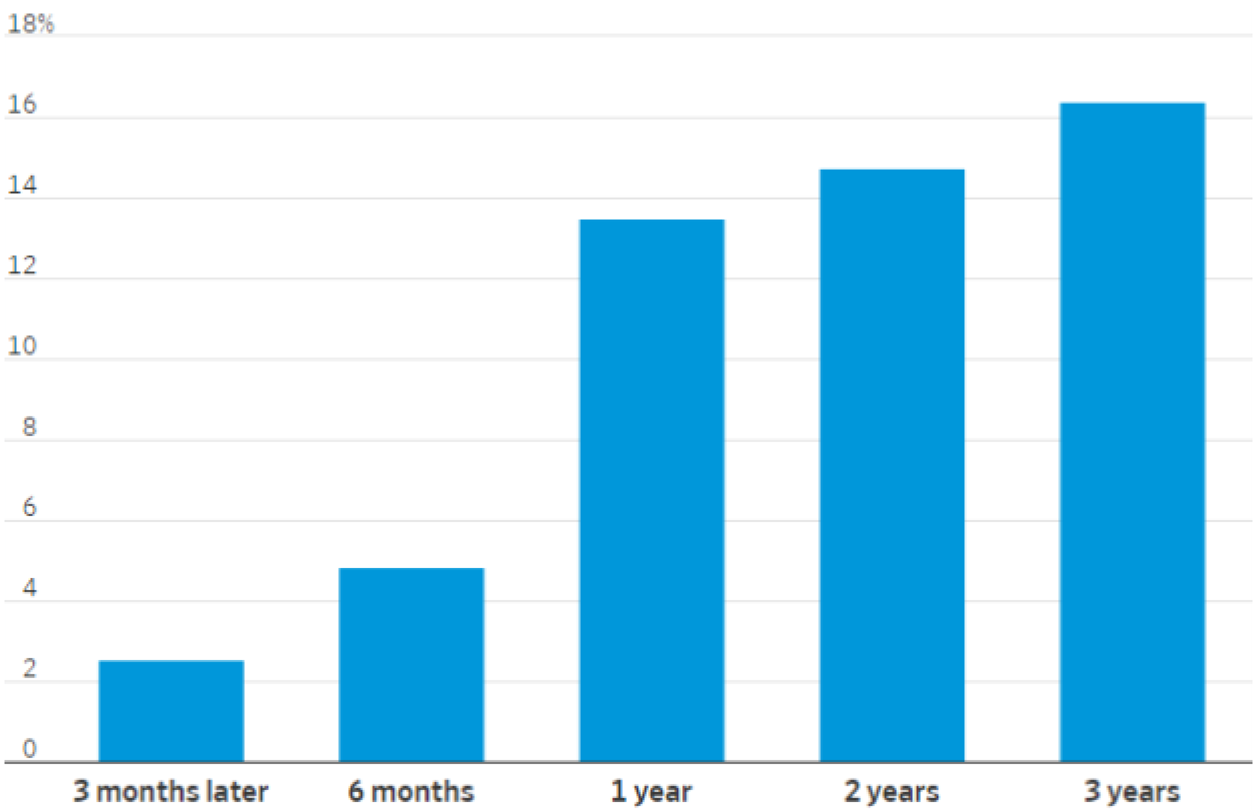
As well, governments are not standing still.

Globally, we now have 24 central banks cutting rates this year by a cumulative 1,085 basis points. This is in response to the inverted yield curves worldwide. Lower interest rates eventually stimulate everything from home sales to corporate investment.

While there has been talk about recessions being inevitable after interest rate inversions, there has been less discussion about how stocks do. The answer? Pretty well.

Yield Curve Inversion

S&P 500 average performance following a 2-year/10-year yield curve inversion



Source: Dow Jones Market Data

Since 1978, there have been 5 inverted yield curves. In every case, stocks were higher one year later, and in 4 cases out of 5 in the next two and three year periods.

The Bottom Line?

1. It is a weak time of year and economic conditions are undecided, at best.
2. It is fine to hold extra cash here. Add gradually over the next few months.
3. The year before a US election (from here into 2020) has generally been positive for stocks since the year 1900.

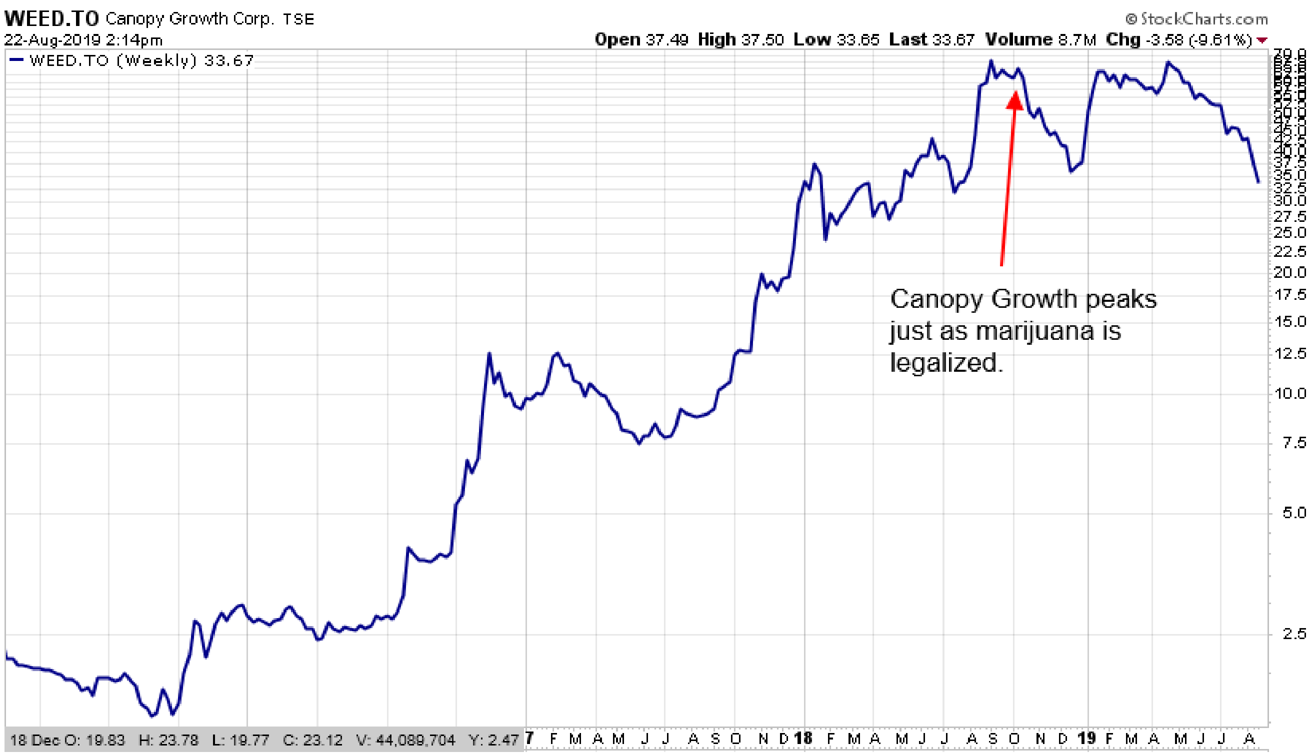
Marijuana – Not So 'High" Anymore

Marijuana has now been legal in Canada for 10 months. We admit, we missed the boom in shares of everything related to "weed", from dispensaries to cannabinoid vitamin makers.

Like most new industries, much of the initial excitement is due to hype as investors pile in to the next hot thing. This time, it was marijuana and its promise of being the first new "sin" substance legalized since alcohol.

In the end, however, marijuana is just a crop – a commodity that can be grown anywhere by anyone. Its price will fall until there is a stability of supply and the most efficient producers emerge. We are not there yet.

Canada's largest producer, Canopy Growth (**TSX WEED**), is half of what it was when marijuana was legalized. Most of its smaller competitors have fared even worse.



Another much-hyped investment, Bitcoin, fell 75% in value after its popularity fizzled, although it has since recovered a portion of its losses. Most of the other digital currencies remain at a fraction of where they were a year ago.

Such is the nature of bubbles.

No Stock for You!

One of the most famous Jerry Seinfeld episodes featured a soup store where the rules were very strict. If you complained about anything, the owner – nicknamed "The Soup Nazi" would proclaim "No soup for you!"

A week ago, Canada's largest forest products company, Canfor (**TSX CFP**), received an offer to be taken private at about $16 per share. It was $34 just a year ago. Kinder Morgan, Canada (**TSX KMI**) – the pipeline company – announced it was selling out a few days later. They join Westjet (**TSX WJA** Canada's 2nd largest airline) and AGT (the pea protein company behind the Beyond Meat burgers) as companies being taken off the stock market and into private hands. Canada's iconic Hudson's Bay Company (**TSX HBC**) is in the midst of its own takeover battle right now. The only question is the final price.

Why is this happening more and more frequently?

For starters, money is cheap. If you need to borrow a billion dollars to buy out a company, it has never cost less to do it.

Second, many companies are finding it harder and harder to deliver growing earnings every three months – the public reporting period – when their own cycle is much longer. Canfor, for example, plants trees that can take 60-years to grow before they are cut into lumber. That gets hard to repeat every quarter! Other costs like shareholder lawsuits, agitating shareholders demanding say on executive pay and climate action, and rising regulatory fees, can make remaining a public company more bother that it is worth.

Jimmy Pattison, the billionaire buying Canfor, says the lumber industry faces many challenges that can be met more easily out of the public eye. And at much lower cost.

Husky Energy (**TSX HSE**), one of Canada's largest oil companies, is also rumoured to be a privatization candidate by its Hong Kong bosses, and Nordstrom (**NYSE JWN**) in the US could end up back in the Nordstrom family's hands.

While it is nice to receive an offer for 50-100% of the current price of your shares, it reduces the number of stocks we have to choose from. Canada's number of public companies has already declined by 17% since 2007. We don't need to see it shrink any smaller.

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