The Market in Review

Paul Siluch, Lisa Hill, Peter Mazzoni, and Sharon Mitchell
Financial Advisors
Raymond James Ltd. – Victoria BC

July 21st, 2017

This week's articles and insights

1. *Forced Evolution*
2. *A Good View to Q2*
3. *Homes Sweet Homes*

"Living species remain unchanged for extremely long stretches of time, and then undergo profound changes in relatively short periods."

- ***Stephen Jay Gould***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	21,581	-0.26%	+ 9.20%
S&P 500	2,473	+0.54%	+10.44% (+2.93% in $CDN)
TSX	15,183	+0.05%	- 0.68%

Forced Evolution

Ever since Amazon (**NASDAQ AMZN**) made its offer to purchase Whole Foods (**NYSE WFM**), the perception of the on-line technology giant has gone from benign cost-cutter to world conqueror. On the day of the announcement, Amazon and Whole Foods shares rose approximately $14 billion in value while the combined market losses in the rest of retail touched $77 billion.

There has been some recovery, but not much. Suffice it to say, retail everywhere was already under siege from cash-starved consumers finding better deals on-line. Amazon adding brick-and-mortar stores to their on-line offerings only made things worse.

This assumes a static battlefield, however. An arena where no one adapts. This is not how human history works, as I show in the example below.

The German army defeated the Polish armed forces in just over four weeks in 1939. They accomplished this using a combination of mobile troops, fast armored tanks and paralyzing air attacks featuring the new Stuka dive bombers. They followed this up by steamrolling through France's famed Maginot line of defensive fortresses. The French leaders believed their defensive system would succeed where the Poles had failed. They made no changes to their plans when the Poles were overrun, and subsequently suffered the same fate.

One big mistake they did not account for was the ability of airplanes to fly over their fortified wall.

The Germans had also significantly upgraded their firepower after WW1. They had far more tanks (which they had organized into six divisions where the Allies had none), more machine guns, and antitank guns. The Allies had barely as many as in World War 1. They were caught almost completely off guard.

Tactics were changed, as well. The German army adopted "lightning war", or blitzkrieg, that utilized their greater speed to punch holes in the enemy line followed by mechanized infantry and foot soldiers. The Stuka dive bombers worked in tandem to attack and disrupt supply and communications lines while spreading panic and confusion.

The parallel here? The retail industry of today is like the Allied armies at the beginning of WW2. They were prepared for the last war – when malls and big box warehouses were as impenetrable as a trench – but not the blitzkrieg of on-line shopping.

What did the Allies do after their initial losses? Well, when the going gets tough, the tough imitate their enemies.

The Russians, for example, retreated further and further within their own country until 1941 when their new tank, the T-34, was finally produced in large numbers. It was thick enough to withstand the Panzer's guns and better in the snow. In fact, it was the best tank of the entire war.

The British countered the Stuka dive bomber with their faster Typhoon airplane in 1941. They developed new mines and anti-tank guns to stop the Panzers.

In short, being down doesn't mean staying down. In everything from wars to evolution, we see organisms rapidly adapt to counter new threats.

Of course, in every war, there are a few that don't survive. Sears (**NYSE SHLD**) is on the ropes, as is Macy's (**NYSE M**) and JC Penny (**NYSE JCP**). Payless Store, Bebe, The Limited, Wet Seal, and American Apparel have already entered bankruptcy.

Once the dust settles, survivors will emerge. They will look more like Amazon than they used to, and some will even begin to outcompete the Seattle giant. In time, Amazon could even be surpassed. Sears and its famous catalogue once owned retail America until it was passed by Wal-Mart in the 1970s. Who knows who or what will upend Amazon?

What other companies have the ability to survive the onslaught? Wal-Mart (**NYSE WMT**) recently bought Jet.com, an on-line site, to beef up its digital presence. Costco (**NASDAQ COST**) is unique in that it already has an annual membership model much like Amazon Prime. Its focus on fresh food should prove a hard "moat" for Amazon to cross. TJX (**NYSE TJX**), the company behind TJ Maxx and Winners, specializes in big one-time sales of discontinued goods. They even undercut Amazon on many days.

As WW2 wore on, the German army relied too much on what had already worked. They introduced no four-engine bombers and no aircraft carriers, for example. They did not commit to newer initiatives, like the jet engine, until it was too late.

More and more stores are creating their own in-house brands that are not available on Amazon. Amazon is also experiencing more problems with counterfeit products being shipped as the real thing. Some brands will only sell through stores or their own websites, or they greatly restrict through whom, and how, their products are sold. Other retailers, like Costco, are able to create a "treasure hunt" experience that Amazon cannot match. Macy's does 20% of its gross revenues with its own private-label brands and saw its own on-line sales grow 18% in the 4th quarter. Is it enough? Hard to tell, but the company knows it has to copy Amazon to survive.

Sears Canada (**S&P/TSX SCC**) could have owned the on-line world if they had seen its potential earlier. They did not move their catalogue on-line until 1998, and even then only hesitantly featured just 500 products. By 1998, Amazon had over 3.1 million customers, which meant any effort from Sears was too little, too late. One day, even Amazon may become too complacent, allowing some new incumbent to take the lead.

We are watching the retail space for the first signs of survivors but it is probably too early to buy the retailers that Amazon is crushing. The choice many investors make – which is the wrong choice - is to sell a winner to buy an undervalued loser.

History bears this out.

Amazon sells about one-quarter of what Wal-Mart sells today. This puts it right where Wal-Mart and Sears were in 1987, when Wal-Mart had one-quarter of Sears Roebuck's sales.

Since 1987, Sears shares have moved from $20 to $9 today, plus a few spin-offs. Wal-Mart passed Sears in 1991 on its way up, while Sears was on its way down.

Since 1987, Walmart shares have appreciated by 25x.

It is still early days for on-line sales and Amazon clearly has the upper hand. And likely will for years to come.

A Good View to Q2

The political climate is uniformly gloomy on both sides of the border. Up here in Canada, the forests of the British Columbia interior are ablaze. The fires have shut down forestry and mining, and tourism is at a standstill. The new provincial government has pledged to hike income taxes on wealthy residents while the federal government is going after incorporated professionals and small businesses, labeling them "tax cheaters".

In the US, President Trump has declared war on our NAFTA trade agreement even as he is unable to pass any of his own new legislation. His popularity is near its lows.

In short, the political news is awful.

On the economic front, however, conditions are actually pretty good. Corporate earnings are graded on how many companies beat what analysts expect, versus how many miss these expectations. The Beat/Miss scorecard looks like this:

68% Beat/Miss historic average (68% of companies have historically exceeded analyst expectations each quarter)

75% Q1 2017
80% Q2 reported up to July 14th (Factset)

Earnings are coming in very strongly, especially with banks and technology.

An increasingly common theme on earnings calls is what we call “Waiting for Trump”. Many companies have been waiting, and waiting, and waiting, for promised health care reforms and tax cuts. These were promises made after the 2016 election that have gone nowhere.

Companies have begun to move on and chase growth outside North America. The rest of the world – Asia, Europe – is strengthening. Those companies with significant overseas operations are doing better than the purely domestic ones. It is good news when more than just the US economy is in expansion.

Canada’s dollar continues to unexpectedly strengthen. The perception had been that we would be stuck with T-Bill rates of 0.5% for a long time to come. As of two weeks ago, we are now at 0.75% with another hike to 1.00% expected by Christmas. This has sent the loonie soaring.

In speaking with international bond managers, their target for the Canadian dollar is now US $0.80-$0.82. This means most of the rise is likely behind us. Rising oil prices have also served to push the Canadian dollar higher.

Overall, earnings are decent, and economic conditions remain benign. Most summers are far more tumultuous, so we’ll happily take this year’s calm.

We want to say thanks to our clients for introducing their friends and family members to us throughout the year. It’s a *tremendous compliment and a huge responsibility, and something we never take lightly.*

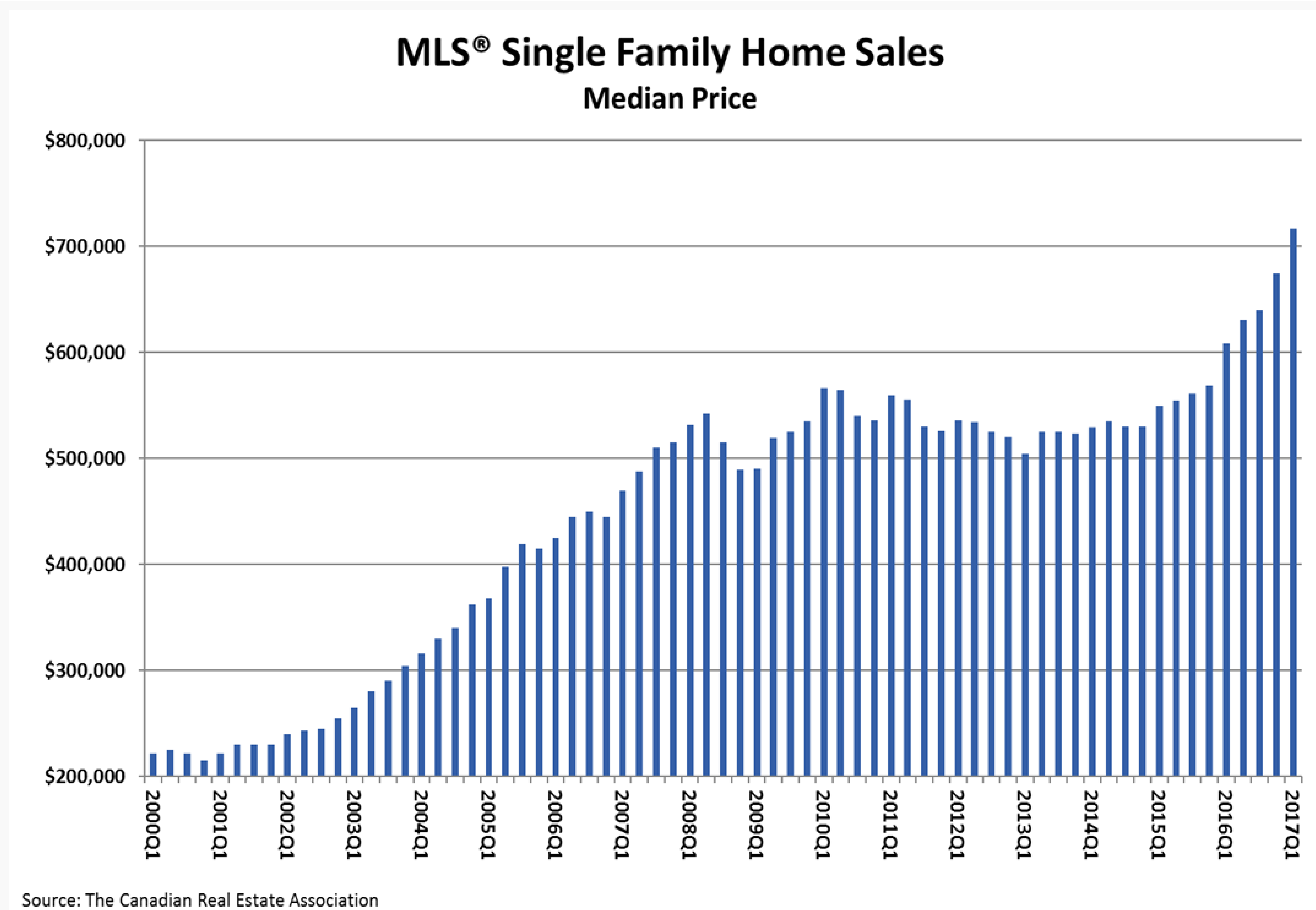
Homes Sweet Homes

We were out with clients recently and we got talking about real estate in Victoria.

I mean, how often are you at a party where people are <u>not</u> talking about real estate in Victoria.

The consensus was that a home is a far better investment than the stock market, with one gentleman saying he would never invest in the stock market again. When probed, he was still smarting after the drop in 2009 because he sold and never bought back in.

The question is: is he right? Here is a graph of median home prices in Victoria BC. In 17 years, the average home has appreciated by 250%.



Real estate has several advantages over stocks.

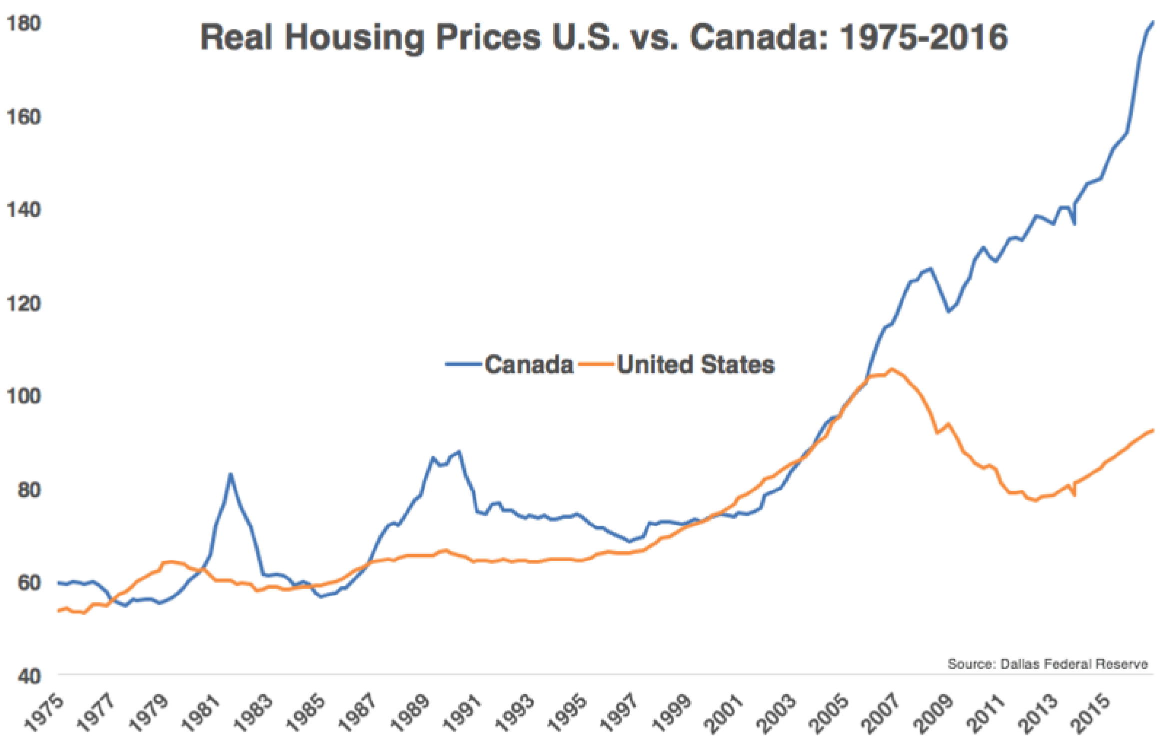
1. No one puts a "*This home is worth $700,000 today*" sign on your lawn every morning. It could go down in price and most people would never know (or care). Stocks get priced every second for all to see.

2. Declines tend to be more shallow in real estate versus the stock market. See real estate prices in 2008 above – hardly a ripple.

3. Homes are purchased with enormous leverage – often just 5% down. This means an investment of $10,000 in the year 2000 bought you that

$200,000 home. By 2004, your house was worth $300,000 but you probably had only put $40,000 into it. In other words, you more than doubled your initial investment because of leverage.

Real home prices in Canada – prices after inflation – did not move much during the 1990s. Once we crossed the year 2000 and interest rates began their sharp decline, prices took off and never looked back. US home prices collapsed in 2008-2009 and are only now recovering, but Canada's did not even pause. The average American's perception of the value in their home is not as strong as that of the average Canadian, and for good reason:



The graph below answers the question once and for all. A home in Victoria has been a better investment than the stock market since the year 2000. Canadian REITs – real estate investment trusts traded on the stock exchange – have been an even better investment.

Source: Morningstar

But the difference between Canadian equities and Victoria real estate is not that large. An average Victoria home is up by 250% while Canada's S&P/TSX index is up 180% in the same time.

And, Canadian stocks rose 200% from 1990 through 2000 while Canadian real estate was flat, on average.

The problem for most people is the volatility. They read about market crashes in the newspaper and see the sickening declines on TV. They get scared out.

The bigger question is what to do with money now. After the huge climb in home prices in Vancouver and Toronto, can we expect the same in the future? Most economists would say “not likely”.

When we talk to both bond and stock managers who have a global mandate, most are now shifting money gradually overseas to Asia, Europe, and the emerging markets. They see better values and higher growth, and these factors are gradually pulling money away from Canada.

Emerging market funds are barely above where they were 10 years ago, for example. Bond managers, too, are gravitating to higher yielding bonds in improving countries like Indonesia, where yields of 6-8% can still be found.

The public loves local real estate and many think it will go up forever. History suggests this won't be the case.

http://www.raymondjames.ca/siluchhill/

We thank you for your business and your referrals and we hope you find our site user friendly and informative. We would welcome your comments.

How to contact us:

paul.siluch@raymondjames.ca
lisa.hill@raymondjames.ca
peter.mazzoni@raymondjames.ca

(250) 405-2417

Amazon.com - Raymond James & Associates makes a market in shares of AMZN.
Costco - Raymond James & Associates makes a market in shares of COST. Raymond James & Associates received non-investment banking securities-related compensation from COST within the past 12 months.
Wal-Mart - Raymond James & Associates makes a market in shares of WMT.

Prices shown are as of close July 21st, 2017.
