# The Market in Review

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## This week's articles and insights

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**"Size doesn't matter. Except when it comes to clothes, food servings, fonts, cancer, shoes, hats, books, asteroids, and bombs."**

\- ***Poster***

### Your Index Report

| | Current | Last Week | Year-to-Date |
|---|---|---|---|
| Dow Jones Ind. Avg. | 20,663 | +0.32% | + 4.56% |
| S&P 500 | 2,363 | +0.80% | + 5.53% (+4.35% in $CDN) |
| TSX | 15,548 | +0.68% | + 1.70% |

## Winner Take All

Concentration of wealth is a big issue these days. The Occupy Wall Street protests began almost six years ago using the slogan "*We are the 99%"* to shame the 1% who hold much of the wealth in the US and Canada. In Canada, the top 20% of the population own approximately 50% of the wealth (source: GlobalNews) and this is closer to 80% in the US.

In fact, this is not a new phenomenon. Similar numbers occurred in the US in the 1920s, when 1% of the population controlled 36% of the nation's wealth. In medieval times, 1% of the population (the royalty) owned closer to 99% of the property and wealth.

Wealth swings back to the populace when there is a shortage of workers and they achieve a wage premium for their services. Historically, this happened after plagues and wars. When the population of workers expands, wages drop and money concentrates back in the pockets of the rich. This is not an argument for or against income disparity. In fact, if you make more than $32,400 per year (source: Investopedia), you are in the top 1% of global earners!

Income disparity occurs in the stock market, as well. We are seeing a concentration of companies and profits unlike anything in decades, and this may help explain why profit margins have gone to such lofty levels. Even though the economy has tripled in size, there are fewer publicly-traded companies in the US than there were in 1970. There are less companies in each industry, as well, allowing the survivors a bigger slice of the pie. A study by *Grullon* shows increasing industry concentration in at least 75% of U.S. industries. We see it today in many categories, from toothpaste to gasoline. Sometimes there are just two brands to choose from.

There is even a term for it: ***Winner Take All***.

Why is this relevant? With fewer and fewer companies making all the money, perhaps we don't have to hold so many for proper diversification. The study cited above shows returns on assets rise the more an industry is concentrated because they are able to raise their prices more easily. The top 20% of firms in terms of profits in the S&P 500 are becoming even more profitable relative to the lowest 20%. The winners are, indeed, taking it all.

Since 1926, in fact, the top 20 stocks out of the 26,000 US stocks available over those years (*source: Bessembinder, 2017*) account for about 25% of the wealth creation since 1926. The remaining 96% returned only what T-Bills returned.

And size matters. Market share increases for the largest companies, meaning the big have an advantage as they get bigger. From 1995 through 2005, the two largest US companies were GE (**NYSE GE**) and Exxon Mobil (**NYSE XOM**). You would have done very well just owning those two. Since 2010, the two largest companies in the US have been Google (**NASDAQ GOOGL**) and Apple (**NASDAQ AAPL**).

Of course, even large companies are targets for disruption. Just ask Sears (**NASDAQ SHLD**) and JC Penney (**NYSE JCP**) about a company called Amazon (**NASDAQ AMZN**). It is important to have some diversification. But how much?

Most portfolio theory suggests anywhere from 15 to 50 stocks is sufficient to diversify a portfolio. It is much easier to own 500 stocks through an index like the S&P 500 now, but do you really need 500 stocks, especially since just a handful make all the returns? The increasing effect of *Winner Take All*, where the biggest companies gain most of the profits, suggests you don't.

We hold approximately 28 stocks in our portfolios and this is a number that works well for us. Our outside managers will have up to 50. More than that and it is difficult to follow them all properly.

## A Swing and a Miss

The past two weeks in both politics and the markets have been driven primarily by one thing: the attempted, and then failed, passage of the *Repeal and Replace* US healthcare bill. This was legislation put forward by the Republican administration to repeal the US health care act known as Obamacare and replace it with something that could better sustain itself economically. Because Democrats felt it took away too much, while many Republicans felt it did not take away enough, it failed to gain enough votes to pass, and was withdrawn.

Heathcare is a very thorny topic in any country. It took seven months of amendments, revisions, and setbacks before Obamacare was signed by the President in 2010, so this is not the end of the world. However, it is viewed as a test to see if President Trump can move his agenda forward. A test to see if he can make it through the swamp he so wants to drain. The failure to pass both his contentious Immigration bill and now Repeal and Replace puts his even bolder Tax Reform proposals on shakier ground.

Trump is swinging hard for the ball, but missing, so far in his term.

Stocks fell only about 3%, and have since made most of the decline back. Many have expected markets to decline even more after the dramatic rise since the November inauguration, and they have been disappointed. What is holding things up?

Consumer confidence, for one thing. This measure of confidence in the economy hit its highest point since 2007. People feel better about jobs and the potential for income growth.

“People don’t spend confidence. They spend income,” said one wag about the numbers. Job growth in the US has been the best since 2009, with over 200,000 jobs added per month for five straight months. A brighter outlook for employment does wonders for retail spending. Private sector wages rose by 6% over those of a year ago, which is a multi-year high. It is important that people are making more money! And the US personal savings rate rose to 5.6% from 5.4% - another good sign.

From a corporate perspective, it is the hope for less regulation that is spurring confidence. The new administration has promised to remove two regulations for every new one added. From 2009 to 2016, the Democratic administration added close to 25,000 new regulations (Washington Examiner) covering everything from water use and Christmas ornaments to school lunch menus and pigs on airplanes. Jim Cramer stated that the former administration added 25 new regulations for each one it removed. Time will tell how many rules Trump can remove or relax, but the rally in stocks speaks volumes about the relief the business world feels.

We still expect some sort of cooling off of the markets. So far we have not seen it.

## Value in the Oil Sands

In Canada, the biggest news in the last month has been the dramatic exit of US oil firms from Alberta’s oil sands. Concerned they are too expensive to develop, too dirty and polluting, and too pipeline-constrained to be profitable enough, three global giants sold their oil sands interests to Canadian Natural Resources (**TSX CNQ**) and Cenovus (**TSX CVE**). On the surface, these are all valid concerns. The new Keystone pipeline just approved will help, but Alberta needs both Energy East and routes through British Columbia to satisfy all the new production coming on-stream. Any new pipeline project is problematic, to say the least.

Before we write off the Canadians as rubes who paid too much for bad assets, consider the following:

- We have seen this before. Foreign oil companies poured into Canada in the 1970s and 1980s (remember Gulf, BP, and Amoco?) only to sell out quietly to Canadian firms over the following decade. Many offshore companies overpaid for oil assets as oil peaked in 2007.
- Canada's oil sands are still the second largest reserves of oil in the world. Demand for petrochemicals is still rising, despite the increase in market share of the renewables.
- Once the facilities are built, operating costs for oil sands assets have dropped dramatically. Most newspaper articles cite US $60 per barrel as the price the oil sands need to make money. If you are building a new open-pit mine, maybe, but not if you buy an existing one and operate it better. Suncor (**TSX SU**) announced their operating costs are now down to as low as $25 per barrel and Canadian Natural Resources achieved $22.53 per barrel operating costs last quarter. Numbers like this make them competitive with even the best Texas properties.
- The Canada's Oil Sands Innovation Alliance (COSIA) was formed in 2012 to allow companies to share technological breakthroughs in efficiencies and the environment. This collaboration has allowed companies to lower their costs while lowering their emissions. Few other oil regions have this level of cooperation.

In other words, don't count Alberta and the oil sands out just yet. While Cenovus may have overpaid for the assets it just bought (the market sure thinks so), most of the other acquisitions have been real bargains for the Canadian buyers.

Canadian Natural Resources and Suncor continue to stand out as the two best to own.

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## Attention Shoppers!

For many years, there has been talk that North America is “over-stored”. From downtown malls to suburban strip malls to Big Box warehouses, the retail industry just kept adding capacity. “If you build it, they will come” has been the mantra of retail for fifty years.

Trees don’t grow to the sky and nothing lasts forever. Analysts always knew something had to give, and that something was a combination of technology, demographics, and the economy.

First, technology. Technology has always been a factor in the retail store experience. What we see now as “on-line shopping” really began a hundred years ago with the Sears Roebuck catalogue. It transformed into TV shopping with the Home Shopping Network, and then into computer shopping. Now, of course, we can buy just about anything through our phones. Why suffer the crowds when we can find what we want on-line and order it with a click?

Second, demographics. The Millennials don’t shop the way the Baby Boomers (1946-1964) and Generation X (1965-1985) did. The kids of the previous generations lived at the mall. Companies like the Gap (**NYSE GPS**) thrived on the traffic. Millennials love a bargain and they rely less on ads and experts, choosing their fashions twice as much through what friends “like” on Facebook (**NASDAQ FB**) than through what experts recommend.

Finally, the economy. “This generation was raised seeing their parents lose their home and they went through the second-biggest recession in the country,” says Jane Hali, chief executive at Jane Hali & Associates, an investment research firm. Millennials will evaluate items in a brick-and-mortar store, then order it on-line. And since many fashions are copied in weeks in Chinese factories, half-price knockoffs have never been more accessible.

The result has been store after store reporting falling sales. Lululemon (**NASDAQ LULU**) reported poor sales this week and the shares tanked. Yoga pants just aren’t exclusive enough anymore, it appears. Other companies, such as Wet Seal, American Apparel, and The Limited have gone bankrupt.

Like all cycles, this one will play itself out in time. More stores will close because we have too many, while others like Wal-Mart (**NYSE WMT**) and Nordstrom (**NYSE JWN**) will fight back with their own on-line sites. Amazon will disrupt and reshape the retail industry, but it won’t ever own it completely. Some items, like fresh food and home supplies, don't lend themselves well to electronic ordering so these types of stores should continue to thrive.

At some point, shares in retail stores will become true bargains and worthy of purchase. But not yet.

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*Amazon.com Inc. - Raymond James & Associates makes a market in shares of AMZN.*
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*Prices shown are as of close March 31st, 2017.*



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