The Market in Review

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This week's articles and insights

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"Without disruptions in life, where would we be?"

- Sarah Gadon

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	25,336	+3.25%	+ 2.49%
S&P 500	2,787	+3.54%	+ 4.22% (+ 6.15% in $CDN)
TSX	15,578	+1.26%	- 3.89%

Disruptive Behaviour

We speak of disruption today as if it were something new. This industry is being disrupted by that invention, or this country by the politics of another. There has always been disruption and there always will be. Perhaps what we need to realize is that it is change that is constant, while stability is only temporary.

In March of 1876, Alexander Graham Bell filed his patent for the first telephone. There are competing claims to the telephone's nationality, as it was invented in Ontario, Canada and the first long distance call was made there, but the first patent was filed in Boston. Both Canada and the US claim Bell as one of their own.

Either way, the telephone upended all forms of communication as its use became widespread. The Pony Express system of stagecoach-delivered messages had been replaced by the telegraph and now the telegraph was set to be tossed aside in favour of the telephone. Surprisingly, both services continued in other forms.

The Pony Express was sold to Wells Fargo where it evolved into an armoured car service. The telegraph grew until the end of WW2 and then evolved into the Telex machine.

But nothing could stop the telephone. It was everywhere by the turn of the century and the cost had fallen enough that many homes had one. While many feared it would hurt society by enticing people to stay indoors and even eliminate regional accents, the telephone instead connected families, neighbours, cities and countries like never before. In the early years of its use, women were discouraged from using it for "idle gossip" – until they found men were gossiping even more.

Like the personal computer 100 years later, it was dismissed as a toy by the incumbents. Western Union was offered the patent by Bell and his investors for $100,000 just after it was filed. The president laughed it off. Two years later, he sheepishly admitted he would pay $25 million for that same patent, though it was never offered again.

Today, the autonomous car is spoken of in the same breath as the first telephone in terms of the changes it will unleash. There are fears that children today will never learn to drive and the act of a human driving a car will one day be outlawed. Few of the worries surrounding the telephone came to pass, even as it opened many doors few saw at the time. Humans are a resilient species. The same will happen with driverless cars. It will be a marvelous era.

Tariff Tizzy

Meanwhile, markets faced another disruptive force this week in the form of the threat of tariffs on steel and aluminum by President Trump. To be fair, the US has shouldered the bulk of globalization in terms of being the largest customer for foreign-manufactured goods. China, in particular, has absorbed, copied, and outright stolen many of America's patents and used them to undercut US industry.

Tariffs are a very blunt tool, however, which is why they are rarely used.

So what is a US steel job worth, anyway?

According to economist Joe Brusuelas from RSM:

"Let's say the tariffs result in saving 10,000 jobs. The 25 percent tax on $29 billion of imported steel, and 10 percent tax on $17 billion of imported aluminum, will result in increased costs passed along to firms and consumers to the tune of $9.15 billion. ***Therefore, the implied cost of saving those jobs amounts to about $915,000 per worker****."*

That's a lot to save a single job – which is why tariffs are often proposed and then quietly removed.

The fear is this could lead to a global trade war. The Smoot-Hawley Tariff bill in 1930 helped exacerbate the Great Depression when small targeted US sanctions against foreign grain mushroomed into thousands of tariffs and levies in every industry. Other countries responded in kind and world trade sank by as much as 40% in the next two years.

In this, like most of President Trump's policies, he is half right and half wrong. The US has a massive trade imbalance with China and a not-inconsequential one with Mexico. US exports to China were $130 billion in 2017, compared with imports from China of $506 billion (TheBalance.com). Both countries have used cheaper labour and currency devaluations to gain market share, and the US is now saying "enough."

However, wide-ranging tariffs are like using a sledge hammer to kill a mosquito – you rarely hit the bug you are aiming at and the collateral damage can be significant. In this haze of integrated manufacturing, Canada finds itself as the largest target in this new tariff war.

As an example of the complexity of trade, consider that Canada is both the largest exporter of steel and aluminum to the US, while also being the largest importer. A full 16% of US steel imports comes from Canada, while 59% of Canadian imports come from the US (Global Steel Trade Monitor). How can you import and export at the same time?

This is the blessing (and curse) of NAFTA and global manufacturing. Steel and aluminum auto parts, to use one example, cross the border several times during the manufacture of a North American automobile. We make the transmissions, they make the fenders, we fabricate the rims, then they add the tires…the lines get so blurred, calculating whose steel it was in the first place becomes almost impossible.

For the moment, Canada and Mexico appear to have been granted exemptions from the tariffs while the NAFTA discussions proceed. This may be just a tough negotiating stance to get a better deal for the US, but we shall see.

Despite the decline so far in 2018, markets are still pricing in a favourable outcome for the NAFTA trade talks and no action on tariffs.

Following Up

In previous letters, we mentioned the weakness in the Canadian dollar. The loonie has dropped over 3% against the US dollar in just the last two weeks, and there are calls for it to go even lower. Canada's economy is slowing down while the US is speeding up, and the Bank of Canada decided to pass on a rate hike this week.

We are overdue for a bounce, but we still expect the Canadian dollar to fall below US $0.75 at some point this year.

Meanwhile, Canadian and US bank stocks survived the correction better than most other sectors. Anything to do with exports - pipelines, auto parts – suffered.

While we are suffering, the US economy is strong enough to overcome the noise of trade friction. US employment and earnings continue to climb.

Ned Davis Research describes current conditions as follows:

“Indeed, the economy is so strong that eight of the ten indicators in our Recession Watch Report have hit escape velocity. This means that the odds are for stronger, not weaker, growth in the months ahead. If mid-1960s and 1987 are the correct parallels, and our key economic indicators are showing strong momentum, it could be many months, if not years, before we see the next U.S. recession.”

Dividend Increases

One area that has been quite rewarding for shareholders is the surge in dividend increases. In the last earnings period (January and February), over one third of our Dividend Value holdings hiked their dividends, with some over 20%. This is a nice increase for those who live off dividend income. It is also higher than normal.

Company		% increase
Canadian Natural Resources	(TSX CNQ)	21.8%
Enbridge	(TSX ENB)	10.0%
Manulife	(TSX MFC)	7.3%
Suncor	(TSX SU)	12.5%
TD Bank	(TSX TD)	11.7%
TransCanada Corp.	(TSX TRP)	10.4%
Disney	(NYSE DIS)	7.7%
Intel	(NASDAQ INTC)	9.9%
Prudential Insurance	(NYSE PRU)	20.0%
AT&T	(NYSE T)	2.0%
Visa	(NYSE V)	7.7%

Source: Bloomberg

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

The Other Trade Ban

Two months before the US announced tariffs on steel and aluminum, China began its own ban on certain imports. And most of these came from the US. You may not have heard about it, but you could feel it in the months ahead.

China imports garbage, and a lot of it. China is the world's largest recycler of paper, metal, and plastic and it is tired of taking our trash.

Now, the industry is not that large in dollar terms – the entire US recycling industry is worth just $5 billion. But that is because trash is priced at trash-like levels (i.e. it isn't worth much). The volumes are big, though. Washington State alone sent the equivalent of 238 pounds of recycling per person to China last year (source: Seattle Times). Until this year, China imported 55% of the world's paper products for recycling.

Thanks to the evolution of Chinese consumerism, China now produces enough of its own garbage to recycle. Recycling still leaves behind about 25% of the original mass, so the landfills in Asia are getting full. They will still take the most lucrative and easy-to-recycle materials, such as metal, but they have completely banned 24 other products. Mixed paper is now stacking up in North America as it has nowhere to go, and little value. The same is happening with certain hard plastics.

It could be a boon to local paper mills, eventually, once they retool to accept second-hand paper. And maybe the Trump tax cuts will induce companies to build local plastic and glass foundries to recycle these products locally.

In the meantime, don't be surprised if you see restrictions imposed on the Blue Box recycling program. There is no market any longer for contaminated paper (pizza boxes, for example) and many types of plastic. The companies who take this stuff from our municipalities can no longer count on China as a willing buyer.

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Prices shown are as of close March 9th, 2018.

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