The Market in Review

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This week's articles and insights

1. *The Thucydides Trap*
2. *Markets in June*
3. *The Allure of India*
4. *A Chat With Cundill*
5. *Canada at 151*

"I've been around long enough to know that empires come and empires go, and I can't tell how long the Google empire is going to last - but I'm pretty convinced that the answer is less than forever."

- Mitch Kapor (founder of Lotus 1-2-3)

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	24,272	- 1.26%	- 1.81%
S&P 500	2,718	- 1.33%	+ 1.67% (+ 6.25% in $CDN)

TSX	16,278	- 1.05%	- 0.20%

The Thucydides Trap

The biggest point of conversation over the past few weeks, by far, has been the tariff wars instigated by President Trump. Import taxes on Canadian steel and aluminum come into effect on July 1st and have already cast a chill on US orders from Canada. Though meant to reduce the proliferation of cheaper Chinese and Korean steel products – which sometimes find their way into the US via Canada – these tariffs are making Canada the collateral damage in this super-power trade dispute.

First, a little history.

In Ancient Greece, you had two empires on a collision course. On one side, you had the older city-state of Sparta, famous for militaristic rule and the brutal training of its men. On the other side, you had the younger Athens, known for its embrace of democracy, its culture and temples (such as the Parthenon), and its money.

Sparta and Athens had joined together to defeat the Persians a decade earlier, but now the Athenians were feeling their oats. It was the first recorded case of a younger power testing an older power, and the Spartans didn't like it one bit. Greece's "growing entitlement, sense of its importance, and demand for greater say and sway," was running smack into Sparta's "fear, insecurity, and determination to defend the status quo." (Graham Allison, 2015).

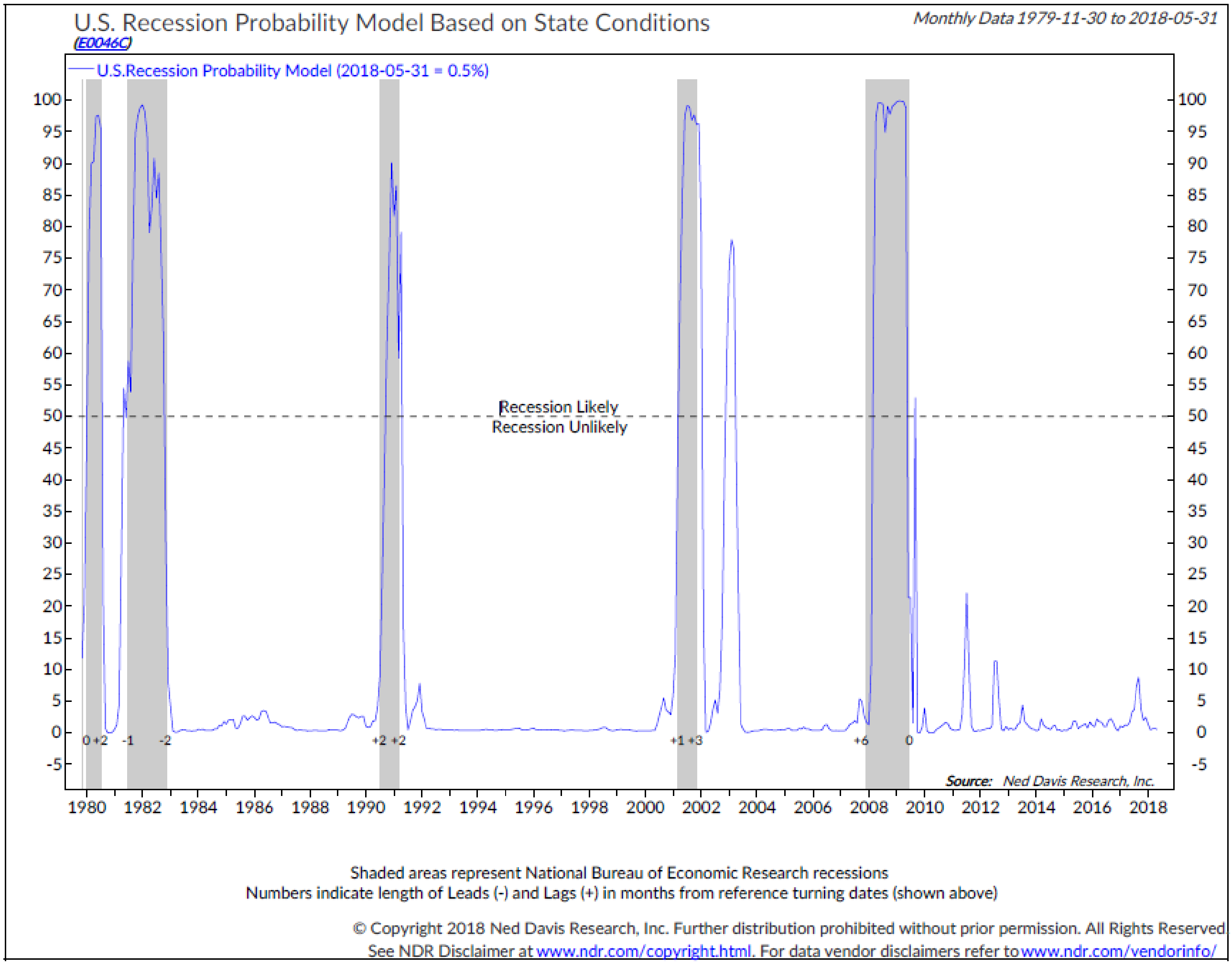
Athens' inability to contain its ambitions, and Sparta's inability to yield to them, resulted in the Thirty Years War and the annihilation of Athens. Greece would go on to be united under Philip and his son, Alexander the Great, but the glory days we associate with the classical era were behind it. Greece eventually became a province of Rome.

Graham Allison coined the term "The Thucydides Trap" after the ancient historian who chronicled the collision between the younger Athens and the older Sparta. He went on to list 16 similar confrontations between established powers and younger upstarts over the last 500 years, and how 12 of them ended in war. The term has most recently been used to describe the growing hostilities between China and the US. It is no secret that China has been using its economic heft to snatch technology and trade secrets from America (just as America built its first textile mill from British designs a hundred years ago), and has used trade barriers to export more than it imports.

Viewed in this light – an existing empire suddenly angry that it is being usurped – President Trump's "America First" strategy appears inevitable. If it wasn't President Trump who reacted this way, the next president probably would. But perhaps not in such an unconventional manner.

Most trade disputes are settled after months of bargaining and conciliations. The tariffs on Chinese goods actually affect only a small percentage of Chinese GDP, and American consumers are the ones who will end up paying higher prices. The Matthews Asia organization estimates the $50 billion in tariffs imposed on China will affect only 2% of all Chinese exports (because many of China's exports do not go to America at all). They expect a reduction in China's GDP growth rate by only 0.1%. Over half of China's economy is now internal consumption.

For now, we view this as a media event. Markets have been quite resilient to all the threats and rhetoric. Our measures of strength in the market averages are quite high, and the Ned Davis Research firm recently declared the odds of a US recession in the next 12 months to have fallen to virtually zero:



Of course, every skirmish has the potential to spiral into something nastier, as Thucydides documented over two thousand years ago. A trade conflict could escalate into a full-fledged trade war, and would impact many global businesses.

We remain hopeful that President Trump's deal-making abilities are what are on display here, and not something worse.

Markets in June

June began as a good month for global stocks but turned sour a week ago when the US proposed even more tariffs on China. Canada, which has been a bit of a dog in the last few years compared to other markets, has outperformed by being flat for the month. The reason? Oil prices are higher, and energy makes up 20% of Canada's index.

Sentiment has also moved toward fear from greed with all the news about trade battles and tit-for-tat tariffs. In the market's perverse way, this is often a good thing. It creates bargains that later push markets higher.

Bonds, which were written off by many as terrible investments in January, have been quietly rising all month. What this portends is anyone's guess – perhaps less growth due to the trade war, or a flight to safety.

We also point out that the big tide of easy global money is turning. Starting next week, the flow of zero-yield money from both the US Federal Reserve and the European Central Bank will go negative for the first time in years. The US Fed stopped its Quantitative Easing program several years ago, and is now set to withdraw US $120BB of this stimulation over the next three months. Even though the European Union is still stimulating - its Central Bank will inject US $105BB in the next quarter – this is the first time that this global pool of stimulus money is shrinking and not increasing.

However, beneath the surface, the number of US stocks in rising trends is still <u>very</u> <u>strong</u>. Lowry's, the technical service we use, recently pointed out that their measure of people leaving the market – selling pressure – just hit a 70-year low. This gives us some confidence that this is a correction, rather than the start of something worse.

Admittedly, though, it is difficult to tune out all the negative noise in the news today.

The Allure of India

While China has the second-largest economy in the world now, it is not an easy market to enter. China demands that outside companies must sign joint ventures and share their technology secrets to do business there, and many outside services such as Google's (**NASDAQ GOOG)** search engine are not allowed.

India is another story. While it is a chaotic place to do business, and it has a reputation for corruption, it is an open and democratic market. It will have a greater population than China by 2025 and, by some estimates, is now where China was economically in 2003. This means India could have a decade of very high growth ahead.

How are companies positioning themselves?

Disney (**NYSE DIS**) is trying very hard to acquire 21st Century Fox (**NYSE FOX**). This will add such franchises as the Avatar movie series, the Simpsons, a big stake in the music-streaming business Hulu, plus the international service Sky PLC and the Star India networks. Disney sees India as a key growth area and this is its foothold.

Walmart (**NYSE WMT**) recently outbid Amazon (**NASDAQ AMZN**) to acquire 77% of Flipkart, which is known as the Amazon of India. Walmart has lost market share to Amazon in America for years. They can't afford to miss out on what will become the most populous nation on earth.

A Chat With Cundill

In the world of deep value investors, the name Peter Cundill stands out. He made a name for himself in the 1970s through the 1990s as one of the best buyers of companies in the 'bargain bin of bad news'. At one point in the 1990s, he held 35% of his fund in Japan after that market had fallen over 70%. It was a country where few managers ventured, and he did extremely well.

Peter died in 2011. The funds under his name live on, but the value style he shared with such titans as Sir John Templeton and Warren Buffett is not nearly as popular as it once was. With "growth" names like Amazon, Google, and Facebook (**NASDAQ FB**) dominating the markets, "value" stocks in sectors such as steel, forestry, and banking seem almost irrelevant in today's economy.

We caught up with the current managers and share some of their value-driven insights:

- "Value" stocks have underperformed "growth" stocks now for a decade. These two have normally traded places every four years or so, so this is one of the longest stretches where value has underperformed in history.
- Rising inflation, interest rates, coupled with tax cuts all point to value stocks outperforming growth in the years ahead.
- They see the most value in US banks, which now have very high levels of reserves and room to raise their dividends. They see US banks as much safer than Canadian banks.
- They also see good value in global energy stocks. This is a sector that has performed poorly since oil's decline from 2014 to 2016. Little exploration has been done and global supplies are tight.

Our style is somewhat similar to the Cundill style. We own Citigroup (**NYSE C**) shares for individual accounts and recently added Cenovus (**TSX CVE**), the Canadian oil giant. Citigroup just passed its mandated stress tests, and is likely to increase its dividend soon.

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

Canada at 151

Another Canadian birthday is upon us. Our country turns 151 this Sunday and we collectively celebrate with a long weekend. The US is stuck with a Wednesday holiday this year, which means a cut-in-half week and low trading volumes in the markets.

I want to look back 25 years because several events happened that have echoes today.

The first event was the free trade deal Canada signed with the United States in 1988. While a majority of Canadians voted against the idea of open markets with the United States, they split their votes between the Liberals and the NDP. This allowed the Progressive Conservative party to win a majority government, which they then used to pass the agreement. By 1993, Mexico had lobbied to join what would be called NAFTA – the North American Free Trade Agreement – and all three countries ratified the agreement in 1993. It proved to be an excellent deal for the Canadian economy, but it was very unpopular in the day.

The second event happened in 1991 but would have large ramifications in 1993. Canada's prime minister, Brian Mulroney, had passed the Goods and Services Tax (the GST) in 1991. It was a national sales tax that replaced many hidden taxes and included many new, previously untaxed, items such as restaurant meals. Once again, it proved to be an excellent deal for the Canadian economy, but it was extremely unpopular in the day.

The public was outraged at the ruling Progressive Conservatives. Mulroney fell on his proverbial sword and was replaced by Canada's first woman prime minister Kim Campbell, who then lost the election to Jean Chretien. Canada had three prime ministers in one year – the first time that has ever happened in our history.

Fast forward to today. Prime Minister Justin Trudeau is once again fighting a battle over NAFTA, but this time to save it from a now anti-trade US administration.

And, he is pushing hard on a new national tax called the carbon tax, which is a levy on fossil fuel usage. On the surface, it is a way to decrease carbon dioxide output. In reality, it is a new source of revenue Canada desperately needs to fund its expanded social programs. Call it the 'GST 2.0' – unpopular but necessary.

Three major provinces are now fighting to overturn it, so our leader has a fierce battle ahead. I am tempted to say it is even more unpopular than the GST, but that is impossible. Everyone hated the GST when it was introduced, even as we just shrug and pay it today. It became one of the most essential tools to repair Canada's broken balance sheet in the 1990s.

So, a national battle over NAFTA and a new federal tax: the echoes of 1993 are loud and clear in 2018.

*Plus ça change, plus c'est la même chose…*the more things change, the more they stay the same.

Happy birthday Canada!

And happy 242nd birthday to our American cousins. Despite our disagreements, we could not be blessed with better neighbours.

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