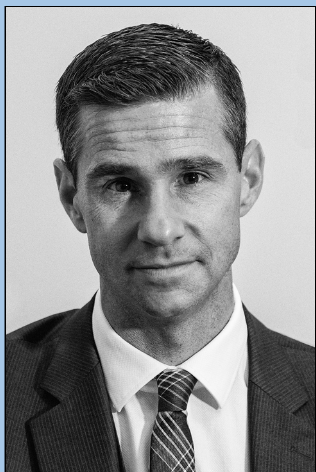
Summer 2017

Financial Insights



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In This Issue

I am freshly back from my annual family reunion in Penticton and I am reminded how fortunate we are to live in such a beautiful and varied landscape. The four-hour drive from the lower mainland is pretty breathtaking. You get amazing granite peaks on the Coquihalla, the rugged savannah of Aspen Grove, the summit at Mt. Pennask, and the long wind down along Okanagan Lake to Penticton. It is well worth the trip! I am also reminded of the fires that currently rage in BC and threaten many communities of equal beauty. My thoughts go out to the brave souls that fight these fires and to those who have experienced loss. We wish you a speedy homecoming.

On a lighter note, the Okanagan valley is a great location for me to do research for the wine pick of the season. I must say, this year's tastings were outstanding. If you are in the area then you must go to Painted Rock in Penticton and Culmina in Oliver. A client suggested Culmina, and boy what an experience. The tasting took over 45 minutes and the wine was exceptional and well-priced. Finally, a nod must be given to Black Hills and their coveted Nota Bene. The 2015 is brilliant, and very drinkable now. For those of you who do not enjoy my passion for wine, there are many options for craft beer enthusiasts. Both the Cannery and Tin Whistle call Penticton their home. But enough of this talk for now, we will revisit it at the end of the newsletter.

The second quarter was a dud for the Canadian markets as the TSX posted almost a -1.73% return. The US market did better, but when you factor in local currency adjustments, the S&P 500 returned just over .50%.[1] Canadian bonds faired a little better at roughly 1%, but fixed income yields are clearly not attractive at these levels. All-in-all, it was a frustrating three months to be a Canadian investor. I think it is important to stress that it was just three months. Investing is time dependent. Markets and securities can experience downward pressure, in the short term, as the Street's opinion becomes disconnected from the long term underlying fundamentals. Remember, successful investing requires patience and discipline.

A recent development worth noting is the Bank of Canada (BoC) raised its benchmark lending rate by 25bps. This is the first-time rates have gone higher in seven years, so it should garner some attention. Backed by a strong Q2 GDP growth, the central bank argued that it was time to raise rates in anticipation of further economic expansion. There seems to be plenty of debate on whether the BoC acted too early given the hot real estate market in Canada and mushrooming consumer debt. Creditors tend to follow in the footsteps of the government and raise their lending rates accordingly. This is precisely what happened after the announcement as the big six banks ratcheted up mortgage rates. The important thing here to remember is that higher rates are not necessarily bad. They indicate improving economic conditions. We must concentrate, instead, on the speed in which they are raised, and the ultimate impact on the consumer.

I hope this newsletter finds you in good health and sound mind. Please feel free to pass on your observations and suggestions for future publications.

Many Happy Returns,

PA Choquette

Patrick A. Choquette

[1] The XIC.TO (iShares Core S&PTSX Capped Composite ETF) total return from (03/31/2017 - 06/30/2017) was used to reflect Canadian equity returns and the SPY (SPDR® S&P 500 ETF) total return (for the same period) was used to reflect US equityreturns. The DLR.TO (Horizons US Dollar Currency ETF) total return (for the same period) was used to approximate the netreturn of long US dollars relative to CAD. The math for the US return is as follows: SPY = 3.07%-(-2.53%) = .53%. ETFs wereused because they represent the actual investible universe that an individual investor could acquire.

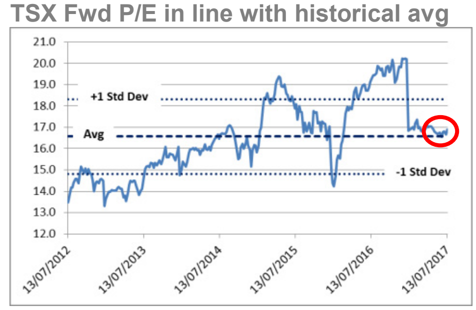
"Markets are expensive"

Right now, a common narrative around the world is that markets are "expensive", especially in North America. The media pundits all seem to agree, there are large risks to the downside with many citing geopolitical risks, economic risks, central bank policy risk, etc. However, at the end of the day, it is our belief that earnings, not headlines dictate market direction in the long run. We are investors, not speculators, and invest in companies under the belief they will have the ability to grow earnings which ultimately drives positive future returns regardless of what short-term headline is hitting the tape. It is our belief that equities have further room to run in this extended bull market and we are now shifting from an interest rate driven bull market to an earnings driven bull market. Plus, relative to bonds, equities still look attractive.

The price to earnings multiple

One metric that market participants favour to gauge the "value" of the market is the price to earnings ratio (P/E ratio). It is a fairly simple calculation—the price of something, for example the index divided by the aggregate earnings of the index constituents. In this formula, price is the easy part. Earnings is where it becomes a bit more difficult. A low P/E ratio suggests markets are "cheap", whereas a high ratio suggests they are "expensive". Trailing P/E is very simple as it just divides the current price by the trailing twelve month earnings that companies have already reported. As a result, it is backward looking and does not offer any insight into future earnings. The other hand is forward P/E, which incorporates analyst forecasts on future earnings and is a better estimate of value in our view. However, we must accept that these earnings forecasts are an analysts' best guess, and are subject to change.

TSX Fwd P/E in line with historical avg

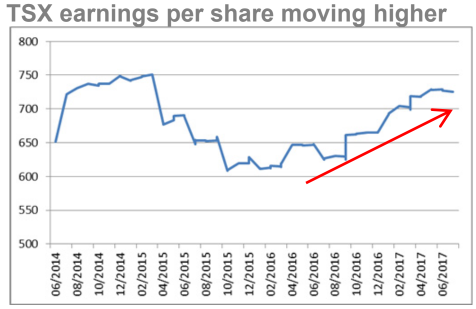


Source: Raymond James Ltd, Bloomberg

Where we are today

Bringing it back to the media's narrative that equity markets are "expensive", we do not feel that Canadian equity is yet overvalued for a number of reasons. With a current multiple of 16.9x forward earnings, the TSX is trading at only a slight premium to the five-year average of 16.6x (see chart). Additionally, we are nowhere near the euphoric highs of 20x forward earnings that we saw in December 2016 when the TSX posted a 21% return for the previous twelve months. Barring no drastic economic or oil priceshocks, we believe it is reasonable for the TSX to trade back up towards the higher end ofthe recent range rather than downward. Just as a refresher, oil was trading sub- US$40 perbarrel last time the TSX traded towards 15x forward earnings.

TSX earnings per share moving higher



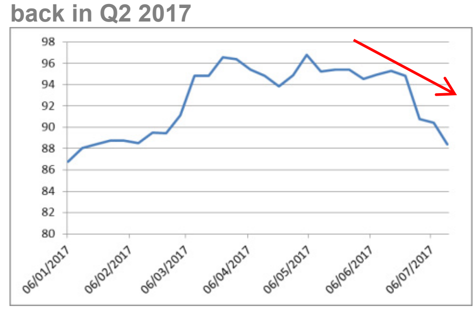
Source: Raymond James Ltd, Bloomberg

TSX earnings are improving

As we stated above, we are believers that earnings are ultimately the driver of long- term returns, and not short-term headlines. As you can see in the chart to the right, earnings in the TSX have drastically improved since the lows of 2015, nearing the previous highs seen in 2014. Consensus is looking for nearly $900 in earnings over the next twelve months. Assuming multiples can expand slightly higher to say roughly 18.5x on increasing optimism which is still a far cry from the 20x plus we saw in December 2016, we could see upside to 16,500+ which is roughly a 9% return from current levels. This is also far below the consensus price target near 17,500.

Additionally, energy earnings estimates have come down dramatically from the beginning of the year on weaker oil prices. For those oil bulls out there, a sustained move above US$50/bbl will add significant upside for current TSX earnings estimates.

TSX Energy EPS estimates have pulled back in Q2 2017



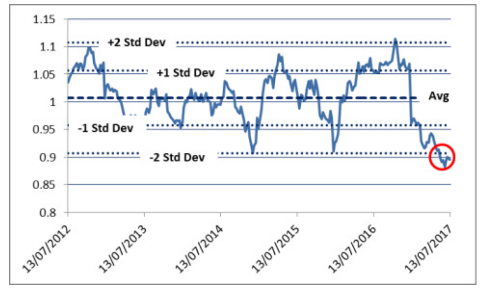
Source: Raymond James Ltd, Bloomberg

Relative valuations matter

Much of the media's commentary about equity markets being expensive is focused around the US. This is not something we deny. When looking at forward earnings, the S&P 500 trades at 18.8x, roughly 1.5 standard deviations above the five year average. When looking at the TSX valuation versus the S&P 500, we are trading more than two standard deviations below the five-year average, and last time we traded this low, the TSX sharply rebounded. Granted no one likes to overpay for anything this world, the TSX looks more attractive to put new money to work today. However, we are not saying abandon US equities completely. Similar to Canada, we believe earnings growth will continue in the US and support equity markets. However, for those with dry powder, consider another look at Canada.

Another consideration when looking at equity valuations is where bonds are trading. Many economists around the world use the Fed Model to determine the attractiveness of equities relative to bonds. The premise is that stocks are undervalued if the forward earnings yield is greater than the yield on government bonds. The forward earnings yield on the TSX currently sits at 2.9%, well above the ten year government bond which is hovering around 1.9% and struggling to break above 2%. We expect equities to continue to attract flows as investors continue to be pushed higher across the risk spectrum in the hunt for yield.

TSX is trading at a steep discount to the S&P 500

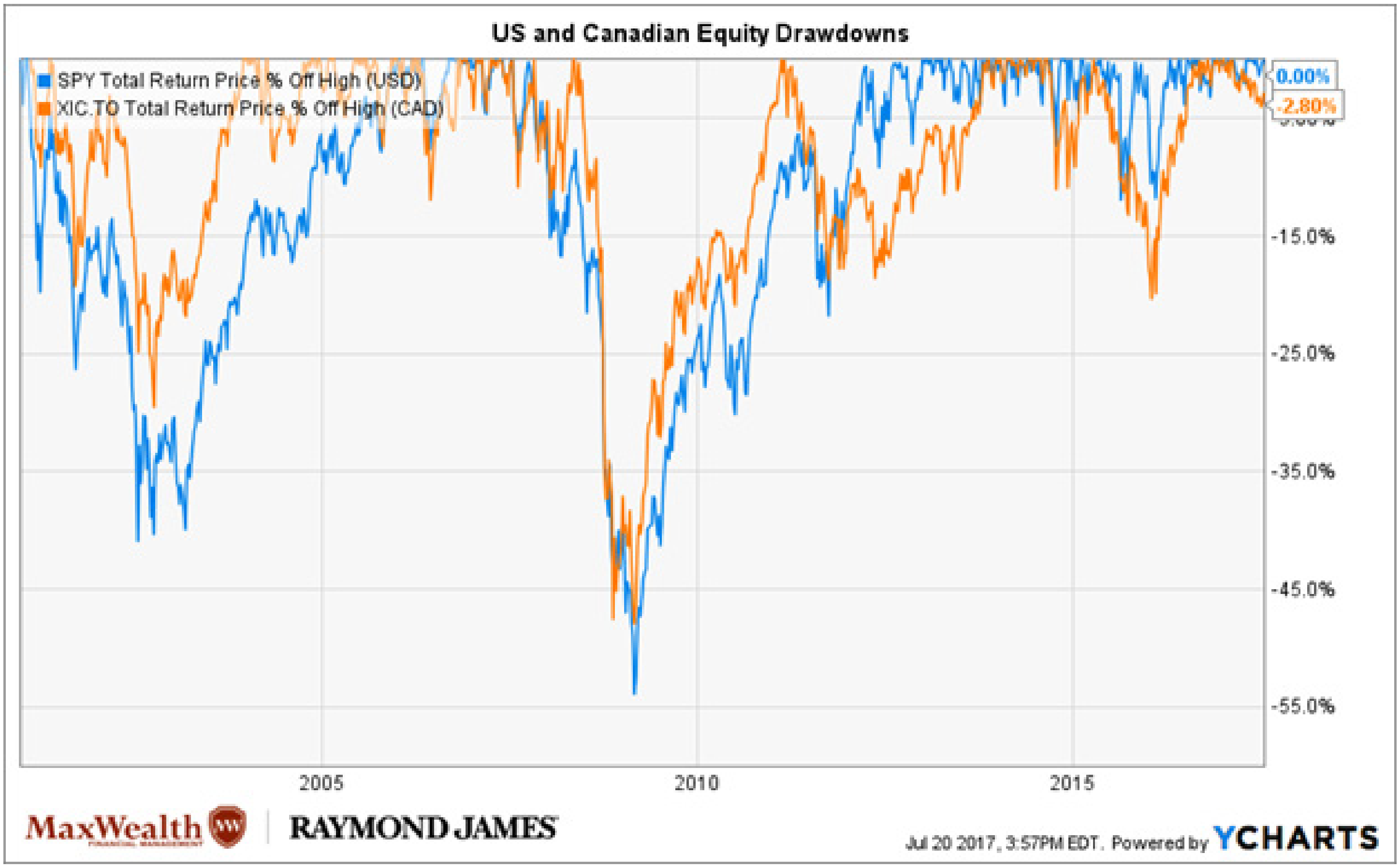


Source: Raymond James Ltd, Bloomberg

--excerpt taken from Weekly Trends July 20, 2017. Credit, Andrew Clee, CFA, CMT

The Price of Return…

I thought it would be useful to reacquaint ourselves with what I call the “price” of return. Simply put, there is no free lunch on Wall Street or Bay Street. Return comes at a cost, and that cost is a peak-to-trough rollercoaster known as drawdown. What the chart below shows is the percentage off the high, on a rolling basis, of both the US (Blue line) and Canadian (Orange line) markets since January of 2001. As you can see, there were multiple times when the drawdowns exceeded 10%. In fact, there were two times in the last 15 years when they exceeded 35% south of the border. Finally, there was the extreme event in 2008-2009 that lead to declines above 50%. So, what can we draw from this analysis?



Firstly, equities are volatile in nature. We need to understand this because then we won’t panic and sell at times of opportunity. Second, the only free lunch is diversity. So, we need to add asset classes and securities that don’t move in tandem like the ones above. That’s where bonds, commodities, real estate, private equity, etc. come in. You don’t build a chair with one leg, why would you build a portfolio with one stock? Finally, have a long-term plan and stick to it even when it is uncomfortable. Self-sabotage is the surest way to derail you from your financial goals. Just remember the above points the next time the market sells off, and you should be able to profit as prices normalize.

Administrative Corner

Brittany Potter
Branch Administrator

Tips on Creating a Budget

When it comes to managing your income and expenses, there are three “budget buckets” to consider:

1. Essential expenses or “I must have this”. Your expenses that you need for survival are allotted to this bucket. You need to pay your rent or mortgage in order to keep a roof over your head.
2. Basic expenses or “I want this”. Lifestyle expense like clothing allowance or personal care.
3. Discretionary expenses or “It would be nice”. These types of expenses come from your wishes and dreams. Examples of discretionary expenses are entertainment and travel.

It is always best to be conservative with how much you allot to each expense by rounding the cost upwards. If you have a range, for example your gas budget (i.e. $75-100/wk), use the higher amount.

Wine Pick of the Season:

PAINTED ROCK 2014 SYRAH $34.99/750ML

An excellent example of a premier Okanagan Syrah. You can lay this wine down for a couple of years to allow the complexity to grow or aggressively decant and enjoy now. Well worth the price!

Cheers!

Notable Quote:

“I am the master of my fate; I am the captain of my soul”

- William Ernest Henley