Investment Illuminati

Canadian equity markets cooled while those abroad maintained their upward momentum, despite events that one could have reasonably expected to derail the rally.

In the United States the distractions persisted, as the rumours and news surrounding the Trump Administration continued unabated, including allegations that the President himself interfered with an FBI investigation of the Executive Office. The U.S. Federal Reserve increased their policy rate target for the second time this year – while reiterating their plans for another hike in 2017 – as well as indicating that they are intent on reducing the size of their massive balance sheet following years of monetary stimulus.

In the United Kingdom, Prime Minister May's idea to build support through another election backfired, with her party losing ground in Parliament and weakening her mandate to negotiate a "hard Brexit". Indeed, the wave of ultra-nationalism appears to be ebbing with the defeat of the Eurosceptic parties in the recent elections within the euro area, most notably in France. Despite all of this, volatility in the markets remained low, and corporate earnings continue to grow in both the U.S. and overseas.

Oil entered bear market territory in the quarter, even as OPEC extended production cuts as inventories grew, and confidence in OPEC's resolve to curtail supply waned. The WTI price hit its lowest level in 2017 at $42.50 (last time was August 2016) and ended the quarter at $46. The slump in oil prices put some downward pressure on the Canadian dollar early in the quarter, however, it rallied aggressively in June as the Bank of Canada adopted a hawkish tone near the end of the quarter. The appreciating Loonie detracted from the strong U.S. equity returns by about -2.7%; international returns were boosted by, on average, 0.7%.

Equity Markets

Foreign equity markets continued to advance in the second quarter, with the S&P 500 index rising 0.4% and the MSCI EAFE index gaining 3.6% in Canadian dollar terms. The strength in these markets was particularly broad, with positive returns generated by 9 of 11 sectors in America, and 10 of 11 internationally.

Domestically the picture was different, with the S&P/TSX Composite index falling 1.6%, and all three of the major sectors in Canada – Energy, Materials and Financials – posting declines. Smaller companies fared substantially worse, with the S&P/TSX Small Cap Index falling 5.5%. Interestingly, this stands in contrast to emerging markets, which rose 3.4% in the quarter. With the passage of time these developing economies have evolved away from a reliance on resource industries to now include some major technology and consumer products businesses, a shift which could serve to reduce the correlation between these developing markets and the TSX Composite index.

Fixed Income

The quarter saw Canadian bond markets outperform domestic equity markets. In fact, on a year-to-date basis the FTSE TMX Canada Universe Bond index has returned 2.4% versus the S&P/TSX Total Return of 0.7%. The benchmark 10-year Government bond started the quarter at 1.63%, was range-bound throughout the quarter, ending at 1.76%. At the short end, bonds returned -0.4%, while high yield bonds outperformed, returning 1.70%.

Commentary

An oft-quoted expression is that "it's not where you start but where you finish". Long-term investors have bought into the message that staying with the markets and letting them do the heavy lifting is paramount to building wealth. Anyone new to investing, be they millennials or those recently committed to building wealth, could be forgiven for thinking where they started mattered most. Markets, broadly, have gone on an eight-year plus run; new investors no doubt think that generating returns is as easy as simply showing up. Just showing up is unlikely to continue to be anywhere near as rewarding as it has been for the last eight years.

Whether investing is new to you or an old practice, there are lessons to be taken, learning and remembering them will have tangible benefits to your investment portfolio. Prolonged bull markets have the effect of fading one's memories around downturns.

The S&P/TSX has more than doubled since its bottom while the S&P 500 is approaching a quadrupling. Periods like this cause the "risk muscle" to begin to atrophy and get selective. Canadian equities performed poorly in 2011 and again in 2015, dropping 11% and 10% respectively. In each of those same years, returns in the broad U.S. markets were trivially positive, which is to say, close to zero. Long running bull markets wash away these periods, times when astute rebalancers seek to buy more assets on the cheap.

Good times also can make investors question the need to hold fixed income in a reasonable proportion as part of their investment strategy. Yields on Investment-Grade bonds have trended lower, leading many to abandon fixed income in favour of high dividend stocks and High-Yield bonds. This works until it doesn't; the Canadian equity market returned 21% in 2016 but has so far this year 1.7% behind the universe of Canadian bonds. The investment illuminati understand that fixed income is the original hedge fund. It acts to protect your portfolio and move in a way contrary to your equities. For historians, the Canadian fixed income market has been negative only four years in the last six decades, with the worst year being down 4%.

Another lesson is to have broad horizons. Canadian stocks may feel comfortable, but that comfort can come at a cost, in what is essentially a three-sector market. Oil languished in the quarter, and this served to weigh not only on Energy and Materials names, but also on the Financials and Telecommunication Services sectors. Familiarity alone makes for a weak investment thesis; "best of brand" stocks exist outside our borders and as such, the full benefits of diversification cannot be achieved using an all-Canadian portfolio. Sadly, the Canadian market is less and less representative of global investment opportunities.

To be clear, the global economic picture isn't completely rosy. Coming from relatively sanguine levels, problematic accounts are beginning to rise amongst the major credit card lenders in America; auto sales are showing signs of plateauing; and the Federal Reserve appears resolved to reverse, in a very measured way, the massive monetary stimulus seen in recent years. Spanish and Italian banks are gasping for air; demographic headwinds and a lacklustre economy weigh on Japan; and the U.K. has begun down the path of Brexit. All this being said, the deep roster of leading global businesses offer quality investment potential for the patient long-term investor.

This quarter's Commentary is about the unflinching resolve and common sense of the investing illuminati. When bull markets run long it can be easy for the masses to think investing is easy- complacency abounds. To that we say – Follow your plan – Diversify – be Prudent about yields – Take gains – Trim losses. Compounding takes time – meaning more time spent in the market and less trying to time the market.

The members of the investment illuminati choose to learn and remember these lessons, and will always fare better than those who do not. Membership is free and the rewards are forever.