February 5, 2018

Market Comment and Outlook

Last week saw the beginning of a modest correction in North America (especially U.S.) equity markets that has been expected and overdue. The market had essentially risen for an extended period, without anything more than a 3% correction.

Why is the market correcting? Partly because it can and should! But the real catalyst for the sell off last week was RISING INTEREST RATES, which squeeze equity valuations and create some competition for stocks. I have said many times in my commentaries that it is rising interest rates and ultimately an **inverted yield curve** (where two-year rates are higher than 10-year rates on U.S. government bonds) that serves as THE major pre-condition (high predictability) for a pending recession. We **are currently nowhere near an inverted curve** (a 70 basis point positive spread still exists between two and 10-year note and bond), BUT the change at the margin is happening with the 10-year U.S. Treasury bond rate busting through 2.63% over the last ten days and then moving to 2.84%. The 10-year bond rate bottomed around 1.4% in 2012 and 2016. It peaked in the 16%-17% range in 1981—so bond prices have been rising from 1981 to 2012-2016 (rates falling, the price and yield move in opposite directions) during the **great bond bull market of 1981 to 2016**. That bond bull is now over. Rates are moving up as the global economy-and America in particular- are growing at a faster rate and INFLATION is finally making a modest comeback, especially in the U.S.

Rising rates are a reflection of a better, stronger economy, and now higher wages and some inflation—a real change from the stagnation, deflation of 2008-2012 in particular for the U.S. But if rates move to the upside too quickly, this presents a greater headwind for stocks as equity valuations compress a bit and the market begins to sense tighter monetary conditions. During this 'back end' of the business cycle, rising rates normally create more volatility in stocks and that is what we're seeing now.

BOTTOM LINE: the **current bull cycle in stocks IS NOT OVER YET**. History shows that at this point in the interest rate cycle, **stocks can and usually do very well over the next 12 to 18 months** still as corporate profits keeping rising on the back of stronger economic growth. Thus, I expect around a 5% pullback here to the 50 day average on the S&P 500 at around 2720-2730 as seen on the chart below. The S&P 500 peaked at 2880 in January. We are well positioned in the Income & Growth and Growth/Capital Appreciation mandates as we have extra cash that can be tapped to add to our equity positions. AND I WOULD STRONGLY URGE CLIENTS WHO WANT TO ADD TO RSPs and other accounts to do so now to take advantage of this pullback. Jeff Saut, our chief strategist in the U.S., expects 2018 to be another good year for stocks (as do I).

TACTICAL STRATEGY GOING FORWARD: I expect another UP LEG in the U.S. equity markets (and Canada) into the spring/summer once this modest corrective period passes. I will likely be doing a substantial amount of equity selling into that move and pushing both portfolios to higher levels of bonds/short term money market positions, locking in equity profits AND GETTING MORE DEFENSIVE. This will be the beginning of the tactical process I have spoken about for the last year or so to prepare for any potential recession. The next U.S. downturn is very likely to be shallow AND brief. We remain in a powerful, LONG TERM SECULAR BULL MARKET for stocks and that backdrop which is the key point to keep in mind.

If you have any questions, don't hesitate to reach out.

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