alizé capital
Gestion de portefeuilles / Portfolio management

La voie des Alizés

Navigating the Trade Winds

January 2018

In this issue:

- ***This year ended well for the markets and our investment strategy***
- ***The world economy is strong and ready to take on rising rates***
- ***The companies' earnings are still robust***

Dear friends,

This past year ended on a very good note. We can be thankful to gradual gains that were constant. 2017 was marked by a steady pursuit of the upward cycle and a very low volatility level. The S&P/TSX picked up where it left off in September, keeping pace with a gain of 3.7% for Q4 and an annual gain of 6.0%. In New York, we scaled new heights, the S&P500 shot up 7.1% in Q4 and was up 11.8% over 12 months ($Canadian). As we were saying back in October, our loonie did not follow through on its earlier strength. The currency situation finally worked in our favour in Q4, pushing up values of foreign and US holdings. We must also point out the end of the year push of oil. This late surge in the commodity did not however translate into gains for the oil sector – at least not for now.

		Closing	Change**	
		31-Dec-17	Quarter	2017
***Stock Indices** (% in C$)*				
S&P/TSX		16,209	3.7%	6.0%
S&P 500		2,674	7.1%	11.8%
MSCI EAFE*		2,051	4.8%	14.0%
Currencies				
CAN$ (US$/C$)		0.7950	-0.9%	6.8%
Euro (US$/EUR)		1.1998	1.6%	14.1%
Commodities (US$)				
Oil (WTI)	$	60.46	17.0%	12.5%
Gold	$	1,303	1.5%	12.6%
Volatility Index				
VIX		11.04	+1.53	-4.53

** MSCI Europe, Australasia and Far East (US$)*
*** Changes are expressed in C$ for Stock Indices.*

The stock market got its groove back towards the end of 2017 and you could sense the frenzy amongst most investors. Presently, we can observe increasing signs of overextension in the S&P500 combined with an overbought situation. We believe that the index is entitled to a well-deserved rest. Especially after a 15 month tear without a single tiny 5% pullback. We could encounter this small retracement in the beginning of the year. For now, on the event horizon, we see no important dislocations, although a correction of 5 to 10% would be almost salutary at this point of the cycle. Nevertheless, the year 2018 looks like another good vintage; we are building on a solid economic footing, sustained growth in corporate earnings and financial indicators that are still favourable.

If the year 2017 turned out like a two act play for Toronto, we believe that the final months paved the way for a renewed assault to new heights. Historically, the S&P/TSX outperforms in the advanced stages of bull markets. If we take into account the strength of the economic indicators across the globe, we think that the timing is right for the Canadian cyclicals to have a great year. The Energy and the Materials sectors, after being notable laggards in the past years, should enjoy immense economic impetus coming out of Asia that would support most commodity prices. Also, we must mention that on price-to-book basis, these sectors are relatively affordable. Finally, in the late innings of this bull run, we favour international markets over American ones as they are cheaper.

The world economy is strong and ready to take on rising rates

The present economic expansion is entering its tenth year and showing absolutely no sign of abating. The real surprise in 2017 was the impressive come back of the Euro Zone. With 20/20 vision, this unexpected backdrop was mostly responsible for the shining performances of world markets. We see no reasons for this setup to change drastically. Quite to the contrary; this favourable conjuncture will spread throughout the rest of the European economic zone and to other emerging markets. For the first time since 2008, this positive contagion brings us a synchronized worldwide economic expansion. For 2018, the GDP growth forecasts are nearing the 4% mark. The main risk resides in the execution of the rate increases by various central banks.

The Fed's slant towards a higher rate regime is back in force. The time has come to put an end to low interest rates without spreading panic in the ranks of financial participants. Up until this point, the Fed's actions were almost flawless; the next increases were well telegraphed and fully discounted (3 or 4 increases in 2018). When you consider that CPI is almost nonexistent and well below the Fed's target, with this much slack built-in, the Fed could not possibly tip into a restrictive policy and derail the capital markets. Stability worldwide will also depend on the path that the ECB will choose towards rates normalization. For now, the consensus for an event horizon is 2019, although London could decide to strike earlier. The point being that if rates increases were to happen unexpectedly in 2018, then it could become a problem and provoke bigger corrections, but this remains an unlikely scenario.

The companies' earnings are still robust

Earnings season is back to the forefront. For Q4, projected earnings growth for the S&P500 is a very healthy 11.9%. What is very impressive is the vigour and staying power. Since past October, analysts were obliged to revise upwards earnings forecasts for all quarters of 2018. The final consensus is an increase of 12.6% for this year. Still in earnest, 2019 is not too shabby coming in at 10.2%. Bay Street's outlook is as good with 10.5% for 2018 and 12.4% for 2019. We persist in believing that a healthy and steady growth in company earnings is the only way to sustain this bull cycle as the price-earnings multiple is already rather high, an expansion seems unlikely (S&P 500 at 18.4 and S&P/TSX at 16.4 times profits of 2018). Looking at the price-earnings ratio, we are dependent on an increase in the denominator (earnings) for the numerator to follow. As such, gains this year should be more or less in line with earnings growth. Consequently, we will be buyers if the indices pullback in Q1.

Conclusions and perspectives

According to our research, this year will also be positive for our equity strategy and the markets. There is one small caveat, market conditions are changing with rates going higher and multiples being high for several indices. Hence, we see that volatility increase seems inevitable. This will provide us with more opportunities to build positions at better entry points. Be aware that we will pursue a pruning of the portfolio by taking profits on expensive holdings and redirecting the proceeds towards less expensive equities. In this context, we think that 2018 will be the revenge of the S&P/TSX on Wall Street. A good performance of the markets is in the cards if of course, the expansion remains solid and that governments tame the protectionism bug. Furthermore, geopolitical risks must remain muted and the rate increases have to be well telegraphed, meaning no sudden surprises. Finally and most importantly, company earnings cannot disappoint, they must remain on a solid path.

www.alizecapital.ca 514.595.3503 | 1.855.595.3503 | 418.780.4440 info@alizecapital.ca