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“By The Way”

September 2018

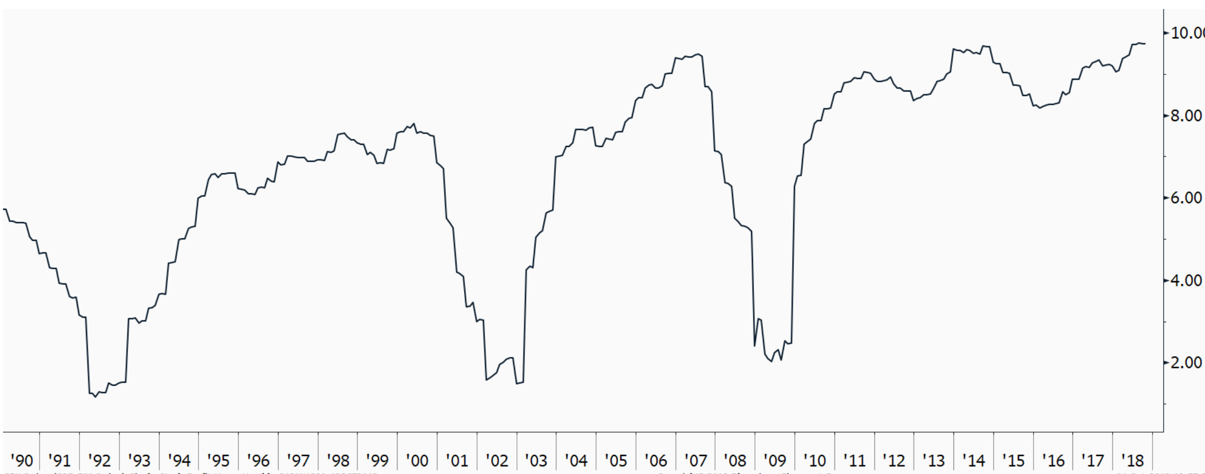
“‘I am relieved that I haven’t been stopped on the street and told to buy stocks to get rich.”

The Dow Jones Industrial Index recently broke out to a new all-time high. It was the last remaining major U.S. index to do so, making it pretty much unanimous that this bull market is alive and well. Combining that new high with the August break out of its sister index, the Dow Jones Transportation Average, confirms a Dow theory buy signal, one of the oldest and most reliable indicators of market health. The ability of the U.S. stock market to grind higher despite a plethora of negative headlines on the socio-economic front is most impressive. While the strength of the indices makes us more sanguine than we were a few months ago, as always there are still reasons to be cautious. To mention just a few that I am watching carefully; the A/D line (which measure the number of advancing issue versus those declining), while positive has not been as powerful as I would like to see. Also, as I have mentioned in the past, the financial sector of the market is often a bellwether of the overall market, and it has been relatively weaker of late; we want to see it strengthen again. In addition, changes in the U.S. tax code have provided a short-term increase in demand for financial assets. In particular, the tax holiday on repatriated foreign earnings has given companies an expanded ability to buy back shares, and a newly enacted reduction in the deductibility of corporate pension plan contributions has had companies accelerating asset purchases. Those dollars will be missed. Despite such technicalities and the risk of a negative geopolitical event derailing the market, the primary trend remains positive.

While I have never been a fixed income expert (it has taken more than 5 years for my forecast of 3% 10-year treasury rates to come to pass), in my opinion, higher interest rates will be the major catalyst that brings on an economic recession and by extension lower stock prices. If that assumption is correct, we are compelled to make every effort to try to anticipate what level of rates would precipitate a decline in growth. One can make a reasonable academic prediction of what a “fair value” might be. I for one, don’t know the answer, but look for the market itself to give us a warning. Unfortunately, I don’t believe the members of the Fed know either. They are continuing on a path of regular increases in regulated rates for the foreseeable future. If history teaches us anything that policy is likely to go on until something “breaks” and a recession will follow. Markets aren’t interested in what should be, but was is, and given that the stock market is a discounting mechanism, the impact might be felt well in advance. One thing I do believe, bond yields have been going down, thus prices have been going up since 1981, but the trend is now reversed and those easy money days are over.

Here is something else I muse on in speculative moments. U.S. corporations have been enjoying something of a perfect storm. While the economy has been growing steadily, company costs have remained low. Aided by low interest rates, low inflation, and virtually non-existent wage growth, profit margins are verging on all time highs. That may be in the process of changing as interest rates and inflation are slowly rising, and with the unemployment rates below 4%, we are starting to see pressure to increase wages. Amazon's new policy to raise its minimum wage to $15 an hour is just the latest sign of this trend. We have continually argued that growth in both the economy and corporate profits is supportive of higher markets, so we would not want to see margins being significantly impacted. The analysts at Strategas Research write that a major impact on earnings occurs when wage growth approaches 4%. We are currently only around 3%, but this is worth keeping an eye on.

S&P 500 Profit Margins



It is a relief to see a new NAFTA agreement come to fruition just as I was losing my resolve that it would ever happen. The economic significance will, I believe, be marginal but it does take one item of concern off the table. Too much ink is being wasted attempting to establish if it is good or bad for Canada. As with all compromises, it is some part of both.

Joe Kennedy famously made a fortune getting short the market prior to the 1929 crash. He later said that when a shoe shine boy started giving him stock tips, he knew it was time to sell. I was reminded of the story recently when I was lectured on Bitcoin by a bartender, and on cannabis stocks by a cab driver. Certainly not definitive, but I am relieved that I haven't been stopped on the street and told to buy stocks to get rich.

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