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Trump's Wall (of Worry)

An old investment adage is the markets climb on a wall of worry. This certainly seems to be the case recently as equity markets throughout the world continue to move positively. But the worries seem to be increasing as well. Rhetoric between North Korea and the U.S. is escalating between the nation's two leaders. The repeal of Obamacare has now twice been unable to gain sufficient support and Trump's tax reduction plan, while popular, doesn't seem to add up. Further, given his volatile relationship with both GOP and DNC representatives in both Congress and Senate it is hard to know whether it will gain the support required to pass into law.

Major market economies continue to improve. Canadian GDP growth was a major market leader increasing by 4.2 year to date ending May 2017. And this is with oil prices just starting to trend positively. Not coincidentally, the Canadian Dollar bottomed a month or so later. The U.S. economy was improving as well until the latter part of third quarter brought Hurricanes Harvey, Irma, Jose and Maria. Harvey hit Texas, particularly Houston and two severe storms (Matthew last October, Irma in September) devastated parts of Florida and the U.S. south-east seaboard. While damages are colossal, insurance will only cover so much and the while the re-building of many of these communities will benefit some industries, many victims will have limited means to rebuild thus muting the potential economic rebound.

Interest rates still remain relatively and absolutely low. For the first half of the year, bond returns were basically flat but the improving economies and modest increase inflation finally made bond holders flinch. In the third quarter, Government of Canada (GOC) Long bonds lost 6.2%, short term GOC's (5 years) lost 1%. While the likelihood of North American Central Banks increasing short terms rates continues to be more likely before year end, it would appear that bond investors may finally be coming to the realization that fixed income investment risk is rising rapidly. If only a small fraction of these bond holders move into equities (where yields are relatively attractive) then equity markets have more to move given the enormous potential demand on equities these converts would provide.

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Admittedly, equity markets have had a long sustained positive return. While bull markets rarely trend positively for so long, the one issue that remains unique to this cycle is the sustained low level of interest rates. While North American Central Banks continue to be slow to raise rates, they are starting to increase. Major European Central Banks, however, are less likely to start raising until their economies gain much firmer traction. Those economies are in the nascent stages of recovery and the UK economy may face significant uncertainties as the discussions regarding BREXIT to date provide little clarity regarding timing or the potential repercussions.

The length of bull markets don't always translate to overvaluation – we do not consider North American equity markets overvalued. Until rates move much higher equities will remain favourable relative to fixed income in our opinion. This does not mean that equities will continue to move higher without interruption. History and logic would dictate that there will be volatility and these pullbacks in prices, depending on the circumstances surrounding them, would be welcomed.