Winter 2017

Happy 2017!

Before we get to the upcoming year, we'd like to reflect on 2016. Last year evolved like a Spanish bullfight, though it didn't end like one.

The Cape Stage is the first of three parts of a Spanish bullfight. The matador waves his cape, enticing the bull to charge. At the last second, the matador steps to the side. With each pass, the matador is wearing out the bull, and accessing the animal's weaknesses.

Early in 2016, oil hit a low of $26.21 and equity markets around the world fell. The fear, of course, was that the bull was tiring.

In the Picador Stage, bullfighters on horseback enter the arena and again taunt the bull into charging. This time, though, they stab the animal in the shoulders each time it passes.

In June, 2016, the shocking news came that Great Britain had voted to leave the European Union. Investors panicked. The bull was more than tired, it was bloodied.

In the Killing Stage, the matador moves in. When the bull makes its final rush, he or she thrusts a long sword between its shoulder blades and through its heart. If done cleanly, the bull crashes to the ground and dies quickly.

November, 2016 brought one of the most surprising results in American presidential history. The bull, many experts were sure, was ready to be dragged from the arena.

But, of course, the bull market didn't die in 2016. In fact, the first two events (the Cape and Picador Stages, if you will), predicted by many to be warning signs of the coming global recession, neither exhausted nor bloodied the bull. Oil ended the year at $52.72, just over double its low in February of last year. The "Brexit" vote yielded a four-day slide of global markets. The S&P 500 dropped over -5.3% while the MSCI All World Index dropped even further at -8.3%. Canada was a little more muted with the S&P TSX Index dropping -2.9% following the vote. One month later, however, the global markets resumed the march forward and the S&P 500 advanced +8.3%, the MSCI All World Index +8.7% and the S&P TSX Index +4.8%. And while the long-term effects of a Trump presidency on global markets are hard to predict, his election resulted in the market instead rising further. Between election day and the end of the year, global markets rose +7.3% for the S&P 500 Index, +4.6% for the MSCI World Index and a whopping +12.6% for the S&P TSX Index in Canada.

As we enter 2017, remember that appearances aren't always what they seem. With that in mind, let's look forward.

Equity markets are at all-time highs, with the phrase "expensive by historic standards" becoming ubiquitous. This, of course, has many investors on edge. But is it even true? Currently the S&P 500 index is trading at 21.3 times last year's actual earnings. The TSX Index is close at 22.3 times and the MSCI All World Index trades at 21.4 times actual earnings. This backward-looking valuation is used often to justify the "high" cost of owning stocks. A more accurate gauge is to look ahead one year-remember, we're paying for expectations, not the past. By this measure the S&P 500 Index trades at 17.4 times, while the TSX and MSCI All World Indices trade at 17.0 and 15.7 times respectively. Over the last 10 years, these same indices have traded in the range of 12 to 24

times earnings. By historic measures, equities are not as "expensive" as some are leading us to believe. In fact, they're valued in the middle of historic norms.

While this sounds great, there is a lot that goes into companies actually being able to achieve their earnings expectations. Here is where the markets may be a little early in their expectations for company-earnings improvements. Global populism and the threat of protectionism, for example, may slow things down. Free trade stimulates earnings while tariffs and trade wars eat into potential profits.

The incoming US administration's comments, vague as many may be, call for caution. We don't believe President-Elect Trump is interested in starting a trade war, but his administration may choose to renegotiate the terms of current trade agreements. In this event, a slow-down is likely. Choosing to negotiate bilaterally rather than multilaterally isn't good or bad, it's simply a change in strategy. And affects not just the US, but all her trading partners, Canada especially.

If the new administration is to be believed, corporate taxation is another likely candidate for change. There's never been a consensus on the "right" corporate profits tax, but opinions abound. The more moderate suggest a decrease from the current 39.6% to 33%. President Elect Trump has stated he wants a 15% top tax rate for corporate profits. (To put this in perspective the median corporate tax rate around the globe is 22%)

It's also possible a tax holiday will be initiated for companies bringing profits back to the US-a huge proposal given that an estimated $2.6 trillion in profits sit outside the country. With a measured approach, OCM believes lower corporate tax rates and the luring of profits back to the US can favor companies' future earnings growths, but it's dependent on how long and difficult it is to get these changes made, and what the numbers look like. (Keep in mind, US companies come in many forms-C-Corps, LLCs, Partnerships, and S-Corps, for example, will all be affected.) However, Canada, with last year's oil price shock and the softening in labor and economy, may not see any noticeable changes in the economy, at least for a while.

So, yes, there are potential changes to consider when projecting earnings expectations. And we haven't even mentioned regulation, environmental rules, and energy policy. Or the countries exploring the idea of following Britain's lead and leaving the EU. Or OPEC's attempt to reassert its influence on the world's oil markets (which might bring more price stability, and help both the US and Canada). But last year gave us lots of unexpected moments, too, and the bull charged forward.

On occasion, the audience at a Spanish bullfighting match will wave white handkerchiefs, signaling to those in charge that the bull should receive an *indultado, or pardon, meaning his life should be spared because of outstanding behavior in the ring. If granted, the bull is returned to the field to live out his life, which could last another 20 to 25 years. Not even OCM is optimistic enough to believe this bull market will last that long. But, despite the breadth of uncertainty, the world's economy is expected to grow 2% to 2.5% this year.*

While we continue to monitor the short-term fluctuations, with a focus on the long-term goals, please have a happy and prosperous 2017.

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