Prepared for MoneyTalks

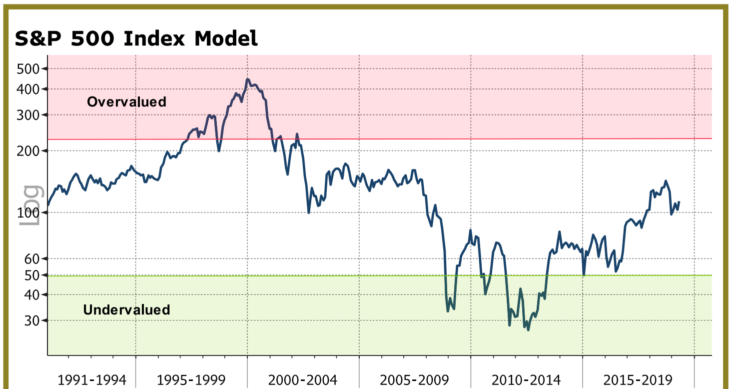
May 13, 2019

Investment Thoughts for 2019

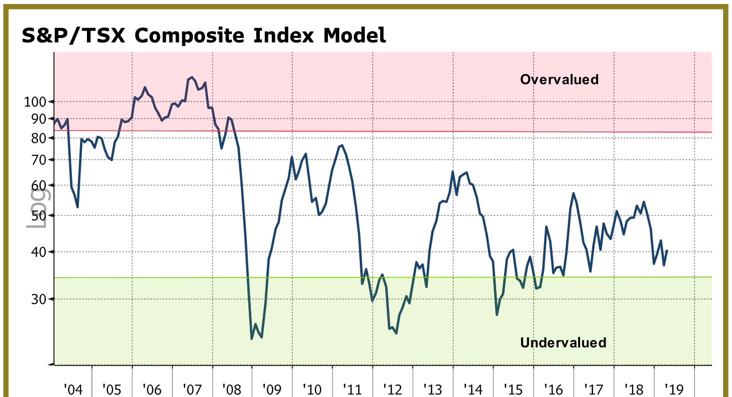
1. Equities are not expensive

Warren Buffett said not long ago that the equity market was “*ridiculously cheap*” (Bloomberg, May 8). We concur! The two models below show that the S&P 500 and the S&P/TSX are in “fair value” range, based on models that include long term interest rates. Indeed, the S&P/TSX is in the bottom half of its “fair value” range.

The 10-year bond yield is an important factor in these models. As Buffett noted: “*If you tell me that 3 percent long bonds will prevail over the next 30 years, stocks are incredibly cheap*”. How so?



Source: Bloomberg, Murenbeeld & Co.

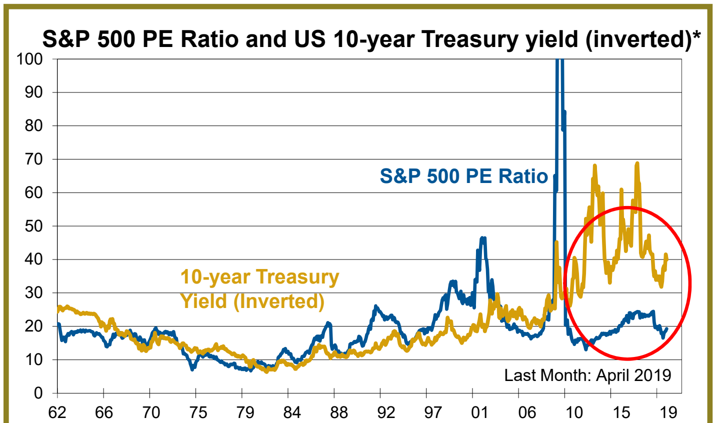


Source: Bloomberg, Murenbeeld & Co.

The explanation is in the next chart where the S&P P/E ratio is contrasted with an inverted 10-year Treasury yield – or to be more precise, 100 divided by the 10-year Treasury yield. This division is a P/E ratio for long-term bonds. With bond yields around 2.5% and a bond price of 100, the bond P/E ratio is about 40 – very high indeed. The equity P/E ratio is around 20, which may be high historically, but it is significantly lower than the bond P/E ratio.

In fact, the chart suggests that the gap between the bond P/E ratio and the equity P/E ratio has never been this wide.

(By the way, the blowup in the equity P/E ratio in 2009 was a biproduct of the Great Recession: there were no earnings that year – which helps explain why many analysts use a



Source: Bloomberg, Macrotrends, Murenbeeld & Co.
**Inversion:100/10-year yield*

5-year or 10-year average of yearly P/E ratios in their assessment of market value.)

The analysis above underscores why the smart investor has been long equities over the last 10 years. US interest rates have never been lower, so there is little to suggest the investor should not be long equities – as Buffett underscored.

None of this suggests that markets cannot decline, of course – or even plunge – despite record low interest rates. Recent events (in 2018-Q4 for example) should make this clear. (The Dow is down again sharply as we write – May 13!) An escalating US-China trade war, an unexpected geopolitical event, Congressional impeachment activities, etc. can and will have (dramatically) negative impacts on equities. But unless the US economy sinks into recession because, for example, the Fed mistakenly raises rates too much, the outlook for US equities (and by default, for most Canadian equities) should remain broadly constructive for 2019.

2. The Fed will not hike in 2019 – unless …

Unless of course the economy continues to surge ahead at 3%+ rates of growth and inflation pressures build. But this scenario is not very likely, nor necessarily negative for equity markets – assuming earnings rise in line with long-term interest rates.

The more likely scenario for 2019 is that the Fed will not raise rates, and may even have to lower them, because US economic growth will moderate on account of spent fiscal stimulus and modest monetary tightening to date (i.e. higher rates and QT – quantitative tightening).

The danger for equities in this case is that slower growth ***plus*** a serious crisis – be it an explosive US-China trade war, a disruptive Brexit, a systemic Eurozone crisis (i.e. an Italian banking crisis), a geopolitical crisis (i.e. Iran) or all of the above – will plunge the US economy into recession.

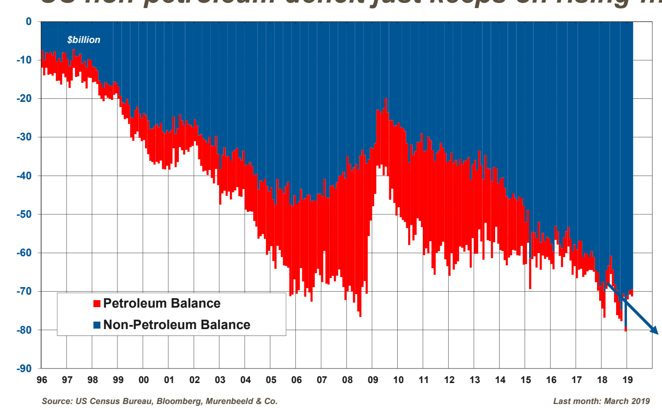
What happens then? The Fed will lower interest rates as far as it can (to 0%) and recommence some form of QE – quantitative easing. The Trump Administration might also decide that the time has come to forcibly devalue the US dollar.

3. The US Dollar is Overvalued

Much of what ails the US economy – low inflation, lack of capital investment, a significant trade deficit, and sub-par growth – can be put at the feet of an overvalued dollar. In our view, the US economy is broadly uncompetitive with a renminbi at 6.70, a euro at 1.10, and a yen at 110. Indeed, why would business invest in the US when the dollar is (seriously) overvalued, as opposed to investing elsewhere and/or buying their own stock with surplus liquidity?

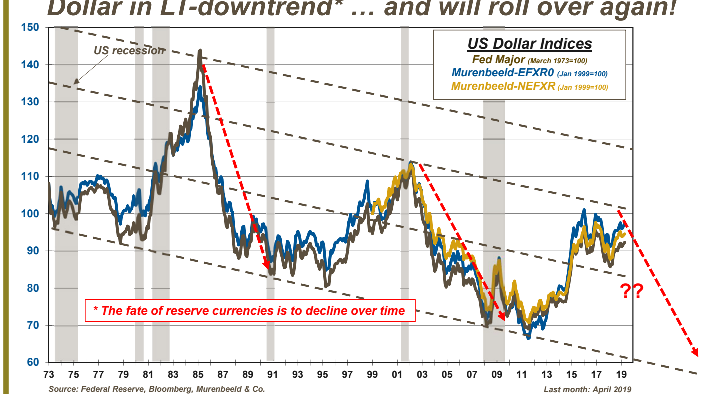
Dollar is Overvalued

US non-petroleum deficit just keeps on rising …



Dollar is Overvalued

Dollar in LT-downtrend* … and will roll over again!

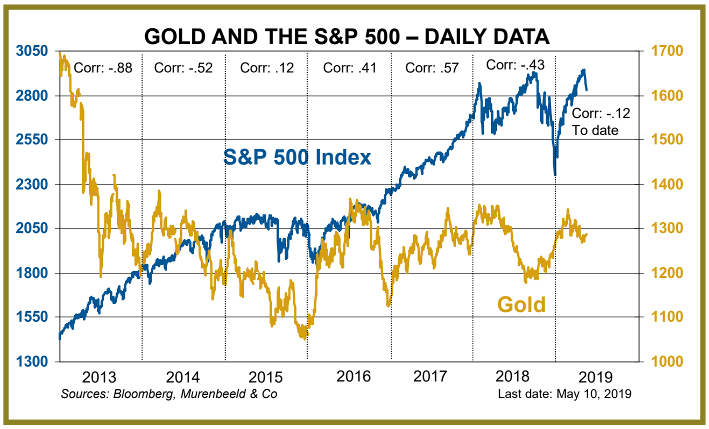


During the presidential campaign Trump said that the dollar needed to decline, that other countries – China – were manipulating their currencies; but to date the dollar has remained super-strong! If the US economy were to go south later this year or next, we could finally see some movement on the dollar front. And this would be very positive for commodities priced in dollars – most notably gold.

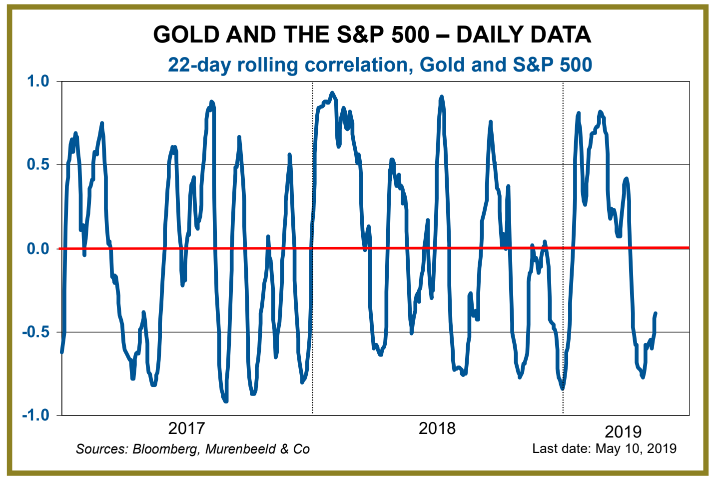
4. Gold will be a good hedge in the next recession

It's not that recessions are good for gold; it is that rapidly easing monetary policies are good for gold. At the start of the Great Recession gold plunged from $1000 to $700, but when the Fed got busy with QE gold rose substantially.

More generally, gold is a decent hedge in a portfolio; the *World Gold Council* has produced many studies that show a modest amount of gold in a portfolio (say 5-10%) provides better risk-return characteristics.



One of the reasons is that gold and equity markets are often negatively correlated – as of late for example. Assuming the negative correlation of 2018 holds up in 2019-20 (which we think it will), then if equity markets do turn down on expectations of recession an investment shift to government debt and gold would be a prudent shift, in our opinion.



(The chart above indicates that the 22-day rolling correlation between gold and the S&P 500 has been disproportionally negative in recent years. When equities are doing well, investment interest in gold wanes. But when equities stumble, gold picks up!)