# ENR Market Outlook

**June 2018**

## Executive Summary:

- The United States has emerged as one of the top-performing markets in the second quarter amid a strengthening dollar, positive portfolio inflows and increasing international economic and political tensions. From currency crises in Argentina and Turkey to political uncertainty in Italy and its future in the euro-zone, investors have dumped foreign assets since mid-May in favor of more stable destinations – mostly U.S. stocks and bonds;
- Technology stocks are red-hot in 2018 and continue to lead global financial markets. According to Bank of America Merrill Lynch, a record $2.3 billion-dollars flowed into tech stocks for the week ending June 8. The FANG stocks (Facebook, Amazon, Netflix, Alphabet-Google) increasingly pose a threat to the market as waves of momentum-based traders chase these companies to higher levels. Investors are dumping emerging markets, European stocks and high-yield bonds;
- The NASDAQ Composite dominates global stock market benchmarks this year, up 11% compared to a 4% gain for the S&P 500 Index, a 1.6% rise for the MSCI World Index and a loss of 2% for the MSCI Emerging Markets Index. Amid a surging dollar since April, current market trends are reminiscent of the 2013-2016 period when international assets measured in dollar terms heavily trailed U.S. domestic securities;
- U.S. small-cap stocks are leading broader composite benchmarks this year as fears of a global trade war, a rising dollar and corporate tax reform provide a strong impetus for investors to buy smaller companies. The Russell 2000 Index has gained 9% and the S&P 600 Small-Cap Index is up 11% -- far ahead of the broader market, up 4%;
- Mounting fears about political instability in Italy and Spain sent tremors through the euro-zone's two largest peripheral debt markets on May 29 with investors dumping the sovereign bonds of both nations and sending European and North American bank stocks sharply lower. Italian bond yields, already at a generational low, saw the two-year note surge to 2.42% before settling lower at 1.73%. Four weeks ago, the two-year Italian government bond traded at -0.31%. Italy is home to EUR 2.3 trillion ($2.7 trillion) of government debt and a perennially sick economy that hasn't grown since joining the euro-zone in 1999;
- The United States is increasing trade pressure on its largest trading partners and allies. In addition to implementing steel and aluminum tariffs in June, the Trump administration is threatening to unravel the manufacturing supply-chain governing the important auto industry – a primary beneficiary of NAFTA since 1993. In late May, the Trump administration launched a national security investigation into imports of cars and parts with a view to imposing a 25% tariff that threatens Asia and European producers. The action in June on steel and aluminum tariffs, though small in aggregate terms, marks a significant escalation by the United States in a long-feared trade war. China, a primary target of trade imbalances with the United States, sporting a nearly $400 billion-dollar trade deficit, will suffer very little from the Trump metal tariffs;
- The volume of mergers and acquisitions (M&A) globally has reached nearly 2 trillion-dollars in 2018, according to *Dealogic*, and on course to outpace the post-financial crisis high set in 2015. M&A booms have historically preceded an economic peak and are viewed by many pundits as a late-cycle economic phenomenon. *Thomsen Reuters* reports that U.S. bidders have been valuing targets at roughly 15 times EBITDA over the past few years compared to the highest average multiple hit before the financial crisis in 2005 at 14.5 times trailing earnings. The boom in M&A has also resulted in a record amount of debt on U.S. corporate balance-sheets while credit quality to finance deals has deteriorated markedly;

- On May 24, President Trump signed the Economic growth, Regulatory Relief, and Consumer Protections Act, designed to ease some of the regulations enacted in the 2010 Dodd-Frank financial reform bill. Despite his promises to roll back most of the financial regulations over the past 18 months, the President was unable to completely overhaul the legislation; most of the Obama-era bill will remain intact. However, the Volcker Rule, which prohibits banks from trading their proprietary accounts, is widely regarded as one of the leading triggers of the 2007-2008 financial crisis; though the Federal Reserve seeks to ease the legislation, lawmakers are unlikely to rescind it entirely. Also, in May, the government eased rules on small banks, reducing capital buffers;
- The U.S. ten-year Treasury bond hit its highest levels since 2011 earlier in May before rallying again below the 3% mark as the month concluded. Despite a big increase in government debt issuance to finance tax cuts and rising inflationary pressures, high quality bonds remain in demand when markets are subject to volatility. Earlier this year, bonds and stocks had assumed their pre-1998 positive correlation relationship. Most recently in early February, all major asset classes declined sharply following a period of computer-generated selling;
- According to *J.P. Morgan*, the gap between U.S. and European corporate earnings has widened in recent years using the MSCI USA and MSCI Europe benchmarks. That gap hit a 30-year high in May. MSCI is the world's oldest global benchmark service-provider dating back to 1969. J.P. Morgan points to big U.S. corporate tax cuts, surging growth in the tech sector and until recently, a stronger EUR helping to boost American earnings. According to *FactSet*, companies in the S&P 500 Index are on course to increase earnings by 25% in the most recent quarter compared to just 6.5% for the STOXX Europe 600 Index. Most of the gap in European earnings can largely be attributed to poor bank results and a strong EUR;
- Among the cheapest sectors of the global market, euro-zone banks have declined sharply as the EURO Stoxx Bank Index sits near a 19-month low and is down 13% in 2018. The latest bout of selling was triggered by recent political developments in Italy and Spain; sentiment remains bearish in banking across the euro-zone as the ECB delays terminating its asset purchases (aka quantitative easing), further eroding bank interest margins. Euribor rates remain negative at -0.35%. Some of the worst-performing banks are based in Germany where Deutsche Bank has plunged 38% and Commerzbank has crashed 24% this year. Bank across most of Europe continue to lack loan growth and higher interest rates;
- Led by higher crude oil prices, commodities are competing with equities as the top-performing asset class in 2018. The benchmark CRB Index has rallied 3% as the energy complex powers the composite. But in June, WTI crude prices have tanked more than 15% following a blistering 43% advance over the past 12 months. Earlier in May, new U.S. sanctions on Venezuelan oil and possible renewed Iranian sanctions boosted the oil price. In June, OPEC and Russia decided to open the spigots to more supply, damping the rally;
- Some emerging market (EM) currencies have started to consolidate heavily vis-à-vis the U.S. dollar after a strong showing in 2017. Argentina (-36%), Turkey (-18%), Brazil (-12%), Russia (-8%) and the Philippines (-6%) have led the decliners in 2018. However, the USD is also making inroads against major market units, too. The biggest loser against the dollar this year among major currencies is the Swedish krona, down 6.4%. Since bottoming in March, the USD Index has rallied 5.6% to its highest level since last October;
- Global financial markets have thus far largely dismissed the threat of a large-scale trade war. The financial impact caused by steel and aluminum tariffs is small compared to total world trade. However, risks are rising that the United States will target foreign autos and auto parts, possibly throwing a monkey wrench into the nine-year secular bull market. Investors are advised to maintain above-average cash balances and some portfolio hedges. The economic cycle is now advanced and the second-longest in U.S. history;

- We'd avoid emerging stock markets, most bonds and the global auto sector. Provided interest rates stabilize at current levels, stocks should continue to outpace bonds. We also favour U.S. equities over foreign stocks this year as macro risks accelerate, benefiting U.S. inbound investments and the dollar. Also, the United States holds an advantage to international markets in 2018 supported by tax cuts, a rise in capital spending and relatively stronger economic growth.

## Global Equities

# Take-Off with JETS as Merger Mania Approaches

As the global bull market progresses into its tenth year in 2018, stocks are fairly-priced across most sectors and in several areas of the market, trading at nosebleed levels. The MSCI World Index of major markets trades at more than 19 times trailing earnings or at the upper end of its historical range since its inception in 1969. The S&P 500 Index continues to fetch its second-highest multiple since the dot-com craze in 1999. Using the inflation-adjusted Shiller CAPE P/E, the American broader market sells at 33 times trailing earnings versus a median historical P/E of 16.15.

Stocks, of course, can trade at lofty valuations for a long time until a bear market or recession arrives. This was most recently the case in the post-2002 bull market, the 1990s and the 1980s. But one thing is certain: bull markets end. As value investors, we're always on the hunt for bargains in absolute and relative terms. In a market that's generally high-priced, that leaves only a few distressed sectors today. Among them and probably the most undervalued is the airline sector.

I know what you might be thinking: an airline recommendation? Well, airlines might host a bad reputation among investors because of leveraged balance-sheets, vulnerability to volatile jet fuel costs, expensive labor inputs, and sometimes, hostile unions. But it's been a super growth area of the market over the past five years with many U.S. carriers skyrocketing 500% or more. That's not boring. The way to make money in this sector is to buy shares when prices consolidate or plunge. It's a volatile sector and stock prices fluctuate regularly.

Airline stocks now rank as the most contrarian part of the global marketplace. Nobody likes them. However, Warren Buffett has made several comments since earlier this spring how he's hunting for an airline to buy for **Berkshire Hathaway** (NYSE-BRKA). Buffett likes cheap stocks.

From its all-time high, the MSCI Airlines Index has declined a cumulative 13% and is off 7% in 2018. Last year, airline stocks in the MSCI index surged 44% -- posting their best calendar year since 2014. But over the past 12 months, investors have dumped these stocks. The biggest losers include Alaska Airlines (-30%), Jet Blue Airways (-20%), Southwest (-15%), American Airlines (-12%) and UAL Continental Group (-7%). Those poor results compare to a 14.5% rise for the S&P 500 Index.

# Why Airlines and Why Now?

I think we're close to a bottom for the airlines, and for several reasons.

First, jet fuel prices, a key input cost affecting airline margins, are poised to decline after soaring more than 40% over the past year. Though it's impossible to predict how any commodity will perform over time, oil prices have already recorded a big rally off their lows in 2016. In fact, West Texas crude has almost tripled following big supply cuts from Russia and OPEC. But that's coming to an end now as both mega oil producers look to replace lost production from Venezuela and possibly, Iran. Plus, U.S. rigs are now operating at their highest rates since 2015 as more oil comes to market amid high prices. That should put pressure on jet fuel prices, which bottomed in January 2016 at $0.93 per gallon and currently trade at $2.10 per gallon – a 126% increase in 30 months.


Secondly, the passage of the boldest corporate tax reforms in three decades will also help U.S. carriers. The bill has four important changes that will have the largest implications for U.S. airlines. These are the reduction of the corporate tax rate; bonus depreciation; interest expense deductibility, and NOLs (net operating loss), which should be bullish for earnings. The two biggest drivers of lower cash taxes are the reduction in the Federal corporate tax rate and the modification of the bonus depreciation option. Most notable related to the latter is the ability to depreciate 100% in the first year (vs. 50% currently) and the inclusion of used aircraft (vs. only new previously).

Third, the U.S. Justice Department won't allow the largest carriers to merge but they might allow smaller airlines to be purchased by the Big Four. The markets haven't priced in a potential bidding war for smaller carriers like Alaska Airlines or Jet Blue. An added bonus: Berkshire Hathaway making an offer for an airline would probably ignite interest in the distressed sector, driving share prices much higher.

Finally, there's valuations. Of the largest four U.S. airlines, Southwest Airlines trades at just 8.4 times trailing earnings followed by UAL Continental at 9.9x, Delta at 11x and American at 11.3x trailing earnings. The biggest carriers basically sell at a 70% discount to the S&P 500 Index. Some of the smaller players like Jet Blue sell at just 5.3 times trailing earnings, Skywest at 6.6x earnings and Alaska Airlines at 8.3x. No other sector is cheaper.

# Buy JETS!

Launched in April 2015, the NYSE-listed **U.S. Global Jets ETF (NYSE-JETS)** is a $100 million-dollar fund investing in a diversified range of American and foreign airlines. It's the only pure airline ETF in the world, and I like the broad diversification. U.S. carriers represent 71% of the portfolio, foreign airlines are 19% and the last 10% invested in several U.S. aircraft manufacturers like Boeing, Textron and General Dynamics. The ETF charges a 0.60% annual fee.


The largest holdings in JETS are U.S. airlines, and that's exactly where you want to be in case Mr. Buffett bids on a U.S. carrier, triggering a takeover frenzy of smaller carriers. The top ten holdings represent 71% of the ETF and include nine U.S. airlines. The biggest holdings are UAL Continental (13.2%), Delta Air Lines (12.4%), Southwest Airlines (11%), American Airlines (10.6%) and Skywest (4.2%).

From its all-time high of $34.66 earlier in the first quarter, JETS trades 11% below its best level.

BUY **U.S. Global Jets ETF (NYSE-JETS)** at market up to $32.25.

# Indexing Perpetuates Technology Mania

Technology stocks are on a tear again this year and drawing record amounts of cash. And as they become a larger part of the market, ETF service-providers are buying more of these high-flying stocks at all-time highs. Tech stocks' big gains in 2018 have contributed to a disproportionate amount to the market's rally. As the S&P 500 Index has gained about 5% this year, much of this advance has been concentrated from two big stocks: **Microsoft** (+19%) and **Amazon.com** (+44%).

Rob Arnott, the founder and index pioneer at *Research Affiliates*, recently claimed in a *Wall Street Journal* article (B10, June 12) that some of the world's cheapest index funds track their benchmarks too closely, a 'self-inflicted wound' that ends up costing investors billions of dollars. His theory is that traditional market-capitalization-weighted indexes (e.g. S&P 500 Index) load-up on companies with the biggest recent price gains, leaving them vulnerable to asset bubbles. According to Arnott, deletions from the index outperform the market by more than 21% in the year after being cut while additions lag behind by 1.3%.


Technology as a 'safe-haven' in the market? Despite rising trade tensions, interest rate concerns, an Italian political skirmish and emerging market turmoil this spring, investors have lunged after big technology stocks and even small company shares. Both sectors are hitting all-time highs almost daily as the U.S. market once again dominates world bourses as it did from 2012 to 2017. A stronger dollar is the main culprit denting returns for U.S.-based investors overseas.

The boom in tech stocks' earnings and resultant share price advances isn't the only driver of the stock market this year.

# The Truth About Earnings

*The Wall Street Journal* (May 31, 'Profit Rise has Hidden Weakness') reported a great story about the divergence in U.S. corporate profits using two different calculations. I always find it amazing how the market reacts and is manipulated by (poor) reporting standards. Profits in Q1 for S&P 500 Index companies surged 26.3% compared to 12 months earlier. However, a Commerce Department measure of corporate earnings showed profits rose by just 0.10% in the first quarter. Apparently, if you strip away the tax cut benefits, the results were much worse. And before accounting for the benefits of the tax cut, profits were down by 6%. That's not a great quarter. The endgame for investors is not only do we have a very expensive U.S. market, but the impact of the corporate tax cuts has already been accounted for in stock prices. Yet the investment community, including some legendary investors like Paul Tudor Jones (interviewed on *CNBC* this morning), believe stocks will finish the year much higher.

# Buybacks Surge

There's something else going on in the stock-market, at least in the United States. It's not just about earnings, inflation and rates. The boom in stock buybacks hit a fresh record in the first quarter to 158 billion-dollars, according to S&P Dow Jones Indices. That's the biggest tally of buybacks in any quarter since 1998 and encouraged by corporate tax reform passed in late December. It's amazing: the surge in share repurchases is occurring when stock prices are at their highest levels in years. For the record, buybacks were a pittance back in early 2009 when the S&P 500 Index was trading at 735 or so. Today, it's above 2,780.


Record levels of share buybacks this year have been crucial to counter-balance the rising flow of redemptions in stock funds and ETFs. Investors redeemed 29.4 billion-dollars out of ETFs and mutual funds in Q1, according to a *Bank of America Merrill Lynch report.* We remain bullish on buyback stocks and recommend PKW.

# Markets Shrug-Off Trade Wars

Meanwhile, David Rosenberg at *Gluskin Sheff* in Toronto (*Breakfast with Dave*, June 11) nailed it perfectly when he mused about the growing trade skirmishes and the potential damage to the markets: 'All I see are equity analysts working through the tax cuts and their effects on the earnings outlook to justify their ongoing bullish forecasts. Nobody seems to even be trying to assess the risks from a break-up of global supply chains and the cost impact on profit margins from rising tariffs….the fact that the Russell 2000 (small-caps) is on a six-week winning streak, and far outperforming the more global oriented large-caps, could be an early sign that trade concerns are causing a shift in investment strategies without necessarily having to abandon the stock market writ large.'

# Argentina Goes Bust -- Again

The International Monetary Fund (IMF) opened its coffers again to Argentina for the second time in 20 years in the second quarter providing a 50 billion-dollar rescue package. Argentina has gone to the IMF three time since the late 1980s. This is nothing new to Argentinians, who have experienced monetary crises on a regular basis since at least the 1970s, including a bout of hyperinflation ending in 1992 that saw the peso crash. It seems the peso collapses at least once every decade. It also looks like the IMF needs new credit officers because you might as well throw all that money into the garbage: it won't get repaid. We remain neutral-to-bearish on emerging markets amid a strengthening dollar and a Fed still determined to raise interest rates.

## Tech Stock Frenzy in Overdrive

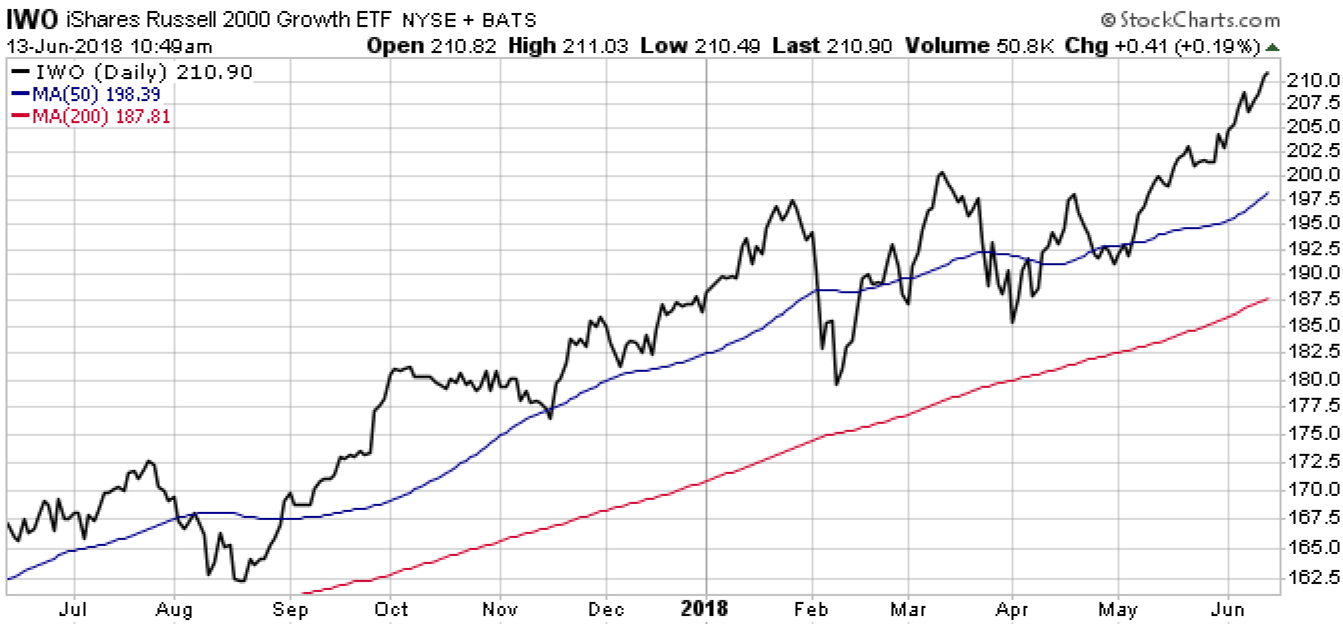
# ENR Market Outlook Portfolio

After briefly trailing international markets in 2017, U.S. stocks are significantly outpacing overseas bourses in 2018. Unlike last year, the USD is firming since April and diluting the returns generated from overseas markets for dollar-based investors. This was the case starting in 2011 through the end of 2016 as the dollar raced higher and foreign markets struggled in USD and to a lesser extent, local currency terms. A good representation of how foreign stocks are performing in dollar terms is the MSCI EAFE Index (Europe, Australasia and the Far East), which holds no U.S. equities and no emerging markets.

Through June 12, the S&P 500 Index is up 4.2% compared to a gain of 2% for the MSCI World Index and a decline of 1.53% for the MSCI EAFE Index. The MSCI Emerging Markets Index has declined 1.54% in 2018. One of the top-performing markets in the world this year is the tech-heavy NASDAQ Composite, up 11.6%.

The **ENR Market Outlook Portfolio** holds a total of 20 open positions, including eight non-U.S. securities. It's been a struggle for most international stocks this year, but we've managed to score a few unrealized gains in London-listed **BAE**

**Aerospace PLC** (+18.5%), **iShares China Large-Cap ETF** (+3%), **Verizon** (+2%) and **Diageo PLC** (+1%). Otherwise, the picture for the first six months of this year isn't pretty for international investors – in both dollars and local currency terms. Most stocks paying a healthy dividend have been smashed (telecoms, utilities, consumer staples, REITs) while almost everything in the technology space has gone parabolic as the markets lunge after growth stocks.




The gap between growth and value stocks continues to widen. For example, over the past ten years, the **iShares S&P 500 Growth ETF** (IVW) has grown 11.2% per annum compared to 7.25% for the **iShares S&P 500 Value ETF** (IVE). The divergence in performance has grown more compelling in 2018 with growth rallying more than 10% and value down 1%. The market is so obsessed with growth lately. The **iShares Edge MSCI Momentum ETF** (MTUM) has surged 10.4% and the small-cap **iShares Russell 2000 Growth ETF** (IWO) has rallied 13%. Nobody wants value, big or small. And what's value anyway? Mostly financials, energy, telecoms and healthcare – all laggards over the past 12 months. If you strip away the performance of the technology-based stocks in these growth indices you'd have a much lower return.

Another widespread explanation for strong small-cap performance in the growth sector reflects investors coming back to a stay home investment strategy from a global one. That makes sense to us given the challenges to the global economy posed by the Fed's ongoing tightening, a strong dollar since April and rising trade tensions. Also boosting small-caps are Trump's deregulation and tax cuts for business. Nevertheless, value stocks haven't been this cheap or neglected in years.

For the record, the trend in overseas markets also favors technology stocks – in both major and emerging market indices. Both benchmarks would be performing much worse without tech stocks. Value investing is also badly trailing growth abroad; the **iShares Edge MSCI International Value Factor** (IVLU) is flat this year or down 0.23%. That compares to a 2% return for the MSCI World Index.


Emerging markets are still trading at a big discount to major markets. EM stocks are trading at a 21% discount to the MSCI World Index price-to-earnings multiple at 11.9x trailing earnings and down from an eight-year high of 13.1x in January. For value investors, EM stocks offer a good entry point here because news and sentiment are so poor. The **iShares MSCI Emerging Markets ETF** (EEM) is 11% below its all-time high in late January.

For 'Best Buys' this month, M&A activity and very cheap valuations make distressed U.S. carriers our first choice. BUY **US Global JETS ETF** (NYSE-JETS) up to $32.25.

**Verizon Communications** (NYSE-VZ) is a leading U.S. telecom and wireless company paying a 5% dividend and selling at just 6.2 times trailing earnings. The stock has been hammered this year along with other big dividend-payers and offers excellent value for income investors. BUY up to $50.

The **iShares China Large-Cap ETF** (NYSE-FXI) still offers good value at 15.5 times trailing earnings and is 17% below its all-time high set more than ten years ago. MSCI recently introduced Mainland Chinese stocks to its widely-followed MSCI Emerging Markets universe. China remains under-owned by the investment community. BUY up to $50.

The U.S. stock buyback theme is a powerful secular investment idea. Long-term studies confirm that share repurchases drive stock prices higher. The **PowerShares Buyback Achievers ETF** (NASDAQ-PKW) is a BUY up to $58.

Nobody wants value stocks – except us. Patient investors buying value-based equities at these prices will be rewarded eventually. BUY the **iShares Russell Top 200 Value Index** (NYSE-IWX) up to $52.50. The ETF is down 1% this year.

This month, we're selling **Daimler AG** (Frankfurt-DAI). Fears of a trade war spreading to the auto industry is growing and we'd prefer to avoid its destructive path. Sell Daimler.

# Market Outlook Stock Portfolio:

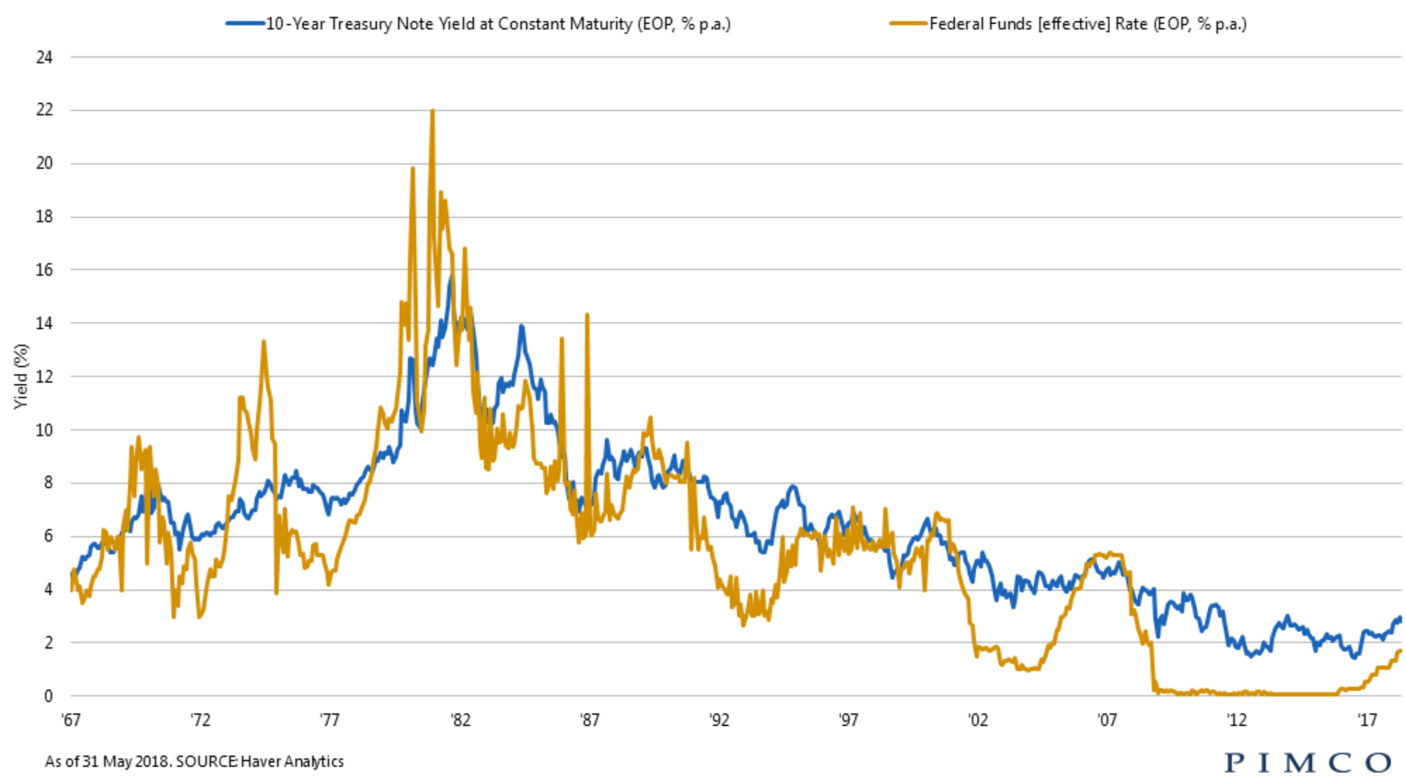
| Security | Listed | Symbol | Entry Price | Date | Current Yield | Current Price | Gain/ Loss | Advice |
|---|---|---|---|---|---|---|---|---|
| **US Global Jets ETF** | NYSE | JETS | $30.67 | Jun 12/18 | 0.46% | $30.67 | New | BUY |
| **iShares China Large-Cap ETF** | NYSE | FXI | $46.40 | May 7/18 | 2.28% | $47.84 | 3.10% | BUY |
| **Verizon Communications** | NYSE | VZ | $47.93 | Apr 5/18 | 4.76% | $48.92 | 2.07% | BUY |
| **PowerShares Buyback Achievers** | NASDAQ | PKW | $59.30 | Mar 6/18 | 0.81% | $59.11 | 0.67% | BUY |
| **Newell Brands Inc.[7]** | NYSE | NWL | $27.60 | Feb 5/18 | 3.60% | $26.29 | -3.08% | BUY |
| **iShares Russell Top 200 Value Index** | NYSE | IWX | $52.46 | Jan 2/18 | 2.24% | $52.04 | -0.25% | BUY |
| **BCE, Inc.[5]** | TSE | BCE | CAD 57.97 | Mar 8/17 | 5.27% | CAD 55.28 | 5.50% | BUY |
| **Daimler AG** | Frankfurt | DAI | € 64.94 | Sep 11/17 | 5.87% | € 62.19 | -0.12% | SELL |
| **Europcar Groupe** | Paris | EUCAR | € 10.25 | Jan 2/18 | 0.00% | € 9.37 | -10.60% | HOLD |
| **BAE Systems plc** | OTC | BAESY | $30.25 | Dec 4/17 | 3.24% | $35.11 | 18.46% | HOLD |
| **Global X MSCI Greece ETF** | NYSE | GREK | $9.41 | Nov 2/17 | 2.41% | $9.27 | -1.49% | HOLD |
| **PowerShares KBW Regional Banking ETF** | NASDAQ | KBWR | $53.35 | Jun 28/17 | 1.65% | $60.59 | 14.25% | HOLD |
| **Huntington Ingalls Industries** | NYSE | HII | $193.55 | May 30/17 | 1.22% | $222.64 | 16.08% | HOLD |
| **PayPal Holdings** | NASDAQ | PYPL | $40.10 | Jan 3/17 | 0.00% | $85.70 | 113.72% | HOLD |
| **Pfizer Inc.[4]** | NYSE | PFE | $32.92 | Jan 3/17 | 3.64% | $36.30 | 16.22% | HOLD |
| **Nestlé SA[3]** | VTX | NESN | CHF 65.15 | Dec 7/16 | 3.16% | CHF 74.54 | 18.62% | HOLD |
| **Diageo ADR** | NYSE | DEO | $113.71 | Jul 4/16 | 2.34% | $147.46 | 35.46% | HOLD |
| **Apple Inc[1]** | NASDAQ | AAPL | $92.79 | May 9/16 | 1.37% | $192.22 | 112.50% | HOLD |
| **General Dynamics** | NYSE | GD | $131.37 | Mar 31/16 | 1.71% | $198.73 | 56.85% | HOLD |
| **Dollarama Inc[2]** | TSE | DOL | CAD 71.60 | Feb 12/16 | 0.30% | CAD 148.79 | 122.68% | HOLD |

**Disclaimer:** The **ENR Global Contrarian Portfolio** owns Power Shares KBW Regional Banking ETF, Nestlé, Apple Inc., General Dynamics and Dollarama. **ENR Medium Risk Portfolio** owns Apple Inc., General Dynamics and Pfizer. **ENR Aggressive Growth Portfolio** owns Power Shares KBW Regional Banking ETF, Apple Inc., General Dynamics, PayPal Holdings and Dollarama.

Fixed-Income

# Bond Issuance Boom Spreads to Convertibles; U.S. Budget Deficit Surges 23% Year-over-Year

In addition to the deluge of bond issuance in global corporate and sovereign debt issuance over the past five years, convertible securities have been on a tear recently. There have been 62 sales worth nearly $23 billion-dollars so far this year, a pace that puts it on track to meet or surpass the peak of the last credit cycle just over ten years ago. Convertibles are a small market and pale in size compared to government debt or corporate bond markets. The surge in new convertibles, however, is another signal coming from the debt market that we're late in the credit cycle. Meanwhile, as interest rates rise in the United States, corporate issuance has taken off again with 34 billion-dollars of new paper hitting the market in June alone – and it's only mid-June.




Yet credit creation remains in a spectacular bull market, especially since 2009 as central banks led by the Fed embarked on the most creative and equally unorthodox monetary experiment since the Great Depression. According to *The Financial Times*, leading global central banks now own 20% of their own government-issued debt. In the United States, the Fed has barely begun to unwind its balance-sheet. It's anyone's guess how central banks will unload this debt pile without harming the financial system. In fact, maybe they'll never sell it entirely.

In total, the six central banks that have embarked on quantitative easing over the past decade — the U.S. Federal Reserve, the European Central Bank, the Bank of Japan and the Bank of England, along with the Swiss and Swedish central banks — hold more than 15 trillion dollars' worth of assets, according to analysis by *The Financial Times*, IMF and central bank figures -- more than four times the pre-crisis level.

In June, the Treasury Department reported that the U.S. government's budget deficit swelled by 23% over the past 12 months, ending May 31, to 532.2 billion dollars. The June 12 report showed the federal budget deficit was 146.8 billion dollars in May, 66% larger than the same month a year earlier. Bond investors also have more bad news. The consumer price index or CPI climbed 2.8% year-over-year through May and its highest since 2012.


We remain largely bearish on bonds since 2013 and don't see any reason for owning debt securities at these absurdly low yields, except for hedging purposes. As a deflation or recession-hedge, long-term Treasury securities deserve a place in a growth portfolio of stocks and other risk-based assets. Since 1998, long-term T-bonds have appreciated markedly when stocks prices decline sharply. But for most investors, bonds at these levels remain poor values ahead of rising budget deficits, Federal Reserve balance-sheet unwinding, more bond supply and a general increase in inflation.

If I was retiring soon, I'd seriously debate holding the traditional 60/40 allocation (stocks and bonds) and redirect the fixed-income portion to a laddered portfolio of short-term Treasury bills. Why would an investor buy a 10-year Treasury today at 3% when a 6-month T-bill yields 2.09%, offering zero interest rate risk and capital preservation? And short rates are still climbing. The chart showing 50-years of T-bond performance and the Federal Funds rate, courtesy of *PIMCO* (see page 12), shows a possible secular bottom for interest rates now underway. If that's the case, bonds are 'dead money' for the next several years and have already lost hefty sums for investors who purchased 10-year T-bonds at 1.37% two years ago. In fact, T-bonds have been a loser for investors since 2015.

## Market Outlook Bond Portfolio:

| Security | Listed | Symbol | Entry Price | Date | Current Yield | Current Price | Gain/ Loss | Advice |
|---|---|---|---|---|---|---|---|---|
| **iShares TIPS** | NYSE | TIP | $113.53 | Dec 7/16 | 2.43% | $111.88 | 1.50% | HOLD |
| **iShares Floating Rate** | NYSE | FLOT | $50.69 | Oct 5/16 | 1.66% | $50.95 | 3.13% | HOLD |

**Disclaimer:** The **ENR Low Risk Portfolio** holds the iShares TIPS Bond Fund and the iShares Floating Rate Bond ETF. The **ENR Medium Risk Portfolio** holds the iShares TIPS Bond Fund and the iShares Floating Rate Bond Fund.

### Foreign Exchange

# ECB to End Asset Purchases in December

Markets don't realize it yet, but the global liquidity spigots are slowly being turned off. On June 14, the European Central Bank (ECB) announced plans to terminate quantitative easing in December. The central bank also announced a further tapering in September of its regular asset purchases. The news drove the EUR 1% lower vis-à-vis the dollar. In 2018, the EUR is down 1.8% versus the USD, -0.70% against the CHF and down 3.9% against the yen.

In the span of just a few months, global investors, including macro FX traders, went from being heavily short the American dollar to heavily long in June. After spending most of 2017 in a draw-down, the dollar bottomed in the first quarter and is now up 6% off its low and up 2.1% in 2018. In addition to a long overdue rally after a big decline last year attracted short-sellers to the currency, a recovery was long overdue, if only temporary. But we think this is more than a bear market bounce and possibly, a cyclical bear market rally that might last 12-18 months. It's also important to stress that it's not just about the dollar: emerging market currencies are weak with several units plunging, further boosting the USD.

We've upgraded our forecast for the USD this year against the EUR because of Italian politics, renewed weak euro-zone inflation data and weaker factory output. The EU reported that output of factories, mines and utilities across the 19 countries in the euro-zone was 0.9% lower in April compared to March but up 1.7% year-over-year. Still, that marked the fourth month in the last five where industrial production has contracted. The ECB won't be in a hurry to normalize monetary policy in a weak economic environment. Also, the ECB will probably start to normalize its base rate from a current -0.36% to 0% -- hardly an attractive lure for FX investors compared to rising dollar rates. Its repo rate is 0%.


Compared to just six months ago, the USD has posted a major U-turn in foreign-exchange markets. The dollar is now almost entirely in the plus column versus world currencies as we head into summer and making some big gains in Latin America (Brazil and Argentina mostly), Turkey, South Africa, Russia, the Philippines, India and even Sweden. Anyone betting against the USD this spring has been railroaded. In 2018, the FX booby-prize goes to the Argentinean peso, down a whopping 41%. Trade concerns across Europe and the Pacific are encouraging investors to purchase USDs, a trend that's likely to accelerate this summer as trade wars simmer, possibly spreading to agriculture and autos.

### Yen still Positive for the Year

# Currency Sandwich Correction Continues

The **ENR Global Currency Sandwich**, including gold, fell again in May and is down 1.52% this year as of June 14 versus a gain of 2.04% for the USD Index. The only currency component showing a gain this year is the Japanese yen, up 2%. The Polish zloty, despite a healthy economy and still one of the fastest-growing European countries, is down more than 4% in 2018. The Canadian dollar is under pressure because of the Trump-Trudeau stand-off and tense NAFTA negotiations. The CAD is down 3.3%.

**2018 ENR Global Currency Sandwich (Equally-Weighted)**:

- **Gold Bullion**
- **EUR**
- **Canadian dollar**
- **Polish zloty**
- **Swiss franc**
- **Japanese yen**

## Commodities

# Buy U.S. Steel as Tariffs Boost 2018-2019 Earnings

Steel isn't boring. Long depressed, the companies in the U.S. steel sector have gone through the roof over the past 36 months amid a boom in iron ore prices until late last year and stronger global economic growth. Steel prices, the finished product emanating from iron ore, has been in a rising trend for the past few years and is now further supported by U.S. tariffs. U.S. steel-producing companies are now in hiring mode as previously shuttered smelters are activated to meet rising domestic demand. With tariffs hurting Canadian steel producers the most, American companies will benefit at their expense, and that means an acceleration in corporate earnings. We like **U.S. Steel** (NYSE-X).


Based in Pittsburgh, United States Corporation is America's 2nd largest steel producer and ranked 24th in size worldwide. The company maintains facilities in the United States, Canada and Central Europe.

United States Steel Corporation reported first quarter 2018 net earnings of 18 million dollars, or $0.10 per diluted share. Adjusted net earnings were 57 million dollars, or $0.32 per diluted share. This compares to a first quarter 2017 net loss of 180 million dollars, or $1.03 per diluted share. Adjusted net loss for first quarter 2017 was 145 million dollars, or $0.83 per diluted share. U.S. Steel is cheap. Even after a huge rally over the past five years, the stock is going to benefit in a big way from steel tariffs entering the United States. Management has cut net debt, raised shareholder equity and the valuation is attractive at just 13 times trailing earnings. The stock is now 21% below its all-time high and offers a strong entry point. BUY **U.S. Steel Corp.** (NYSE-X) up to $40.

## Market Outlook Commodity Portfolio:

| Security | Listed | Symbol | Entry Price | Date | Current Yield | Current Price | Gain/ Loss | Advice |
|---|---|---|---|---|---|---|---|---|
| **United States Steel** | NYSE | X | $37.61 | Jun 12/18 | 0.53% | $37.61 | NEW | BUY |
| **iShares S&P GSCI Commodity Trust** | NYSE | GSG | $16.34 | Jan 2/18 | 0.00% | $17.55 | 7.41% | BUY |
| **Pioneer Natural Resources Co.** | NYSE | PXD | $170.17 | Mar 8/18 | 0.10% | $193.41 | 13.75% | HOLD |
| **ETFS Physical Platinum** | NYSE | PPLT | $88.54 | Nov 2/17 | 0.00% | $85.65 | -3.26% | HOLD |
| **Randgold Resources** | NASDAQ | GOLD | $61.93 | Dec 31/15 | 2.54% | $78.50 | 32.67% | HOLD |
| **Newmont Mining** | NYSE | NEM | $17.99 | Dec 31/15 | 1.11% | $38.59 | 118.12% | HOLD |
| **Schlumberger** | NYSE | SLB | $69.75 | Dec 31/15 | 2.86% | $68.66 | 5.61% | HOLD |

<u>Shareholder Disclaimer</u>:

1. ENR or its employees or its access persons own shares of Apple Inc.
2. ENR or its employees or its access persons own shares of Dollarama Inc.
3. ENR or its employees or its access persons own shares of Nestlé
4. ENR or its employees or its access persons own shares of Pfizer Inc.
5. ENR or its employees or its access persons own shares of BCE Inc.

Eric N Roseman
June 14, 2018
Montréal, Canada