NEWSLETTER

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Strongbox
tailored wealth management

What should you be doing?

Given the many political and philosophical uncertainties and worries about the future of the world that we wrote about in our last newsletter, why is most economic news still good, and markets continue to be strong?

The MSCI World Index rose 20% in 2017, and the US market is now at is at an adjusted price/earings ratio of over 32, a level only seen historically in 1929 and during the dotcom bubble.

How is this possible given all of the serious issues of geopolitical uncertainty, social problems and rising inequality that are glaringly obvious? Why are none of these issues leading to significant market volatility?

First, as a recent survey of fund managers by Bank of Amercia/Merrill Lynch found, many investors are knowingly and consciously over-weighting equites despite the high valuations. The main reason for this is a negative one – shares are expensive, but they are still relatively more attractive than the main alternative, bonds, especially government bonds. 48% of fund managers are over-weight equities, but even more – 59% - are underweight bonds.

Then there's the fact that the global economy is finally getting over the GFC and growing well, which should deliver good returns to investors, and finally, the Trump administration's tax cuts package which has reduced the corporate tax rate in the US from 35% to 21 % is also good news for businesses and their owners. We could debate the extent to which this may already be reflected in the valuations, but it is certainly helping sentiment.

However, there are still a significant number of risk factors at play in the global economy.

Central banks are working hard to reduce their interventions in the market and raise interest rates at a pace that will not cause a major correction, but whether they will succeed remains to be seen and higher than expected increases in interest rates could have some very negative results (cont'd on next page).

Equities comment

The top performer in the model portfolio for the year was Monadelphous which gave a capital return of 89% for the year! As we wrote about this stock recently, this time we will look at the next achiever – Suncor +50% .

Suncor is a Canadian company and its business is digging up Alberta tar sands and converting them into crude oil. Suncor also has the benefit of 1500 retail sites and that allow it to sell the oil that it produces. Hence it is a vertically integrated business along the lines of Chevron and Exxon. This vertical integration gives it a higher profit margin than it would have were it to be a pure oil extractor. Suncor's operations are concentrated in the Alberta region and this allows it to reduce costs and to expand its source of raw materials. Suncor's management is strongly focused on reducing its cost of production – the key metric being the cost per barrel of crude. The company was producing 450k barrels of oil per day in 2012, it now plans to be producing 800k barrels by end 2019. Currently Suncor has reserves going out 35 years! The company has consistently grown its discretionary cash flow and this should greatly benefit shareholders in the future as it starts to use the cash to retire shares. When oil is priced anywhere north of $60 per barrel, Suncor's prospects are very rosy indeed.

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Model Portfolio

No changes to the model portfolio in the last quarter. It continues to be difficult to find good value in the market and we do not expect to be buying any more holdings in the foreseeable future. The big question is whether the tax break for US companies which was recently passed is already in the price or not. We suspect it must be and that is at least part of the reason that valuations are at new records. The upcoming reporting season will have a big impact on our outlook we suspect. If earnings are poor, we may need to start trimming aggressively.

Model Portfolio
Initial value $1m **Current Value** $2.24m
Cash 37% **Shares** 63%

Performance		**Bottom Performing Shares (ytd)**		**Top Performing Shares (ytd)**	
6 months	+10%	Teva	-47%	Monodelphous	+89%
12 months	+9.5%	Noble	-24%	Suncor	+50%
since start	+124%	Euro	-21%	Aetna	+45%

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Numerous geo-political risks ranging from war with N Korea to instability in Syria and the Middle East to Russian aggression are still as present as they were last year (if not more so) and there is also the risk of a slow-down in the Chinese economy as interest rates there rise. Add to that the fact that whatever good the Trump tax cuts may or may not do, they will not help the massive budget deficit, and may in fact exacerbate the social inequality issues which are already a significant risk.

It seems that the sheer number and range of risks to the markets is making it difficult for investors to worry about any of them!

As economist Nouriel Roubini observed in a May 2017 article, "Even with geopolitical conflicts proliferating around the world, global financial markets have reached new heights. But while there are many explanations for why investors might be underpricing today's risks, there is no good reason for them to ignore the possibility of another "black swan" event on the horizon…...It is well known that markets can price the "risks" associated with a normal distribution of events that can be statistically estimated and measured. But they have more trouble grappling with "Knightian uncertainty": risk that cannot be calculated in probabilistic terms."

Let's hope 2018 is not the year that this one of these risks crystalises!

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