Thackray's TOP 10 Prognostications – 1/2 Year Update 2018 –

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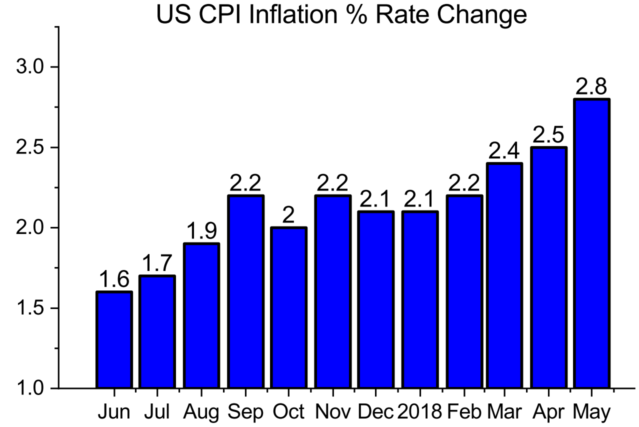
At the end of 2017, I released my Top Ten Prognostications (actually nine prognostications as number 7 was removed at the last minute). Now that we are half way through the 2018, I thought it would be a good time to update the record for the remainder of the year.

❶ *Inflation - Increase in 2018*

Inflation has generally been rising over the last few years. So far in 2018, CPI has increased from 2.1% in January to 2.8% in May (Bureau of Labor Statistics).

US CPI Inflation % Rate Change



Source: Bureau of Labor Statistics

Investors are not just concerned with rising prices of every day items that are used to survive, but also the rise in average hourly earnings of workers. Wage increases are "sticky." Once a wage increase occurs it is difficult for it to be reversed. Wage increases push up the cost of items being produced and add to inflation. Once the inflation cycle has started, it is difficult to control.

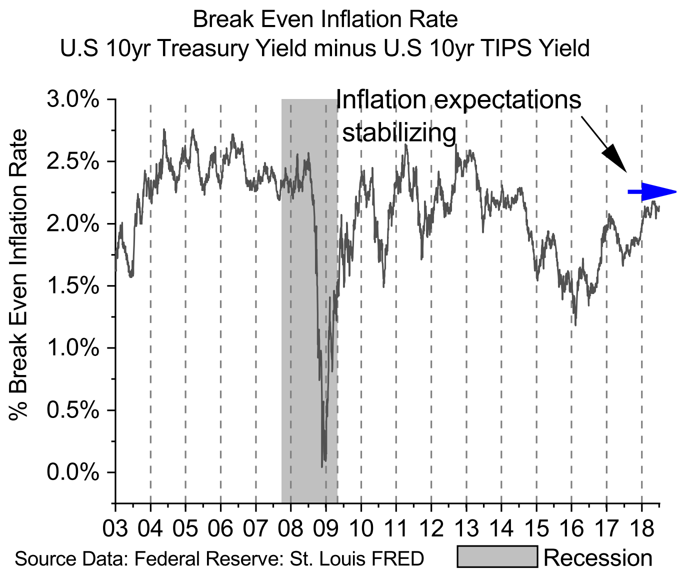
One of the objectives of the Federal Reserve is price stability. Historically, once inflation rises past 2%, the Federal Reserve becomes concerned and raises its federal funds rate in order to try and maintain control of inflation. If inflation hits 3%, this is considered a danger zone and an escalation of increases in the federal funds rate is warranted.

There is talk from many pundits and some of the Federal Reserve governors, that it might be okay to let inflation run hot for a while in order to help the economy maintain its growth. Despite this being dangerous "thinking," it will probably become a major topic of conversation in the future.

In the past, the Federal Reserve has been blamed for bringing on recessions by raising its interest rates too quickly and too high. There is a general belief that recessions are avoidable and the Federal Reserve just needs to not raise rates too fast. Although pacing the rate increases would definitely help reduce the probability of a recession, it is not necessarily the case and it is extremely hard to do.

This perception that Federal Reserve can mitigate the damages of a recession by holding back on increasing rates largely has to do with human perception. We tend to view relationships in a linear fashion when they are often parabolic. Many investors believe that a rate hike by the Federal Reserve has an equal impact on subduing inflation at all inflation levels. This is incorrect. Once inflation takes root it becomes harder and harder to control and requires more drastic action. When inflation starts rising rapidly, small rate hikes have a limited effect. Taking action early, despite the increased risks of a recession is often the best prescription.

Inflation expectations started to increase in 2016. In 2018, inflation expectations have shown signs of stabilizing. This does not necessarily mean that inflation is not going to rise in the future, but rather indicates a slower path higher or the remainder of 2018.



Expectations for 2nd half of 2018:

The Federal Reserve will probably be aggressive in its rate hikes compared to expectations and will blamed for increasing rates too fast. Despite the action from the Federal Reserve, the result will probably be inflation ending up modestly higher than where it is currently.

❷ *Canada outperforms USA in 2018 – eh!*

Initially in 2018, the US stock market rocketed in the first part of the year, leaving behind the Canadian stock market. Since March of this year, the Canadian market has been outperforming the US stock market. At this point in time, the S&P 500 is a bit ahead of the Canadian stock market on a year-to-date basis.

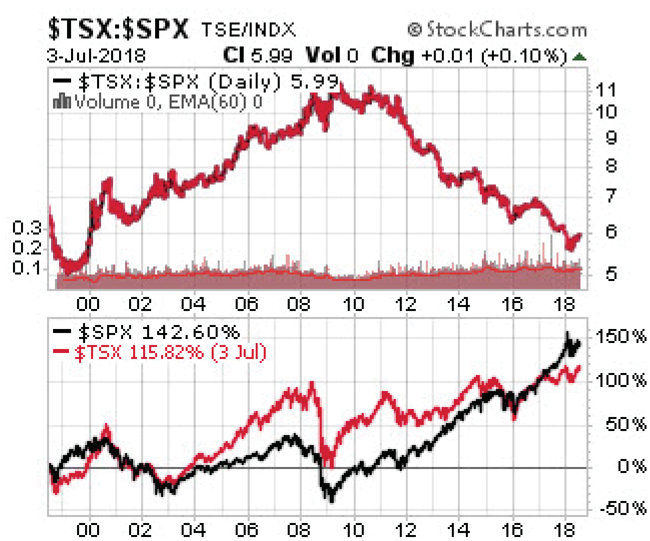
From a seasonal basis, the US stock market tends to outperform the Canadian stock market in autumn. My forecast is in jeopardy.

The US is in a trade "war" with a number of countries around the world, including Canada. Each side of the war has said that they will ratchet up counter tariffs if tariffs are imposed on them. This creates an interesting situation as everyone loses if tariffs are enacted.

One of the reasons that global growth has persisted over the decades is that tariffs have been reduced in the process of globalization. The US will get hurt if the tariff war plays out, but Canada will probably get hurt more. The tariff war will probably lead to a global economic slowdown, which means less demand for resources, which hurts Canada more than the US.

The current trade war is not fully priced into the stock market as investors are still calling it a trade spat. The general belief is that it is much to do about nothing and that everything will get resolved, because it is not in anybody's interest for a trade war. Ok, this sounds logical, but wars are not logical. Emotions get revved up and somehow stupid decisions take place.

On top of the trade wars, Canada is probably destined to underperform the US market as world economic growth slows. The US has strong economic growth, but most of the rest of the world is starting to show signs of slowing, including Canada. In a slowing growth scenario, Canada typically looses out. So far, Canada has performed well due to the rising price of oil. Currently, a number of oil supply disruptions are taking place simultaneously around the globe which is supporting the price of oil. The result has been an improving Canadian stock market. However, if the trend of slower global economic growth continues, this would translate into slowing demand for commodities. In this scenario, it is expected that Canadian stock market would underperform the US stock market.



Expectations for 2nd half of 2018:

Canada is expected to underperform the US in the second half of the year due to seasonal tendencies for the US stock market to outperform in autumn and slower global economic growth.

❸ *Canadian banks - underperform the TSX Composite Index in 2018*

My prognostication for Canadian banks to underperform the TSX Composite Index has been correct so far. In my full year prognostications, I stated that Canadian banks would initially outperform the Canadian stock market in their seasonally strong sector from January 23rd to April 17th. At the beginning of the year, Canadian banks performed well, but fell apart starting in mid-March. Towards the end of March, Canadian banks started to underperform the TSX Composite. Canadian banks are still supported by a rising trend line (see graph), but the underperformance relative to the TSX Composite is more telling.

It is interesting to note, that one of my rationales for weaker Canadian banks was based upon an overheated residential housing market slowing down. The real estate market in Canada is softer compared to last year, but not significantly so. And yet, Canadian banks have still underperformed. A slowing economy or increasing interest rates in Canada could still have a negative effect on the housing market and hence have a negative impact on Canadian banks.

So why are Canadian banks out of favor? Many investors have not noticed, but international banks are struggling and are underperforming equity indexes, including Systematically Important Financial Institutions (Sifi's). Some investors call this group of banks "too big to fail" banks including Deutsche Bank which has fallen over 40% year-to-date.

It is not just banks overseas that are having trouble, it is also US banks. So far this year, investors have shied away from US banks. Why? A flattening yield curve reduces their profits. When Jamie Dimon, CEO of JP Morgan publicly stated a few years ago that rising rates were good for the US banks because of rising net interest margins, everyone jumped on the band wagon. Every time rates went up, investors got excited. This appears to no longer be the case, as investors have come to the realization that even if the Federal Reserve raises its federal funds rate, it does not mean that banks are going to make more money. If the ten-year US Treasury yield does not have a corresponding move upwards, the yield curve gets flatter and it is difficult for banks to make money in this environment.

As both the Federal Reserve and Bank of Canada raise their rates, US and Canada have been experiencing flattening yield curves, which is hurting bank profits. The trend of flattening yield curves will probably continue and as such, Canadian banks will probably continue to underperform the TSX Composite.

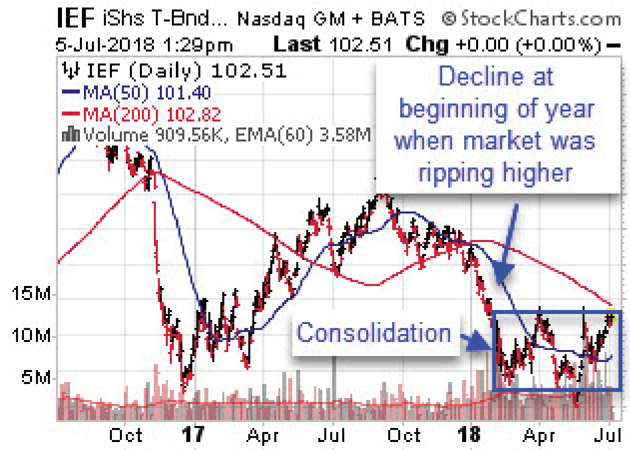
Expectations for 2nd half of 2018:

Canadian banks will probably moderately outperform the TSX Composite into November. Canadian banks have a strong seasonal period from October 10th to December 31st, but often fade in November when they start releasing their Q4 earnings. Overall, in the second half of the year, Canadian banks are still expected to underperform the TSX Composite Index, due to slowing economic growth.

❹ *U.S. Government bonds set to decline in 2018*

US government bonds are so far negative year-to-date as rising inflation has forced bond yields higher. For seasonal investors, the good news is that bonds have performed well in their seasonal period, starting in early May. The seasonal period for US government bonds does not finish until October 3rd. At this time, it is expected that US government bonds could continue to perform well until the end of their seasonal period.

After the end of the seasonal period for US government bonds, at the beginning of October, bonds are expected to decline once again as concerns of rising inflation expectations impacts the stock market. On average, in autumn, positive expectations for economic growth in the next year tend to push bond yields up and bonds down. This year is not expected to be any different.



Expectations for 2nd half of 2018:

US government bonds are expected to perform well in their seasonal period, particularly August and September. In October through to December, US government bonds are expected to perform poorly, as they have often done on a seasonal basis. On a yearly basis, US government bonds are expected to be negative.

❺ *U.S. outperform Europe in 2018*

I have heard it all before, "Europe is a bargain", "the valuations are much cheaper than in the US", "Europe has better growth prospects." Sure, Europe is cheaper and there will be pockets when Europe does outperform, but overall Europe will probably continue to lag the US stock market. Look for the ECB to continue its easy monetary policy as it tapers less than expected.

On June 29th, it was rumored that the ECB could be implementing a form of "Operation Twist" similar to program that the Federal Reserve implemented in 2012. This procedure has the central bank buying longer dated bonds and selling shorter dated bonds. In essence, this flattens the yield curve. Although the objective of Operation Twist is to stimulate the economy with lower rates, there are some operational side effects including hurting the financial institutions with a flatter yield curve. Given that European banks are suffering, I am not sure that this is the best plan.

The law of diminishing returns is starting to kick in for the ECB. Their loose monetary policy actions are providing little benefit. The system is already saturated. The Federal Reserve suffered the same problem and over time its quantitative easing program became less effective. The ECB is no different and its policy actions are going to be less and less effective.

Expectations for 2nd half of 2018:

Europe will continue to underperform the US stock market in 2018. There may be some reprieve from this trend based upon trade tensions diminishing, but overall the trend is set for European underperformance.

❻ *Volatility set to increase in 2018*

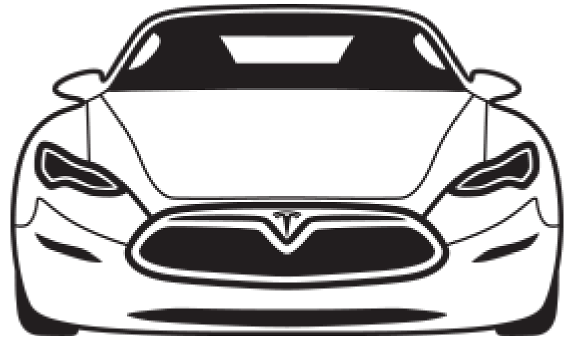
So far this year, volatility has increased, with a spike in early February that caught sellers of volatility off guard. Trumps tweets and arguments in public between his advisors on policy have added to volatility. Recently, volatility has settled down somewhat, but investors should not count on low volatility being the new normal. On a seasonal basis, volatility picks up in late July with increasing volatility occurring into October. On average, October is the most volatile month of the year.

Volatility tends to increase in the stock market before elections, as elections bring uncertainty, which investors abhor.

Expectations for 2nd half of 2018:

Volatility will probably increase in the second half of 2018. Volatility tends to increase at this time of the year and also the potential for the US election and international events to cause increased uncertainty will probably push volatility higher.

❽ *Tesla- driving downhill in 2018*



So far, my prognostication is off the mark, as TSLA is higher than it was at the beginning of the year.

Investors are really divided, strongly, on Tesla. One group of investors believes in Elon Musk's vision and Tesla's future domination in electric vehicles. The second group believes that Tesla will struggle and either fail to produce enough cars or fall victim to competition from the many other EV cars scheduled to hit the road in the next two years.

I fall into the second group of investors and believe that Tesla will stumble both in manufacturing and suffer due to competition. Currently, Tesla has moved some of its Tesla 3 manufacturing operations outside its main building into a tent. Without getting into the possible reasons for the move, I really have to question the quality control of production in a tent. I know that if I were a buyer of a Tesla 3 being made in a tent, I would cancel my "tent car" order. The bigger problem that I have is that Tesla does not have a significant competitive advantage compared to the host of world auto manufacturing companies poised to enter the EV space. Ironically, in May, Elon Musk and Warren Buffet got into a public spat about the importance of companies having a competitive advantage that creates a barrier to entry (moat) for other firms to compete. Musk essentially believes that a moat protecting a competitive advantage is not important as a good company should be able to innovate fast enough to keep ahead of its competitors. Warren Buffet believes that companies with a defendable moat of a competitive advantage over competitors is important for the long-term success of a company.

I wish Musk good luck, but I side with Buffet on this issue. Musk may change his mind as competition enters the EV market in 2019 and 2020. The valuation of Tesla still baffles me for a car company that is producing a commodity product, a car.

Expectations for 2nd half of 2018:

Although my initial prognostication is off the mark, I am still standing by my prediction and expect TSLA to be lower for the full year of 2018.

9 *Poloz - changes his mind about changing his mind (this is a given in 2018)*

When I initially stated the prognostication on Poloz changing his mind about changing his mind, it was a satirical comment on his flip-flopping his stance on rate hikes. He continues to be "purposely" opaque in his comments. Poloz is not as bad as in 2017, when he did a disservice to the business community with his lack of direction which increased uncertainty for businesses for their financial operations. Poloz has attempted to improve his communication, but still gets poor marks compared to the Federal Reserve.

In the last week of June 2018, Poloz gave a Bank of Canada speech and said, "we can be clearer in our communications." Obviously, I am not the only one that sees the Bank of Canada's opaque communication as a problem. Poloz has recently stated that he wants to communicate with the language that soccer dads could understand. It appears that he does not understand the communication problem: it is not the level of language, but the fact that the Bank of Canada's guidance seems capricious.

Expectations for 2nd half of 2018:

Poloz will improve his communications, but it will still fall short of expected standards. I still expect Poloz to stumble his way through the rate cycle and continue to frustrate investors.

10 *Bitcoin - ~~$1,000,000~~ $3,000 at some point in 2018*

At the time of my original prognostication, Bitcoin was trading just shy of $14,000 USD. Investors are polarized on the future of Bitcoin. On the extremes, some investors believe that Bitcoin will be the world's currency and on the other end of the spectrum, some investors believe that it is a scam. Although I see value in the blockchain process, I continue to doubt Bitcoins value as a medium of exchange.

So far this year, Bitcoin has fallen sharply and is now trading in the $5,000 range.

Expectations for 2nd half of 2018:

I still stand by my prognostication that Bitcoin will probably touch $3000 at some point in 2018.

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