April 2017

Dear Client,

Portfolio Review – April 2017

Interest rates in the U.S. were higher.

The best performing markets were the International markets.

A Brief Review of the First Quarter

Interest Rates and Currency

Interest rates in Canada remained low throughout the quarter with the yield on 10-year Government of Canada Bonds ending the quarter at 1.63%, while the yield on 5-year Canada Bonds was just over 1%. Interest rates in the U.S. were higher with the yield on 10-year U.S. Government Bonds standing at 2.41%. The higher U.S. interest rates have helped keep the U.S. dollar relatively strong compared to other major currencies.

The value of the Canadian dollar fluctuated between 74 U.S. cents to 77 U.S. cents over the quarter and closed the quarter at the lower end of this range with a value of 74.5 U.S. cents.

Equities

The major markets around the world provided positive returns over the first quarter. In Canadian dollar terms, our market[1] gained 2.4% while the U.S. market[2] gained 5.2%. The best performing markets were the International markets. The International Developed market[3] gained 6.5% and the Emerging Markets index[4] was up double digits at 10.6% for the quarter.

Is the Trump Rally Fake News?

There has been a good deal of talk recently in the news media about the so-called "Trump Rally," as the U.S. stock market has performed reasonably well since the U.S. election. Some analysts have credited this positive performance in large part to President Trump's "America First" policies.

[1] S&P/TSX Composite
[2] S&P 500
[3] MSCI EAFE (Europe, Australasia, Far East)
[4] MSCI Emerging Markets Index

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This narrative, however, may be a little too tidy.

This narrative, however, may be a little too tidy and on closer analysis the market gains may have little to do with the President's proposed policies. As shown above, the International markets have actually performed better than the U.S. market since the beginning of the year and there may be some broader underlying forces, other than the proposed policies, driving the improvement in global economic activity.

A recent lead article in *The Economist* periodical stated: "Mr. Trump's claims to have magically jump-started job creation are sheer braggadocio."

Improvement in economic performance was not confined to the U.S.

The article points out that the U.S. economy added jobs for 77 months in a row prior to the U.S. election and that improvement in economic performance was not confined to the U.S.

In other words, the better economic performance may have little to do with President Trump's policies but instead was due to other factors.

The Economist article argues that the improvement in world economic activity is mainly due to the monetary policies followed by Central Banks around the world which have kept interest rates low and thus allowed economies to repair themselves after the financial crisis of 2008.

Studying the Past to Understand the Future

We believe a study of the historic trends in the security markets can be useful in helping understand the dynamics of the current market and also give some insight into what to expect for the future.

Trends may not exactly repeat earlier times but they do tend to share certain similarities.

As Mark Twain is reported to have said *"History doesn't repeat itself but it often rhymes."* This quote could be applied to the securities market, for over time we see certain trends which may not exactly repeat earlier times, but they do tend to share certain similarities.

The S&P 500 index represents a well-diversified group of companies.

In Appendix A, we have summarized the progress of the overall U.S. equity market, as represented by the S&P 500 index since 1970. We use the S&P 500 index because the data is readily available and it represents a well-diversified group of companies. In other words, it is a good representation of what an investor would have earned if they had invested in a well-diversified portfolio of equity securities.

There are a number of key points to note from the information set out in Appendix A:

$10,000 invested in the broad U.S. market in 1970 would have grown to over $800,000.

1. First, most investors are surprised by how much the equity markets have risen since 1970. At the end of 2016, the S&P index stood at 2,251 (at April 1st it was 2,368). At the end of 1970, the S&P index was just over 90. $10,000 invested in the broad U.S. market in 1970 would have grown to over $800,000 by the end of last year. This represents an annual return of about 10% per annum which is in line with the annual returns for the U.S. market since 1900 of over 9%. In other words, the 46-year period set out in Appendix A is not out of line with gains over much longer time periods.

2. A second key point to note is how irregular the gains have been, with a couple of five-year periods when the return was negative which were then followed by periods of substantial gains. Over the long-term, the gains have been substantial but they were not earned in a steady, comfortable manner.

While the growth in the index value has been quite erratic, the growth in earnings and dividends has been very steady.

3. A third point to note is that while the growth in the index value has been quite erratic, the growth in earnings and dividends has been very steady. In virtually every time period set out in Appendix A, the earnings and dividends increased. In 1970, the earnings per unit of the S&P 500 were $5.13 (dividends $3.14) and by last year the earnings per unit had grown to $128.00 (dividends $45.70). Over time, it is the steady increase in earnings and dividends which moves markets higher and provides investors with substantial long-term returns.

The "financial crisis" of 2008 seems to "disappear" in the longer-term numbers.

A sharp market sell off with quick recoveries is not unusual.

4. A fourth point to note is how the "financial crisis" of 2008 seems to "disappear" in the longer-term numbers. As can be seen, the S&P 500 index stood at 1,184 at the end of 2005 and 1,123.6 at the end of 2010. From a five-year perspective, the market appeared to be down a little, but nothing drastic. This longer-term perspective "hides" the dramatic 49% market sell-off in 2008, which was regained over the next three years. This type of sharp market sell-off, with relatively quick recoveries, is not unusual as there are many years where the market is down over 15% at one point during the year only to recover quickly over the following twelve to thirty-six months. The most drastic decline and recovery occurred in 1987 when the market was down 34% at one point in the year only to recover by year-end to register a 2% gain for the year.

5. A fifth point to note is the importance of paying attention to the market "valuation." The most common measure of market valuation is the price-to-earnings ratio (P/E). Over time, the U.S. market has generally traded in a P/E valuation range of between 12 times and 18 times. The P/E for the market in 2000 soared to over 28 times. This was the period of the notorious "tech bubble" which set the stage for poor market returns for the next 10 years. It should be noted, however, that while the index level sold off dramatically, the earnings continued to climb from $50.00 per S&P 500 unit in 2000 to over $77.00 per unit in 2010. Dividends also increased during the same period by over 40%.

Markets can make extreme gains even after they have reached relatively high levels.

6. A final point to note is markets can make extreme gains even after they have reached relatively high levels. The 1997-2000 period was such a time, when the P/E level for the market was a relatively high 19.3 times yet the market gained almost 86% over the following three years. This was the period when the phrase "irrational exuberance" was coined.

Outlook and Strategy

Currently, the equity markets around the world are trading at or near record levels, but the market valuation metrics are still reasonable by historic standards.

Currently, the equity markets around the world are trading at or near record levels but the market valuation metrics are still reasonable by historic standards. Interest rates have also remained low which means that equity securities remain "the best alternative" for long-term investors who wish to earn positive returns after inflation.

Attached as Appendix B, is an update of a checklist prepared by Strategas Research Partners (a specialty investment research firm) which compares the current market to the bull market peaks of 2000 and 2007. As can be seen from the checklist, only one of the nine items on the list is marked as being in what they consider dangerous territory.

The current cycle appears to be following a pattern similar to the late 1990's.

With the background of the Strategas bull market checklist in mind, this stage of the current cycle appears to be following a pattern similar to the late 1990's when the market continued to move higher even after many of the market valuation metrics had reached elevated levels. While optimism is spreading, it appears to be spreading slowly and there remains an abundance of scepticism, which means there remains room for equity valuations to march higher as those sceptics become buyers.

In most years markets have recorded intra-year declines of 10% or more even as the markets have continued to move higher.

However, there is one major caution we would like to highlight. The market volatility has remained very low over the last 14 months with only small corrections that did not exceed a 5% decline. Equity markets with such low volatility are not the norm, as in most years markets have recorded intra-year declines of 10% or more even as the markets have continued to move higher. In other words, the patterns of past markets are telling us that we should not be surprised when markets become more volatile.

While equity markets will continue to be volatile, we continue to view a broadly diversified equity portfolio as the best way for clients to protect and grow the purchasing power of their capital with the caveat that short-term liquidity needs should be set aside in an asset that is not subject to the volatility of the market.

Sincerely,

CYPRESS CAPITAL MANAGEMENT LTD.

Appendix A

The S&P 500: 1970 – 2016
Growth in Index, Earnings & Dividends
December 31, 2016

Year	Index Level[(1)] $	Earnings $	Dividends $	Dividend Yield %	P/E[(2)]	Interest Rate[(3)] %
1970	90.3	5.13	3.14	3.5	17.6	7.6
1975	72.6	7.96	3.68	5.1	9.2	7.8
1980	110.9	14.82	6.16	5.6	7.6	10.7
1985	171.6	14.61	7.90	4.6	11.7	10.8
1990	339.9	21.34	12.09	3.6	15.9	10.0
1995	465.2	34.00	13.80	3.0	13.7	7.6
1997	766.2	39.72	15.50	2.0	19.3	5.9
2000	1425.6	50.00	16.27	1.1	28.5	6.0
2005	1184.4	69.93	22.22	1.9	16.8	3.6
2010	1123.6	77.35	22.73	2.1	14.5	2.8
2015	2028.2	121.50	43.39	2.1	16.7	1.8
2016	2251.6	128.00	45.70	2.0	17.6	1.7

Source: R. Shiller, MIT Press, S&P and Bank of Canada

(1) At December 31st for each year
(2) Price to Earnings Ratio
(3) Yield on 10-year Canada Bond

$10,000 invested in 1970 in S&P 500 would have grown to over $800,000 by December 31, 2016

Appendix B

STRATEGAS' BULL MARKET TOP CHECKLIST MIGHT SUGGEST REAL TROUBLE IS A LONG-WAY OFF

Bull Market Top Checklist

	2000	2007	Current	Comments
1. Blow-off top	✓	✓	*x*	No signs of panic buying or speculative excess in public equity markets.
2. Heavy inflows into equity market funds	✓	✓	*x*	Retail participation in the market rally continues to be conspicuous by its absence. Inflows into equity funds compared to bond funds still remain below levels seen at prior peaks.
3. Big pick-up in M&A activity	✓	✓	*x*	While M&A activity picked up meaningfully in 2015, both deal volume and deal value have faded in 2016, falling below levels witnessed in previous peaks.
4. IPO activity	✓	✓	*x*	An already moribund IPO market in 2015 has turned even worse in 2016. Activity has just recently started to pick-up in recent weeks but Renaissance Capital estimates that deals and deal volume are off almost 50% this year.
5. Rising real interest rates	✓	✓	✓	5yr-5yr breakeven expectations have moved higher rather quickly, potentially detrimental to multiples should it continue
6. Weakening upward earnings revisions	✓	✓	x	Upward earnings revisions are steady but are uninspiring.
7. Erosion in number of stocks making new highs	✓	✓	x	The market's breadth is far healthier today than it was during the period of consolidation between 2014 and early 2016.
8. Shift towards defensive leadership	✓	✓	x	For the time being cyclicals and technology remain leaders which is a positive in our book.
9. Widening credit spreads	✓	✓	*x*	With defaults rising, corporate credit spreads bear watching. At the moment however, credit spreads are behaving.

Strategas Research Partners – April 2017