Quarterly Report
AUTUMN 2018

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Managing For Markets Engulfed with Both "FEAR" and "GREED"

OVERVIEW

The current market can be classified as having elements of both fear and greed operating within it. This is an unusual mixture, given that global asset appetite typically correlates across all major risky asset prices. Nonetheless, that is what is currently evident within financial markets. It's a rare occurrence, coming around roughly every three years (Longview Economics), and is typically brought on by divergent global trends, tightening monetary policy and/or tightening financial conditions (at least in some areas of the global economy). History reminds us that equity markets rarely have three consecutive up years without a significant setback. It is possible that the January-April sell-off earlier this year was such a setback.

Despite the steady flow of negative news about protectionism and crises in emerging economies, global growth is holding up well. The labor market has continued to strengthen, particularly in the U.S., making another interest rate hike this year a near certainty. Global manufacturing growth and world trade have slowed (trade wars), but this has been offset by strong services growth. Emerging market (EM) currencies have continued to weaken, but for now, the problems seem concentrated in countries (i.e. Turkey & Argentina) with relatively large current account deficits. While global Purchasing Managers Index (PMI) may be off their peaks, they remain firmly in expansionary territory while consumer and business confidence remains elevated.

It seems clear that the current trade war between China & the U.S is likely to escalate until significant pain is felt on both sides. What is less clear is exactly what those pain thresholds are. A decade ago the growing mutual dependence of the two economies earned them the nickname "Chimerica", something neither wants to be part of today. The Chinese don't want the technological dependence, and the Americans don't want the persistent trade deficits. Now, as both dig in on their trade dispute some see an economic cold war looming, in which the U.S. and China seek to lead competing economic blocs. Driven by a powerful coalition of security and economic officials, the U.S. is entering an existential conflict with China for global economic, technological and geopolitical dominance.

Investment orthodoxy holds that the economy careens into recession and equities viciously contract following a yield curve inversion. While an inversion has preceded each recession over the last 50 years, the lead time is extremely inconsistent, with recessions following anywhere from 14 – 34 months after the curve goes upside down. More importantly, we've never had a U.S. recession when the real fed funds rate is near zero, and almost never had an inverted yield curve with positive corporate profits growth. Furthermore, historically, an inverted yield curve has been accompanied by a variety of other ominous economic signals, including layoffs and credit deterioration. As of now none of these metrics seem strained.

"While investors seem to be caught between the fear and greed scenarios they have to be impressed with the market's ability to ignore "bad news". Then again, a bull market always climbs a wall of worry. From late 2008 to date, investors have been bombarded with dark headlines, "China slowdown", "European Debt Crisis", "Inverted Yield Curve" and so on. As the markets climbed, doomsayers became more numerous and vociferous, but all fell on deaf ears as the market kept its northeasterly direction. Why? Because earnings continued to improve thanks to the Fed, and they will continue to improve in the months ahead. Earnings momentum drives equity prices, not headlines or P/E's". (wise words from the well-respected Leon Tuey).

Global equities have diverged recently

Source: Datastream, Goldman Sachs Global Investment Research

UNITED STATES

Metaphorically, the U.S. economy is on fire, running on the "sugar rush" of tax reform. The second quarter (4.2%) will probably mark the peak of growth in this cycle. Soaring small business confidence, corporate tax cuts fueling surging company profits and a labor market that is not only creating jobs but is also drawing participants back into the workforce all dominate news flows. Meanwhile, as the Fed continued the process of unwinding its balance sheet, it also raised the fed funds rate for the 8th time this cycle and forecasted a further hike in December as well. While eliminating the term "accommodative" in its policy statement, the Fed said that it was not a policy change but rather confirmation of the continuing process towards normalization. The Fed also raised its view of domestic economic growth, noting the fiscal policy boost, elevated confidence and U.S. energy investment. Inflation was still viewed as contained, and thus far they saw little evidence of a tariff impact in the numbers, but admitted supply chain concerns were mounting. A range of sources (Fed Officials, business surveys & earnings calls) are pointing to an outlook on investment spending to worsen as trade tensions rise. The pervasiveness of these anecdotal warnings warrant close attention to the hard data, which to date shows little evidence that the expansion in business equipment spending is coming to an end. Despite default rates which remain low, U.S. bankers are putting the brakes on real estate loans to buy office buildings, hotels and shopping malls. They are warning of mounting risks in commercial real estate and their loan terms that they view as "too loose".

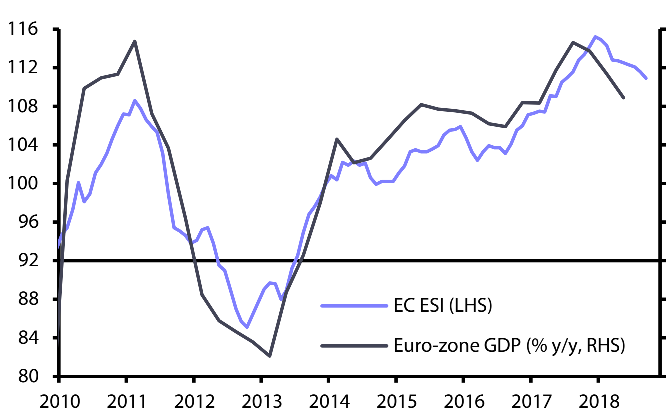
CANADA

Economic circumstances suggest that investment growth should be strengthening. Capacity utilization is at a decade high, the unemployment rate is unusually low and wage growth is picking up. Furthermore, machinery and equipment investment growth was strong to start the year. However, according to the Bank of Canada and its Business Outlook Survey, that strength will not be sustained through the remainder of the year. The number of companies that are intent on increasing investment has dropped (trade concerns) to a level consistent with stagnation in investment spending for the second half of this year. That however, may now change with the 11th hour agreement on a revised NAFTA deal (now USMCA). While the macroeconomic implications of the new deal are minor, the diminished risk of auto tariffs is good news for the Canadian economy. The effective removal of that threat could see the loonie rise further and may free up any investment projects that had been delayed. Meanwhile, the declines in commodity prices (global trade tensions) highlight the connections that make Canada more vulnerable than many advanced economies to developments elsewhere in the world. The jump in headline inflation was partly due to rising energy prices but also appeared to reflect a pick-up in general inflationary pressure, especially services where there are tightening capacity constraints. The Bank of Canada's commitment to take "a gradual approach" meant that a rate hike in the 3Q was unlikely, but we do expect an increase in the fourth quarter.

EUROPE

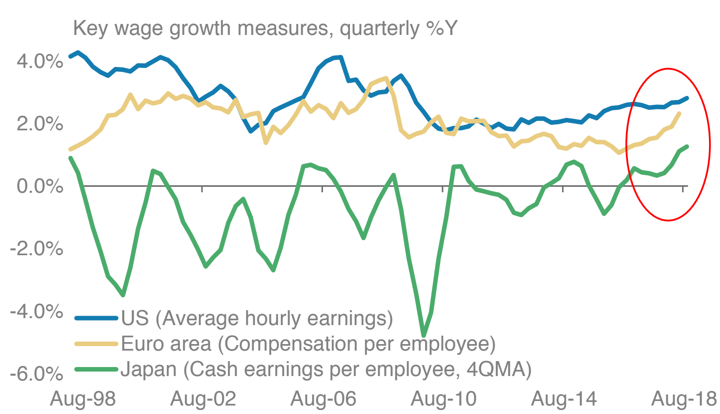
After expanding above potential in the second half of 2017, GDP growth cooled down through the first part of the year. Unfortunately, the latest readings of Euro zone PMIs and consumer confidence reinforce the notion that the soft patch persisted into the third quarter. However, soft patches are different from contractions. Growth is still positive and, although PMIs have peaked, they remain well in expansionary territory. Also unfazed by the slowdown was European Central Bank (ECB) president Mario Draghi who when questioned specifically about the slowdown in industrial production said "it was just one of the signs that the economy is converging to its steady-state path". While the first interest rate hike is still some time away, the Bank's focus on the recent modest pick-up in wage growth may have them ultimately raising rates somewhat faster than the market

Euro-Zone Economic Sentiment Indicator (ESI) & GDP



Source: Thomson Reuters

G3 wage growth^ on an upward trend



Source: Morgain Stanley

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expects. Meanwhile, Italy's huge public debt risks lurching out of control as borrowing costs jump and the country's insurgent government plays chicken with the deficit limits. They have promised the moon and even if they only do a fraction of what they say, risk spreads will rise and eventually there will be a reckoning. While Brexit has long been a focus for the market, economic data and monetary policy have generally determined market direction. The economy remains on track for moderate growth, held back by weak consumption and business investment. The Bank of England (BoE) hiked its policy rate for a second time this cycle and will probably do so again next year, provided the process to leave the EU goes smoothly. To this end, BoE Governor Mark Carney, extend his stay in order to provide stability through the exiting process.

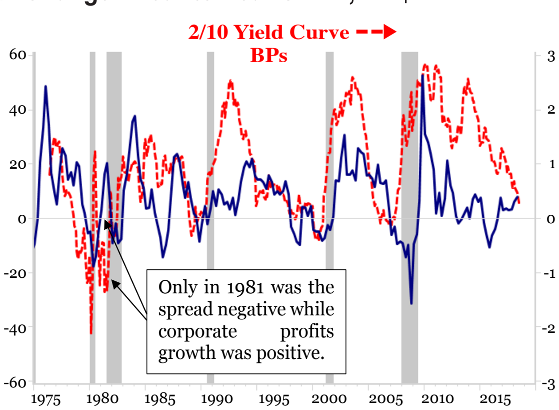
EMERGING & DEVELOPING MARKETS

The state council executive meeting hosted by Premier Li Keqiang signaled that monetary and fiscal policy would be further fine-tuned to boost domestic demand, but also that it should not be taken as a "large stimulus package". More defensive in nature, Beijing easing is aimed at sustaining a moderate pace of growth, with monetary, currency, fiscal and regulatory policies now leaning towards assuring growth does not go below the 6.5% level. China has already announced tax cuts and spending initiatives, with probably more to come and there is room for fiscal push. Infrastructure is expected to benefit directly while the high levels of manufacturing fixed asset investment should be sustained as long as fiscal and monetary policies stay accommodative. In Japan, the Nikkei is well off its January peak, in part because of trade war and Emerging Markets (EM) concerns. Investors remain generally bearish on and uninterested in Japan. However, Japan's economy and corporate profits are stronger now than in January and in early September Abe said he plans to raise the retirement age to 70. Experts have said that this is likely to lift long-term GDP growth by as much as 0.5%. On the fiscal front, the earthquake in Hokkaido along with several other natural disasters this summer, have increased the odds of fiscal stimulus. Meanwhile, manufacturing PMIs declined in most EM Asia countries reflecting risks to trade, linked to the Sino-U.S. trade tensions and tariffs. From a "Money Flow & Sentiment" point of view, despite a -20% bear market in EMs since January, less than 20% of debt &equity inflows from 2016 -18 have been redeemed in the last four months.

COMMODITIES

Supply/demand fundamentals should be the key drivers of pricing for the base metals complex. However, metal markets continue to move on trade headlines, pricing in the ripple effects of trade barriers on global growth and metal demand. Notwithstanding recently announced (with more to come) Chinese stimulus, with trade tensions escalating and U.S. elections upcoming, bullish sentiment is unlikely to return in the short term. However, mining equities are pricing in commodities 24% below spot levels (Barclays - Sept 20th) implying significant bearishness built into current valuations and prices moving deep into cost curves. Meanwhile, robust pricing of non-exchange traded commodities, rising premiums and falling inventories for base metals suggest decent underlying physical market conditions. Meanwhile the oil industry is now seeing a pick-up in new projects, with shale being a key driver. Investment outside of the U.S. is also set to increase, but at a slower pace. On a stand-alone basis, most of the international conventional projects are more attractive than U.S. shale from a break-even/NPV perspective. However, international activity levels are not expected to return to the 2013-14 levels, as fewer oil companies are willing to take on large scale Greenfield projects. U.S. independents are retreating to the U.S. onshore, national oil companies (NOCs) are more focused on domestic opportunities while international Exploration & Production (E&P) are more are more starved for capital than before the downturn. That leaves the integrated oil majors, which are today largely prioritizing capital discipline, shareholder returns and balance sheet strengthening rather than major growth opportunities.

Corporate Profits Before Tax with IVA and CCAdj
% Change - Year to Year SAAR, Bil.$



Source: Bureau of Economic Analysis

Mining closely tied to fortunes of EM
(R-square 82% since Jan 2000)

Source: Bloomberg

RECOMMENDATIONS

If there is one constant in financial markets, it is the prevalence of "noise". Investors are constantly bombarded with bits of information, tons of research and hordes of opinions. Sifting through it all, zeroing in on the little that matters and ignoring the rest, is key to successful investing. Rarely has this adage been truer than in recent months. Based on the headlines and the breathless opinions expressed in financial circles/media, asset markets should be coming apart. However, the global expansion is still on track and unlikely to be upset by prospective tightening of USD monetary conditions, the trade war or economic stress in vulnerable emerging economies. Inflation is firming in key currency areas, but remains modest in the U.S. and well below central bank targets in the euro area and Japan. At the same time, corporate America has never been in better shape, with boardroom optimism running high. Furthermore, it was Chinese stimulation in 2009 and 2015 that pulled the global economy (and global equity markets) into recovery, and with July's announcements by the People Republic of China (PBOC) and the state council, history may be repeating itself. The effects from these policies are already being felt with the foundation having been laid for a robust recovery in 2019. Therefore, with economic expansion (and U.S. tax cuts) underpinning earnings growth in the U.S., the euro zone and Japan, and expected stronger growth in China (EMs and commodities will benefit), we continue to recommend an overweight to equity risk. Our higher than normal cash positions will be redeployed (using market opportunities) once the macro picture clears. Third quarter economic strength caused interest rates to rise, finishing the month of September close to cycle highs (U.S. and Canada). Although there are still uncertainties (trade wars) surrounding future growth, we are likely to see higher rates, especially in the U.S. While the Bank of Canada is also expected to raise rates, its policy may change depending on the outcome of the ongoing NAFTA negotiations. With yield curves close to flat in both countries, rate hikes may push up longer term yields as well, straining fixed income returns (negative through the last quarter). Because of a more diversified approach, concentration on higher yield vehicles and shorter term bonds, our fixed income strategy still eked out a positive return, as it has through this entire period of gradually rising rates.

FORECAST 2018

	Current 30-SEP-2018	2018 Range	2018 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	1.50%	1.00% - 1.75%	1.75%
Federal Funds Rate	2.00%	1.50% - 2.25%	2.25%
10-year Canadian Treasury	2.43%	1.85% - 2.65%	2.60%
10-year US Treasury	3.06%	2.35% - 3.35%	3.30%
COMMODITIES			
Gold (US$/oz.)	$1,192	$1,176 - $1,235	$1,230
Copper (US$/lb)	$2.81	$2.65 - $3.35	$2.95
Oil WTI (US$/bbl)	$73.25	$52.00 - $80.00	$76.00
MARKETS			
S&P/TSX Composite Index	16,073	15,042 - 16,800	16,750
S&P 500 Index	2,914	2,575 - 3,075	3,030
CANADIAN DOLLAR/US DOLLAR	$0.77	$0.75 - $0.82	$0.80

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