Volatility Strikes Back

Quarterly Commentary Q1 2018

In this issue

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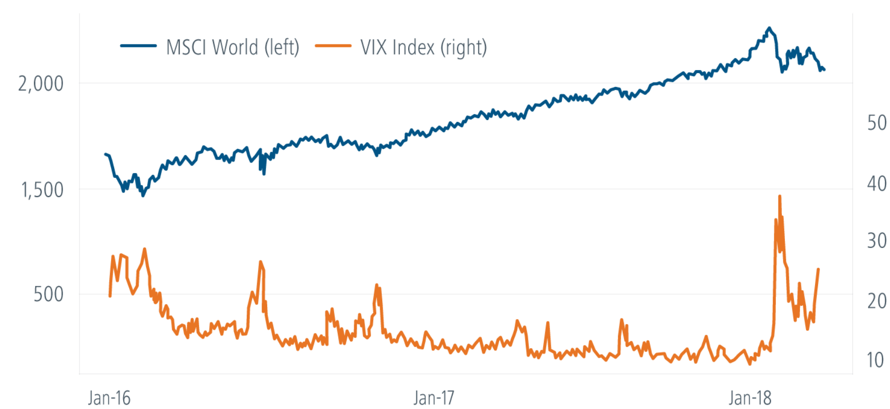
We will remember 2017 as one of the least volatile years we can recall as the The CBOE Volatility Index (VIX®)—the market's collective "fear gauge"—hit an all-time low, bottoming at 9.14 in November 2017, dropping more than 17% in 2017. In our previous commentary we noted market sentiment had evolved from concerned optimism to the "Fear of Missing Out". No sooner had we gone to print than along came Q1 2018 to remind us all that volatility and falling equity markets have not been abolished by a Trump executive order.

Equities started the year on a strong footing, continuing the path of the past two years as investors cheered solid growth numbers and positive corporate earnings releases, but by February, global equity markets were unsettled by the Trump administrations trade policy. Equity markets sold off by about 10% in early February and the VIX index of implied volatility spiked to a reading of 50, ending a period of low volatility enjoyed since the end of 2016. Although we remain constructive on global growth prospects for the year, a new element of risk has emerged and it comes in the form of tariffs and the prospects of a "tit for tat" trade war which could derail the global economy.

MSCI World Index vs VIX Index



Source: Bloomberg Finance L.P.
As at March 21, 2018

Q1 2018 – Fasten Seatbelts - Turbulence Ahead

Equity market concerns over the U.S. Federal Reserves (Fed) interest rate normalization were a factor as U.S. interest rates continued to move higher and bond markets underperformed and posted negative returns in the quarter. Interest sensitive sectors such as utilities, pipelines and financials were all under pressure as interest rates moved higher. We believe the root cause of the increased market volatility centred on the Trump Administration's get tough policy on trade and they have specifically targeted what they believe are trade practices by China, Mexico and Canada. The President has threatened to tear up the North American Free Trade Agreement (NAFTA) and he has slapped tariffs on imported steel and aluminum. It is important to realize that the U.S. does have the upper hand when it comes to trade, given that they are less dependent on exports but they also have an obligation to supply U.S. dollars to the world as the U.S. dollar is still the international reserve currency for trade. The President must realize or will soon realize that this does require the U.S. to run current account deficits with the rest of the world and slapping tariffs on trade in hopes of eliminating the trade deficit is simply not possible in the absence of an alternative to the U.S. dollar as the primary international reserve currency. We do not believe a trade war is imminent but we understand that we are dealing with a U.S. President who believes that the "art of the deal" is to begin negotiations by hitting his counterpart over the head with a bat and then begin negotiations. It is not in anybody's best interest to ignite a trade war and we believe that concessions will be made on all sides.

After a strong run of above-potential growth for the Canadian economy in 2017, growth moderated in the first quarter of 2018 but that did not stop the Bank of Canada (BOC) from raising interest rates in response to a pickup in inflation. Although the BOC remained cautious on future interest rate increases, interest rate sensitive utilities, pipelines and financials sold off sharply in the quarter.

Outlook for Q2

Equity markets will continue to focus on rising trade tensions but will also have to grapple with the prospects of higher U.S. fiscal deficits and inflation as a result of the recently enacted U.S. Tax Cuts and Jobs Act. Although inflation may eventually prove to be transitory, the massive fiscal stimulus of tax cuts comes at a time when the U.S. economy is at or nearing full capacity and employment. The Fed raised interest rates in March and the new Fed governor, Jerome Powell, maintained a hawkish tone suggesting that higher interest rates are likely in 2018. This may be tempered if the U.S. economy falters as a result of increasing trade restrictions, however, we believe the U.S. will not risk derailing the global economy and it will eventually soften its stance while extracting modest concessions that the President can take back to his base of support in advance of the 2018 mid-term elections. President Trump has made a point of judging his Presidency based on the performance of the U.S. equity markets. If equity markets were to stumble as a result of one of his administration policies, he will quickly reverse course rather than risk losing seats to the Democrats later this year.

The outlook for the Canadian economy remains clouded by the uncertainty surrounding the ongoing NAFTA negotiations and although we expect them to conclude with minimal changes, we should not underestimate the possibility of a negative outcome. The Bank of Canada acknowledged this risk in its March monetary policy decision and they have softened their stance on higher interest rates but maintain that if inflation or the economy picks up steam, we should expect higher short-term interest rates in 2018. The challenge for the BOC is to assess the impact of higher interest rates on an economy levered in household debt, which stands at over 170% of disposable income, and the slowdown in the housing market brought on by gov't policy changes which include a foreign buyer tax and changes to lending guidelines for financial institutions. The housing sector has played a significant role in boosting GDP and declining housing market activity will have a contagion effect across Canada, particularly in the Provinces of British Columbia and Ontario.

One area of concern we are watching closely is the ongoing battle between Alberta and B.C. over the stalled Trans Mountain pipeline in which owner Kinder Morgan is looking to expand the pipeline capacity. The lack of leadership at the Federal level threatens to pit one Province against the other as the B.C. Gov't backed up by the Green Party fight the pipeline expansion. Alberta has threatened to retaliate by throttling the flow of oil and gas into B.C., exacerbating the oversupply of trapped Alberta crude due to the Federal Gov't playing politics and having scuttled two other pipeline expansions. We should expect rising tensions from within Alberta and we should not rule out the very real prospects of calls for separation if the Federal Gov't gives more credence to social license over economics.

Equity Markets

The Canadian equity market fell in the first quarter of 2018 as the S&P/TSX Index fell 4.52% and nine of the eleven sectors posted a negative return led by utilities and pipelines. The information technology sector was the best performing sector posting a 10.18% return, while the financial sector, the largest in the S&P/TSX fell 4.52%. Energy, the second largest sector, fell 9.44% Q/Q, despite a 7.48% increase in global oil prices.
After starting the year on a positive note, U.S. stock markets plunged early in February after bonds sold off amid fears of a more aggressive federal reserve as economic growth accelerated and wages appeared to be rising after years of stagnation. There was then a short-lived rebound as investors poured back into some of the beaten-down sectors but that was short-lived as President Trump slapped tariffs on Chinese goods heightening fears of a trade war. The sell-off was amplified by concerns that leading technology companies (Facebook, Google, Amazon) might face a regulatory crackdown related to data privacy and antitrust concerns. Markets were able to pare some of the steep losses and ended the quarter with solid gains on the last day of trading. The S&P 500 Index fell 0.76%. The **Dow Jones Industrial Average** (**DJIA**) fell 1.96% and the NASDAQ managed to rise 2.59%.

Portfolio Activity

Canadian Core / Equity Income

Interest sensitive equities were under pressure during the quarter as interest rates moved higher. In the core dividend portfolio, we sold Emera and replaced it with Enbridge. Enbridge is a leading North American oil and gas pipeline, gas processing, and natural gas distribution company. We believe that ENB's business model offers stability with a solid earnings growth profile supporting dividend growth over the coming years. It has a solid base business and a $22 billion commercially secured project pipeline that the company is developing over the 2018 to 2020 timeframe. The company's capital program is expected to support the annual dividend which is at 6.8%.

The high yield equity income portfolio had a tough quarter and we have taken steps to upgrade the portfolio in light of the interest rate outlook. We sold Superior Plus, Corus Entertainment, and Cominar REIT. We bought Enbridge Inc and Chemtrade Logistics.

Canadian Growth Portfolio

We sold three holdings due to sector reallocation and deterioration in financial metrics. We sold Thomson Reuters and OpenText on a sector reallocation and Enercare due to falling financial metrics. We added three new positions, Norbord, Brookfield Infrastructure and Dollarama.

US Growth Portfolio
During the quarter we sold Dr. Pepper after it received a takeover offer from Green Mountain/Snapple, along with Nvidia, Stryker, Garmin and Genuine Parts. We bought Micron Technology, Estee lauder, Intuit, Juniper Networks, Motorola Solutions and United Health.

Top contributors during the quarter were: Estee Lauder (EL), a cosmetic product manufacturer which surged 8.2% after analyst's highlighted strength across product lines and the firm announced to its workforce through optimization. Micron (MU), a semiconductor manufacturer increased 6.8% after several analysts upgraded their ratings to buy expecting sales improvement in Q2. Tapestry (TPR), a luxury and lifestyle brand rose 4.0% on continued strong retail sales. The company also appointed Anna Bakst to serve as CEO and brand president of Kate Spade. Detractors during the quarter were: Amgen (AMGN), a biotech company which fell 7.2% as cholesterol med competitors announced price cuts that may force the firm to cut prices of its own product even more to grab market share. Hasbro (HAS), a toy manufacturer fell 11.8% as Toys ‘R’ Us was unable to find a buyer or reach a restructuring deal with creditors and decided to proceed with liquidation sales on March 23th. AbbVie (ABBV), a biotech company, dropped -18.3% after posting disappointing Phase 2 results from its lung cancer drug Rova-T acquired from Stemcentrx back in 2016 for nearly $5.8 billion.

Summary

As volatility picks up, we will continue to invest in companies that we feel have the ability to continue to deliver on the key metrics that can drive share price appreciation and hopefully portfolio outperformance. Although the first quarter of 2018 was challenging, we will continue to apply our disciplined approach to stock selection which has weathered the first quarter volatility and we believe it will continue to work well over market cycles.

Contact us today

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