REVIEW AND COMMENTARY
1ST QUARTER – 2018

Dark & Stormy

Equities prices in the past quarter underwent the volatility we had anticipated at the beginning of the year. Several days of significant swings in equity prices made several hundred point swings in the indices common place. However, it is important to have some perspective. In 1987, on a rather dark October Monday, the Dow Jones lost over 500 points. This year, on February 5th 2018, the Dow Jones fell 1175 points. The important difference is that in 1989 the Dow Jones went from approximately 2200 to 1700, a 22% loss. This past February the same index went from approximately 25,520 to 24,375 representing a 4.6% move. A 22% move from today's market level on the Dow Jones would be closer to 5000 points. While we can never rule out something equally significant in the future (though markets are more closely regulated) the 1700 mark on the Dow Jones was very close to the bottom and almost 30 years later the market has increased, without including dividends, approximately 14 times.

There are a few things that appear to be contributing factors to market volatility. Over the past decade the role played by computers and trading systems has become far more significant. These programs pay little attention to fundamentals but can react to a plethora of news items. Furthermore, increased rhetoric regarding isolationism and populism in the U.S. contributed more noticeably to volatility during the latter half of the quarter. President Trump alarmed markets, even some members of his own cabinet, when he abruptly announced steel and aluminium tariffs on economic allies and foes alike. Not unexpectedly, trading partners objected. Some were granted exemptions while others, most notably China, retaliated with reciprocal tariffs. Interestingly, China strategically targeted tariffs on products directed toward his political support base such as soybeans, fruits and nuts. The voters who will be hurt by the tariffs significantly outnumber those who will gain from the tariffs on steel and aluminium. It would appear that China is astute in the understanding of the U.S. political landscape.

U.S. technology stocks which are heavily weighted in most US indices have come under pressure as well. Beyond some of the more influential companies (Amazon and Netflix in particular) being priced close to perfection, the most recent revelation at Facebook has contributed significantly to share price weakness in the sector. Facebook's issue stems from the disclosure that potentially more than 50 million Facebook users were targeted by Cambridge Analytica for political purposes prior and during the U.S. Presidential Election. While it is hard to believe that anyone on Facebook should be surprised that their privacy may have been invaded given it appears to be a platform of publicity, it seemed to resonate more broadly with users that such information was used for political

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purposes. To add further insult to injury for the technology sector, President Trump has targeted Amazon claiming that they do not pay taxes and are contributing to the losses at the US Postal Service. (It should also be noted, that the CEO of Amazon, Jeff Bezos, also owns the Washington Post which has not been particularly supportive of the President.) While both claims appear inaccurate, price pressure on Amazon stock translates directly to the broader market since it is a widely held, influentially weighted company among the various U.S. equity indices and one of the more successful performers over the past few years.

One concern, voiced by many Canadian investors, is why our equity markets are struggling more than US equity markets. There may be several reasons. One, is the concern of how NAFTA and future trade relations will be negotiated with the U.S. Second, interest rates have moved up marginally in the past few months both in Canada and the United States. Predictions are they will continue although there is uncertainty as to how much and how quickly. The major Canadian index is heavily weighted toward financial companies and if you add in utility companies, these two sectors represent just less than 40% of the SP/TSX index. Both sectors had losses in the quarter – Utilities almost 6%, Financials 3.5%. While interest rates look poised to move up further, we don't expect the increase to be significant enough to impair either the economic prospects of either the U.S. or Canada or the majority of companies listed within the index. Pipelines have been particularly weak over the past quarter and we would consider the weakness overdone. Profits and dividend increases in this sector should be expected in 2018-19.

Energy shares, again heavily weighted in the index, have also been quite weak, down 9.4% over the quarter. This is despite the price of crude oil prices being relatively and absolutely strong. During the quarter, U.S. Sweet Crude increased by just over $4 to $64.92 USD/BBL, approximately 7.5%, but Canadian Energy Company stock prices went the opposite direction. While this negative correlation may partially be explained by the price differentials that are realized by Canadian producers, the disparity seems too great in our opinion and waning attention to the sector provides an opportunity.

Finally, recent changes to U.S. tax law have drawn capital from across the world into U.S equity markets. Corporations will have lower absolute and comparative taxes which should correspond to increased cash flows and profits. These two factors usually translate into higher prices and increased attention. Thus, other countries with less favourable tax platforms will be comparatively less attractive encouraging more opportunistic short term investors to gravitate toward the more favourable conditions. This will continue until some level of parity is achieved. Equity prices in Canada and the U.S. have reflected this, however, it would be imprudent to think these trends will continue indefinitely. Politically, there are some storms brewing. The Russian investigation continues, despite the growing contempt of the President; voter targeting through online data mining have raised further concern of election tampering. Additionally, potential election campaign violations from the President's legal representation may create a constitutional showdown, particularly with the U.S. mid-term elections in November; and, concerns over the excessive turnover in White House staff and cabinet members increase concerns over the political stability and policy. With future relations with Russia, China and North Korea hanging in a precarious balance, U.S. equities may lose the allure of the past year making Canadian, and other major indices, more attractive.