Q2 2018 MARKET REVIEW & COMMENTARY

Headwinds and Tailwinds

I was asked in a recent interview what was the most important headwind and tailwind affecting client portfolios during the first half of 2018. My answer was the same for both: the Washington reality show that is President Donald Trump.

The tailwind was the tax reform package that effectively lowered US corporate tax rates to 21%. The bill also allows companies to write down capital expenditures within one year, which should provide a major incentive for companies engaged in capital expansion programs. Moreover, thanks to a one-time tax incentive to re-invest those funds many of these same companies now have access to repatriated capital coming from offshore holdings. That number may be as high as US $3 trillion and could boost US GDP even if President Trump is unable to garner support for a federal infrastructure program that would include a border wall.

As for headwinds, President Trump's "Art-of-the-Deal" style does not always resonate with countries in the same way it does with business. It is one thing for a real estate power broker who has a firm grasp of his business to use aggressive negotiating strategies to extract a good deal. It is quite another to use a stick and carrot approach in trade negotiations with a national adversary who is not necessarily motivated by a business-first agenda. Mean-spirited name calling attacks as were witnessed in the G-7 meetings can have unintended consequences, not the least of which may be an all-out trade war.

President Trump has been fixated on Canada's unfair tariffs on US dairy products. These tariffs are meant to protect Canadian farmers in much the same way as the US imposes tariffs on tobacco imports to protect Carolina farmers. Ironically, Canadian dairy tariffs were in large part removed as part of negotiations within the Trans Pacific Partnership, which President Trump refused to sign.

Name calling and brow beating national allies seems counter-productive for someone purportedly trying to get a deal. Well, there's the rub! President Trump may *not* be seeking a deal on NAFTA nor with the EU, mainly because *not* 'compromising' on a deal both plays well with his base and provides a distraction from countless attacks on his personal and family business.

We are hopeful that President Trump's bluster is ultimately for the best interest of America. We can work with that because, as Prime Minister Trudeau has pointed out, he cannot imagine a leader who would draw a line in the sand that harms his people. Perhaps his willingness to throw allies under the bus is designed to send a message to China that he will double down on unfair trading dealings, which place the US at a distinct disadvantage. If getting deals to prevent theft of intellectual property and to break down barriers to the Chinese economy is his final goal, that approach may have merit.

However, if President Trump's diatribes are fixated on a misguided view that trade deficits, if they exist (more on that in a moment) are bad, the higher prices from a long-drawn-out trade war should nullify any benefits of the new tax cuts, which were intended to empower American consumers.

Q2 2018 MARKET REVIEW & COMMENTARY

Our other concern is that President Trump's fixation on trade deficits may be underpinning a negotiation strategy intent on bringing manufacturing jobs back to the US. Despite the fact it is backward looking, that view does play well to his base. However, a modern US economy now grounded in services and information technology rather than manufacturing, which dominated the '70s and '80s, has much more to lose than to gain from such a policy.

To add substance to this discussion one needs to understand the fallacy of trade deficits. When we talk about foreign trade most of us think about ships and planes bearing goods produced in one country delivered to customers in another. These shipments are included in the merchandise trade statistics that are used to calculate trade surpluses or deficits.

The merchandise trade number is important because companies use it to screen potential markets. Governments factor it into export promotion strategies and Wall Street analysts study it for clues that might herald shifts in interest rates or currency values. It also provides fodder for politicians who want to grandstand about international inequality.

On the other hand, what if the whole system of collecting information on international transactions is based on concepts that are hopelessly out of date, and thus the merchandise trade stats are misleading?

In today's environment, much of what the US exports is information technology in the form of software, advertising and services. However, in counting merchandise trade even packaged software is not typically included as an international transaction. A British citizen may buy software developed in the United States but there is a fair chance the software was duplicated at a plant in Britain. Because this sale involves two British parties, it does not register as a U.S. export nor does Britain regard it as an import.

Tallying software exports is made more difficult by the fact that so much software is directly downloaded or shipped pre-installed on computers and peripheral hardware. The hardware may end up in the trade numbers, but government systems do not account for the embedded software.

Furthermore, packaged software is quickly becoming obsolete. For example, I recently purchased a new computer and loaded Microsoft's Office 365. Assuming the software distribution originates south of the border it would represent a US export and a Canadian import. More likely the software, which is simply binary code delivered via the Internet, is coming from a source inside Canada and, like our British example, does not show up in the numbers. Taking that to another level, most of that software (like Office 365) is leased at a much lower monthly rate where updates are constantly being delivered over the Internet, and thus packaged as a service. How does one value this in a merchandise trade balance?

The same applies to advertising on Facebook and Google – the former as part of a global social network, the later delivered through a global search engine. Income generated from these sources should be defined as service exports but there is no way to efficiently calculate its impact on trade deficits or surpluses. I suspect if one were to accurately evaluate this segment those purported deficits would turn into surpluses. Yet even when presented with contrary numbers from the US government, President Trump is adamant that US trade deficits exist and that US consumers have been treated unfairly.

Anyone developing an investment thesis and trying to predict markets requires one to take into account both President Trump's likely objectives and his propensity to disrupt. If he is intent on bringing manufacturing jobs back to the US at the expense of its neighbours, then we must accept the real possibility of a trade war.

An all-out trade war will be detrimental to high flying companies like Boeing and Caterpillar. It will also have implications for giant tech companies – notably Apple and Amazon – that get much of their revenue from foreign countries.

A trade war may also benefit domestic companies like the major US banks – notably Bank of America, Citigroup and J.P. Morgan Chase – as well as be more profitable for domestic small-cap companies that are directly impacted by changes to the tax code.

If his end goal is to open China's borders, to stop China from stealing intellectual property and play fair, then President Trump's disruptive approach might work. 'Might' being the key word as there are strong arguments on both sides. Given that uncertainty, we must try to build an investment thesis on the back of what we know.

We know that changes to the tax code will benefit US companies and probably cause some of the multi-nationals to re-position their overseas production. These changes clearly benefit smaller, profitable domestic businesses, many of which reside in the Russell 2000 small cap (symbol IWM).

The other thing we know is that a resolution to trade disputes is not being priced into the market. Should one of President Trump's targets buckle in the best interests of their citizenry, markets will respond positively and quickly.

Think about it in terms of what happened in January this year. The US markets rallied on the back of tax reform, but have since stagnated on the trade headwinds. Remove those headwinds and market focus should return to the tax tailwind and the subsequent removal of trade barriers.

The trick is to manage through the uncertainty in order to benefit from a positive end game.

Richard N. Croft, CIO

Pool Review & Commentary

TCG539 Option Writing Pool

During the first quarter of 2018 we moved away from selling short term options – with an average term to expiry of 21 days – to selling longer term options to take advantage of higher volatility (i.e. average term to expiry of 55 days). That strategy is paying off as the share class has rallied 4.34% through the second quarter 2018. The pool is up 1.63% year to date as of the end of June 2018.

The pool continues to follow a dual style mandate with about 50% of the portfolio holding value stocks and another 45% falling into the momentum camp. Most of the momentum plays are with the FAANG stocks (i.e. Facebook, Apple, Amazon, Netflix and Google) which have rallied sharply despite trade frictions.

We continue to maintain this strategy although we have lightened our exposure to longer term options as volatility contracts. Currently our average term to expiry is 41 days. Unless volatility spikes because of a negative surprise in second quarter earnings or on the trade front, we suspect this shortening of expiry terms will to continue.

Richard N Croft, CIO
Portfolio Manager

TCG534 Income Pool

After a slow start to 2018, the Income Pool continued its long track record of consistent, benchmark-exceeding returns, showing 3.7% for Q2 vs 2% for its RWI Income Benchmark. Year-to-date, the gains were 2.6% for the pool vs 1% for the benchmark.

Investors tend to put a high degree of emphasis on returns but it is important to consider the relative level of investment risk required to generate those returns. Over the last twelve months the Income Pool generated a respectable return (5%) that meaningfully exceeded its benchmark (2.5%) but did so with a maximum draw down (relative loss at any given time over that period) of -1.85% compared to -3.28% for its RWI Income Benchmark.

The relative outperformance of the Income Pool can be attributed to the active covered call allocation. The current market is exhibiting a high degree of uncertainty as a result of interest rate and tariffs fears, which in turn cause options to trade at generous premiums. Stable valuation metrics within an overall strong economy leads to an ideal investment environment for cover call writing. We continue to write short term options during periods of high implied volatility, which benefit from larger premiums and a higher degree of time decay, and in turn generating excess income for the pool.

We continued to actively manage our hedging strategy using puts on the S&P 500 ETF (SPY) throughout the second quarter. In addition, we maintained our option writing strategy on the 20+ year US Treasury Bond ETF (TLT) as it has been an effective way to enhance the yield with modest risk. Both strategies have been working well and we will stay with them until market conditions suggest otherwise.

The cash position of the Income Pool fluctuated as we patiently waited for market opportunities, subsequently deploying the cash aggressively during market sell offs. The screening approach for these opportunities in the underlying equity portion of this covered call allocation could best be summarized by the investment advice of Baron Rothschild, an 18th century British nobleman: "buy when there's blood in the streets."

While, fortunately, current global conflicts are more financial than life-and-death, the hypersensitivity of the market and subsequent overreaction to temporary issues present opportunities to buy solid companies at a sizable discount. Oracle, Constellation Brands, and Alibaba Group all exhibited sell offs of more than 10% and were added to the Income Pool.

Mark McAdam, CFA
Portfolio Manager

Q2 2018 MARKET REVIEW & COMMENTARY

TCG531 Equity Growth Pool

Substantial gains early in the second quarter were slightly offset by the end of June, as trade war concerns shifted market sentiment to the downside. The resulting Q2 performance was 4% for the Equity Pool vs its S&P TSX TR benchmark. However, the pool's year-to-date returns of 4.2% still compare favourably to the 2% delivered by the TSX so far.

At the end of the quarter, a variety of short-term market events created a perfect storm within the Equity pool. The overweight Technology and Industrials sectors, which have significant international and thus tariff exposure, reacted sharply to trade war fears. The "Amazon effect" also hit one of our Health Care stocks as the digital market place acquired an online pharmacy and investors expressed concerns around declining profit margins. Bank stocks were hit by a flattening yield curve, as this also causes pressure on margins. In a flight to quality, Momentum and Growth stocks lost ground to Value and Dividend stocks as trade tensions escalated.

While short-term events can create volatility, it is important to distinguish between material developments and market (or social media) "noise". On trade wars, although President Trump's tactics appear disruptive to markets, it is useful to evaluate what the US administration wants. Since tariff revenue is immaterial to running the US economy, President Trump may be seeking to end intellectual property rights violations in China as well as unfair trade practices. The US being the bigger trading partner will likely be able to get China to come to the table to solve this problem. If this happens, markets will once again begin their march forward.

The reason we think markets may continue to move higher is because analyst optimism continues to improve moving into Q2 earnings, which are currently being reported. Expectations for S&P 500 sales and EPS numbers in the quarter have risen since the end of March, and Q2 EPS results are expected to rise 22% from a year earlier. Since the underlying growth dynamics and economic fundamentals are still sound, we believe the recent Momentum reversal has been an interruption rather than a material change in market dynamics.

Notable actions taken in the Equity pool included put writing on Momentum stocks to take advantage of higher implied volatility. As overall market volatility has increased since February, we continue to deploy additional cash into some low-beta, Momentum equities, as these stocks tend to continue appreciating reliably in a growth-oriented environment. During the quarter, we also took the opportunity to add to current Technology holdings on the market pullback, while also writing well out-of-the money covered calls on some of these names to increase yield and maintain significant upside to some top performing companies.

Alex Brandolini, CFA
Portfolio Manager

Q2 2018 MARKET REVIEW & COMMENTARY

Market Summary

	Month End June 2018	Q1	Q2	YTD 2018
S&P/TSX Index Composite	1.35%	-5.19%	5.92%	0.42%
S&P 500 Composite	0.48%	-1.22%	2.93%	1.67%
Nasdaq Composite	0.92%	2.32%	6.33%	8.79%
MSCI EAFE	-1.39%	-2.20%	-2.34%	-4.49%
MSCI Emerging Markets	-4.57%	1.07%	-8.66%	-7.68%
MSCI World	-0.17%	-1.74%	1.09%	-0.67%
FTSE TMX Bond Universe	0.58%	0.10%	0.52%	0.62%
CBOE Volatility Index	4.28%	80.89%	-19.43%	45.74%
Gold	-3.85%	2.38%	-5.48%	-3.24%
Oil (WTI)	10.61%	7.41%	14.18%	22.64%
CAD:USD FX	-1.95%	-1.24%	-1.50%	-2.73%
RWI Income	0.96%	-0.97%	2.03%	1.04%
RWI Balanced	1.05%	-0.48%	2.23%	1.74%
RWI Growth	1.21%	-0.90%	3.04%	2.11%

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