Q3 2018 MARKET REVIEW & COMMENTARY

Market Highs Give Reason to Pause

Rising Rates

Since quantitative easing ended, equity investors have all but ignored the US Federal Reserve (Fed). Interest rates stayed below inflation and the bulk of large-cap S&P 500 companies, flush with cash, were hiking dividends and initiating massive stock buybacks. The risk of higher interest rates seemed to be on the back burner.

That abruptly changed as the recent 2018 third quarter came to a close. At their September meeting, the US Federal Reserve (Fed), as expected, raised short term rates by 25 basis points (0.25%), increased their forecast for GDP growth to 3.1% and removed the *accommodative* language from its press release. Economists generally agreed that FOMC members were of the view that short term rates are at a neutral point where monetary policy neither stimulates nor restrains growth and where inflation is firmly anchored around the Fed's 2% target.

The impact of the Fed meeting was not felt by equity markets until the yield on ten-year US Treasury bonds crossed the psychologically significant 3% threshold. At that point investors became genuinely concerned that higher rates could short-circuit global growth.

The Fed is pushing rates higher because US unemployment is at historic lows, and that is causing wages to rise faster than forecast. The fear is that the Fed may step up their tightening stance in an attempt to cool inflationary pressures.

10-year rates moving higher

Source: St. Louis Federal Reserve

We think that view is aggressive. More likely, the Fed will continue its current program of raising rates once a quarter as surprise moves in the latter stages of a historic bull market would not be helpful.

Assuming the Fed maintains its steady-as-she-goes approach, long-term interest rates should increase in parallel to changes at the short end of the yield curve. That should alleviate fears of an inverted yield curve which has been spooking investors. The yield curve becomes inverted when short-term rates are higher than long-term rates, and it is generally believed that an inverted yield curve is a precursor to an economic slowdown within 12 to 18 months of the inversion.

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Given the sharp rise in government deficits, above-trendline GDP growth and elevated inflation fears, we believe long-term rates could rise 100 basis points over the next twelve months. Most likely the current 3.2% yield on the 10-year Treasury bond will edge up another 15 basis points by year-end. That will cause US and Canadian mortgage rates to increase by 25 to 50 basis points over the next six months.

The caveat is President Trump's US-against-the-World tariff reality show. A prolonged period of tariff-induced friction in the global economy could spook investors to seek out the safety of fixed income securities, which would lead to short periods of lower rates.

Trade War Fall Out

Having just completed the USMCA trade deal, President Trump now has more ammunition to push China into submission. Unfortunately, this trade war could drag out longer than expected and investors need a playbook to deal with the fall out.

What is a tariff?

A tariff is a tax on goods coming into a country. A tariff is in addition to any duties and other fees that may be applied. The idea is that a tariff increases the cost of a foreign product which theoretically makes domestic alternatives more attractive.

How Do Tariffs Impact US Businesses?

President Trump is applying economic pressure to persuade companies to use fewer Chinese goods by seeking replacement parts from items manufactured in the US or imported from a friendlier trade ally.

According the BusinessInsider.com: *China tariffs are particularly damaging because they focus on intermediary goods, or parts. US firms, including many small-to-medium-sized businesses, use these parts to make finished products. By increasing the cost of parts, the tariffs will force companies to either pass on the cost to customers in the form of higher prices, cut costs in other areas like the workforce, or shift operations outside of the US to avoid the tariffs altogether*.

Trump has always said that tariffs are a negotiating tool but the longer it takes to resolve a dispute the greater the potential harm to the US economy.

What does it mean for the average American?

When the input costs for a business rise, management has three options: absorb the cost, which negatively impacts margins; pass along the cost to the end user, which could slow consumer demand and push up inflation; or to cut costs, usually through layoffs.

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Notes BusinessInsider.com: *An increase in the price of Chinese goods would have huge ripple effects. Twenty-three states count China as their top source of imports and 45 states have China in their top three. Given the reliance, the price increase would cause widespread pain for many consumers across the US*.

On a macro level, the direct impact tariffs might have on the US economy is modest – likely no more than 10 basis points of total US GDP. The larger issue is how such tariffs might impact the behavior of companies and consumer spending patterns. If costs are rising, managements may delay new investments and focus on cost cutting initiatives, and consumers may put off purchasing discretionary goods because of higher costs. Think of these behavior issues as possible unintended consequences on the US economy that could result in a more dramatic slowdown.

Inflation Expectations

At the end of September year-over-year US Inflation slowed to 2.7%, down slightly from the 2.9% reading at the end of August. This was the lowest reading in four months as the economy benefitted from a slowdown in cost of fuel, gasoline and shelter.

The main concern is wage inflation, which over the past three years has outpaced the consumer price index. That is a good thing if wage growth is offset by productivity increases.

Then there is no impact to profit margins and only a marginal effect on inflationary pressures. At this point we continue to monitor wage gains in the US as a key driver of Fed policy.

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Earnings Outlook

We expect third quarter earnings for S&P 500 companies to increase by more than 19% over the same period last year. That would be the highest rate of increase since Q3 2011 (19.5%).

But the double-digit earnings growth may not be enough to overcome the many challenges facing corporate America – notable among them tariffs and labor costs. Investors will be paying attention to management's view on these issues and how they impact future earnings expectations.

And there lies the rub! Markets do not generally value current metrics but rather try to assess the potential and pitfalls months from now. Given the outlook for higher interest rates, as well as the impact tariffs are having on supply chains and input costs, most econometric models are predicting 10% earnings growth for 2019, well down from 2018 levels.

Also consider Amazon's recent decision to raise their minimum wage to US $15 an hour, which is well above the US $7.25 federally mandated number. Amazon is the second largest employer in the S&P 500 index, and this decision is sure to spark debate on minimum wage standards across a broad swath of US companies.

Unfortunately, we are witnessing a one-two punch from tariff threats and rising wages at a time when earnings growth is on a downward trajectory. On the positive side corporate America is benefitting from lower taxes and the US economy continues to grow above trendline. That may be enough to mitigate some of the impact from the aforementioned challenges facing business.

Currently the Investment Committee is viewing the recent October market selloff as part of the longer-term bullish trend and our outlook still factors in slow to modest growth. That said, given current conditions our Portfolio Management team has been actively capitalizing on the pull back and increased volatility in the options market, while continuing to reduce risk exposure where applicable.

Richard N. Croft, CIO

Pool Review & Commentary

TCG534 Income

Despite a downward trend for September, the Income Fund was up 2.64% for the third quarter overall and 5.32% year-to-date, vs its RWI Income benchmark, which was down -0.99% for the quarter and flat for the year so far.

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The relative outperformance can be attributed to an overweighting of certain asset classes and stock holdings. The pool increased its exposure to the iShares 20+ Year Treasury Bond ETF (TLT) via a covered call strategy to 8%. This strategy benefits from the high option volatility short-term, and benefits longer-term by capitalizing on the expected flattening of the yield curve.

One of the Income Pool holdings (EnerCare Inc.) was sold to generate a one-day return of 52% as a result of being acquired by Brookfield Infrastructure. Broadcom (AVGO), Estee Lauder Companies Inc (EL), and Consolidation Brands (STZ) have all experienced strong returns since they were added to the Income Pool and the positions were closed out of the fund as part of our profit taking strategy.

Notable investment trades included Marsh & McLennan Companies Inc (MMC), Facebook (FB), and Thor Industries Inc being added to the fund. Each of these companies has experienced multiple contractions in equity values, which the Investment Committee deemed to be a temporary price adjustment due to one-time corporate issues that are expected to reverse. The fund also covered these stocks with call options (or wrote puts against short-term cash). With implied volatility on the options higher than normal due to the pullback in share value, the increased premium collected helps further reduce the cost basis of the shares and enhances the fund's cashflow.

The fund exited its sector exposure to Oil because of deteriorating fundaments, and added Telecommunications, which is trading at very compelling valuations. We continue to take specific actions to mitigate risk by including exposure to Gold sector, protective options, and covered call strategies that benefit from market pullbacks.

Mark McAdam, CFA
Portfolio Manager

TCG531 Equity Growth

Despite being off more than 1% for the month of September, the Equity Growth fund finished Q3 up 2.78%, and gained 7.09% year-to-date, vs down -0.57% and up 1.36% respectively for its Toronto Stock Exchange Total Return (TSX TR) benchmark.

After a long period of business and market uncertainty, Canada finally agreed to replace NAFTA with the United States-Mexico-Canada Agreement (USMCA). While this was good news for Canada, given it sends 75% of exports to the USA, Canadian markets failed to gain traction over the quarter. With trade regional trade uncertainty now gone, Canadian valuations should become more compelling, barring further negative developments in the US administration's global trade war policy.

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Despite weak performance in the Canadian market, gains continued through the third quarter in the Equity Pool with strong performance from Technology, Industrial and Health Care shares. Both Canadian and US Technology holdings continued to benefit as Growth stocks in the pro-growth environment observed in the third quarter. Underpinning this performance was a broad market advance as US stocks recovered to their late January peak, albeit with less valuation baggage. The pool's holdings in Health Care continued to be driven by companies with outperforming business models and M&A activity.

Nonetheless, the quarter did offer moments of volatility and the opportunity to write options with higher premiums. While some stocks were sold upon reaching target, others were acquired on pullbacks via a combination of long shares and put writes. Other long-term holdings offered covered call opportunities as prices on some stocks reached peaks. These approaches help gain exposure to new opportunities in a more risk-managed way. Given that the companies we hold have robust business models and are intended to be long-term holdings, this type of portfolio construction leaves room to actively manage a portion of the pool during shorter-term market volatility.

Alex Brandolini, CFA
Portfolio Manager

TCG539 Option Writing

Our Option Writing Fund is designed to drive cash flow using income generating option strategies regardless of market direction, but that goal has been more challenging in a lower-market-volatility environment.

Both the Option Writing Fund and its Montreal Exchange Covered Call Writers Index (MX CWI) benchmark finished September relatively flat but were up for the third quarter and 2018 overall: 2.61% fund vs 1.94% benchmark in Q3, and 4.28% vs 3.59% year-to-date.

As far as factor allocation in the fund is concerned, the fund has stayed the course with value stocks representing about 50% of the portfolio, and momentum stocks 44%. The cash position has been reduced to take advantage of new opportunities, and a hedge in the form of a bearish put spread on the S&P 500 was added to help offset some of the broader market volatility, which has been rising since the beginning of October.

As approximately half of current short option positions were to expire during October we expected to add new positions, extending the term to expiration of these positions both to take advantage of recent higher volatility and to mitigate risk.

Richard N Croft, CIO
Portfolio Manager

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Market Summary

INDEX	Month End September 2018	Q1	Q2	Q3	Q3 YTD 2018
S&P/TSX Index Composite	-0.83%	-5.19%	5.92%	-0.92%	-0.50%
S&P 500 Composite	0.38%	-1.22%	2.93%	7.14%	8.94%
Nasdaq Composite	-0.95%	2.32%	6.33%	6.95%	16.35%
MSCI EAFE	0.59%	-2.20%	-2.34%	0.76%	-3.76%
MSCI Emerging Markets	-0.76%	1.07%	-8.66%	-2.02%	-9.54%
MSCI World	0.39%	-1.74%	1.09%	4.53%	3.83%
FTSE TMX Bond Universe	-0.97%	-0.96%	0.52%	-0.96%	-0.35%
CBOE Volatility Index	-5.75%	80.89%	-19.43%	-24.67%	9.78%
Gold	-0.87%	2.38%	-5.48%	-4.65%	-7.74%
Oil (WTI)	4.94%	7.41%	14.18%	-1.21%	21.15%
CAD:USD FX	0.03%	-1.24%	-1.50%	0.71%	-2.04%
RWI Income	-1.23%	-0.97%	2.03%	-0.99%	0.04%
RWI Balanced	-0.92%	-0.48%	2.23%	-0.39%	1.34%
RWI Growth	-0.64%	-0.90%	3.04%	0.31%	2.43%

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