January 2018

The Quarterly

With this commentary, we plan to communicate with you every month about our thoughts on the markets, some snap-shots of metrics, a section on behavioural investing and finally an update on MacNicol & Associates Asset Management (MAAM). We hope you enjoy this information, and it allows you to better understand what we see going on in the market place.

"You love money and power and capitalism. You know they're never going to love you back"
- Grace Farrell [Oliver "Daddy" Warbuck's Secretary from the hit Broadway musical Annie]

The Numbers:

Index:	**Year-to-Date:**
S&P/TSX:	+8.51%
NASDAQ:	+28.91%
Dow Jones:	+25.36%
S&P500:	+19.82%

Interest Rates:	**Canadian**	**US**
90-Day T-Bill:	0.87%	1.41%
5-Year Bond:	1.61%	2.28%
10-Year Bond:	1.89%	2.48%
30-Year Bond:	2.22%	2.81%

Economic Data:

- Copper continues higher in 2018 suggesting further economic strength
- Crude Oil now confidently through $60 per barrel
- Canadian labour market data and business outlook surveys strong: Bank of Canada hike very likely
- Earnings expectations for the S&P500 raised from the $145 to the $155-160 level on US tax reform
- Gold stronger in late 2017 and early 2018 but beginning to show signs of fatigue as *The Quarterly* goes to print

Valuation Measures: S&P 500 Index

Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	20.7	19.2
P/B: Price-to-Book	3.20	2.90
P/S: Price-to-Sales	2.20	2.00
Yield: Dividend Yield	1.85%	2.05%

Year-to-date Performance, by Sector: Jan 8th, 2018

U.S. Markets	Close	Net	1 Day %	YTD %
Dow Jones	24774.30	28.09	0.11%	25.36
Dow Jones Transports	10697.21	24.55	0.23%	18.28
Dow Jones Utilities	720.41	3.38	0.47%	9.22
S&P 500	2682.62	2.12	0.08%	19.82
S&P 400 Midcap	1905.52	-0.21	-0.01%	14.75
S&P 600 Smallcap	939.71	-0.56	-0.06%	12.14
NASDAQ	6939.34	3.09	0.04%	28.91
Russell 2000 (Smallcaps)	1543.94	-0.29	-0.02%	13.76
BKX (Banking)	107.15	-0.12	-0.11%	16.73
BTK (Biotech)	4257.66	13.48	0.32%	38.46
XOI (Oil Index)	1338.66	-3.82	-0.28%	5.57
SOXX (Semiconductor)	1263.36	4.48	0.36%	39.37
XAU (Gold/Silver)	85.32	-0.34	-0.39%	8.18

Happy New Year


[Oliver "Daddy" Warbucks and Annie]

This is our first commentary of 2018 and we thought it would be entirely appropriate to look back at 2017 for lessons as to what 2018 might be like for investors. 2017 was full of many memorable teachings for market observers and investors alike. For example, did you know that a Corporation could dramatically increase its value simply by incorporating the term "Blockchain" into its name? This Portfolio Manager was once the sole proprietor of "Little Joey's Landscaping", an unremarkable provider of: grass cutting, weed trimming and yard waste bagging services to the greater Mississauga area during the mid 1990s. A going concern in its day "Little Joey's" easily funded all of its expenses and even afforded its owner [me] a shiny new mountain bike with the modest profits earned. To say that "Little Joey's" lived up to its full potential though would be a lie. If only I knew then what I know now, I would have taken "Little Joey's" to a listing on the Toronto and New York Stock exchanges. Yes, I would have become famous…and rich. Perhaps not "Daddy" Warbucks rich or Little Orphan Annie famous, but rich enough to supplant my mountain bike with something a little less pedestrian and famous enough to draw the contemplation of on lookers.

They would ponder, *"Hey isn't that Big Joe the Blockchain Kingpin?"*

Of course, Blockchain technologies and cryptocurrencies were not around in the 1990's, but perceptions and realties were. Lesson number one from 2017 then is that the scars of the global financial crisis have obviously healed and been replaced by damage of a cognitive sort: amnesia. Memory loss is beginning to cause investors to re-think their perception of modern market realities and forget lessons of the past.

2017 also taught us that if you are going to be self righteous, you had better have a pretty good "Plan B" in your back pocket, or a *holier-than-thou* track record of getting things exactly right. Canadians were very quick to point out the superiority of our own financial system to Americans, shortly after the global financial crisis nearly sunk the rest of the planet into the abyss. However, what Canadians somehow forgot to realize was that Central Banks, not only in the United States but globally, had already established a precedent of bailing out investors with plummeting lending rates and liquidity infusions. Recent examples include Orange County, the Tequila Crisis, LTCM (Long-Term Capital Management) and the Dot.com bubble. The memory lapse led to some strange behavior. Rather than using the period of nearly subterranean interest rates to further increase our "superiority" Canadians from coast-to-debt-laden-coast were busy piling on the debt like drunken Tabbies addicted to catnip. Don't get us wrong, everyone likes to dream every now and again. The perception that you are Daddy Warbucks is a relatively harmless fantasy many of us have, and even a guilty pleasure a few of us can indulge in. Although, when that perception becomes a mainstream realty of any republic bank-vault like superiority can devolve into a Banana Republic on the brink quickly. We're not for a moment suggesting that Canada will have trouble paying its lenders a la Argentina. What we are saying is there's perception and then there's reality.

Are we being overly zealous? Not even slightly…


[Canadian pockets empty after food, fuel and debt expenses]

Statistics Canada reported recently that the average Canadian owes $1.71 for every dollar of disposal income they have and that's tough when things inflation in food and fuel is added on. Those debt figures are a lot worse for low income Canadians. We are now some of the most heavily indebted people walking the face of the earth, and from that perspective, you might say Canadians are leaders. Leaders at perceiving things as far more optimistic than they are. We are aware that the Loonie made another run towards the 80-cent range in and around the time the jolly fat guy in the red suit flew over Canada. We presume that confidence in the Loonie was due to "blockbuster" Canadian labour market data. But in the last five days leading into The Quarterly hitting the printers, the Loonie did a pretty spectacular swan dive lower. We think NAFTA has an awful lot to do with this [more on that in a moment] but we also think Bank of Canada, Governor - Stephen Poloz should have as his own personal New Years resolution - a commitment to establish himself as either a conservative or a moderate, and not as something in between.

Canadians are a pious, and self-righteous bunch, it is just too bad that we preach at the altar of VISA, MasterCard at HELOC. May-be this is all just a bad New Year's Eve hangover…stay tuned.

Lesson number three from 2017 is that stock markets only go up and not down. This one irks me, if only just a bit. I have had great seats to some spectacular crashes and corrections over the past 19-years of observing markets. I also happen to be running certain of my prescribed mandates with elevated levels of something called cash, whatever that is.

But why should something as trivial as valuations trouble me after all?

I mean what is so wrong about the Dow Jones Industrial Average approaching 30,000 points, besides the fact that the Dow raced through its most recent 5,000-point ascent in only 12 months? For those in the know, a 5,000-point movement in the Dow is something that normally takes 6 or 7 years to achieve, and sometimes even longer than that. Investors, it would appear, really don't seem to care.

The chart above from Charles Schwab demonstrates client cash levels as a percentage of total assets. Cash it would appear is a four-letter word. Unfortunately, history shows that meager retail cash levels often flat line prior to (and not as a result of) market meltdowns. We note that the above chart's relevance because unlike sentiment surveys which tally how investors are feeling, the cash as a % of total client assets chart from Schwab shows what millions of investors are actually *doing*.

What could possibly go wrong…

The final lesson from 2017 is alternative facts. Don't like the cold hard truth about something impacting you today? Easy, change it…by making up lies. The President of the United States does it all the time. Even people around the President are doing it. Heck, even people that *use to* be around the President are doing it. Steve Bannon used terms like "Treasonous" and "Unpatriotic" to describe the now infamous 2016 meeting at Trump Tower between the Trump campaign officials and a Russian lawyer who was supposedly offering damaging information about campaign opponent Hilary Clinton.

What about now?

Well here is a more recent quote from Mr. Bannon the erstwhile employed member of team Trump:

"Donald Trump, Jr. is both a patriot and a good man. He has been relentless in his advocacy for his father and the agenda that has helped turn our country around. My support is also unwavering for the president and his agenda — as I have shown daily in my national radio broadcasts, on the pages of Breitbart News and in speeches and appearances from Tokyo and Hong Kong to Arizona and Alabama. President Trump was the only candidate that could have taken on and defeated the Clinton apparatus. I am the only person to date to conduct a global effort to preach the message of Trump and Trumpism; and remain ready to stand in the breech for this president's efforts to make America great again. My comments about the meeting with Russian nationals came from my life experiences as a Naval officer stationed aboard a destroyer whose main mission was to hunt Soviet submarines to my time at the Pentagon during the Reagan years when our focus was the defeat of 'the evil empire' and to making films about Reagan's war against the Soviets and Hillary Clinton's involvement in selling uranium to them. My comments were aimed at Paul Manafort, a seasoned campaign professional with experience and knowledge of how the Russians operate. He should have known they are duplicitous, cunning and not our friends. To reiterate, those comments were not aimed at Don Jr. Everything I have to say about the ridiculous nature of the Russian 'collusion' investigation I said on my 60 Minutes interview. There was no collusion and the investigation is a witch hunt. I regret that my delay in responding to the inaccurate reporting regarding Don Jr has diverted attention from the president's historical accomplishments in the first year of his presidency"

- Steve Bannon

A "witch hunt" huh? Which witch is Bannon bantering about?

In closing 2017 will undoubtedly be remembered as the year when unadulterated lunacy gained acceptance in the illusions of investors expectations, in almost even facets of modern Canadian finance, in investor appreciation for a little something called cash and of course in the wonderful world of politics.

So what about 2018?

The MAAM investment team believes a number of risk factors currently threaten Canadians with capital. One of the more obvious examples of this is NAFTA (North American Free Trade Agreement). NAFTA is clearly being discounted by far too many Canadians. The MAAM investment team is especially perplexed by this laissez-faire approach that Canadians have towards an issue as axiomatic as NAFTA.

What do we think is going to happen?

There is a low degree of predictability with respect to the potential outcomes of NAFTA negotiations and negative tail risks could have meaningfully broader impacts. However, we believe Canadians aren't currently contemplating a significant negative outcome, in part, because a NAFTA rescission may result in Canadian-US trade being subject to the Free Trade Agreement (FTA) of 1987. We are not suggesting that Canadians immediately leap into some sort of NAFTA fuelled selling hysteria, but we are advising Canadians to pay closer attention. And in case you don't subscribe to our notion that NAFTA will be a page 1 Canadian investment news story, consider this: there have been thirty-seven (37) US Presidential visits to Canada by twelve (12) standing US Presidents over the past century. Canada is **by far** one of the most frequent international travel destinations for a US President to visit for obvious reasons. Since FDR, only two US Presidents, Gerald Ford and Jimmy Carter, have never visited Canada while in office. As ***The Quarterly*** goes to print, we are within hours of DJT (President Trump) having served one full year in office *without* a Presidential visit to Canada. So, to those Canadians who remain sanguine about NAFTA we applaud your calmness, but we encourage you to remember that in DJT you are talking about a guy who pulled the United States out of the Trans-Pacific Partnership and Paris climate agreement yet tweets that his friends in the Great White North have "nothing" to worry about.

If anything, 2018 is going to be a **busy** year for Canadian investors even if NAFTA risks fizzle or someone deletes DJTs Twitter account. The impact on changes to Canadian mortgage rules, pipeline regulatory approvals, the recent "flip-a-coin-to-decide" posture on the part of the Bank of Canada and commodity price impacts underscore that Canadians will be spending a heck of a lot of time watching Hockey Night in Canada. Several hours of additional research per week will be mandated to ensure the integrity of portfolios from St. John's to Vancouver. But there is an alternative; you can hire us to do it.

A second, and important, trend we see in 2018 is sectoral change. Currently we are holding cash allocations at elevated levels and we are also transitioning new client accounts into our diversified mandates more slowly than in years gone by. Our goal is to be prepared, and pragmatic: we wish to arrive at Industrials, Healthcare and IT are trading at levels that suggest expensiveness. Energy and materials on the other hand offer better value. There is a larger, broader and greater depth in the US Industrial sector versus that of Canada. Even with the generally more competitive business environment south of the boarder the US Industrials sector generates higher returns on an aggregate basis. We will be taking a closer look at this area as our investment team returns from the holiday break. We like where we stand with infrastructure investments and would look to add on weakness.

A third important trend is the balance of cyclical growth versus secular value. As interest rates begin their slow ascent higher, we feel growthier names or names accumulated by investment programs which screen for positive momentum could come under pressure. Next is the value that resources stocks represent. The MAAM investment team has been patiently watching developments in commodity markets to determine the optimal time to expand our investments in this area. We're also wanting to ensure we dust off any non-bank financials that represent attractive investment opportunities to our investors, but offer a wide moat which protects capital.

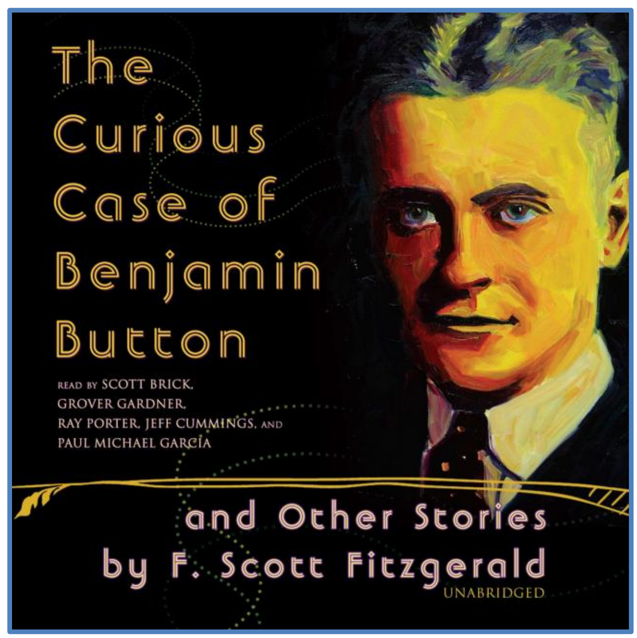
The final thing to watch for is detailed in a Case Study below and focuses on the impact that rising rates could have on fixed income investors. Please read this Case Study carefully as we truly feel it has a lot to offer.

2017 wasn't a bad year for Canadian investors; it just wasn't a great one.

Canadian equities did "okay" in 2017 but were a long way from being world class. Canadian markets finished positively for 2017 but well short of powerhouses like range toppers China and South Korea. How did Americans with Canadian investments do? On a US dollar basis Canada's global ranking worsens, for example Shanghai and the FTSE100 vault past the S&PTSX, but that stigma is cushioned by better absolute performance in American dollar terms.

The Curious Case of Benjamin *BOND*ton: A MAAM Case Study

For the past four or five years Analysts and Portfolio Managers on Bay and Wall Street have begun the new year by issuing fresh predictions that bond yields both domestically and abroad will rise and vaporize the underlying value of a reliable source of income for many, generally retired, clients. By and large, many of those same Analysts and Portfolio Managers have failed in pinpointing either the timing, direction or extent of yield movements.



[The Curious Case of a Man (or bond?) headed in reverse]

So what makes us…and 2018 so different?

But before we get to that, a brief Case Study:

A number of years ago, this Portfolio Manager was happily buying BBB-rated paper for elder members of his immediate family with coupons averaging 5.50% and in some cases as high as 7.65%. Speaking candidly, this very same Portfolio Manager, at the time, was openly gloating as to his; sheer, raw, unbridle genius (remember that part earlier about being self righteous?). Unfortunately, a small, subtle nuance called reality kicked into high gear not too long ago and yours truly hasn't looked more like a *jenius* and less like a genius. That small, subtle nuance is called **reinvestment risk**.

Investopedia [still one of our favourite websites] defines reinvestment risk as follows:

"Reinvestment risk is the risk that future coupons from a bond or bonds will not be reinvested at the prevailing interest rate from when the bond was originally purchased".

What an understatement…this Portfolio Manager and many, many more are struggling to reproduce the previously gloated bond coupons with little success.

As it turns out many of the bonds issued years ago are now being redeemed early but their issuers and refinanced at more favourable rates. Favourable to the issuing company of course, and that presents a big problem. In the United States, we feel yields on the US 10-year note could rise by 30, 40 perhaps even 50 basis points. Either way, yields are moving higher and not lower and it is becoming increasingly apparent that the top of the bond market occurred at some point during the summer of 2016 when the yield on the US 10-year flatlined at a hair over 1.40%. Why are we so confident? Firstly, nominal growth in the United States likely shifts higher from a range of 3-4% to 4-5% due to tax cuts, deficit spending and infrastructure. Financing the deficits will be the US Treasury issuing a trillion dollars of debt in 2018. Global Central Banks and not just The Bank of Canada or the US Fed will be tightening monetary policy by raising rates, cutting quantitative easing and pruning their balance sheets. The deluge of money that has been met with a copious quantity of supply means interest rates are headed higher.

So what do investors do with their existing fixed income positions and bond funds?

The gist of the matter is this: traditional approaches to fixed income will not work anymore. We are actually starting to see evidence of this to be true rather than purely theoretical.

It will be a slow grind downwards for bond investors, but may-be not quite that slow. High yield bonds continue to fuel investor perception on fixed income portfolios doing better than underlying reality suggests so this is a case of a slow-moving train that appear to be way off in the distance: blink your eyes and its on top of you. Yields are rising and high yield spreads have been squished so tightly that capital gains are just about out of the question. The future is now for bond investors and the MAAM Alternative Debt Fund is in position, and not a moment too soon it would appear.

Behavioural Investing: "*Why did I buy this stock again*?"

Amnesia is a deficit in memory caused by brain injury, disease, psychological stress or drug use. Memories can either be wholly or partially lost, and there are two primary variations of amnesia: retrograde and anterograde. The former is the inability to retrieve information that was acquired *before* a particular date while the later is the inability to "deposit" short-term memories into one's long-term memory "bank". We are certainly no where near qualified to speak about the medical aspects of amnesia, but as Portfolio Managers, we can say that the present behavior of investors can be summarized by the following sequence of events:

The 2008/2009 Global Financial Crisis caused a lot of investor scar tissue in the form of the psychological stress it most assuredly placed on those with savings. Need a refresher? The Dow Jones Industrials began their morning on September 29th, 2008 at a robust 11,139 points. Just slightly less than two months later, on November 21st, 2008, the Dow had sunk to 8,046 points, the intra-day low took the average as far down as 7449 points. This psychological stress most assuredly caused investors to forget why they invest in the first place. We frame this as investment grade anterograde amnesia. In the period that followed the collapse, monetary policy makers the World over competed to see who could devalue their nation's currency the fastest [by slashing interest rates and infusing the financial system with liquidity]. Many market observers, ourselves included, termed this monetary injection as "financial heroine". Well as we approach the 10-year anniversary of the collapse of Lehman Brothers, we feel the prolonged period of "drug use" by investors has been in some ways more closely analogous to recreational drug use as oppose to medicine. The so called drug binge, if you will, has of course in our view caused the prevalence of retrograde investor amnesia as a lot of investors today seem unable to recall past lessons learned. At MacNicol & Associates Asset Management, investment brinkmanship forms no part of our investment process. While markets may continue to be driven by the momentum of the absent-minded masses, we will continue to offer those with capital a safer harbour for their investments.

Firm News:

Thursday January 25th- Contributing to the RRSP Discussion
Thursday February 15th – Let's Talk TFSA!
Thursday March 22nd- Gold Outlook

If you would like to register for any of the upcoming events hosted by MacNicol, please R.S.V.P to brook.pickering@macnicolasset.com.

And for those with a healthy appetite for predictions don't forget to check out Blackstone's Senior Strategist Byron Wien for his webcast on *"The Ten Surprises of 2018"*. Ask us for a copy if you are interested.

MacNicol & Associates Asset Management Inc.