MacNicol & Associates Asset Management Inc., 145 Adelaide Street West, Third Floor, Toronto, Ontario, M5H 4E5

June 2018

The Monthly

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.

"The EU is the old Soviet Union dressed in Western clothes" - Mikhail Gorbachev

The Numbers:

Index:		**Year-to-Date:**
S&P/TSX:		0.58%
NASDAQ:		10.60%
Dow Jones:		2.11%
S&P500:		3.62%
Interest Rates:	**Canada**	**USA**
90-Day T-Bill:	1.27%	1.93%
5-Year Bond:	2.14%	2.81%
10-Year Bond:	2.29%	2.96%
30-Year Bond:	2.32%	3.08%

Economic Data:

- US 10-Year rallies sharply against a backdrop of Italian geopolitical risks in the Eurozone driving a flight of capital into US treasuries
- The US Dollar strengthens on Euro weakness with the EUR/USD back at October 2017 levels
- G7 Meeting dominated by trade and tariff talk
- US unemployment at 2-decade low, wages rise 2.7%
- Media critical of POTUS tweeting about jobs report ahead of release by the Bureau of Labour Statistics
- Gold struggles in mid May now just below $1,300
- Oil corrected sharply in final week of May to begin June at $66 per barrel

Valuation Measures: S&P 500 Index

Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	17.3	18.3
P/B: Price-to-Book	3.1	2.8
P/S: Price-to-Sales	2.0	1.9
Yield: Dividend Yield	1.86%	1.96%

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

U.S. Markets	Close	Net	1 Day %	YTD %
Dow Jones	25241.41	95.02	0.38%	2.11
Dow Jones Transports	10842.82	3.84	0.04%	2.17
Dow Jones Utilities	664.09	3.55	0.54%	-8.19
S&P 500	2770.37	-1.98	-0.07%	3.62
S&P 400 Midcap	1990.78	1.22	0.06%	4.75
S&P 600 Smallcap	1035.70	-3.43	-0.33%	10.62
NASDAQ	7635.07	-54.17	-0.70%	10.60
Russell 2000 (Smallcaps)	1667.78	-8.17	-0.49%	8.61
BKX (Banking)	109.78	0.13	0.11%	2.87
BTK (Biotech)	4807.09	-39.30	-0.81%	13.85
XOI (Oil Index)	1547.60	20.01	1.31%	15.88
SOXX (Semiconductor)	1424.34	-13.60	-0.95%	13.67
XAU (Gold/Silver)	82.99	-0.39	-0.47%	-2.68

Source: Jeffrey Saut, Raymond James

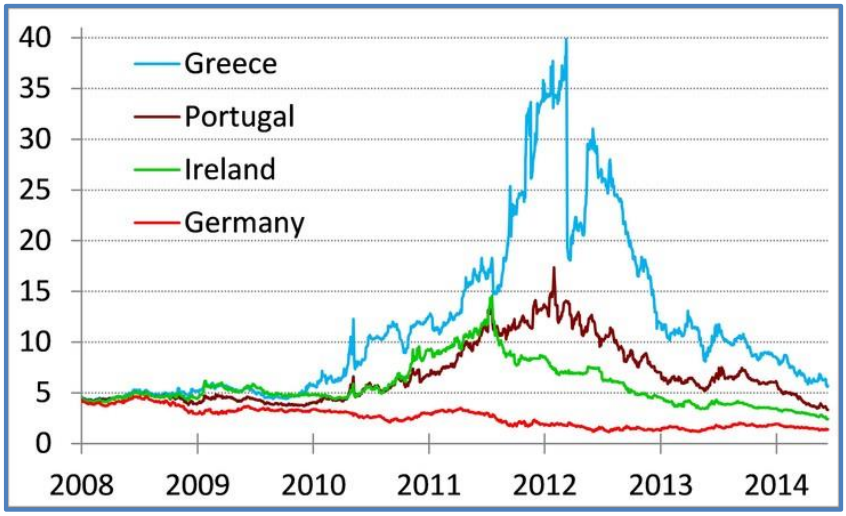
What will it take *now*?

On July 26th, 2012 European Central Bank President Mario Draghi gave what most investors term the "whatever it takes speech" at a conference in London. Verbatim remarks of the speech can be found on the European Central Banks [ECBs] website by clicking media and then scrolling roughly half way down the page. The speech was as historic as any given by a Central Banker because, back in 2012 bailout negotiations to debt laden EU members dominated financial media while the yields on certain EU sovereign credits dominated the heavens.

[European Central Bank Chief "Super" Mario Draghi]

Who can forget this chart comparing "PIG" (Portugal, Ireland, Greece) bonds to well-oiled German bonds:

Sensing disaster nearly 6-years ago, Draghi, a key steward of the European financial system and a modern-day Picasso in the art of helping hold together a multi-member state of which that many say should not exist leapt into action. Although, the speech was peculiar too because Draghi chose to compare the Euro to a bumble bee (i.e. an insect that shouldn't fly yet does). An insect metaphor by a central banker trying to assure investors that the European financial system was not collapsing was bold, brazen and bewildering.



Recall that Draghi also said that the bumble bee (the euro) would "have to graduate to a real bee, and that's what it's doing" in the same speech. Unfortunately, the recent performance of the euro looks more like a financial version of academic probation and less like an event where graduates access the great hall of a hundred year old building through an ornate baroque entrance for their newly minted diplomas.

["Souvlaki" Bonds at one point were worth not much more than the pita breads they were printed on]

In this edition of *The Monthly* we ask the question: what will it now take?
6th in the G7

The Italian economy is big, G7 big.

Even if you did not know the exact size of the Italian economy, you may have some inkling that it is much bigger than the economies of Portugal, Ireland or Greece. For specifics the World Bank figures the Italian economy to be 9.5 times the size of the Greek economy and a healthy 2.5 times the combined size of the Greek, Portuguese and Irish economies together. Italy, as should be obvious by now, is no small peripheral European nation. With the new Italian government now in power, many politicians and market commentators suggest all is well in the Eurozone. Industry experts also use the fact that recent spreads did not reach the same magnitude as they did during the sovereign debt crisis of 2011/2012, as a positive indicator. Looking at the situation from a different perspective the MAAM investment team notes; that just last month 2-year Italian government bonds experienced a much larger price decline than they had at any point during the 2011-2012 crisis when systemic risks to the Euro area were far more acute. Additionally, potential "cracks" in the market were also revealed during the VIX (CBOE Volatility Index) spike on February 5th.

Meanwhile back in New York

In New York our investment team met with a firm that focuses on buying extremely inexpensive French banks for pennies on the dollar. It certainly seemed like an interesting strategy for generating outsized returns but potentially fraught with risk. When we inquired about whether it was easy to find French lenders on the cheap, the representative from the firm in New York quipped "It's actually very easy." We knew there had to be a little more to it than that. The chart from Nomura Securities and the IMF explains very quickly why a strategy underpinned by cheap French banks isn't that hard to fasten together at all.

%		2017	Germany	France	Italy	Austria	Neth.	Spain	Greece	Euro Area
Non-resident debt holdings	EA investor	Germany	-	7.0%	4.8%	14.0%	10.6%	6.6%	3.4%	6.3%
		France	3.4%	-	7.4%	8.6%	10.5%	8.8%	5.4%	6.2%
		Italy	1.7%	2.2%	-	1.3%	2.4%	4.8%	3.3%	2.0%
		Austria	0.8%	0.5%	0.5%	-	0.8%	0.8%	0.4%	0.7%
		Neth.	5.6%	3.6%	1.0%	8.1%	-	1.6%	1.3%	3.0%
		Spain	0.4%	0.5%	3.7%	0.3%	1.4%	-	0.0%	1.2%
		Greece	0.0%	0.1%	0.3%	0.1%	0.1%	0.4%	-	0.4%
		Total EA	**20.3%**	**24.4%**	**26.2%**	**40.3%**	**38.1%**	**31.0%**	**19.3%**	**29.2%**
	Non EA investor	US	2.5%	3.4%	1.0%	1.5%	8.8%	1.5%	2.1%	3.5%
		UK	3.1%	2.2%	0.5%	1.5%	3.2%	1.9%	2.6%	2.4%
		Japan	3.1%	5.0%	1.5%	1.9%	5.3%	1.6%	0.0%	3.2%
		Sweden	0.4%	0.2%	0.1%	0.1%	0.2%	0.2%	0.0%	0.3%
		Norway	1.2%	0.5%	0.2%	0.8%	0.7%	0.4%	0.0%	0.6%
		Canada	0.2%	0.2%	0.1%	0.1%	0.2%	0.1%	0.2%	0.2%
		NZ	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%
		Hong Kong	0.4%	0.2%	0.0%	0.0%	0.3%	0.0%	0.0%	0.3%
		Bermuda	0.1%	0.3%	0.0%	0.1%	0.6%	0.0%	0.0%	0.2%
		Jersey	0.0%	0.0%	0.0%	0.4%	0.0%	0.0%	0.0%	0.1%
		SEFER	17.0%	8.2%	0.9%	8.9%	6.6%	3.2%	0.0%	6.8%
		Total ex-EA	**32.3%**	**22.4%**	**5.1%**	**18.4%**	**30.4%**	**9.9%**	**6.8%**	**20.8%**
	Total non-resident		**52.6%**	**46.8%**	**31.3%**	**58.8%**	**68.5%**	**40.9%**	**26.1%**	**50.0%**
Resident			**47.4%**	**53.2%**	**68.7%**	**41.2%**	**31.5%**	**59.1%**	**73.9%**	**50.0%**
Total			**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

[The French love Italian Debt, maybe a bit too much]

Your attention is directed to the number 7.4% because it shows that French banks have been gorging themselves on Italian debt for longer than any of us might care to know save for the NY firm we mentioned earlier. The gluttonous nature of the France's appetite for Italian debt is made even clearer when it is compared to the 5.1% figure in the row labelled "Total ex-EA". France holds more Italian debt than the entire United States, United Kingdom, and Japan combined plus a few other countries on top of that for good measure. This is dangerous because Italian debt itself is looking dangerous. Italy's fiscal situation is precarious, and it has not been helped by years of asset purchases by the ECB. "Whatever it takes" has resulted in a situation in which the ECB is effectively the only net buyer of Italian sovereign debt.

Thus, there is little question that the ECBs corporate sector purchase program has helped underpin Italian credit both literally and figuratively, since investors were driven further down the credit quality ladder in search of yield.

We thanked the representative from the New York firm fixated on floppy French banks and politely said *au revoir*. The absurdity of an insect metaphor is the absurdity of the entire situation in Italy itself: Italian credit is trading at a premium to Italian government bonds which, are themselves trading at a premium to Italy's fiscal reality. We believe that intrepid investors should separate the buzzing sound of the bee's wings from the painful itch of its stinger.

Does Anyone Seriously Believe That Italy Will Exit The Eurozone?

We don't either, and political instability is hardly a new phenomenon in Italy. The country has had roughly 3 times as many post war Prime Ministers as the United Kingdom or Germany. Yes, Italy swore a new populist coalition leadership into power earlier and to many this brought closure to the political turmoil that hit global markets earlier. This change in Italy's government also vaulted a ton of investment capital on a non-stop flight to the United States.

The MAAM investment team is skeptical that the simple fact that so long as the Prime Minister's suite is (for the time being) occupied it will reverse the euro carnage. The new government has the potential to be quite confrontational on some very key issues and again, when it comes to Italy you aren't dealing with a "rounding error". At the same time political brinkmanship will most likely come out of the gates swinging and then moderate over time. Still this could be an inflection point for the Euro as most of us cannot help but to be taken back to a time before the "whatever it takes" speech. Not only are we less sanguine than the masses regarding the entire situation in Italy but we are also pessimistic on the Euro itself. We certainly distance ourselves from the more provocative narrative that Italy will exit the Eurozone, but we do think the Italians have the potential to reorganize the structure of the eurozone sufficiently enough to wreak long-term havoc on the euro. In short, even though politicians and central bankers will attempt to ease the concerns of investors a continued downwards spiral for the euro is likely.

Again, what it will take?

Clearly Mario Draghi will have to be more sympathetic to the potential fallout from his actions. Crucially Draghi will also not want to be seen as distancing himself from a discussion on winding down asset purchases purely from first quarter economic weakness or the problems in Italy. Draghi has been successful (thus far) at avoiding broader contagion within the EU however, an increasingly discordant President Donald Trump could aggravate the situation in Europe at a time the continent (and Draghi) cannot afford. Draghi may very well look through Q1 eurozone weakness and the situation in Italy, but he will only do so if there is no unexpected tightening of financial conditions, which we argue has already occurred. Italian bonds plummeted on the populist vote sending 10-year yields from 1.8% in early May to the more current 3.0% level. An awfully fast movement in an awfully big bond market in an extremely short period of time. Italy's one saving grace in all of this could potentially be its massive holding of Gold.

[The "Super" one will have to be the sympathetic one - Mario Draghi]

The Italians are in debt and their banking system in shambles, but the country is home to the world's 3rd largest (sovereign) gold reserve with roughly 2,500 tons of the stuff available. The IMF technically owns more Gold than Italy but since it lacks a currency and so Italy really only falls behind the United States and Germany in Gold as a share of foreign exchange reserves. Mario Draghi knows this but he also knows that in an environment of central planning he cannot take Italy's riches for granted. The issue in Italy is something that cannot be dismissed as transient or simply a one off. Look for continued weakness in the euro, political brinkmanship to return to a website near you this summer and ongoing strength in most things American.

The MAAM Investment Team
Resilience: Technically Speaking

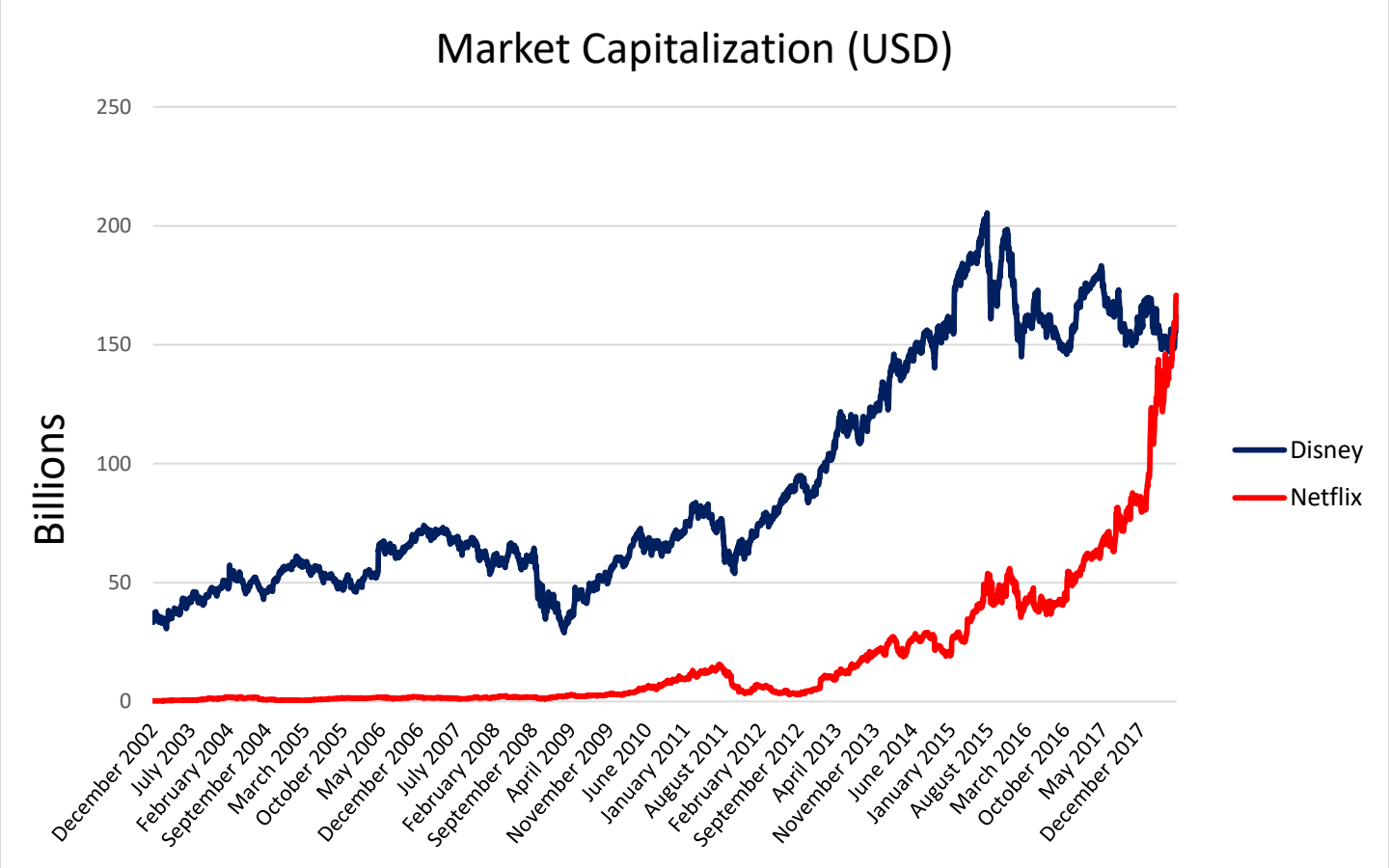
Some investors we speak with are perplexed by the tenacity of US equities and bonds. Eurozone fragility and how it relates to the ECB's plans for their own asset purchase programs are a big reason why, and we cover that in the previous article. A huge migration of investment capital into the United States has caused US markets such as the S&P500 to resume their upward trajectory towards levels last seen before the February "flop". Turmoil in the Brazilian Real, Turkey's inflation problem and an Argentinian debt restructuring are not helping stem the flow of money into all things American.
Andrew Adams, a noted technical analyst we follow, recently pointed out that Technical Analysis can be useful in deciphering exactly what the market wants to do. This is true even if what the market wants to do doesn't make much sense. Adams then goes on to site several pieces of evidence supporting his bullish view:

Small and Microcap Stocks hit all time highs in May and continue to trade higher
The NASDAQ composite hit a new all time high earlier
The S&P500 now sits a solid 8.5% above it's February "flop" levels
The NYSE, NASDAQ and S&P500 Advance/Decline line ratios are an all-time highs
The number of stocks hitting 52-week highs continues to expand

Capital flows from across the Atlantic have done more than simply reignite a bull market and position the market on technically stronger footing. They have also reignited something that we tend to advocate against, ignorance of the fundamentals and indiscriminate buying.

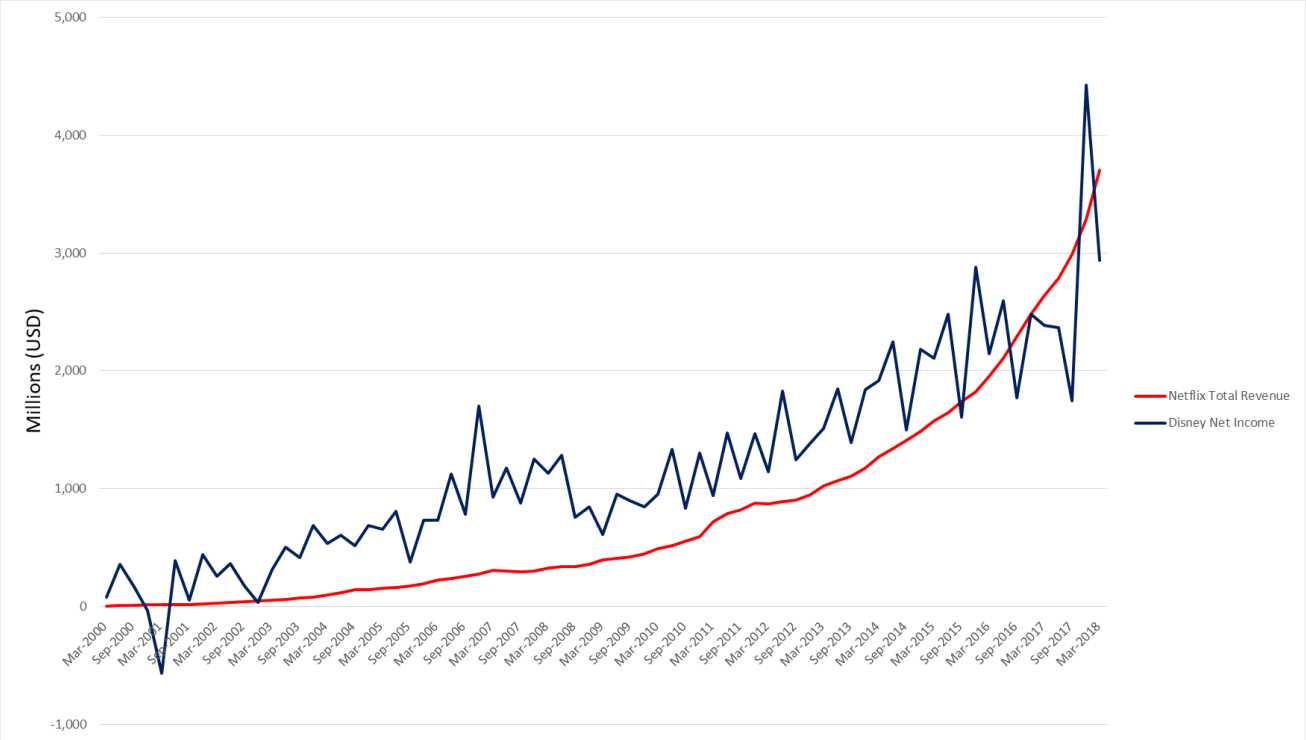
Caveat Emptor Momentum Traders

Though many examples of market excess froth to bubblier proportions, consider the market cap of Netflix's stock compared to that of rival Walt Disney. As *The Monthly* hits inboxes Netflix's market cap sits roughly $3 Billion higher than that of Disney.



[The Market Capitalization of a Company that burns cash exceeds the market capitalization of a company that creates cash, what could possibly go wrong?]

Don't get us wrong, we are big time Netflix fans when it comes to access to entertaining content. Besides who really watches set tv programing these days anyways other than for sports? The combination of point-and-click on demand viewing is a Godsend for parents and millennials. So while the valuation argument may not sway you, perhaps some harder data points will. The Walt Disney Company **earns** nearly what Netflix **revenue** brings in. In other words, the total amount of money Disney has left over after it has paid for all costs associated with producing its media, all the salaries of the people who produce it, the interest on its debt, its corporate taxes and even a provision for depreciation of its physical assets; Walt Disney still has more money left than Netflix has before accounting for any of these items.



[Netflix' Revenues have grown over the years, but after all is said and done Disney is still far more profitable]

While we agree that technical analysis brings a critical component to any investment program it is not the be all and end all. To that end, we encourage a balanced approach that takes into consideration valuations, fundamentals, the balance sheet, technical and frankly – a bit of common sense. At MAAM we are always glad to provide you with our views on markets and investing. If you or anyone you know would like a complimentary portfolio review and description of our services for investors, please feel free to call us at **416-367-3040**.

Overconfidence, Psychological Colorblindness, Investor Kryptonite and the Cash That Makes It All Better

Superman never made any money, saving the world from Solomon Grundy. He also didn't make any money by making bad investment decisions. Despite buoyant conditions in many North American markets, the MAAM investment team cautions investors against the dangers of overconfidence. We also advocate for having a clear defined investment policy statement that makes a notable allocation to cash. Cash moderates investment returns, quashes complacency and acts as the crash test dummy so you don't have to. Of course, excessive levels of cash can also be detrimental to your financial health because they expose more of your nest egg to the eroding force of inflation. This is something the we have written about extensively in recent years. Though in the context of current market structure a little bit of cash

could go a long way towards not only helping you avoid unintended overconfidence, but also towards helping you remain comfortably invested for the long-term and thus able to thwart inflation's damaging assault on your savings.

Investment markets around the world are characterized by the presence of high frequency trading algorithms, systematic trading platforms and the proliferation of passive investing or ETF's. Just about all of these next generational investment innovations have two things in common: they are largely devoid of the watchful eye of an experienced money manager and they have not been thoroughly stress tested in a worse case scenario. Yet two recent examples of how these new aged investments performed when stressed out just a little did not inspire any confidence. Monday August 24th, 2015 and Monday February 5th, 2018 are two dates the MAAM investment team (fortunately yet unfortunately) knows quite well. These two dates mark recent flash crashes in which the market unexpectedly droped by a lot in a short period of time. On the one hand we were saddened to hear fear in the voices of many investors, but we were pleased to see how our portfolios - which combine carefully selected equity and fixed income instruments along with alternative investments and cash - performed amidst the mayhem. We weren't up by any stretch of the imagination, but we can tell you that we were an awful lot further from the bottom that many others who we sadly have not yet met. August 24th and February 5th then are two of more than a dozen instances since the Lehman Brothers disaster in which overconfidence was severely punished, and in which the proximate cause of these so-called market anomalies was the very financial innovations (high frequency trading algorithms, systematic trading strategies and ETF's) designed to protect investors from such anomalies. Passive investing in particular has its own set of challenges, such as the notion that an ETF can be more liquid than the liquidity of the underlying securities in the ETF. This concept is intended to replicate the idea that bargain basement fees will free the average investors from the crippling tyranny of high cost active management.

The problem is that ETF's and other "machines" in conjunction with exceptionally loose monetary policy have transformed buying the dip from an anachronism to a bonafide investment strategy. We ask the following questions: what happens if that slam dunk ever misses the mark? Will the entire complex of programmatic algorithm trading implode on itself in a wave of adverse selection? Will ETF's just cease when the liquidity incongruence between top fund and underlying asset gets exposed? Will days like August 24th and February 5th be looked back upon with fondness of observing a rift between two pre-schoolers?

We certainly hope not, but for the record how is your confidence now? The point is this when liquidity evaporates selling pressures are exacerbated. Academic research has shown that high frequency algorithmic trading systems have a difficult time analyzing complex fundamental news such as Italy's recent political change, in other words the robots are psychologically colourblind. Human traders by contrast are much more adept at trading this type of news successfully and play adverse selection to their strength. At MAAM we term this real Portfolio Managers one upping Robotic Portfolio Managers but the reality is the Robots aren't better than us they are just faster at analyzing a very discrete data set. As an investor you have a voice to which we will listen. Overconfidence in a market environment dominated by machines is the

kryptonite that can rob even the most heroic investor of returns. Remember to keep your cash close to your heart and your human portfolio top of mind.

The MAAM Investment Team

Firm News

"Project Miami" planning is now well underway. If you would like to receive updates including speakers list, agenda and other key details, please email brook.pickering@macnicolasset.com

Survey to follow …

MacNicol & Associates Asset Management Inc.