



Jack Way
Vice President

“By The Way”

June 2018

We have long expressed the belief that the more than generous monetary stimulation provided by the world’s central banks over the past decade was responsible for a large part of the rise of global stock markets. It has also been our position that in order for that momentum to continue, now that governments are shifting away from those aggressive monetary policies, markets would need to see more fiscal stimulation with a concomitant strong economy and growing corporate earnings. In large part the scenario is playing out as hoped, particularly in the world’s largest economy, the USA. A market driven by fundamentals also suggests we should shift our investment emphasis to more cyclical and economically sensitive stocks and less so to stocks tied to overall strength in financial markets.

The era of a rising tide floating all boats has come to an end, and now there is an opportunity, and in fact a need, to find excess returns by being more selective in one’s portfolio. Passive strategies, such as ETFs that track an index like the S&P 500, benefitted from the all-inclusive rise in stocks, and have grown to represent almost half of all equity exposure. As blogger Jared Dillion writes, investment ideas work until too many people jump on board and then they become unstable. Here is the caveat I see. Given 85% of these funds are market weighted, a decline in the most heavily weighted stocks such as Apple, Netflix or Amazon would have a disproportionate affect on returns, and could even produce a negative feedback loop as lower prices cause forced selling in the ETF which causes lower prices etc. etc. As the folks at Strategas write, everyone isn’t getting a trophy anymore. It’s time to devote more time to analysis and stock selection. In addition, I believe allocations to bonds and other fixed income investments should be lowered in such an environment.

To briefly follow up on the global economic outlook, a simple summary of where we are today would show the U.S. up, but Europe, China and Japan down. Here are just two estimates for the second quarter that sum up the strength in the US; real GDP is tracking at a 4% rate, and S&P earnings are forecast to come in at +20.5% on the heels of the +23.2% reported in the first quarter. For the other three economies down is too strong a word as results are weakening but not yet weak. An optimist would say this is just a “soft patch” and not a long term trend. For example, the Purchasing Managers Manufacturing Index in Germany is 3% below its 12-month average, but still expansionary at 56.9% as of the May report. Similarly, Japan is 0.4% below, but at 52.8%. China is at 51.9%, flat for the last 12 months, which is getting close to the 50% level that divides growth and decline. It is worrisome to see the yuan is weak again and the country’s stock market is down more than 20%, which raises the possibility someone knows more than me.

The S&P 500 remains constrained within a trading range. Constraint, however, is not a word in Donald Trump’s lexicon. I will deal with that later. While the market is range bound, and short-term forecasting is a mug’s game, we still search for historical precedents, signs and omens within the market. The following is an abridged list of some of the things we are watching. The

industrial and financial sectors of the S&P have been weak; as these are the two sectors most closely correlated with the overall market we want to see a positive change. Sentiment measures are almost always contrarian signs, so it is a positive to see a spike higher in the put/call ratio which indicates investors have a growing concern about the market. As a rule, this presages higher prices. I am not a great believer in seasonality, but the third quarter of a mid-term election year is usually weaker while the fourth quarter is strong. Additionally, since 1946 the US market has always been higher one year after a mid-term election.

Globally, central bank monetary policy cannot be described as tight, but it is certainly much less accommodative than five years ago and regulated rates along with open market operations are definitely on a path to tighten even more. The problem is, despite the great minds at banks like the FED, history tells us they have no idea when to stop. Basically they will keep raising rates until something breaks, and then we get a recession and lower markets. While not necessarily predictive, I can't help looking back at 1937 when the government concluded the Great Depression was over and tightened spending and monetary policy, which threw the economy back into recession and led to a 54% decline in the Dow Jones Index. There is no evidence we are near such a crossroads, but the central bankers must tread carefully.

Finally, we have to deal with Trump and trade wars. The President's negotiating style is so confrontational to friend and foe alike (okay, Putin might be an exception) that it is impossible to predict the end game to all of this. In the midst of all his frustrating rants, there is much truth in what he is saying; China has been blatantly stealing intellectual property for decades, and the Canadian Supply Managements System is unquestionably protectionist. That does not negate the serious and long term risks involved in a potential global trade war. We must assume Trump will back away from the abyss before it is too late. The alternative is too unsettling to ponder. While I might find his rhetoric disconcerting, the fact is the President's approval ratings continue to go higher in the US as he challenges the rest of the world. Nonetheless, the trade issue is the cause of much of the uncertainty and volatility across all markets.

It is reassuring to me that in the face of so much disquieting news, the market continues to hold its own, and in my mind still affords investors the promise that the current trading range will be resolved to the upside.

Forward Looking Information and Disclaimer

This document may contain certain forward-looking statements. These statements may relate to future events or future performance and reflect management's current expectations. Such forward-looking statements reflect management's current beliefs and are based on information currently available to management. Although the forward-looking statements are based upon what management believes to be reasonable assumptions, there can be no assurance that actual results will be consistent with these forward-looking statements. Neither the Funds nor their respective managers assume any obligation to update or revise any forward-looking statement to reflect new events or circumstances. Actual results may differ materially from any forward-looking statement. Historical results and trends should not be taken as indicative of future operations. The Fund is not guaranteed, its value changes frequently and past performance may not be repeated. Unless otherwise indicated and except for returns for period less than one year, the indicated rates of return are the historical annual compounded total returns including changes in security value. All performance data take into account distributions or dividends paid to unitholders but do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns.