JANUARY MARKET COMMENTARY & FORECAST

MARKET PERFORMANCE

Market	Return (%)*
Canada (S&P/TSX)	(1.4)
US (S&P)	3.5
MSCI (World)	3.0
Best (Brazil)	13.1
Worst (Switzerland)	(6.9)

**In Canadian dollar terms as at January 31, 2018*

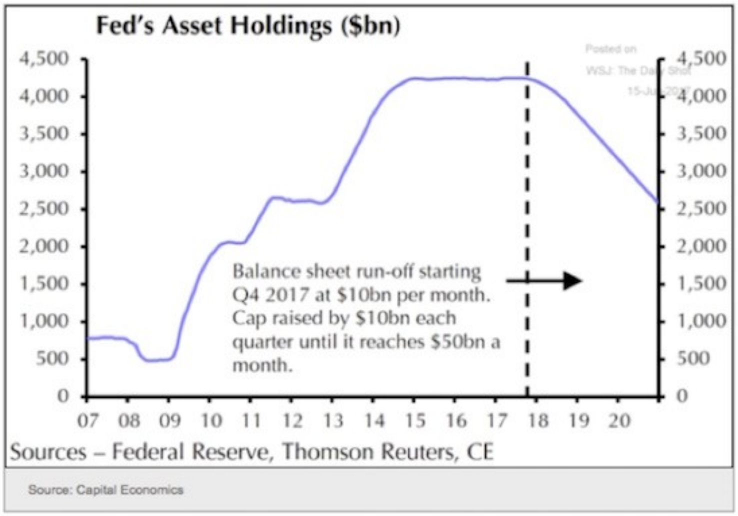
Interest rates take centre stage…

January was a month for the ages in the stock markets. The markets managed to hopscotch soaring equity and commodity prices and higher bond yields. The MSCI World markets jumped 5.3% for January continuing the wicked streak of gains from last year. Other markets went along for the ride lead by the biggest markets of all in the US. The Dow Jones and S&P 500 closed up 5.9% and 5.7% respectively. The only major down market for the month was the TSX closing down 1.4% as the challenged Energy sector was down 5.4% even as the price of oil jumped 7.1%. Concerns about the Canadian government's inability to get pipelines and infrastructure built to serve the energy industry is casting a black cloud on the sector. Utilities, Telecommunications and REITs also dropped on concerns of rising interest rates.

Interest rates have been rising now for over a year. We have always believed that the cost of money, measured by interest rates is a leading indicator for the equity markets. Since 2008 and various global Central Banks' intervention in the capital markets through quantitative easing ("QE") strategies, interest rates have diminished in their capability of being a leading indicator. Recent equity market behaviour is sending a message that interest rates are returning to being a leading indicator for the equity markets. We believe this is a result of a combination of events, starting with the Federal Reserve entering a quantitative tightening policy and the Trump administration's tax reform and pro-business policies which have led to a rise in rates. The benchmark US 10-year bond dropped 3.2% for the month while the yield has jumped to 2.71%. This yield is now up 40bp from a year ago and at a 4-year high. Similar increases in yields have been experienced in other major economies. We will analyse the reasons for the increase in bond yields below.

The demand picture for bonds is deteriorating as one of the biggest buyers of US bonds will ease up on the purse strings. The Federal Reserve ("The Fed") has indicated that it will be stepping back from the market in its desire to remove the QE it initiated after the credit crisis. Chart 1 shows the Fed's balance sheet decreasing by $10B/month and ultimately $50B/month.

Chart 1



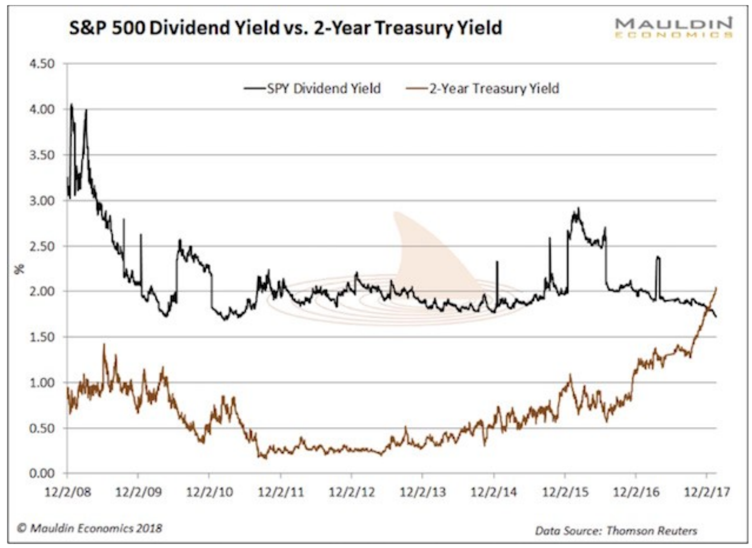
This cutback in demand will come at a time when the supply of new debt instruments is forecast to increase. This increase in supply is the result of the US government's goal to decrease income taxes while at the same time increasing spending. The US government debt is officially $20 trillion (yes trillion) and projections for this year's budget deficit could push above $1 trillion.

The Fed has been increasing rates steadily and has indicated that "further" interest rate hikes are coming with estimates of up to 3-4 hikes in 2018. This has been pushing 2-year rates to 2.15% which itself is a 9-year high. The impact of higher short-term rates is spreading to mortgage rates. A US 30-year mortgage has been steadily increasing from 3.41% in 2016 to current levels of 4.15%. Other central banks globally are also in tightening mode such as the Bank of Canada and the Bank of England.

The upswing in global growth projections has also been a cause for higher interest rates. Higher growth ultimately leads to higher inflation. This is because higher commodity prices and wage pressure from full employment levels will have an impact on the inflation picture. Even though inflation has not been an issue so far, employment growth and labour shortages in some areas could result in some wage pressure moving inflation higher. Inflation could surprise on the upside due to the synchronized global growth, governments enforcing minimum wage structures immediately rather than gradually, increased asset prices especially for real estate and stocks, increased commodity prices and increased taxes.

At some point, the higher rates will start cutting into asset purchases such as housing and equities. Higher mortgage rates (as mentioned above) will impact homeowner affordability while higher interest rates compete against equities. Chart 2 shows that the 2-year treasury yield has surpassed the S&P 500 yield on equities for the first time since the credit crisis. As the gap widens, the incentive to own bonds instead of stocks grows. This is one of the reasons that the global stock markets have been dropping with the Dow Jones posting its largest-ever point decline on record and having corrected by 10% at the low point from its recent highs (all within under a week).

Chart 2



We would like to close with a brief commentary about the recent market events in early February. Our view is this is a market correction, and while we've had a precipitous drop in the Indices and we believe that the markets will continue to have extreme volatility in the short term, the recovery will be more of a bathtub shape than a V-shape. We remain invested and we have been selective buyers of companies that provide growth revenues and earnings, and via our proprietary investment model, have the opportunity to provide investors with meaningful capital appreciation.

And once again, we've been able to write to you without discussing Bitcoin or cannabis stock price highs!

CANADIAN FACTS

Kitchener, Ontario garbage man Nyle Ludolph was troubled by the vast amounts of waste he saw every day and he asked the question "Can't we do this a better way?" His answer came in the form of a simple blue box when he championed the world's first municipal curb-side recycling program in 1983.

*Adapted from

Ingenious - How Canadian Innovators Made the World Smarter, Smaller, Kinder, Safer, Healthier, Wealthier, and Happier, by David Johnston & Tom Jenkins

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