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Strategic Outlook, July 2016

It is with pleasure that I welcome my colleague, Julia Ainsworth, to the production of this biannual commentary. Since last September, Julia has actively participated in our research efforts and I am convinced that her contribution will add value to readers.

Laurent Wermenlinger

Portfolio Insight

2016 kicked off with a great deal of volatility and fear in financial markets. Factors which contributed to this situation included central bank interest rate policies, Chinese economic instability, and oil prices. Since mid-February, markets have been in a rising trend with hiccups along the way.

Fears were subsiding and global markets were calmer until mid-June whereupon the attention of the world was drawn to the United Kingdom referendum and the resulting decision (“Brexit”) to abdicate its membership in the European Union (EU).

Our previous *Strategic Outlook* announced our transition from a growth stance to one focused on capital preservation. This was accomplished from late 2015 to early January 2016, a period which involved major changes to achieve a more defensive portfolio. These decisions cushioned the portfolio against the subsequent market declines; however, performance has lagged since global markets began their recovery.

Central banks continue to dominate global economic policy and other significant headwinds persist; these problems are unlikely to be resolved in the short-term. In light of this, our goal to reduce risk while still participating in global markets remains unchanged. Our primary objectives are:

1) Capital preservation;
2) Increased portfolio diversification;
3) Opportunistic deployment of cash.

The above goals are being met by higher cash balances, insurance-like instruments (i.e. currency hedges, real return bonds, gold), asset class diversification (i.e. infrastructure, real estate), investments with an income stream, and maintaining the flexibility to rapidly deploy cash as opportunities arise.

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Macroeconomic Themes & Portfolio Applications

In the previous *Strategic Outlook*, we discussed the prevailing themes which could impact investors in 2016. Particular emphasis was placed on the rationale and impact of central bank policies. The following is a continuation of that discussion in which we outline current prominent themes and how they are impacting investment decisions.

Central Bank Policies

Since the 2008 financial crisis, global central banks have been highly accommodative in supporting financial assets, hoping that this would translate into growth in the real economy. In fact, in June 2014 the European Central Bank lowered interest rates so much that they were negative. The Japanese central bank followed suit in early 2016, a decision which shocked global markets in part because negative rates are often viewed as an act of desperation. The intention of negative interest rates is to stimulate credit growth since consumers can borrow at low rates and banks are incentivized to lend. Additionally, low rates can weaken a currency and consequently improve that country's exports. Negative interest rate policy is a new experiment and there is a great deal of uncertainty as to how long a capitalistic system can function under these conditions.

Central bank policies have played an important and critical role in the aftermath of the global financial crisis, but there is a limit as to how long monetary policy should dominate. It is critical that governments take the lead via budgetary policies which directly stimulate economic growth. The level of risk and uncertainty associated with a situation controlled by central banks are too high for the potential reward. As such, we are unlikely to revise our defensive posture until we see major global central banks pass the baton to governments.

China

The Chinese economy does not necessarily need to have a crisis in order to impact global markets. As the world's second largest economy, its problems reverberate rapidly. Chinese policymakers have been attempting to transition to a consumer-driven economy for many years, following a model which has been successful for other countries in the past. There are obstacles to their progression such as high private sector debt, low-consumption, and powerful vested interests. Within this context it will be a balancing act for the government to wean the economy from its debt dependence without excessively hurting economic growth. The Chinese government has pursued aggressive stimulus and

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fiscal policies to provide economic stability and this is likely to continue; however, it will be a bumpy path.

We consider that it is essential to invest in China, given that it is one of the major drivers of the global economy. However, in order to be consistent with our overall macro economic concerns, in early January we reduced the allocation of the portfolio to China as a precaution. Going forward, we will regularly review this posture with the intent to increase our holdings as we feel comfortable that an acceptable level of stability has been reached. Given that China will require many years to reach their goals, it is unlikely that the portfolio exposure will be high in the near-term.

Oil

Oil prices have been in a downward trend since mid-2014. This has largely been due to oversupply and an inability of the members of the Organization of the Petroleum Exporting Countries (OPEC) to cooperate. Crude oil prices have improved since hitting a low of around $26 per barrel in February 2016 and are now hovering around the $50 mark, which is still unprofitable for many producers. The progress is partially explained by a reduction in supply, although substantial oversupply lingers. Commodity-exporting countries, like Canada and many emerging markets, are the most sensitive to changes in the price of oil.

For the past year, we have been favouring countries who are net-importers of commodities. They stand to benefit from cheaper prices and are less affected when prices suddenly drop. For example, we have favoured countries like Japan and India over Canada. In general, we are careful with our allocation to the energy sector due to its high correlation with the Canadian dollar, a currency to which we have a high degree of exposure.

Brexit

The decision of the U.K. to revoke membership in the largest global trading bloc is bound to cause concern and uncertainty. Uncertainty is found at all levels: U.K. economy (5th largest in the world), EU economy, consequences for emerging markets and other trading partners, process of exit (has never been done before), potential for other EU members to exit, political instability across the U.K. – especially with respect to Scotland and Northern Ireland, and even peace. Financial markets do not like elevated levels of uncertainty and, accordingly, they swiftly plunged following the results of the referendum.

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Beyond a period of uncertainty and its associated market volatility, we do not expect that Brexit will cause a global crisis. It is in the interests of all parties to negotiate a smooth exit for the U.K. and maintain mutually advantageous trading relationships going forward. We are taking advantage of market volatility to diversify the portfolio's holdings and purchase quality assets which have suffered price declines.

Conclusion

The path forward is likely to face more bumps, curves, and roadblocks than what we have experienced in the past few years. Despite this, it is possible that the status quo of central bank policies, low growth, and low inflation continues for quite some time without a major crisis.

Our defensive posture may lead to underperformance if markets advance. Given that our key guiding principle is the preservation of our clients' capital, it follows that investment decisions must be mindful of the current elevated level of global macro economic risks. Ultimately, acceptance of a potential sacrifice in positive returns is required to avoid exposing clients to excessive risk.

Our goal will be to focus on investments which improve diversification, generate income, and enhance portfolio stability. We will also take advantage of the flexibility achieved over the past few months, to capture opportunities which offer attractive risk/return profiles.