

# Market Commentary

## First Quarter 2018



### Harbour Fund Harbour Global Equity Corporate Class CI Canadian Investment Fund

The quantitative-easing induced haze that has characterized global capital markets for much of the last decade has cleared in jarring fashion. An era of extremely low volatility, in which markets trend in only one direction (up), seems to be over. Witness the wild gyrations in global markets over the first quarter of 2018. Equities went parabolic during January, with the MSCI World Index increasing almost 7%. This was followed by the sharpest sell-off witnessed in years that, in many cases, more than erased January's stellar gains.

Market commentators are struggling to articulate an easy-to-understand narrative to explain the wild market action, although the initial upswing was at least self-explanatory. Markets rejoiced alongside coincident indicators of global growth that included, among other things, buoyant manufacturing numbers, upward earnings revisions, steadily higher commodity prices, and U.S. tax cuts. The party ended abruptly on January 26 when a surprisingly strong U.S. wage reading led market participants to conclude that faster interest rate increases were in order. Higher rates mean higher borrowing costs, fewer share buybacks, less lucrative mergers and acquisitions (M&A), and higher discount rates (i.e.: lower valuations). In short, many things that propelled markets higher in recent years are less certain if the market assumes higher interest rates. Global stocks duly plummeted.

After this initial sell-off, markets settled and bounced throughout the month of February only to resume their decline in March, although the trigger this time around was different. Interest rates concerns gave way to fears of a global trade war led by U.S. President Donald Trump's imposition of Chinese tariffs. In addition, mega-tech woes compounded, with Facebook leading the way in terms of corporate misdeeds.

Against this "interesting" backdrop, Harbour Fund and CI Canadian Investment Fund, both Canadian-focused mandates, performed well, while the performance of Harbour Global Equity Fund was slightly challenged.

If we take a closer look at performance throughout the quarter, all Harbour equity funds performed well during the upmarket in January, were somewhat weak during the first sharp correction, and performed well during the second downdraft in March. The differing performance between the two sell-offs was the result of two factors. First, the U.S. dollar rallied during the first correction (as it often does during risk-off periods) but didn't do much during the second. Our bearish view on the U.S. dollar (and thus,

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our underweight) therefore hurt us during the first correction but was a non-factor during the second. The second reason for an improved experience were adjustments we made to the portfolios during the month of February. Risk was reduced somewhat in cyclical areas such as industrials and banks. Cash in turn increased (from already elevated levels).

Currently, the funds' posture is defensive, but not overly so. We carry a high level of cash, however our individual holdings are balanced between defensive sectors and pro-cyclical sectors such as machinery, and financials.

What then do we make of the downdraft? As hinted in the first several paragraphs, we believe that market participants are focused on the obvious headlines of the day (be it trade, Facebook, or something else) while there are in fact more powerful forces at work in the form of monetary tightening. Keep in mind, global central banks created more than \$14 trillion over the last nine years in the hope of avoiding a deflationary outcome post credit crisis.

While the goal of avoiding deflation was indeed accomplished, it would be naïve, in our opinion, to believe that this amount of financial "medicine" could be administered without some unintended side effects. Extraordinary liquidity in financial markets typically results in misallocation of capital in the real economy, the most recent example of course being the U.S. housing bubble of the last cycle. Where did the excess liquidity go this time? Where are the distortions in the real world?

The excesses in my opinion are hiding in plain sight. Excess liquidity drained into the stock market in the form of share buybacks, M&A, and financially engineered products such as ETFs. U.S. corporations, for example, bought back an astonishing \$4 trillion worth of their own shares thus boosting earnings per share. On the flipside however, the U.S. stock of capital equipment was allowed to age and now stands as the oldest on record. In other words, U.S. corporations used cheap debt to buy more of their existing capital stock as opposed to re-investing into their business. An argument can therefore be made that corporations have borrowed from the future and earnings have been artificially inflated.

Now, global money supply is tightening. The U.S. Federal Reserve is in the process of shrinking its balance sheet (ie: selling the bonds that it bought with printed money back to the market). Money is therefore being sucked out of the system. While the European Central Bank is still in money-printing mode, they are doing so at a slowing pace and will likely start to outright withdraw liquidity some time in 2019.

What are the consequences of this monetary contraction? I'm not exactly sure. Although, if we can agree that printing \$14 trillion probably benefited the stock market one way or the other, that when money is sucked back out of the system there might be negative consequences to capital markets.

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Is that what we are witnessing in today's volatile environment? Or is this period no more than an overdue correction in a strong bull market? A healthy shakeout that will reset valuations at a more reasonable level on which asset prices can resume their steady march upward? The real economy is still doing very well. In fact, you would never know what is happening in financial markets by speaking with corporate executives around the world who are (at least today) saying profits are strong and business is booming.

No doubt, we will have to wait a while to understand what exactly is going on at this moment. In the fog of confusing market action one can only, at best, make an informed guess as to what is unfolding.

While most of the commentary this month is of a macro nature, the fact is that we spend most of our days at Harbour doing bottom up, company-specific research. We have a healthy respect for what "might" be happening in capital markets today which is why we are proceeding with a high degree of caution. But that is not stopping us from buying solid companies trading at reasonable prices.

Perhaps not surprisingly, our favourite investments these days are those which do not have some large macro factor that will drive the fortunes of the company. An example of this is our recently added US Foods.

US Foods is the second largest U.S. distributor of food to restaurants, hotels, golf courses, senior's homes, and pretty much any other entity that serves food off a menu. As you can imagine, people eating food is fairly detached from most macro indicators. Powerful idiosyncratic trends underpin our investment thesis. Demographic trends (millennials eating out more), margin improvement, and a huge M&A opportunity are just a few of the factors that we believe will benefit US Foods in the coming years.

There are several other fantastic companies that we have been buying throughout this correction. In most situations, however, we are still in accumulation mode so we will delay discussing them until the next update. We have lots of cash and have been waiting a long time for the opportunity to buy great companies at decent prices. In most cases, those prices have not quite materialized, but we are certainly a lot closer today than we were on January 25. In the meantime, we will take our time and deploy our cash carefully through this volatile period.

Thank you for your continued support.

*Ryan Fitzgerald, CFA*  
*Senior Portfolio Manager*

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<b>Class F Returns (in %) as at March 31, 2018</b>	<b>Year-to- date</b>	<b>1 year</b>	<b>3 year</b>	<b>5 year</b>	<b>10 year</b>
Harbour Fund	-3.3	-0.8	-1.0	3.0	3.0
Harbour Global Equity Corporate Class	0.2	2.7	1.6	7.6	5.0
CI Canadian Investment Fund	-2.5	2.2	4.2	8.3	5.4

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