

# Market Commentary

## Fourth Quarter 2017



### Harbour Fund Harbour Global Equity Corporate Class

Is it possible for government central planners to design a system that consistently produces the desired economic outcome? China comes to mind as having an uncanny ability to do just this, evidenced by its ability to predict, with precision, the future GDP growth rate of its sprawling economy. Then again, most suspect that there is some sort of accounting slight-of-hand when it comes to China's GDP reporting.

Can the developed world accomplish such a feat? "Probably not," conventional wisdom would say, after all, market-based economies are best left alone to sort out the specifics of supply, demand, prices, and yields. Modern day central bankers, however, do not seem predisposed to "conventional wisdom" and so proceeded, post the financial crisis in 2008-09, to orchestrate the largest ever monetary intervention. It is hard to argue with the result as one must strain to remember the last time the global economy was on the firm footing that it finds itself today. Signs are everywhere that economies are accelerating, indeed a strange phenomenon considering the recovery began over nine years ago. Shouldn't we be at a point in the cycle when economies are growing tired and prone to slow down? In this context, is it possible that quantitative easing actually worked?

For those who do not wake up every day thinking about the obscure world of central banking, a short review of the happenings in the world of money is as follows. With simple keystrokes, central bank wizards have created approximately US\$14 trillion since the end of the financial crisis. This newly created, out-of-thin-air money was injected into financial systems through the purchase of bonds (or, in the case of Japan, also the purchase of the stock market). Not surprisingly, this new buyer, with infinitely deep pockets, forced the price of said bonds up, or conversely, yields down. Depressed borrowing rates across the globe was the desired (and accomplished) outcome with the idea that consumers and corporations would re-leverage themselves and boost economic growth.

Displaced bond investors who could no longer earn an acceptable return fled to other asset classes, such as stocks and commercial real estate, thereby inflating those prices too. Corporate executives (especially in the U.S.) fell into line and did their part by borrowing almost-free money to repurchase their own stock thereby inflating earnings per share. This was a key reason that U.S. corporate earnings growth outstripped sluggish GDP growth in recent years.

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This activity helped propel the prices of stocks, bonds, real estate, Da Vinci artwork, and just about everything else to new highs. What is real and what is not real in such a manipulated market structure? Was it central bank manipulation that sent prices to all-time highs? Or did prices recover all by themselves, as you would expect from such lowly lows that were reached in March 2009? The answer is probably both, so it is up to the academics to argue the extent to which central banks influenced this record-setting bull market.

Harbour listens to these academic arguments with interest but does not dwell on unknowns. We strive to be aware of the macro setting as opposed to predicting it. Otherwise, we focus day to day on finding good companies with solid balance sheets and trustworthy management teams – those that can weather a variety of economic conditions.

On that note, the Harbour equity funds had an up and down year (in that order). We made excellent progress restructuring the portfolios in 2016 and the results were on display during the first half of the year with strong performance from both Harbour Fund and Harbour Global Equity Corporate Class despite conservative stock holdings and cash levels approximating 15%. Key contributors during the period were large technology holdings such as Oracle, Symantec and Mobileye, Canadian hard asset manager, Brookfield Asset Management, and (in the global fund) German warehouse automation supplier, Kion Group.

Also on the positive side, our bearish view on the U.S. dollar (in part related to the previously mentioned monetary debauchery) continued to play out, so our elevated hedges throughout the year protected a substantial portion of our U.S. holdings. This contributed to performance in Harbour Global Equity Corporate Class since our benchmark is completely unhedged. In Harbour Fund, while the U.S.-dollar hedges were even higher than on the global side, currency still detracted a small amount from relative performance against the Canadian-dollar-denominated Toronto Stock Exchange.

The third and fourth quarter were more challenging. As global markets staged a good updraft, the Harbour equity funds were held back by several detractors. The aforementioned Oracle and Symantec reported somewhat soft quarters, triggering declines. In both cases, the companies are still held in the funds and are favoured long-term holdings. Real estate company, Colony Northstar, one of our more idiosyncratic investments, also detracted from performance as bond yields started moving higher, creating a headwind for interest rate sensitive sectors. Finally, in Harbour Global Equity Corporate Class, lodging company Extended Stay suffered a drawdown due to missteps in its California region.

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In all cases described above we strongly feel that company fundamentals are on track and our long-term theses stand in good order. It is disappointing that the short-term hiccups were timed against the backdrop of a strong market. In the case of Extended Stay for example, management recently guided market expectations higher citing a rectification of its third quarter operating challenges. The stock recovered well over half its losses, although it did not completely make up lost ground before the end of 2017.

Finally, our conservative positioning began to catch up with us as the year wore on. In a world where all asset prices are rich, cash is one of the few remaining ways to hedge against unforeseen market events. We held a lot of cash throughout the year and continue to do so even as the global economy accelerates.

Valuations are high and bargains are difficult to come by. Low hanging fruit was picked a long time ago and the difference between “good value” and “value trap” is increasingly obscure. Yes, it is true, the U.S. appears to be breaking out of its 2% GDP funk with two consecutive quarterly readings above 3%. Housing, autos and the consumer are strong, and S&P earnings keep revising up. Europe is doing well and most emerging markets are recovering from the depths of their 2015-2016 slowdown.

It seems increasingly difficult for the market to construct a bearish narrative. Recall how low inflation and low growth were for years described as a goldilocks scenario for stocks since zero inflation and zero-bound rates enabled corporate earnings to be leveraged higher. Now we are in a period of accelerating growth, rising rates and perhaps rising inflation. This too is a goldilocks scenario that is described as “reflation” and is also a boon to stocks, especially those of the banking and commodity variety.

At Harbour, constructing a bearish narrative is not quite as challenging. It’s not that we don’t enjoy a party as much as the next chart-toting Chartered Financial Analyst, it’s just that we strive to manage money conservatively and thus spend additional time thinking about how things might go wrong. While we do our bottom-up work on high-quality prospective investments, in the back of our minds is the possibility that things might not be quite as they seem.

To this point, it is only the U.S. Federal Reserve that has begun the process of withdrawing a fraction of the money it created. Other central banks continue to print, so global money supply continues to grow. Against the backdrop of an already strong global economy, money printing is

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akin to throwing gasoline on an already large fire. The key question that market participants continue to ignore is, “What happens when the gasoline runs out? Does the fire keep going by itself?” This question will be answered in time as the European and Japanese Central Banks begin their quantitative easing wind downs and the Fed slowly increases its bond selling.

In the meantime, for advisors and investors who are looking for equity exposure but are weary of putting capital to work nine years into a bull market, we would encourage them to take a look at the Harbour funds.

Thank you for your continued support.

*Ryan Fitzgerald, CFA*  
*Senior Portfolio Manager*

<b>Class F Returns (in %) as at December 31, 2017</b>	<b>Year-to- date</b>	<b>1 year</b>	<b>3 year</b>	<b>5 year</b>	<b>10 year</b>
Harbour Fund	7.0	7.0	1.2	4.6	3.2
Harbour Global Equity Corporate Class	9.4	9.4	4.2	9.7	4.5

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