Market Commentary
Second Quarter 2018

HARBOUR ADVISORS

Sentry Global Monthly Income Fund

Performance summary

- In the second quarter of 2018, the fund returned 2.1%. An overweight allocation and stock selection in the financial sector added to performance. Stock selection in consumer staples detracted from performance during the period. The fund's fixed-income selection was a primary contributor to performance during the quarter.

Contributors to performance

- **BP** was a notable contributor to fund performance during the second quarter. BP is an oil and gas exploration and production company, operating globally. During the quarter, BP benefited from rising Brent oil prices, which climbed 13%. BP's financial performance is more sensitive to oil prices than others, as it has higher cash commitments including its ~5.4% dividend and its paydown of debt. Further, the company is getting closer to an inflection in free cash flow over the next few years, as Macondo costs start to decline and the company returns to growth. BP provided a total return of roughly 22% during the quarter.

- Another notable contributor to performance over the period was **Safran**. Safran supplies aerospace and defense systems to both commercial and government clients. The company is also joint venture partners with GE, in CFM International, which is the world's largest supplier of jet engines for commercial airplanes. The company is amid a ramp up in production of its new LEAP commercial jet engine. This ramp up is going much better than its competitors ramp up on a competing engine. This should bode well for further market share gains and reduce anxiety from investors on potential risks in the ramp up process. The company is also seeing strength in its aftermarket business, as flight hours continue to grow globally. The stock was up roughly 23% during the quarter.

- **Other notable contributors:** Royal Dutch Shell, UnitedHealth Group, Microsoft, Visa, Rio Tinto and Kennedy-Wilson

Detractors from performance

- **General Dynamics** was a notable detractor from performance during the second quarter. General Dynamics is a diversified defense contractor and a leading supplier of business jets. In general, the defense sector was weak across the board, as positioning was crowded in these names into the quarter. Nothing fundamental changed with the sector thesis during the quarter. For General Dynamics though, a component of the weakness comes from the company's business jet exposure, a unique exposure where its other defense peers don't compete. This business is currently ramping up production of its new Gulfstream jet, where investors are worried about margins and competition from other players. Further, this part of the business could see weakness if global growth slows. Therefore, the market is taking a wait-and-see approach. The stock was down roughly 15% during the quarter.

- Another notable detractor from performance was **ING Group**. ING is a bank with operations across Western Europe. ING's underperformance was driven by uncertainty in Europe post the elections in Italy. These uncertainties, drove expectations for lower growth in Europe, putting pressure on European financials. Further, global trade concerns weighed on European banks, as the majority of European nations are export oriented. ING Group was down 7% on a total return basis during the quarter.
- **Other notable detractors:** Sensata Technologies, Millicom, Neo Performance Materials and Danske Bank.

Portfolio commentary

At Harbour, we are conservative investors and we invest in a prudent, diversified manner, not putting all of our eggs in one basket. For each of our funds, this includes security, sector and geographic diversification, and portfolios that include a combination of pro-cyclical and defensive securities. Our investee companies are selected for their individual merits, and our investment horizon is measured in years, not months. By definition, we have high active share – meaning that our funds do not look like an index, and as such, of course, don't perform like an index. As our primary mission is to protect capital and to grow it prudently, often we err on the side of conservatism and risk avoidance. Periods such as this past quarter, where the noise and volatility are loud are often those in which we are out of step with the market around us, and this period was no exception. Growth stocks beat value stocks, high-yield bonds beat investment-grade bonds, and long-term investment theses took a back seat to short term sentiment. To our view, not making money, and permanent loss of capital are not the same thing. We worry about cost, not opportunity cost.

- Names eliminated include: Barrick Gold, Caterpillar, Siemens Healthineers, Danske Bank and Henkel
- New names introduced include: Baidu, Philip Morris, S&P Global and Apple

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The second quarter of 2018 was marked by divergence – divergence in asset class performance, divergence in investor expectations, and mostly, divergence in the narrative that investors had been using as their guidebook until now.

Coming into 2018, the accepted view was that the world was enjoying global synchronous growth and that after a period since the financial crisis in which the United States offered the best returns in equity, debt and currency markets, there were now many more – and often cheaper – options for investors. This had created an environment in which capital fanned out around the world, seeking better returns in Europe, Asia and emerging markets. Global stock markets enjoyed a steady run from the lows in early 2016 to late January 2018, but when markets corrected in February, the tone started to change. The S&P 500 Index corrected 10% from its January peak, and five months later has yet to reclaim that level. Most global markets are churning sideways and, outside of the Nasdaq, most of the global stock exchanges have generated little in the way of return thus far this year.

There have been many culprits, but two factors seem to be dominating the minds of investors. The first is that global liquidity likely peaked in January, and after a decade of easy money, we are now in a global tightening cycle, removing the oxygen that asset values breathe. The second is that increasingly volatile trade rhetoric voiced by U.S. President Donald Trump's administration, now embroiled in trade disputes with all of America's major trading partners at the same time, has become a scenario that investors are having difficulty deciphering.

The result is that there has been a divergence between investor sentiment and the current business reality. In their quarterly commentaries, corporations are reporting that operating conditions are favourable, yet investors are skeptical – effectively driving up the equity risk premium. Those investment themes linked to global growth (primarily industrials and commodities) have suffered as investors fretted that the trade rhetoric would lead to growth-damaging tariff policies, and emerging markets sold off 10% as the trade-weighted U.S. dollar strengthened 5% in the quarter. All of a sudden, growth everywhere outside the U.S. looked less of a sure thing as either the tighter liquidity imposed by the rising U.S. dollar or the possible trade-related growth slowdown caused stocks in many markets to de-rate. Bucking the trend were U.S. domestic consumption names, large cap U.S. technology companies, and the energy and utility sectors. Broadly speaking, investors have once again become more conformable investing in the United States – and to companies not exposed outside the country, in favoured momentum growth names, and in interest sensitives like utilities that would benefit in a risk-off, slowing global environment.

The dollar, as always, is relevant as a barometer and arbiter of global growth. A hawkish U.S. Federal Reserve and a protectionist administration are reinforcing U.S. dollar strength. This remains problematic in a world that is largely run on dollars. Asian borrowers have added $10

trillion in debt since 2009, much of it borrowed in U.S. dollars. As the dollar strengthens – from rising U.S. rates, growing protectionism and capital repatriation – borrowing costs increase in much of the world and crowd out growth. This is why we have seen weakness in commodities and considerable volatility in non-U.S. markets. The two $64,000 questions for the balance of this year are 1) will the Trump trade rhetoric have as much bite as it has bark, and 2) will the Fed maintain a tightening profile if there are adverse consequences globally from the liquidity reduction? A "yes" to either or both of those questions would be incrementally negative to stock prices at the margin.

Our two cents? Inflation remains low but as the U.S. economy approaches full employment, we will need to see productivity growth to offset wage inflation or the Fed will be pressured to keep raising interest rates. Whether companies will invest in productivity enhancing capital remains to be seen – to this point they have a declared preference for debt reduction, buybacks and mergers and acquisitions before they think about capital investment. The trade rhetoric is disruptive, and irrespective of whether larger and broader tariffs are implemented, we imagine that there is already an effect on the pace of business investment. It is very difficult as a CEO outside of the United States to consider investing in new capacity if you don't know what the terms of trade are going to be with one of your biggest global customers. As long as there is uncertainty around those terms, there will be an overhang that will cause companies to defer spending, and that could cause growth to slow among America's trading partners, further reinforcing dollar strength. It is also important to remember that we are almost a decade into the cycle and stocks are no longer as cheap as they once were. Corporate buybacks are at record levels and tax changes are driving a big part of the earnings beat. Typically, when a company beats earnings based on tax changes and stock buybacks, analysts call that a "low quality beat." Strangely, we don't hear that expression anywhere these days. According to one of Warren Buffett's favorite indicators, market cap to GDP, U.S. stocks are at their second highest valuation level ever, and very close to their 2000 peak – this coming at a time when two-year treasuries (risk-free short-term money) now yield more than the S&P 500 Index dividend yield. Suffice to say, we are not all-in equity bulls.

Class F Returns (in %) as at June 30, 2018	**Year-to-date**	**1 year**	**3 year**	**5 year**	**Since inception (6/7/2013)**
Sentry Monthly Global Income Fund	1.2	4.0	4.5	9.2	9.3

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