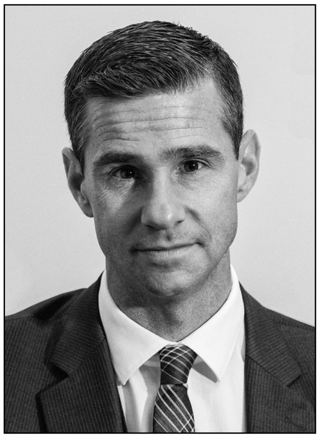
# Portfolio Management Commentary

Quarter Ending September 30, 2017



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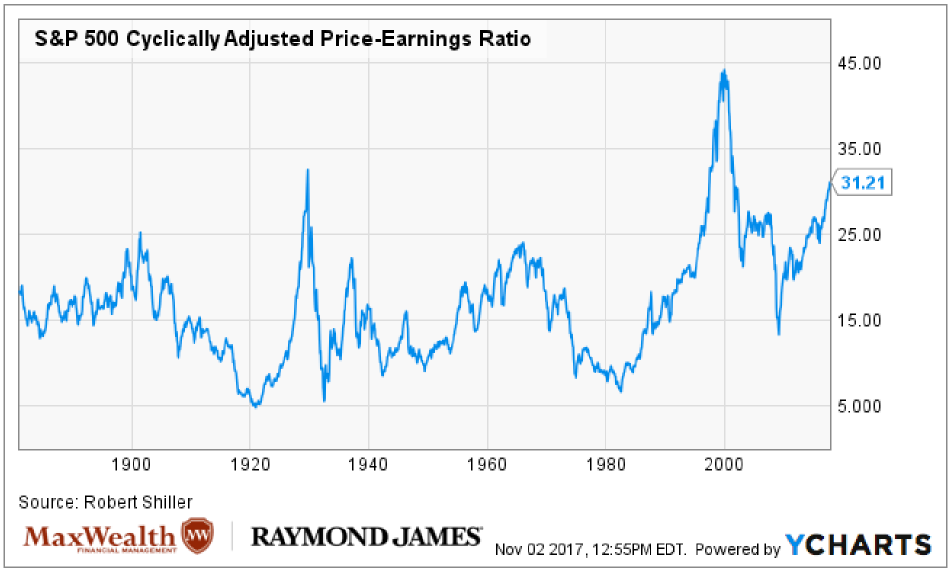
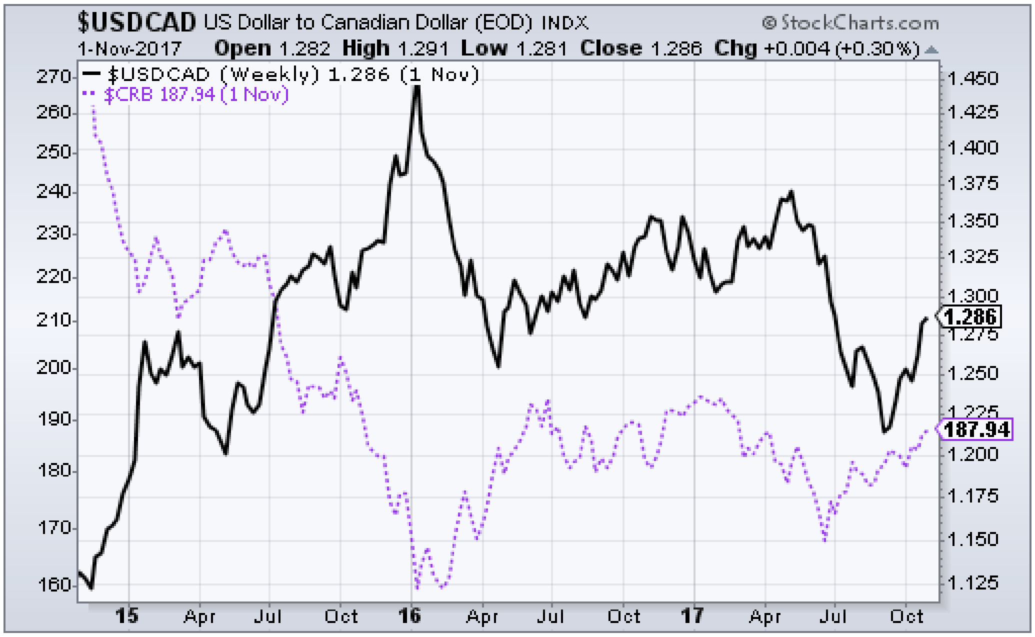
Here is a quick recap of the quarter. North American indices rallied in the wake of an increasing "wall of worry" and a period of seasonal weakness. Ongoing political tensions in the US and the threat of global military conflict could not derail the path of equity returns for the quarter. Clearly, the internal energy of the equity markets was not used up, and a lack of viable options in competing investments, provided the necessary backdrop for a continued bull run. So where does that leave us now? Many are worried that key valuation levels in the US markets are stretched into bubble territory and that a great deal of caution is warranted. I tend to agree, and I would like to draw your attention to the following chart.




What this chart illustrates is that when we normalize earnings by time and inflation for the S&P500, we are substantially above the historical norm of 16.80 dating back to 1881. Critical levels in the past were met with market sell offs, as in the late 1920's, and in the Dotcom bubble of 1999-2000. At the current print of 31.21, we are approaching extreme levels of overvaluation based on this methodology. So, should we sell everything and sit in cash in order to sidestep the calamities of the past? No. Markets can be expensive for years and prices can continue to rally. You would have missed out on most of the post-financial crisis rally since 2009, if you would have used valuation as your only metric. Also, Canadian markets do not show this level of overvaluation because of the exposure to Energy, Basic Materials, and Financial Services. My suggestion is to be cautiously optimistic for the 4th quarter, but with a keen eye on managing risk. Investors will not pay higher prices forever.

Foreign exchange was rather dramatic in the past quarter for the Canadian dollar. I think the visual chart below provides an interesting perspective. Firstly, the USD did stabilize after plunging to a low of nearly 1.20 in early September. Two back-to-back rate increases by the Bank of Canada and a $10 increase in the price of Crude oil lit a fire under the CAD. Based on the latest $USDCAD cross rate, the momentum looks to be continuing as we approach the 1.30 mark mentioned in last quarter's commentary. I maintain a neutral weighting on USDs in the portfolios.




Source: Stockcharts.com

We look again to a technical review of the major markets. First up is the S&P 500. As you can see the index continues its steep ascent since November of 2016. We are still comfortably in an uptrend.


Source: Stockcharts.com

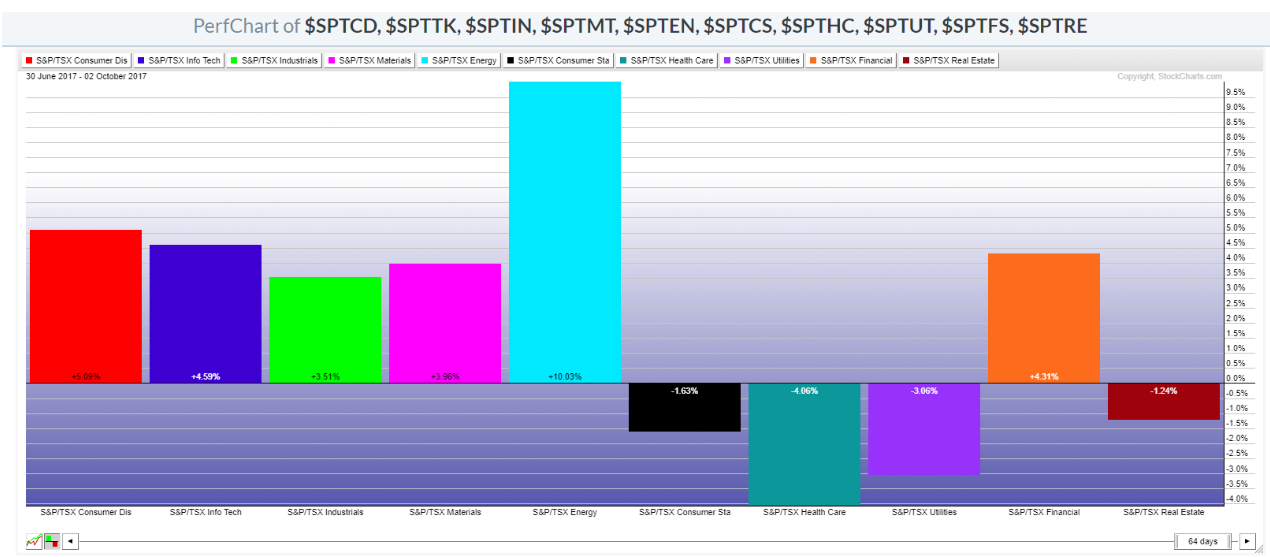
The 14-week RSI reading of 74+ indicates an overbought condition for the index, so maybe buying pressure is waning. Price support levels come in around 2480 and then again at 2420. For perspective, if the index were to retreat to these levels it would be a decline of 4%-6.5% based on current prices.

The TSX showed a dramatic increase in the month of September right after it put in its yearly lows. Since then it has been on a tear as it finally closed above the dreaded 16,000 level on Halloween.


Source: Stockcharts.com

As mentioned in other communications, 16,000 represents a very significant technical hurdle which could lead to auspicious gains to the upside. I would not be surprised to see the index flirt with this level for a while as a consolidation of buying pressure occurs. The TSX has moved up quite quickly over a short period of time. This type of market behaviour is often accompanied by mean reverting trades.

One interesting way to see the strength of the underlying market, in our case the TSX, is to drill down into the sector performance on an absolute basis. Clearly, the 3rd quarter favoured energy, consumer discretionary, and financial stocks while the defensive sectors: consumer staples, health care, real estate, and utilities detracted from performance. Careful attention should be paid to the leading and lagging sectors because they show us where fund flows and smart money congregate. In the past 3 months the bet was on risk assets.



# Your Portfolio

The 3rd quarter of 2017 provided modest gains for all managed portfolios as Canadian equities posted a September rally, the $USD climbed, and international crisis was averted. Our patience was rewarded as we maintained our positioning and price appreciation occurred for most of the portfolio positions. As anticipated, inter-security volatility was high, but broad market volatility remained low as evidenced in the relatively low levels of the $VIX. As a fresher, the $VIX is the implied market volatility of the S&P 500. When it is low the perceived risk is low. Coincidently, it is at the lowest levels since the index began in the early 1990's. Some argue that this is positive for markets. Others argue that this is a contrary indicator expressing risk amnesia. Regardless, the level is very low and subject to some form of mean reversion.

Activity in the portfolios was light for the quarter. A notable change was the sale of Foot Locker (FL) and the subsequent purchase of Home Depot (HD). Clearly, FL did not work out as an investment thesis. The small earnings miss in the Spring turned into a bigger problem in the Summer. Even though the financials and valuation of FL paint a compelling picture, it is clear that the creative destruction caused by online retailers is changing the environment for box retailers. I am not sure how Foot Locker can survive. Home Depot, on the other hand, is an example of business that does not have an online competitor. Contractors, DIY enthusiasts, and gardeners typically want physical contact with the goods they buy. Maybe this will change in the future, but for now, HD represents the consumers choice.

# Final Thoughts

As we enter the final quarter of the year, statistics would argue that we are in the most productive timeframe for equity returns. Cleary the markets want to go higher and their uptrends are in tact. But as mentioned earlier, I caution that a correction may be on the horizon. This should not be looked upon with dread, however, as we have some cash reserves available to take advantage of a sell off. The truth is we never know when the next correction will occur. Nor do we know the magnitude of that correction before it occurs. All we can really do is to adapt to the changing market environment with an eye towards return, but return not in isolation of the risk taken. As always, I wish you the best for the upcoming quarter.