Volatility is Back!

A. Market Update – First Quarter Review

Volatility finally returned to the stock market in the first quarter. After a 20% gain in 2017 (US markets), the S&P 500 rose another 7% in the first three weeks in January, before declining more than 10% over the next two weeks. Then over the next month the Index rose 8%, before losing 7% over a two week period in mid-March. After all these ups and downs, stocks finished down by approximately 1% for the quarter in the US and by 5% in Canada.

The Volatility Index, which had been trading at record lows for an extended period, settling in at near all-time low around 10 for most of the past year, spiked to 37 in February. Over the past five years, this level has only been reached once, in 2015. Exciting swings in the stock market are back! While swings in the market tend to unnerve the average investor, it increases our excitement as more opportunities emerge.

While it is often hazardous to attempt to explain market moves, it is fair to argue that the leading reason for the quick and rapid drop in February was concerns over inflation, rekindled by accelerating wage growth in the US. This shift in perception might signal that the economy has turned a corner and will require much higher interest rates! As we have discussed many times, when interest rates begin climbing they will inevitably have a dampening impact on the value of all assets, including financial assets, such as stocks and bonds. This means that we need to proceed cautiously and only invest in high quality businesses at the very best prices.

The volatility in March was likely influenced by the change in US trade policy. In our minds, President Trump is very serious about shrinking the US trade deficit and reordering current global trading relationships. This is a topic that President Trump had been discussing in public for more than 30 years, long before he became the US president. To think that he is not serious about this issue is very naïve. Too many commentators have dismissed his words as negotiating tactics, but his feelings on the subject are authentic and he has surrounded himself with advisers that share his view. It is important to note that his top economic adviser, Gary Cohn, who opposed tariffs, resigned in March after he failed to change the President's mind. Shortly thereafter, the President announced the imposition of import taxes on steel and aluminum.

The whole area of "fair trade" built on the back of free trade is an important issue. But the reality is, contrary to all the hype in the mainstream media, there is no such thing as free trade when it comes to the global economy! It is more appropriate to refer to global trade as "managed trade" or "negotiated trade". The problem with this negotiated trade is that many developing countries, such as China, have been given preferential treatment! This has allowed them to take advantage of countries through limiting access to their markets, while demanding full access to global markets, particularly the large Western economies. This does not even begin to deal with the whole area of intellectual property theft, which some economists estimate is valued in the hundreds of billions of dollars each year.

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There are many reasons to support free and fair trade, if in fact it is free and reciprocal trade. First, free trade allows the global (and domestic) economy to grow at a faster rate, which should raise employment levels and lift incomes. Second, it helps to raise the standard of living for people around the world as capital is invested globally. This all assumes that the countries engaged in trading are also responsible countries. That responsibility needs to extend to the how they protect the environment, human capital and includes the protection of human rights and liberties. Trading with abusive countries that do not protect human rights, rape and pillage the environment and steal from companies (through excessive taxes and stealing intellectual property) operating in their country will not benefit the global economy but reinforce corrupt regimes, of which China is exhibit A. In this case it would be better to punish not reward countries that are using abusive tactics to gain a production edge.

How far will President Trump go remains uncertain. It is entirely possible that new trade rules will end up having a much more modest impact on the global economy and will not derail global growth. But the risk of a trade war has risen, and as investment managers we need to watch the situation carefully and respond accordingly.

One other noteworthy development during February and March was the weakness in the shares of several large tech companies. This was triggered by the revelation that a consulting firm used some of Facebook's data without their permission. Facebook lost approximately 15% of its market value in the wake of this news. The major issue on investors' minds is what the repercussions will be on the overall technology industry and in particular social media companies, who collect substantial personal data! It is quite likely that legislative changes will be made that could interfere negatively with some of the revenue models of various technology firms. Other technology stocks declined as well, because of fears over greater scrutiny of their business practices and given their already high valuations. For example, Alphabet (Google) and Amazon both lost approximately 10% of their value over a two week period during the month of March. We continue to selectively invest in the technology space and wild swings in the stock prices of great companies will not deter us from investing in them, providing their business models are intact and their ability to grow their respective cash flows continues unimpeded!

North American Equity Market Statistics

During the first quarter, the Canadian equity market decreased by approximately 5%, and over the last 12 months dropped by 1%. The Canadian market has been one of the worst performing equity markets in the developed world, over the past 10 years! Despite the underperformance, we have managed to generate reasonable returns, staying ahead of the overall market index by avoiding the worst performing stocks and minimizing our exposure to some of the underperforming sectors.

In the first quarter, only one sector in the S&P/TSX generated a positive rate of return; the information technology sector. It increased by 10.1%, spurred on by Constellation Software and Shopify. All other sectors in the S&P/TSX turned in negative returns. The sectors ranked from worst to best performing sectors were Healthcare (-13.7), Energy (-10.4%), Telecom (-7.7%), Utilities (-6.9%), Consumer Staples (-6.2%), Materials (-4.6%), Financials (-4.2%), Consumer Discretionary (-3.4%), Industrials (-3.0%) and Real Estate (-0.7%).

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Pertinent market action during the first quarter of 2018 and during the last 12 months is captured in the following table.

	March 31, 2017	Dec. 31, 2017	March 31, 2018	3 Month	1 Year Return
CAD/USD	$.7507	$0.7971	$0.7752	-2.75 %	+3.26 %
Oil WTI (US $)	$50.60	$60.42	$64.94	+7.48 %	+28.34 %
Gold (US $)	$1,249.20	$1,296.50	$1,325.47	+2.23 %	+6.11 %
Silver (US $)	$18.22	$16.86	$ 16.37	-2.90 %	-10.15 %
S&P/TSX	15,547	16,209	15,367	-5.20 %	-1.16 %
S&P 500	2,363	2,674	2,641	-1.23 %	+11.76 %
Cdn 10 yr	1.62%	2.04%	2.09%	+5 bps	+47 bps
US 10 yr	2.40%	2.40%	2.74%	+34 bps	+34 bps

One of the best performing assets year-to-date and over the past twelve months has been gold, while silver, another one of the precious metals, has been one of the worst performing assets. We learned a long time ago to never make short-term or even medium term predictions on the prices of any commodities, especially precious metals. We will simply point out what we believe to be the obvious; precious metals are quite inexpensive and well positioned to advance looking forward. Given the increasing level of inflation, the record levels of consumer, corporate and government debt, and the increasing trade concerns around the world, precious metals should be bid higher as the year progresses. We continue to own the world's leading royalty and streaming companies in the precious metals space. If the markets do the "wild thing" on the downside, these companies should do the "wild thing" on the upside! Because they are all growth companies, they should also continue to create long-term value, while protecting us from extreme volatility.

In the US, growth remains healthy and while fiscal stimulus runs the risk of eventually overheating the economy, it significantly reduces the risk of a recession this year. Key early warning indicators for the economy continue to paint a positive picture of the growth outlook. Consumer confidence is elevated, jobless claims remain low and job openings are the highest on record. House prices continue to rise and building permits for new homes are rising, though not at an obviously excessive pace. Business investment intentions are also strong, given recent tax changes.

The US Federal Reserve (Fed) appears to be increasingly confident that the US economy can withstand higher interest rates. In March, Fed members, under Jerome Powell's new leadership, revised up their expectations of the pace at which they will increase interest rates next year. The Fed's median expectation is now three rate rises in 2019 and they were only one member away from shifting their median expectation to four rate rises this year.

Until recently, the market was not convinced that there would be so much monetary tightening. Indeed, the market started the year expecting the Fed to raise interest rates only twice by the end of 2019. Since then, the market has shifted to price in two more rate rises over that period, explaining the rise in US government bond yields this quarter. If the Fed does end up tightening at the pace it expects, the bond market still has some catching-up to do, suggesting bond yields could still move higher.

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The key question is: what level of interest rates will start to weigh meaningfully on economic activity? Though this question is always difficult to assess in real time, we are increasingly monitoring areas of the economy that have seen an increase in leverage. We are particularly mindful of the fact that leverage in the corporate sector is high by historic standards and the corporate debt service ratio is rising. This could be the primary channel by which higher interest rates eventually pose a risk to the US economy, and by extension, to the global economy.

Despite the higher expectations for US interest rates, the US dollar has weakened, against a basket of global currencies, year-to-date. Markets have focused on the fact that the US will have to borrow more to finance its stimulus. This could cause the US to import more goods as a result of higher fiscal stimulus spending, and put downward pressure on the dollar.

Overall, despite the volatility, the outlook for global growth continues to look positive, with the removal of monetary policy accommodation still gradual. The road ahead will be bumpier, but that will also mean greater investment opportunities for those who are patient and welcome the volatility!

During the first quarter, the price of bonds continued to drop, with yields on both the 10-year government bonds in Canada and the US increasing by 5 and 34 basis points respectively. Year over year yields continued to climb, putting significant downward pressure on the values of bonds. When it comes to ROCKLINC, our investors are largely sheltered from the volatility in bond values, since we continue to invest in quality bonds with very short durations! While we watch to see how aggressive central banks will be in lifting interest rates, we continue to invest in short-term quality bonds for two reasons. First, they help dampen volatility in client portfolios. Second, all the fixed income (bonds) positions we own are liquid and can be sold quickly in the event the world's stock markets sell off, and we need some cash to take advantage of cheap equity prices! **The bottom line is that the level of debt around the world cannot withstand a major move in rates without bringing on a serious recession/depression in the global economy.**

B. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, in aggregate, across all our accounts, they were down 1.1% during the first quarter of 2018 and up 3.7% during the last 12 months (period ending March 31, 2018). Our average annual compound rate of return over the past 3 and 5 years is clocking in at approximately 5% and 7% respectively. These returns are after all fees. These returns are based on an asset mix of approximately 65% invested in equities with the remainder invested in short-term deposit accounts, bonds and preferred shares. This mix has varied over the past five years but in general we have averaged approximately 62-66% invested in equities. The performance we are discussing is our aggregate performance across all our accounts. Each client's portfolio is unique, and performance will vary, based on your risk tolerances and specific asset allocation.

When we dig further into our numbers, we find that our basket of equities actually decreased by 1.7% during the first quarter, but increased by approximately 6% during the past 12 months. Our equities have been compounding by approximately 11% per year, over

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the past 5 years. It is interesting to point out that there has been a significant difference in performance between Canadian and US equities. Over the past five years, our Canadian equities have been compounding at 8% per year, while our US equities have been growing at 16% per year! This underscores the greater investment opportunities outside Canada. We will continue to allocate money in global businesses and glean the benefit of global growth and diversification in your portfolios. Given the conservative nature of our portfolios, we are pleased with our progress, but are working hard to grow your portfolios even faster in the years ahead.

During the first quarter of 2018 our top holdings turned in the following performances. These 16 companies represent approximately 60% of our equity exposure, given the concentrated nature of our investing. All returns are in Canadian dollars.

1.	Brookfield Infrastructure	-3.5%
2.	Brookfield Renewable	-7.3%
3.	Franco-Nevada	-12.0%
4.	TD Financial	0.0%
5.	American Tower	+4.7%
6.	First Capital Realty	0.0%
7.	Ecolab	+4.7%
8.	American Water Works	-6.2%
9.	Becton Dickinson	+3.7%
10.	Nutrien (formerly Agrium)	-4.8%
11.	Google	+1.5%
12.	Honeywell	-2.2%
13.	CCL Industries	+12.0%
14.	Amazon	+25.5%
15.	Wheaton Precious Metals	-5.0%
16.	Input Capital	-4.0%

As you can see from the foregoing list, there was quite a divergence in performance across our top holdings. The most important factor we focus on, is the underlying performance of the business. In the case of each company we own, we are more than pleased with the operating performance of each business. We remain long-term owners in each company. Even if the scoreboard does not look great, it's the playing field that matters and eventually a great game played on the field, will be reflected in an amazing score!

For the time being, as long as the market is volatile, our focus is on first, selectively adding new companies as we come across new opportunities, second, pruning underperforming businesses and third, taking full advantage of market swings that provide us with the opportunity to buy one of our exceptional companies at a great price! Warren Buffett calls this swinging at "fat pitches".

Overall, we are off to a strong start in 2018. We have been able to hold our own and give up very little value, in the face of a volatile and negative market. We expect the challenges to remain for the foreseeable future and will continue to be vigilant in protecting your capital. As we have stated on previous occasions, it is not a time for complacency.

C. Company Update - Nutrien

We have owned Agrium throughout our client portfolios from the inception of Rocklinc in 2010. Recently Agrium merged with PotashCorp to form a new company called Nutrien. Putting these two companies together has created the world's largest provider of crop inputs and services. With the world's population expected to increase to 10 billion by 2050, and a general decline in quality arable land, the importance of producing quality food has never been greater. Looking ahead, the demand for increased food production efficiency will continue to grow in importance. Nutrien is in an excellent position to help the agricultural industry meet some of these long-term challenges.

The Nutrien business is divided into 2 main segments: Retail and Wholesale. The businesses within these two segments impact every stage of the agricultural cycle. During downturns in the agricultural cycle, they can enjoy the steadier and consistent revenues from the retail segment and during upswings in the agricultural cycle, they are positioned to participate in the high growth wholesale division.

In the retail segment, Nutrien is the largest agricultural retailer with branches spread across North America, South America and Australia. Leveraging its 1,500 locations, Nutrien distributes crop nutrients, protection products and seeds directly to farmers. The retail arm prizes its well-established relationship with farmers, which provides them with a strong, consistent and growing revenue stream along with access to sell its higher margin proprietary products. The Company enjoys a long run-way for growth as the retail market remains highly fragmented, allowing Nutrien to pursue both organic and 'roll-up' growth opportunities.

Nutrien's wholesale business produces and markets crop nutrients (nitrogen, phosphate, potash) critical in the crop production process. The business owns high quality reserves in stable regions, boasting one of the industry's lowest cost producers in all key markets. The recent merger with PotashCorp creates a $30 billon giant with substantial economies of scale (management expects $500 million in annual synergies) and a more diverse asset base to drive value.

Management remains cost conscious and shareholder focused. Nutrien has taken advantage of its large balance sheet and the weak ag market with disciplined cost management and capital allocation over the past several years, unlike many of its competitors. Several expansion projects that are nearing completion will create a large increase in free cash flows in the coming quarters, adding to the current leverage to nutrient prices.

From an investment perspective, Nutrien's preeminent positions in both the agricultural retail and wholesale markets, its strategically located and vertically integrated asset base and recent merger with PotashCorp cements its attractive investment prospects as they continue to provide the essential inputs to feed the global population. We remain long-term investors in the company and look to add to our positions over time, at the best prices.

D. Moving Forward – ROCKLINC Investment Portfolios

As we have explained many times, the market is manic-depressive! Given the current state of information flow, some "fake news" mixed in with some truth, we suspect the swings in the market might be even larger, than what we have been accustomed to in the past! Add to this, the non-traditional leadership style of President Trump and we have a perfect recipe for volatility! As investors, we must be prepared to take full advantage this volatility, or significant price swings.

Our basic strategy, which has not changed, continues to be summarized in the following six points!

1. Diversify across asset classes, sectors and geographic regions.

2. Invest in businesses with strong balance sheets, backed by hard/tangible assets.

3. Invest in firms that produce essential products and services, in growing industries with long-term secular growth trends well established.

4. Avoid/minimize highly leveraged financialized firms that have incomprehensible balance sheets, loaded with risky derivatives.

5. Keep high quality liquidity in portfolios, in order to take advantage of any extreme moves in the stock market.

6. Stay optimistic and opportunistic without being naive to the risks all around us. **It is not a time to be complacent, volatility is back, make sure you have some gold!**

If you have any questions pertaining to your account please call or email for an appointment.

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