

INSIGHTS

4th Quarter 2019

General Comments

The year, and decade for that matter, ended on a positive note with global stock markets delivering exceptional gains. As we reflect upon the year, what stands out is the myriad of unsettling issues that investors had to endure: numerous trade wars, an inverted yield curve, political drama across the globe, and an absence of corporate earnings growth. Disenchanted with the prospects for economic growth and the stock market, many investors became unnerved and sold their long-term holdings – at one point in the year, more than \$200 billion of US equity mutual funds and exchange-traded funds had been redeemed. In hindsight, such actions underscore the futility of trying to time the market by making sudden and radical shifts to one’s investment strategy. Fortunately, investors who followed Bellwether’s advice and stayed the course were well-rewarded. In fact, long-term investors have experienced incredible returns since the Financial Crisis in 2008/2009 – led by the S&P 500 which has gained more than 250%. While a more positive tone towards global trade sets the stage for a positive start to 2020, we must also turn our attention to a new set of challenges and opportunities for the coming decade.

Investment Returns

As noted above, 2019 was a banner year for investors with strong gains in both fixed income and equity securities. The strength of the US consumer combined with the Federal Reserve’s decision to reverse the direction of monetary policy and cut interest rates three times provided enough firepower to weather a challenging economic and geo-political landscape.

While the bond market gave up some of its earlier gains in the final months of the year, lower interest rates and a healthy environment for corporate bonds

led to an almost 7% return in 2019. For much of the year, Bellwether’s fixed income strategy had trailed the performance of the bond market by a sizeable margin. We were pleased to see this gap narrow appreciably in the final quarter as preferred shares rebounded and Bellwether’s Alternative Income fund delivered an annual return of nearly 10%.

Growing expectations of a US/China trade deal powered stock prices in the final quarter – the MSCI World Index (in Canadian dollars) rose 6.62%. We believe that you will be quite satisfied with the performance of our equity strategies. Information technology was the best performing sector in Canada and the United States by a wide margin, and our strategy benefited from positions such as Apple and Microsoft.

A typical “Balanced” investment strategy earned a double-digit return over the past year. These above average returns are unlikely to be repeated anytime soon as we are in the later stages of this economic cycle.

The following table summarizes key index returns for the 4th quarter and year:

Index	4 th Quarter	2019
FTSE Bond Universe	-0.85%	6.88%
TSX Composite	3.17%	22.88%
TSX Small Cap	5.53%	12.84%
S&P 500 (in Cdn\$)	7.00%	25.25%
MSCI World (in Cdn\$)	6.62%	22.31%

All returns shown are the total index return including income

Global Trade Tensions Ease

For much of the year, investors worried about the negative consequences of a shift towards more isolationist policies that could reduce the benefits of globalization. On multiple occasions, the United States imposed significant trade tariffs on various countries. As we have written extensively in the past, such trade wars do not benefit anyone – predictably, the world experienced a sharp decline in global trade and manufacturing activity. The uncertainty also led to a drop in business confidence – many companies put capital spending plans on hold. Worries that these negative trends would begin to negatively impact consumer spending grew throughout the investment world. Fortunately, we saw positive progress on many aspects of global trade in the quarter.

Most importantly, the US and China announced that “phase one” of a trade agreement had been completed. The deal has now been signed and more specific details are beginning to emerge. China has committed to buying significant amounts of US products (agricultural, industrial and energy). In exchange, the US has agreed to cancel proposed tariffs on \$160 billion of consumer products coming from China that were due to take effect in December and to reduce existing tariffs on \$120 billion of Chinese imports by 50%. On a disappointing note, the US will still maintain 25% tariffs on \$250 billion of Chinese imports that were introduced earlier – likely as an “incentive” to further negotiations as the two countries begin working on the next phase of a broader trade deal.

We also saw the US-Mexico-Canada trade agreement (USMCA), which will replace NAFTA, move a little closer to final ratification. It was finally passed in the US House of Representatives in mid-December and was recently approved by the US Senate. The main highlights of this 16-year accord are as follows:

- 75% of auto content must come from USMCA nations, compared to 62.5% currently. Any vehicle that does not meet the content rules would be subject to a 25% import tariff. In addition, 40% of auto production must be completed by workers whose pay averages more than US\$16 per hour. These terms essentially reduce incentives from moving auto production to Mexico to capitalize on lower labour costs.

- NAFTA’s dispute-settlement mechanism, which allows an independent panel to adjudicate anti-dumping and countervailing duties cases, remains in the new agreement. This was a critical win from a Canadian perspective.
- The US will receive expanded access to Canada’s supply-managed dairy market. Canada will allow the US tariff-free access to 3.6% of the market, phased in over a 20-year time horizon.
- The entire agreement is subject to review after six years to identify and fix unforeseen issues.

Even the painfully slow-moving Brexit process recently moved a step closer to becoming reality. Having failed to secure an acceptable agreement with the European Union over the past couple of years, Theresa May resigned as Prime Minister of the UK. Boris Johnson took over and quickly secured an overwhelming majority in parliament after a general election in December. The UK parliament then passed legislation to formally leave the EU at the end of January 2020. The United Kingdom and the European Union now enter a transition period to negotiate the terms of their future trading relationship. While finalizing a comprehensive free trade agreement in less a year will be challenging, there is growing hope for a limited agreement that will cover critical industries.

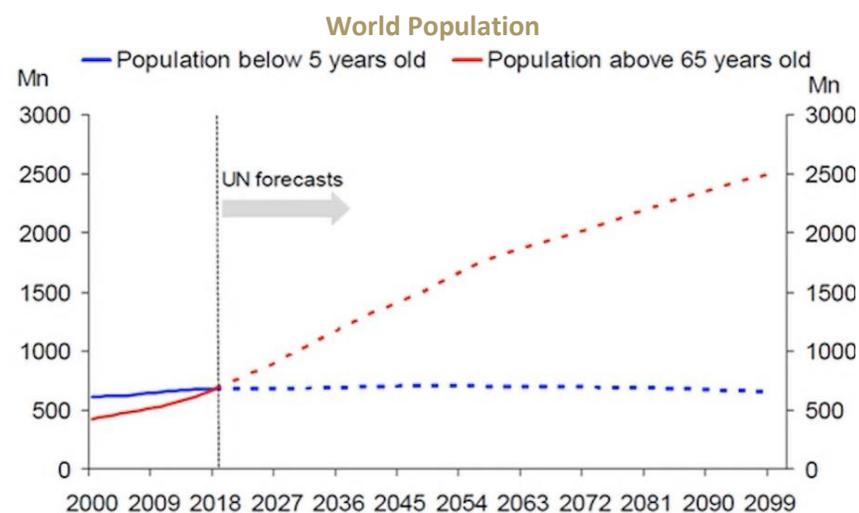
While the environment for global trade remains murky with several unresolved issues, markets have reacted positively to the steps that have been taken in recent months.

A Tougher Road Ahead...

As stewards of our clients’ investment portfolios, we must continually assess the future without the benefit of a crystal ball. While our team devotes much of its time to assessing the investment environment over the coming 6-12 months, we must also consider the longer-term outlook and prospect for future returns. As mentioned earlier, the past decade delivered exceptional returns to both bond and stock investors. This followed a 10-year period in which many investors experienced a decline in the value of their investments thanks to the technology sector crash in the early 2000’s; followed by one of the worst bear markets in history during 2008/2009. It is challenging to know what the next

decade will bring, but we do expect returns to moderate in the coming years for several reasons:

(1) The demographic profile of the developed world will likely restrict growth as many of the world's largest economic powers are faced with rapidly aging populations. As shown in the graph below, there are now more people in the world over the age of 65 than below the age of 5 for the first time ever. The United States just experienced the weakest population growth (0.5%) in the past century. China, Japan and many European countries are all in the same boat. There is no question that the ageing population will place a burden on future growth in these countries; as consumption patterns change, a shortage of qualified workers curtails production, and soaring healthcare costs strain government coffers.



Source: United Nations, Haver Analytics, DB Global Research

(2) Falling interest rates have been a key reason that financial markets have performed so well over the past decade. As rates approach zero (or even move into negative territory), the prospect for ever lower rates obviously decreases. In addition, the extreme level of interest rates has had a negative impact on society – consumer, government, and/or corporate debt levels have risen dramatically; various asset prices have soared to lofty levels; and central banks now find themselves with a much more limited toolbox to combat the next economic downturn that will eventually come.

(3) For various reasons, we have been living in a low inflation, low growth world for many years. This has generally been positive for investors as it has allowed

interest rates to remain lower for longer and has put off the normal “excesses” that often build up towards the end of an economic cycle. However, these conditions will eventually lead to lower investment returns. For example, bond yields are very low within a historical context (even below zero in some countries) – it would be naive to expect sustainable, positive returns from a security that has a yield close to zero. Furthermore, such an environment will eventually stifle price appreciation for stock investors as low GDP growth slows corporate earnings growth, and the multiple that investors are willing to pay for those earnings reaches a peak.

The trends previously outlined certainly concern us as long-term investors. We will need to continually re-assess the investments that we own today and sell ones that appear to be most vulnerable in this environment. However, there will also be opportunities that emerge in our changing world as new countries begin to take leadership positions in the global economy. New companies will form and thrive in the coming decade; industry dynamics will shift; and investors will need to adapt to such changes.

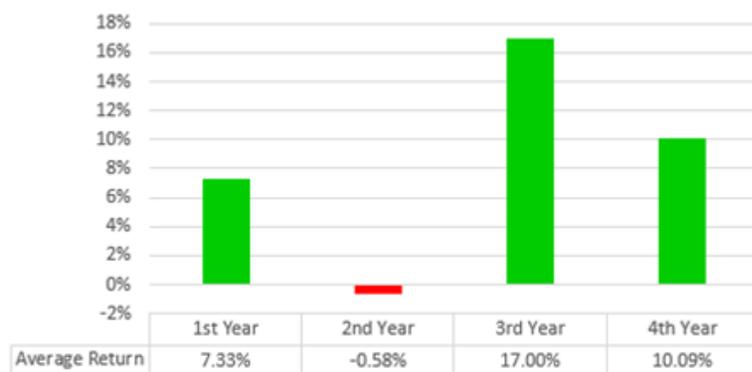
We strongly believe that having a well-diversified investment portfolio will be the key to succeeding in the coming years. Investors who have a combination of debt and equity securities stand the best chance to earn reasonable returns. Over the long run, participating as business owners by becoming shareholders should continue to deliver the highest returns. However, it is equally important to have some exposure to more stable securities that reduce portfolio volatility during negative time periods for stocks. We also feel that an emphasis on dividend growth stocks provides a compelling combination of income and capital appreciation along with more stability of capital through the tough times. While we are bound to go through some challenging periods over the coming years, we cannot lose sight of the long-term benefits of investing in a diversified portfolio. Guaranteed investments (e.g. GICs or term deposits) have struggled to provide returns that are above the rate of inflation and, thereby, achieve an investor's long-term investment objectives.

Outlook and Strategy

While there are some long-term challenges that will eventually confront investors, we remain optimistic about the year ahead. The US economy is in excellent shape and we are hopeful that the significant stimulus introduced by

many countries in 2019 plus improved trade relations will lead to a rebound in global growth. Interest rates are likely to remain low and supportive for markets, while there is a significant amount of money invested in short-term securities that may find its way back into equities. We have yet to see a wave of money pouring into stock markets which typically occurs towards the end of the economic cycle. 2020 could also shape up to be a decent year, if historical patterns hold true. The year following an exceptionally strong year in stocks (like 2019) is often a relatively decent one. Additionally, as the chart below demonstrates, the fourth year of a presidential term is typically a positive one as the incumbent tries to create a positive environment for their re-election. We think Trump realizes the importance of a strong economy and stock market for voters.

US Presidents' First Four Years: Average Stock Market Returns (since 1945)



We believe that our fixed income strategy is well-positioned. As the economic environment slowly improves and yields rise, traditional bonds will likely struggle to produce positive returns. In contrast, our fixed income strategy should hold up well in a rising interest rate environment. The dividend yield on preferred shares remains very attractive and we see the opportunity for some modest capital appreciation. While these investments lagged the bond market in 2019, we would not be surprised to see them leading the way in 2020.

While stock market valuations are now above historical averages on some metrics, they appear to be reasonable when compared to fixed income alternatives. Further appreciation in equities likely hinges on a rebound in corporate earnings growth – for a change, there is room for companies to

exceed consensus analyst expectations, which are more conservative than normal. The US election is bound to create volatility in certain sectors as politicians attempt to win votes – healthcare is a favoured target of both Democrats and Republicans as everyone would prefer to see lower drug prices, so we will need to be mindful of our exposure to pharmaceutical companies. We will also look at potentially increasing our holdings in companies that can leverage an improvement in growth outside of North America.

As always, we must balance our conviction that stock markets will have a final leg upwards with the known and unknown challenges that lie ahead. For this reason, we began to move to a more defensive position in our investment strategies in 2019 – first, by lowering overall exposure to stocks and, secondly, by further reducing exposure to traditional stocks in favour of real estate and infrastructure, which we deem to be lower risk and less volatile. The Bellwether Global Real Estate and Infrastructure fund has been added to many of our strategies over the past quarter. We think it will provide an element of stability to portfolios, while continuing to generate an attractive level of income in today's low interest rate environment.

We take our fiduciary duty to manage your investment portfolios very seriously. Every decision that we make is with your interest in mind. We realize that today's investment climate is challenging with historically low interest rates, a slow growth global economy, and potential political minefields. We will continue to monitor global conditions and make the most appropriate changes to your investment strategy when needed. Thank you for your trust and confidence.

Please do not hesitate to contact your investment advisor or portfolio manager should you have any questions regarding your account or our strategy.

– The Bellwether Portfolio Management Team –