



### EXECUTIVE PERSPECTIVE

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Our Fall edition of *Global Thinking* seems to hit into uncertain times for Canada. Most prominently, the North American Trade Agreement (NAFTA) is being renegotiated with the United States ... even as Canada's airplane maker, Bombardier, has been docked a duty of 300% on aircraft delivered to the U.S.

Canadians can hardly be faulted for sensing a chill wind with its southern neighbour. Yet, historically, Canada and the U.S. have provided an enviable example to the world, possessing the longest undefended border; in peaceful relations for the past 205 years; and sharing many values and cultures. These are warmer realities that we are sure will continue ... and prevail over recent strains.

What is the outlook for domestic and world investment markets in the future? The *Global Insight* article (beginning on this page) provides some excerpts from the *Super Trends and Tactical Views* publication that is updated quarterly by Tyler Mordy, President of Forstrong. He tackles a wide range of factors impinging upon financial markets. Conclusions? You will find some of them unconventional. Global portfolio diversification is essential.

In keeping with the objectives of this publication — to provide you with an overview of our global views, key portfolio strategies and long-term financial trends — the *Portfolio Update* section (found on the last page) meets this task. Indeed, given uncertain times of change and global-connectedness, we have been particularly active with tactical strategies this year. The *Portfolio Update* explains these changes.

Do you have any questions about our investment views and/or services? If so, please contact us. We also encourage you to visit our website. There, we post additional publications (to which you can subscribe on-line if you wish). Some of these are produced as a direct response to the questions we hear from you. Therefore, please continue to forward us your questions.

As always, we hope that you will find benefit in reading this Fall edition of *Global Thinking*, and thank you for your patronage.

#### Notable Quote

*"How many millionaires do you know who have become wealthy by investing in savings accounts? I rest my case."*

- Robert G. Allen



### GLOBAL INSIGHT

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(We present here several major investment strategy perspectives that we hold at this time. For a more complete review, please see the full report of *Super Trends and Tactical Views* (which is accessible on our website).

**Global Financial Crisis Anniversary: What Have We Learned?** This year marks the tenth anniversary since the onset of the global financial crisis, the credit crunch that changed the world. In many ways, it serves as a demarcation line in reshaping economies, financial markets, politics — even our culture. And it remains unfinished business.

Few predicted that the topography of the post-crisis period would be so foreign: freakish monetary policies that dragged interest rates below the previously-unthinkable zero bound, advanced economies stuck in "slower for longer" growth phases (with lost decades now stretching into quarter-centuries in countries like Japan) and alarmingly rapid wealth convergence of the developing world with the developed one (where China's near 40% contribution to global growth last year dwarfs the contribution of other major economies).

All of this is new territory. And the ground is constantly shifting, with collateral effects in international markets running far higher than normal. For example, the tentacles of the Federal Reserve's post-crisis monetary easing reached far beyond American borders. Policy convergence became the rage where central bankers had no choice but to try to outdo the effects of one another. Of course, currency volatility soared in this environment and remains elevated today.

As such, it is more important than ever for investment managers to incorporate a top-down global view of the world even where they are not constrained within one particular asset class or strategy. New realities are calling for new approaches.

→ **Investment Implications.** *Portfolios today must be highly diversified, not only across asset classes, but also across global risk factors. Compared to traditional asset allocation approaches that are typically backward looking, fixed and statistically driven, macro approaches are forward looking, dynamic and informed by global macro trends. When included in a portfolio of strategies, a global macro strategy provides a key offset to the classic bottom-up approach. In this new landscape, the value of managers with global-macro, multi-asset class experience will become increasingly evident.*

**Emerging Markets.** In the world of high finance, investors may be wondering if the dramatic outperformance of emerging market (EM) stock markets in 2017 is just a passing dream. After all, the rally in EM this year is almost surreal, outperforming most developed stock markets by double digits (meanwhile, Canadians are missing out, with record “home bias” weightings in their portfolios).

Yet, we have been here before. EM underperformed US stocks for much of the 1990s, especially the latter part of the decade. From 2000 on, however, they outperformed the US for 10 of the next 12 years.

Could we see a similar path today? Absolutely.

Now, all signs point to a rebound in EM economies. Upward earnings revisions are stronger in EM than any other major regional index and earnings growth is stronger than any other index (with the exception of the UK’s FTSE 100). What’s more, a global upturn has almost always been a reliable signal for identifying inflection points in EM’s growth and profits cycle. In contrast with the US, EM business cycles are only just entering a broad-based expansion phase, inflation is not on the horizon (meaning that monetary policy will remain accommodative) and profits have plenty of room for improvement. In short, the conditions that the US has enjoyed over the last seven years have arrived in EM.

When examining sentiment, we are at a classic stage where investors are just starting to take notice. But we are only in the foothills of a long journey. By the time this rally is nearing completion, the consensus will be declaring emerging markets king. We are nowhere near that phase.

→ *Investment Implications. EM fundamentals look attractive (particularly versus Western countries) and have been broadly improving for some time. Beyond younger demographics, lower debt levels and orthodox monetary policy, the numbers tell a compelling story. For example, in the mid-1990s inflation rates above 20% were not uncommon. Today’s EM inflation is trending below 5%. Looking ahead, EM country and sector selectivity will remain key. Favor domestic-focused, reform-minded, commodity importing countries. Most are found in Asia.*

**Regime Change: Limits of Low Rates.** Replying to criticism during the Great Depression for changing his position on monetary policy, John Maynard Keynes famously quipped “When the facts change, I change my mind. What do you do, sir?” Our Investment Committee may use the same words regarding our interest rate outlook. Having been vocal proponents of a “lower for longer” view since 2009, we adjusted our positioning in the summer of 2016: the 36-year bond bull that started in 1981 may be over.

We are indeed entering a regime shift away from loose monetary tight fiscal policies to tight monetary loose fiscal settings (not least in the US, which has become a leading indicator of what other global policymakers will do in the post-crisis period). Consider the Fed’s latest moves. For only the second time since June 2006, they raised the benchmark interest rate by 25 basis points in December 2016 and twice again in 2017. Given the positive tone of the Fed’s comments on the economic outlook and its slightly more hawkish view on the trajectory of rates, the unnerved market reaction underscores that investors recognize this profound monetary policy shift.

→ *Investment Implications. In the same way that investors took more than a decade after 1980 to believe that inflation would not rise again into double digit figures, today’s investors — conditioned by at least 35 years of disinflation and declining interest rates — will take years to become convinced that the secular environment has changed. Bond rallies will still present themselves. We expect a gradual reversal in yields that will play out over many years. And while a spike in rates is clearly detrimental to fixed income investors, a slow and steady rise allows for a higher reinvestment rate without incurring large capital losses. This is wonderful news for retirees who have had considerable difficulty generating sufficient income in an abnormally low interest rate environment.*

**Diversifying Fire and Fury.** Finally, what danger does North Korea present for global investors? Clearly, Trump’s indulgence in nuclear brinkmanship carries risk. Pyongyang potentially firing missiles at US territory in the Western Pacific is also real. And there is a global existential threat should it ever escalate into intercontinental warfare.

Consider that most geopolitical events are false alarms. Most warnings are false simply because big turns are rare events. Remember Y2K, Saddam Hussein’s so-called “weapons of mass destruction” and, recently, Brexit? None of these widely-feared threats materialized or they delivered benign outcomes.

More often than not, geopolitical events create opportunity. Rummaging through past post-crisis periods produces a long list of stellar returns after the initial event. For example, the Cuban Missile Crisis in October 1962 was a 13-day confrontation between the US and the Soviet Union, widely considered the closest the Cold War came to full-scale nuclear warfare. However, after the crisis subsided, the Dow went on to gain more than 10% that year.

Geopolitical events often have binary outcomes. By this we mean that it would either produce an extremely large portfolio loss or gain. There is no knowing which ahead of time. As such, narrowly focusing on one type of risk is speculative at best.

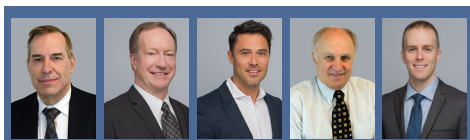
What’s more, such speculation hinges upon achieving two near-perfect tactical portfolio actions. One is getting out at the right time; the second is to get back into the markets at the right time. The first decision is difficult at best. The second step is often overlooked. There are plenty of analysts who have predicted doom (most far too early) only to fail to re-invest at the appropriate time. Both errors can be catastrophic.

A far better approach is to accept that a wide possible set of scenarios may unfold. From there, investors can insulate against a number of outcomes by diversifying portfolios across global investment classes and also readying them for a change in the macro outlook.

→ *Investment Implications. A large number of people have become financially poor, trying to avoid popularly perceived risks by running for the hills. They fail to realize that if there were no risks for which to be compensated, there would be no returns possible above a risk-free rate. But that doesn’t mean that one shouldn’t manage risks. To the contrary. What we advise against is a non-diversified definition of risk (in other words, a 100% bet).*

# PORTFOLIO UPDATE

## Q4 2017



**Forstrong Investment Committee**  
 Wilfred Hahn (Global Strategic Advisor & CCO)  
 Mark Arthur (CEO)  
 Tyler Mordy (President & CIO)  
 Ken Hawkins (Research Manager)  
 David Kletz (VP, Portfolio Manager)

After a decade of systemic jitters following the Global Financial Crisis, financial markets seem to have finally come to a point of quiescence. Investment market volatility has near-collapsed (witness the trend of the S&P

VIX). To a large part, this is attributable to economic volatility also declining. The classic business cycle appears to have been in hibernation; economic growth chugging away at a low but steady rate of 2.0% or so for quite some time.

A notable result of these developments is a high degree of confidence in the world's major central banks (they rescued financial markets from deep crisis according to popular consensus, didn't they?) and a continuing positive outlook for economies. Understandably, that is comforting. However, we would gauge these sentiments as reflecting some unwarranted complacency. Even the U.S. Federal Reserve is thinking that it is safe to begin monetary "normalization."

We should not lose sight of the extraordinary developments and policy measures that were required to bring us to this point. Not only did the major central banks pump some \$15 trillion of liquidity into financial channels (this still continuing), but also, budget deficits have remained high and debt levels have continued to increase around the globe. Therefore, to conclude that risks are now benign is premature. As such, we continue to believe that broad global diversification remains the prudent course at this time.

Viewing the global environment, there are still plenty of moving parts to anticipate. Most prominently, currency markets have experienced pronounced moves this past year. Crucially, the Canadian dollar (as well as most other major currencies) soared against the U.S. dollar. Thankfully, this was anticipated and currency hedges were employed in our portfolios. However, in the medium term, we now believe that the U.S. dollar is likely to recover somewhat versus the Canadian dollar and other world currencies. While this may only be a relief rally in a longer running downtrend, it does introduce new tactical strategies in client portfolios. We next outline these and existing strategies.

**Prudent Global Diversification.** Overall, we remain widely diversified across all asset types. All portfolios continue to include exposures to global assets, as this has proven to significantly reduce portfolio volatility over the past several decades.

**U.S. Dollar-Driven Strategy.** The performance of U.S. dollar assets was poor over the past several quarters for most global investors based outside of America. This was attributable to a weak U.S. dollar, declining 12% year-to-date vs. a trade-weighted basket. Given this significant decline, we have begun to again increase our exposure to the dollar, reducing our significant underweight. This has required a number of active strategies — eliminating gold-related securities and materials sectors, selling Brazilian equities, increasing dollar-linked emerging market fixed-income; and, modest increases in U.S. equities and fixed-income relative to rest-of-world assets.

**Shifts in Overall Asset Mix.** Portfolios remain modestly overweight in equities and underweight fixed-income securities. This stance is reflected in all regions globally, excepting emerging markets. Relatively low interest-rate risk and continuing high interest yields are still attractive in this region. Importantly, cash weightings have been further increased to a higher overweight. Continuing low interest rate levels, nevertheless, reduce our zeal for aggressively high cash levels. Floating rate type assets have been employed to establish additional liquidity positions.

**Remaining Cautious on Interest Rates.** Bond duration has been further underweighted. Otherwise, we prefer above-average dividend yielding equities. Interest-income scarcity remains an enduring theme that we emphasize. We continue to scour the world for higher yield.

**Equity Sectors Favoured.** Overweight positions in healthcare and financials are continued. The latter sector-weight is reflected in Canada, Europe and the U.S. A friendlier regulatory environment as well as expected reforms in Europe and elsewhere appear beneficial for this latter sector.

**Emerging Markets Exposure Reduced.** Portfolios this year have benefited significantly from our sharp over-weights in emerging market assets. We continue to believe that this will remain an attractive investment sector over the long-term. Nevertheless, the heated investor attention to this sector now warrants a reduced exposure.

**Changes in Opportunity Strategies.** Changes to this category of investments included the following: Reduced exposure to frontier markets and China equities; allocations to European small caps were increased and a position initiated in Swedish equities; positions in Brazilian equities and gold miners were eliminated.

**Currency Trends.** The U.S. dollar has returned to a more neutral valuation vs. most major currencies. The Canadian dollar is therefore likely to trade in a range, leaning to some downside vs. the USD. As such, there is no need to maintain currency hedges. These have been removed.

We continue to counsel investors that financial markets are facing high levels of uncertainty and unprecedented conditions. Nevertheless, we forecast long-term portfolio returns to be comfortably above cash returns (recognizing that securities portfolio returns are random over the short-term and can be highly variable for any given year).

	Versus Benchmark			Change from previous quarter
	Under	Neutral	Over	
<b>Net Global Asset Mix</b>				
Cash			■	↑ Increased
Total Equity			■	↓ Decreased
Total Fixed Income	■			↓ Decreased
Opportunity		■		● Unchanged
<b>Canada Investments</b>				
Bonds	■			↓ Decreased
Stocks	■			↓ Decreased
<b>U.S. Investments</b>				
Bonds		■		● Unchanged
Stocks	■			↑ Increased
<b>International Investments</b>				
Bonds		■		↑ Increased
Stocks			■	↓ Decreased