MacNicol & Associates Asset Management Inc., 145 Adelaide Street West, Third Floor, Toronto, Ontario, M5H 4E5

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The Monthly

With this commentary, we plan to communicate with you every month about our thoughts on the markets, some snap-shots of metrics, a section on behavioural investing and finally an update on MacNicol & Associates Asset Management (MAAM). We hope you enjoy this information, and it allows you to better understand what we see going on in the market place.

"Whether you're passive or active, as a basic principle, depends on how much information you have."

- Harry Markowitz [The Father of Modern Portfolio Theory]

The Numbers:

Index:	**Year-to-Date:**
S&P/TSX:	-7.05%
NASDAQ:	-1.83%
Dow Jones:	-3.47%
S&P500:	-3.46%

Interest Rates:	**Canada**	**USA**
90-Day T-Bill:	1.18%	1.58%
5-Year Bond:	2.08%	2.57%
10-Year Bond:	2.36%	2.86%
30-Year Bond:	2.51%	3.15%

Economic Data:

- US 10-year yields rapidly approaches 3%
- US Treasury auction data signal weaker demand for US Paper
- American Jobs report strong signalling wage inflation may impact corporate profit growth
- Canadian Jobs report softer though primarily reflecting part-time positions across the holidays
- EIA oil production figures well ahead of estimates contributing to a sell off in which oil crossed back below the $60 level

Valuation Measures: S&P 500 Index

Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	16.4	17.3
P/B: Price-to-Book	2.7	3.2
P/S: Price-to-Sales	2.1	1.9
Yield: Dividend Yield	1.78%	2.05%

Year-to-date Performance, by Sector: Feb 10th, 2018

U.S. Markets	Close	Net	1 Day %	YTD %
Dow Jones	23860.46	-1032.89	-4.15%	-3.47
Dow Jones Transports	10159.60	-400.99	-3.80%	-4.27
Dow Jones Utilities	647.90	-9.86	-1.50%	-10.43
S&P 500	2581.00	-100.66	-3.75%	-3.46
S&P 400 Midcap	1801.29	-61.25	-3.29%	-5.22
S&P 600 Smallcap	893.05	-25.49	-2.78%	-4.62
NASDAQ	6777.16	-274.82	-3.90%	-1.83
Russell 2000 (Smallcaps)	1463.79	-44.18	-2.93%	-4.67
BKX (Banking)	106.08	-4.91	-4.42%	-0.59
BTK (Biotech)	4399.31	-182.24	-3.98%	4.19
XOI (Oil Index)	1260.12	-39.47	-3.04%	-5.65
SOXX (Semiconductor)	1218.66	-53.84	-4.23%	-2.74
XAU (Gold/Silver)	79.86	-0.68	-0.85%	-6.35

Bad news, it looks like he was right…

"Believe me: We're in a bubble right now. And the only thing that looks good is the stock market — but if you raise interest rates even a little bit, that's going to come crashing down," Trump said. "We are in a big, fat, ugly bubble. And we better be awfully careful."

- Candidate Donald J. Trump

Although it may be difficult for us to say this, Donald Trump [back then a candidate] was right, the stock market was in a big fat bubble. As *The Monthly* commentary hits the printers much of the air used to inflate that bubble would appear to be leaking out of it. Maybe leak isn't exactly the right word. Surge or tsunami seem better suited at describing what is going on here. So what exactly is going on and what caused investors to panic bigly just about the time the Philadelphia Eagles celebrated their first ever Super Bowl Championship?

More on both in a moment.

For now, do us a favor and just try to relax. We know that is a pretty big favour to ask: after all…

1. The Dow Jones and S&P 500 had their entire 2018 year-to-date gains incinerated in the span of just 4 trading session [January 29th, January 30th, February 2nd and Monday February 5th].
2. The VIX volatility index [a measure of "fear"] was up 97% on February 5th
3. Emerging Markets imploded along with Junk Bonds.
4. ETF's across the globe were rocked.
5. Two popular "Robo Advisor" websites failed under the pressure of client activity.

Yours truly was exiting a client meeting during the midway point of February 5th when I was slapped in the face, by this footage from CNBC the popular business news channel:

A number like 1,500 points really does command one's attention especially when followed by the word "drop". Whether you were a veteran money manager or one of the millions of investors seduced by the caring caresses of complacency, it was hard not to notice Monday February 5th. So then why would we nonchalantly advise you to take a deep breath at a time of such extreme angst? Here at MAAM we manage portfolios for real people and not virtual benchmarks. What that does is causes us to emphasize the importance of capital preservation. Our efforts to raise cash in previous quarters were not always met with cheers, but we made them with the full conviction in our disciplined time-tested process.

So what happened?

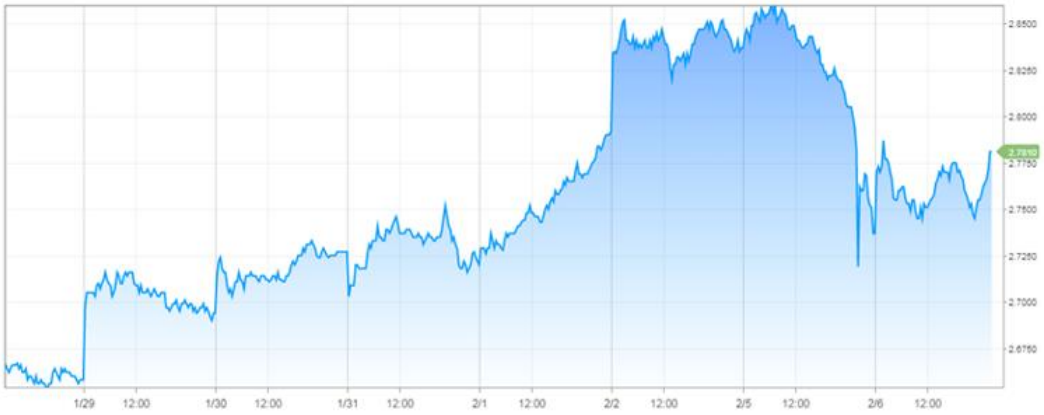
[US 10-Year Bond Yield]

The MAAM investment team believes there were a variety of factors that ultimately were at play when we bid farewell to January and greeted February, although some carried more heft than others. At the top of our list is the hefty bond market. At roughly 10 times the size of the stock market, the bond market's influence on the financial world is iconic. Included below is a recent image of the yield for the US 10-year Treasury Bond. The chart shows that rates have been on the up and up for a little while now, but it also shows that the pace of rates accelerated quite recently. This rise in yields reflected our view that; the infrastructure focused deficit spending on the part of the US Government would lead to a rise of treasury bond issuance by the US Treasury. What's more, this is all occurring at a time when the appetite for US bonds globally was weakening. Additionally, rate hikes by the US Federal Reserve made the case for bonds that prove to be much more problematic.

While we do not know this for certain, the MAAM investment team suspects ~~is~~ that at a certain point, quantitative trading programs called "algorithms" began to detect the rise in yields as potentially harmful to stock markets. Among other investment vehicles, stocks get their valuation clues from the bond market as the yield on the 10-year was punted towards 3%. One example of this is the US 10-year Treasury being used as the valuation kingpin for most Equity Fund Managers.

Now this isn't the first time in the recent past that the yield on the US 10-year note approached 3%. As a matter of fact, back in December of 2013 the yield on the US 10-year note exceeded 3% when it briefly hit 3.03%. So why is the market suddenly obsessed with the 3% level this time around? Well back in early December 2013 as clients and Portfolio Managers were crossing off to dos on their Christmas Shopping lists and getting ready for staff parties, the Dow Jones was only at 16,000 points versus the 26,000+ point levels seen just days ago. The realty of the world investors live in today is one in which, stretched valuations have led to more sensitivity on the part of equity investors as yields float higher and higher. In a world where money was continually forced fed into momentum driven ETFs, the resultant volatility begat more volatility. Hence the proximate cause for the correction in equity markets was none other than the bond market. This correction was the paradoxical cause of yields falling not soon after the carnage began and was vicious enough to have scared the pants of clients and Portfolio Managers alike. The image below is also an image of the yield on the US 10-year note, but this time it is a very narrow image spanning only five days. The point is to draw your attention to money flowing back into bonds just as quickly as it left equities.

In conclusion, we believe that rising interest rates [a surrogate description for inflation] was the main culprit behind the recent sell off. This was followed closely by lofty valuations, a bewildering maze of ETF based "robo-traders" and a market that was way overdue for a reality check. However, there were some aggravating circumstances to also consider. For example, on Friday the US Labour Department released an employment report that showed what many of us already know, which is that the US Labour market is strong. Unfortunately, the way the stock market sometimes interprets labour market statistics is that while wage growth is good for the economy, on the whole, it is bad for corporate profits. When companies pay workers more, they reward shareholders less.



[US 10-Year Bond Yield during the meltdown]

But are we out of the woods?

Don't lose the forest for the trees…

While the initial shock of watching equity markets decline sharply in late January and early February has subsided. Investment "rubber necks" were slow to turn their focus back to what caused the meltdown in the first place, which was the speed in which yields rose in a market for equities that can only be described as pricey. Wednesday February 7th provided some clues as to the bond market's next move in the form of a luck warm 10-Year Note auction and a budget deal which included higher spending and a suspension of debt limit.

[We're broke…*I know*…highways and bridges will cost Billions…*I know*…QE ends in 2019…*I know*…why are you just standing there…*I don't know*]

Dear Treasury Secretary Steven Mnuchin:

You can do more with more
You can do less with more
You cannot do more with less

And so it is ordered…by the Bond Gods…

Attached below is a one-second chart of the yield on the US 10 Year Note, yes you read that correctly and yes we have an app for that. We are long term investors but as we sometimes like to say: the long-term is a series of short terms. Semantics aside we are trying to illustrate a point.

The objective of the myopic yield chart is to illustrate the point that once the initial shock of the carnage subsided, investors returned to their main preoccupation and that is a concern over inflation. To the best of our understanding the two blue arrows mark the point in time when equity flows into treasuries ceased and angst over inflation returned to the fore. Investors are well advised to take inflation seriously. It is the silent destroyer of capital that wreaks havoc on those with savings.

This period of expansionary fiscal policy and deficit spending is set to weigh heavily on the treasury market at precisely the time when foreign demand for US treasuries is unclear at best. All the while when the Federal Reserve is set to take the punch bowl away as they unwind their own balance sheet down. On balance these forces have the potential to sucker punch an equity market which at recent valuations is fighting for credibility among investors.

So is it over yet?

We believe that despite elevated valuations and extreme near-term volatility, equity markets remain well supported. Accordingly, another quadruple point loss event likely isn't in the cards. Unfortunately, we do feel that the period of smooth sailing many investors experienced will not likely extend into the immediate future. At 3% we believe the bond market is simply firing a shot across the bow, one that will elicit volatility and uncertainty. At the 4% or 5% level we believe it could be a different game all together.

Thus we offer this:

A 10% correction in equities is a perfectly normal part of the natural ebb and flow of markets. We just haven't experienced one in a while and so the whole experience then has shock value. Additionally, the MAAM investment team has been building cash reserves in portfolios long before the "fiasco in February" and we have been careful at deploying capital for new investors. Careful and not clairvoyant. Prioritizing the safety of our clients' capital is not an option for us it's a way of life.

The MAAM Investment Team

***Crude* oil, slick process**

As Portfolio Managers, the MAAM investment team keeps a close eye on global energy markets. As Canadians, we also keep a close eye on companies *linked* to global energy markets; such as Canadian oil and gas exploration and production companies. In and around the 3rd quarter of 2017, yours truly unambiguously if not brazenly recommended an investment in this area at a meeting of the MAAM research team, which occurs each Thursday at 9am.

A truly *crude* idea

Thank goodness for a team-based approach that draws upon the perspectives of numerous able minded individuals. Not soon after making the aforementioned recommendation did a senior partner of our fine firm note that, for whatever reason the share prices of a number of widely regarded Canadian Energy companies like Canadian Natural Resources [CNQ:TSX], Suncor [SU:TSX], and Cenovus Energy [CVE:TSX], were narrowly responding to movements in crude. To be clear, many of these stocks and others that survey the oil "spill" did rally off the very low "basement" oil levels seen in early 2016 and then again throughout parts of 2017. Recently, a lot of these same stocks have had a change in heart. In other words, the underlying movements in crude oil prices helped the stocks, until they didn't.

What did the stock market and my senior partner see that I missed?

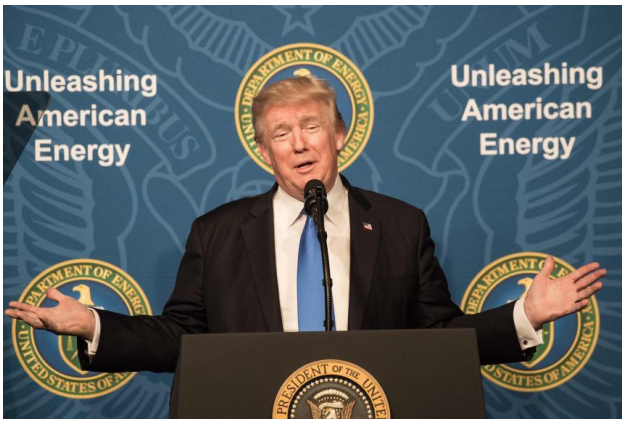
The answer in hindsight would appear to be politically motived, as it often is. To be sure the invisible hand of supply and demand played its part, but not without some "encouragement" from a certain ex Real Estate Developer turned Reality T.V. star turned…well you know:

So why have Shale Executives at US Oil companies been drilling at such a frenzied pace in areas like the Permian Basin?

How frenzied?

"The EIA estimates that U.S. crude oil production averaged 10.2 million barrels per day (b/d) in January, up 100,000 b/d from the December level. EIA estimates that total U.S. crude oil production averaged 9.3 million b/d in 2017 and will average 10.6 million b/d in 2018, which would mark the highest annual average U.S. crude oil production level, surpassing the previous record of 9.6 million b/d set in 1970. EIA forecasts that 2019 crude oil production will average 11.2 million b/d".

- US Energy Information Administration February 6th [www.eia.gov]



Now surely oil executives are not fools. Selling more of the product you specialize in when prices are higher is a good thing. But the EIA's own reports previously forecast US oil production topping the 11 million barrels per day in November of *2019*. Their recent revision is striking because, if 10.6 million barrels per day is forecast to be the 2018 average, then it is entirely possible that oil production eclipses 11 million barrels per day this year. A full year ahead of schedule. We all know President Trump is a pro oil type of guy. He sells his love of US oil production not merely as energy independence but outright energy dominance.

Though it may be possible Trump is fighting another battle, like one with Russia over tensions in Syria. Curiously, Russia garners an awful lot of its state revenues from the oil game and that means falling oil prices are not good news for our Russian Comrades. The MAAM investment team feels that lower oil prices are another anti-Russian tool being used by the White House to twirl Russian foreign policy away from independence and towards White House control.

We will continue to watch energy prices, and the prices of energy stocks for signs of either an easing in geopolitical tensions or more credible claims of restraint on the part of oil executives and adjust accordingly. In the meantime, it is reassuring to know that our process here at MAAM is democratic and refined.

Fear and F.O.M.O.

In a previous edition of *The Monthly* commentary we covered the psychological phenomenon known as "Fear of Missing Out" (F.O.M.O.) and how it drives investors to chase returns. Chasing returns can result in. among other things, the size of certain Exchange Traded Funds [ETF's] eclipsing the GDP of your typical, medium-sized European nation. It can also result in poorer investment returns. In this edition of *The Monthly* commentary it would be difficult if not impossible to incorporate recent market turbulence into our publication. At MAAM, we have a robust, time-tested investment process that has worked well in time not just in theory. Our point is this, don't let short term fear derail your long-term financial goals. Sometimes the best defense against a Bear is courage. Working together with your family or your Advisor the MAAM investment team will give you the courage to stand up to market volatility so that your dreams can sail safely into harbour.

Firm News

On Thursday February 15th, 2018 at 2 pm, David MacNicol and Joe Pochodyniak will discuss RRSP's and Tax-Free Savings Accounts (TFSA's) in a webinar designed to help you optimizing your retirement or general savings plans.

The MAAM investment team recently attended the Foundation, Endowment & Not for Profit Investment Summit in Toronto.

The MAAM investment team is featured in an upcoming edition of the National Post.

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