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

July 2018

The Quarterly

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.

"If you're waiting for all the risks to go away, you're never going to own stocks again".

Andrew Adams, CFA, CMT
Raymond James

The Numbers:

Index:		**Year-to-Date:**
S&P/TSX:		-4.51%
NASDAQ:		13.35%
Dow Jones:		1.40%
S&P500:		4.90%
Interest Rates:	**Canada**	**USA**
90-Day T-Bill:	1.45%	2.07%
5-Year Bond:	2.13%	2.82%
10-Year Bond:	2.23%	2.95%
30-Year Bond:	2.27%	3.08%

Economic Data:

- Domestic equity market stronger while emerging markets underperform on stronger US Dollar
- Yuan sharply weaker versus the US Dollar
- Bank of Canada raised its target overnight interest rate to 1.5% on business investment and exports however trade and business confidence continue to be headwinds moving forward
- Gold weaker since mid June continuing to struggle for footing
- Oil prices move materially in June and July mainly on Russian production expectations and more recently tensions with Iran

Valuation Measures: S&P 500 Index

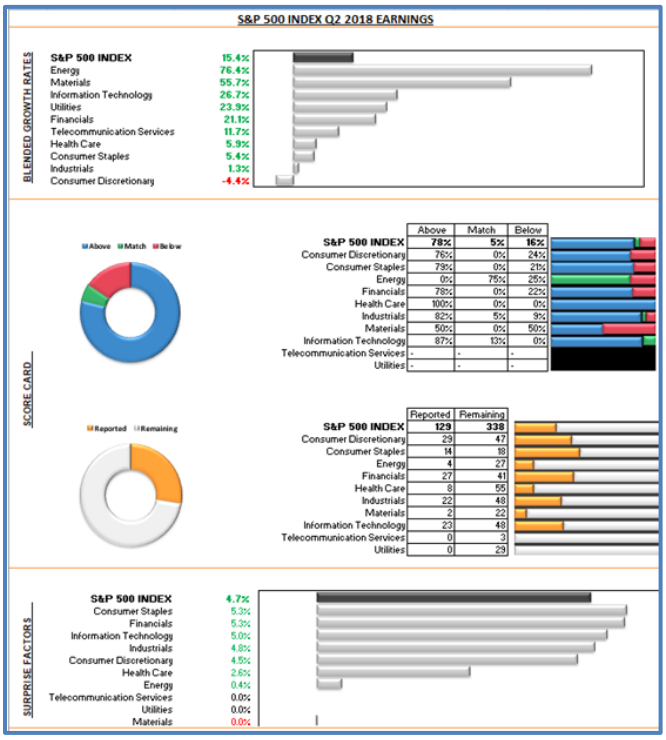
Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	17.23	18.01
P/B: Price-to-Book	3.03	2.85
P/S: Price-to-Sales	2.16	2.05
Yield: Dividend Yield	2.30%	2.37%

Year-to-date Performance, by Sector: July 23rd, 2018

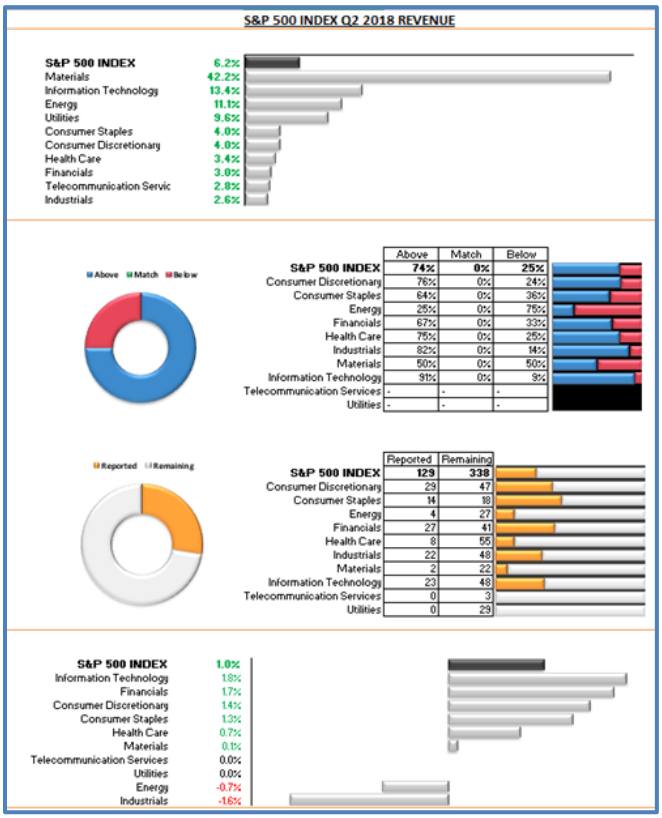
U.S. Markets	Close	Net	1 Day %	YTD %
Dow Jones	25064.50	-134.79	-0.53%	1.40
Dow Jones Transports	10747.65	45.42	0.42%	1.28
Dow Jones Utilities	723.96	6.36	0.89%	0.08
S&P 500	2804.49	-11.13	-0.40%	4.90
S&P 400 Midcap	2009.05	7.80	0.39%	5.71
S&P 600 Smallcap	1058.97	6.84	0.65%	13.11
NASDAQ	7825.30	-29.15	-0.37%	13.35
Russell 2000 (Smallcaps)	1701.31	9.44	0.56%	10.80
BKX (Banking)	106.79	-1.50	-1.38%	0.07
BTK (Biotech)	5113.40	14.11	0.28%	21.11
XOI (Oil Index)	1490.95	-1.78	-0.12%	11.64
SOXX (Semiconductor)	1365.82	-3.65	-0.27%	9.00
XAU (Gold/Silver)	79.00	-1.17	-1.46%	-7.36

Source: Jeffrey Saut, Raymond James

Thrilled…but only for the time being…



We are thrilled that investors are paying closer attention to corporate earnings reports and revenue guidance. This shift in attention is a welcome departure from daily tariff talk and central banker speak. Some research departments are calling for $158 in S&P500 earnings in 2018 and $174 in 2019. Those earnings estimates translate into an index trading at roughly 18x the current year's forecast and 16x next year's. Small wonder that the S&P surmounted the 2,800 level earlier in the month. The Dow Jones Industrial Average regained some confidence too, returning to the 25,000-point level it occupied previously in the year. Our friends at Strategic Analysis Corporation provide their familiar earnings and revenue "score cards" below and even seasoned readers of *The Quarterly* are forgiven if the seemingly random assortment of charts and tables still does not make any sense. Fortunately, your attention need only be drawn to the blue part of the circles in the upper left-hand corner. As *The Quarterly* goes to print 3 out of 4 companies in the S&P500 have posted earnings and revenues that exceeded expectations.



As thrilled as we were to take a break from daily trade talk and central bank speak, we knew it probably would not last long which is why we feel the next leg higher could be a tough nut for the markets to crack. Not only do numerous resistance levels await markets, which could limit further upside potential, something even more menacing does too and we will get to that in a moment. But first, let us be clear, we are not suggesting the imminent implosion of markets around the word, not by a long shot. We simply feel things operate a little differently in a world in which you have an S&P500 north of 2,800 points and a Dow Jones north of 25,000 points. As always, the MAAM investment team approaches its duty of deploying client capital optimistically but with a healthy dose of profession skepticism. Our inability to get overly excited by what is at the end of the day one data point (a single quarter's worth of earnings reports) stems from the fact that we are long-term investors, but ones who know that the long-term is a series of sequential short-terms.

If investors were mesmerized by trade talk or arcane central bank missives in the last quarter, we feel they will be downright transfixed by them in the future and there are two very good reasons why:

For one thing, stocks are a smidgen more expensive now and we all know what happens to expensive stocks that fail to deliver.

[The Netflix "nosedive" a cautionary tale for expensive stocks that fail to deliver the goods each quarter and the momentum driven ETFs that feast on them]

The other, which should come as no surprise, US President Donald Trump. The President (like us) is concerned about the stock market rally. He is *not thrilled* about the US Federal Reserve raising interest rates. Higher interest rates can impact the stock market because financial institutions will increase the rate they charge customers to borrow money. Higher rates will also impact existing borrowers in variable rate loans. Higher rates mean higher costs associated with servicing debt, and that means less disposable income. Less disposable income for US consumer is not great for the stock market. Higher rates also mean that businesses will expand their operations more slowly and may delay or even cancel expansion plans. Rising rates can also take a bit out of corporate profits in many sectors of the market. Thus higher rates have impacts on markets today and in the future. Most important of all though is that rising rates in the US mean that foreign investment capital is "sucked" state side, which puts upward pressure on the US dollar. A big part of the President's campaign was tax reform, and this is what many investors believe is propping up the stock market.

The President knew he could jam tax reform policy through congress with relative ease by requiring foreign trading partners to pick up the slack of lost tax revenues domestically. It was a plan the average American loved: lower

taxes for themselves, higher "taxes" for everyone else. A well thought out platform elegantly sold to the American people and to Congress. In the real world though things do not always go so smoothly.

Remember that burly US dollar?

The Chinese Yuan and other currencies have grossly underperformed the US Dollar resulting in a lack of tariff potency. This may explain why the President keeps moving the bar higher and it is most certainly the reason why he views price action in the Yuan and other trading currencies as "illegally" engineered.

[The Chinese Yuan materially lower in May, June and July]

We disagree with the President on the legality concerning what the Chinese wish to do to their own currency. The last time we checked China is a sovereign nation. But the actual explanation around price action in the USDCNY is probably a lot more nuanced than Mr. Trump leads on. China knows that it could never win a full-blown trade war with the United States but then it doesn't have to. China can effective wage a currency war with the Americans that has broader and deeper implications than the absolute size of a tariff on a semiconductor or running shoe imported into America.
It is unfortunate that the President's relatively decent grasp of the precarious dynamics at play in the U.S. debt market come with strings attached such as his substantially weaker understanding of monetary policy and currencies. The reality is treasury supply is rising (we termed it a Treasury "Tsunami" in a past edition of *The Monthly*) and the US Federal Reserve is running down its gargantuan balance sheet. That's the sort of "dynamic" that is likely to put *upward* pressure on the term premiums at some point and lead to the always unpleasant circumstance of rising rates and rising deficits. Small wonder the President is not thrilled with the Fed…

["Whose side are you on anyways…not thrilled"]

The funny thing is that back in September of 2016 then Candidate Trump was similarly disappointed with former Chair Janet Yellen's handling of US monetary policy. Back then he criticized Chair Yellen

for keeping rates too low and in so doing helping fuel the big, fat, ugly stock market bubble. President Trump's decision to publicly castigate The Fed came dangerously close to suggesting the central bank be terminated. We (like most) take Mr. Trump's twitter tweets with an amount of levity that boarders of hilarity. But we truly hope he does not commandeer yet another topic he seems to know little about.

Central banks and governments are supposed to be independent much like sovereign nations.

If Mr. Trump is not thrilled with rising rates at home and US dollars they help inflate, he should have thought about that before engaging a country like China in a trade war.

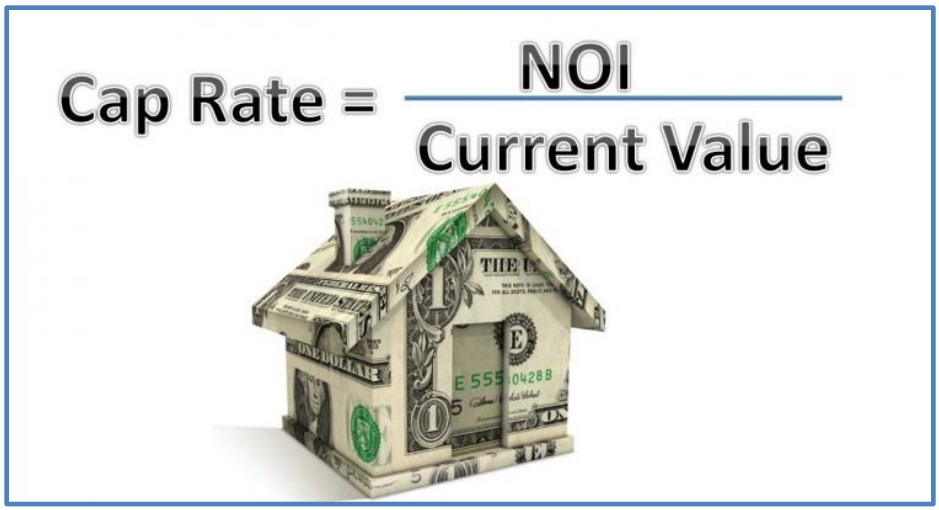
We were thrilled by the attention the market has been paying recent to corporate earnings reports and what corporate leaders are saying about their firms' revenues. Although, we fear that all too soon markets will return to doing what they have been doing for a little while now, which is obsessing over trade talk and central banker banter. Unfortunately, we cannot blame them. Jerome Powell seems to be in a hurry to normalize US interest rates, maybe he is worried about something, and maybe that something is inflation. Stocks are a good long-term hedge against inflation but they have been rising non-stop for 9 ½ years. We think a trade war with China is potentially something the United States cannot win over the long-term and we are certainly not thrilled about that.

The MAAM Investment Team

The King of all Real Estate Investment Ratios

If you are a real estate investor or work in the real estate industry, chances are you hear the term cap rate several times a day and have a deep understanding or keen awareness of this unbelievably important financial ratio.

The cap rate, or more formally capitalization rate, is the ratio of a property's net operating income [NOI] divided by its current market value or sales price. The cap rate shows the potential return on a real estate investment. Planning a capital investment in a real estate project and how much to spend on capital enhancements during the project to improve returns and make one's exit strategy more profitable, are all decisions that involve precision.



[Most investors like buying an asset when it is cheap so look for undervalued properties with higher cap rates]

At MAAM we deploy a variety of real estate investment strategies in our MacNicol 360 Degree Realty Income Fund but the greatest emphasis is placed on a strategy called Value Add. Value add strategies target properties that have cash flows already in place, but which seek to increase those cash flows by making improvements to the property or by repositioning it.

Examples of specific value creating activities investors may pursue include: a) physical improvements to the property b) increasing efforts to lease vacant space at the property or c) improving the management of the property, and thereby increasing customer satisfaction or lowering operating expenses where possible.

Once the net operating income of a property has grown the asset is typically sold to capture the resulting appreciation in value. For many investors value add strategies provide the perfect balance of risk vs. return, offering in-place cash flow at the time of acquisition with significant upside potential in the form of value appreciation. Knowing a lot about cap rates is key because the level of capital enhancement needed to successfully complete a real estate investment depends on property classification. Indeed cap rates vary by property classification or what we term product type. Our preferred product type at MAAM is multifamily residential real estate, which in turn has four classes A-D.

[Take it from us: the hood above the range, hands-down the hardest part of this project]

Class A assets are found in major markets of gateway cities and command broad interest from institutional investors like life insurance companies, pension's plans and REITs who aggressively pursue the asset. Class A assets typically have cap rates in the 4-6% range. Class B & C assets don't see quite the same level of competition from institutional investors and financing is typically arranged through a larger bank. Cap rates for class B and C assets depend on the market but generally fall in the 6-8% range. Class D assets tend to be financed by local banks and have very little secondary interest. You can expect cap rates of +8% in most markets.

[Class A Multifamily Residential Real Estate]

Location is everything when it comes to real estate investing, but we argue that knowing your market and product are equally important. Cap rates are essential to know, and you obviously want to buy at a higher cap rate since greater opportunities exist for product improvement. However, intrepid investors cannot buy based on cap rate alone. For example we would never buy a 6% cap rate property that simply flows cash flow to us and is totally devoid of additional upside potential. On the other hand we would certainly be interested

in learning more about a Class B multifamily residential complex with a 6% cap rate that offer present day cash flows but also the upside of refurbishment optionality.

The cap rate is a critical ratio in real estate investing, it's one piece of a very complex puzzle. At MAAM we try to get to a position where we can sell into a spread of 100-150 basis points since we know that offers our investors good return potential and a margin of safety during troubled times. If you love to invest in real estate, then learn to love cap rates. And if properties just aren't your thing, give us a call.

You'll be glad you did.

Anxious, at times

Are you the type of person that hates entering a room full of people you never met? Do you enjoy conversations with one or two people but avoid an audience at all costs?

Like millions of people investors also have their own happy medium. They seem comfortable in stocks at certain price points yet far more apprehensive of them at elevated levels. We noted earlier in *The Quarterly*, that Netflix stock was severely punished once it failed to provide investors with their quarterly quota of good news. Stocks have their own intrinsic risks, factors we term security specific risks. People have their own variation of these same risks which are rooted in medical explanations. From there we have the environment around an investment or person. Some people may simply make you feel anxious. For investors exogenous factors like interest rates or currency movements, or more even recently what the President of the United States tweeted the night before may also impact investment anxiety. Investment anxiety is more easily described than the human sort because the financial world has created all sort of statistics focused on understanding volatility and confusion.

At MAAM our time test investment process takes a lot of the emotion out of investing. We view investments as business opportunities and have a rigorous buy and sell discipline. Complementing our well-developed process are dedicated people. We may not make you feel completely comfortable all the time, but knowing your investments are well looked after is certainly a good start.

Firm News

MacNicol & Associates is pleased to announce that is has finalized a list of top notch guest speakers for it's What's the Alternative? Investment Conference being planned for Miami Florida.

MacNicol & Associates Asset Management Inc.