November 2018

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.

"I believe that music is connected by human passions and curiosities rather than marketing strategies"

- Elvis Costello

The Numbers:

Index:		**Year-to-Date:**
S&P/TSX:		1.12%
NASDAQ:		9.67%
Dow Jones:		5.91%
S&P500:		5.25%
Interest Rates:	**Canada**	**USA**
90-Day T-Bill:	1.71%	2.36%
5-Year Bond:	2.44%	3.04%
10-Year Bond:	2.47%	3.19%
30-Year Bond:	2.53%	3.39%

Economic Data:

- The Bureau of Labor Statistics reported the economy added 250,000 jobs in October
- US dollar gained ground versus the Loonie closing in the $0.76 range
- WTI Oil was sharply lower in October reflecting mainly inventory build
- The IMF Revised Global Economic Growth lower at its latest meeting
- Gold was higher in October but began giving back most of those gains in early November action
- US Fed, ECB and Bank of Canada among major global central banks that continue a narrative of monetary policy normalization

Valuation Measures: S&P 500 Index

Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	22.8	23.8
P/B: Price-to-Book	3.10	2.90
P/S: Price-to-Sales	2.15	2.09
Yield: Dividend Yield	1.88%	1.90%

Year-to-date Performance, by Sector: September 8th, 2018

U.S. Markets	Close	Net	1 Day %	YTD %
Dow Jones	26180.30	545.29	2.13%	5.91
Dow Jones Transports	10714.49	240.38	2.29%	0.96
Dow Jones Utilities	747.10	6.95	0.94%	3.28
S&P 500	2813.89	58.44	2.12%	5.25
S&P 400 Midcap	1910.12	28.17	1.50%	0.50
S&P 600 Smallcap	992.06	11.79	1.20%	5.96
NASDAQ	7570.75	194.79	2.64%	9.67
Russell 2000 (Smallcaps)	1582.16	26.06	1.67%	3.04
BKX (Banking)	101.50	0.93	0.92%	-4.88
BTK (Biotech)	4874.16	83.42	1.74%	15.44
XOI (Oil Index)	1407.00	25.17	1.82%	5.35
SOXX (Semiconductor)	1257.47	14.84	1.19%	0.35
XAU (Gold/Silver)	65.59	-0.72	-1.09%	-23.09

Source: Jeff Saut, Raymond James

Disclosure...

Don't ask us about disclosure...

For 17 years, MAAM - along with a good number of other Portfolio Management firms like ours - have unambiguously told clients the truth, the whole truth and nothing but the truth when it comes to things like performance and fees. Recent initiatives from the Regulators like CRM II [Client Relationship Management "Model 2"] were not about firms like ours catching up with the broader investment industry. When it comes to transparency this firm is the pace setter and many of the requirements of CRM II were things we had been disclosing to clients for years. More recently the regulatory sphere in Canada has set it sites on the subject of Referral Agreements and here again our model has always been above water. So you can only imagine our

surprise when a quick internet search revealed very little in the way of disclosure requirements on Foreign Exchange Rates charged to client accounts. This gargantuan, not to mention extremely lucrative part of the Banking business, is something many clients know little about. This prompted us to do a little digging of our own and introduce a new feature to ***The Monthly***. Moving forward we will be updating you not only on currency rates but the costs associated with affecting such transactions with major financial institutions. We feel you will find this exercise revealing...

We surveyed all the Banks and some Custodians to compare Foreign Exchange Rates charged. As you can see in the chart below there is a wide variance between Institutions. We tried to include some other firms but they do not post public rates online or require a membership fee. Let us know if we have left any organization off here and we will try to include in future publications.

As of November 9, 2018 2:44 PM	**$ 5,000**	**CAD**		
Banks	**Rate**	**Buy USD**	**Cost**	**% Difference from Spot Rate**
CIBC	No Public Rate Posted Online			???
Interactive Brokers	1.3219	$ 3,782	$ -	0.0%
Laurentian Bank	No Public Rate Posted Online			???
National Bank	1.3320	$ 3,754	$ (29)	-0.8%
Raymond James	1.3340	$ 3,748	$ (34)	-0.9%
Royal Bank	1.3489	$ 3,707	$ (76)	-2.0%
Scotia	1.3577	$ 3,683	$ (100)	-2.7%
TD	1.3553	$ 3,689	$ (93)	-2.5%
Spot Rate	1.3218		**Best Rate**	

Financial Sankalpa…

One of the things I love about Yoga is the ease with which I can squish a couple of back bends into my hectic schedule and claim to be semi-productive in one aspect of my life. However, yoga and I are somewhat of a new item. I did not even consider yoga as a plausible exercise solution until recently and if you would have asked me to join you for a couple of twists in a Yoga studio 15-years ago, I would have declined, most likely in an irreverent (possibly snarky) way to boot. By the same token, if you would have asked me 15 years ago, whether interest rates would remain at mid-1950's levels for nearly a decade a similarly cranky dismissal would have awaited you.
The other thing I love about yoga is its uncanny ability to increase mental focus and awareness, which I know clients will love. Markets of late have been quite tricky to navigate and stamina [both cognitive and physical] are necessary to make sense of it all.

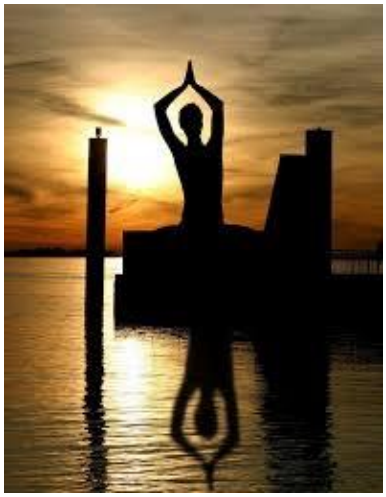
In this edition of ***The Monthly***, the MAAM investment team takes a look at the markets in an effort to help investors find their only financial sankalpa.

Making sense of financial markets is supposed to be easy: stock prices, bond yields and currencies act like they care about longer term economic fundamentals. Yet financial markets always react to new information rapidly, in fact they often overreact to new information. When the markets of today retrace yesterday's overreaction it can lead to a case where investors are left stumbling to reconcile the high-speed nature of financial market action with the evolution of slower moving economic fundamentals. Economic fundamentals, such as labour market indicators, arrive with a lag after all Corporations let workers go because of a recession not in anticipation of a recession. Financial markets on the other hand "live for the moment" and change by the second. Ignoring financial market action though can be perilous. Consider for a moment some of the financial market action we have witnessed in 2018: yield curves were flattening throughout much of the first half of the year prompting many to question whether slower economic growth was headed our way. At the same time, higher and higher stock prices supported a more positive economic outlook as investors expected corporate profits to continue reaching new highs. Shortly after Thanksgiving though, financial market action began to unravel with higher yields and sharper declines in the stock market. Trying to harmonize exactly why financial markets changed so drastically between Labour Day and the start of our new post-Thanksgiving workout craze is difficult (like yoga itself) still we found the exercise worthwhile nonetheless.

Trying to interpret financial market action comes with risks of its own. Financial markets are not intractably uniform. Instead they reflect a wide distribution of views. Financial markets also evolve over time. Still we extract what we can from financial market action and use that information to corroborate our views of the economy.

Looking At The Economic Picture From A Broad Perspective

The world has made good progress on distancing itself from the global financial crisis of 2008. Several, reform minded, pro-business nations, have made more progress than others. Though taken as an aggregate, the world economy now produces a level of output that is approaching full capacity. Accordingly, monetary policy has begun the process of returning to levels that history judges as more normal. In previous editions of ***The Monthly***, we described a more synchronized global economic expansion that now appears to be driven by fewer, but stronger, participants. Fiscal stimulus in the United States has helped that nation set the pace as the benchmark for global growth. On the other hand, numerous trade actions and the constant threat of more, have had their impact on economic growth in many areas of global markets. Back in October, the International Monetary Fund (IMF) cut their outlook for global economic growth to 3.7% from almost 4.0%. The IMF noted that trade tensions have begun to affect global economic activity. The actual term used by the IMF was "hit". In a prepared speech at the IMF annual meeting, the fund's Chief Economist had this to say...



"Earlier projections now appear to be overly-optimistic given that risks from further disruptions in trade policies have become more prominent."

- Maurice Obstfeld

IMF Chief Economist

[IMF realty check]

The increasingly disproportionate influence of China and the United States on global economic growth is drawing investors to more carefully consider the escalation of tariffs between those two nations. This topic has become a more prominent fixture on investment team meetings at MAAM. Escalating trade tensions have caused the prices of various industrial commodities to decline and a Hawkish Fed continues to support an increased value for the US dollar on the world stage. US dollar strength has of course strained various emerging markets and while many global Central Banks expect this hurtful trend to continue, we believe yesterday's overreaction is today's opportunity. Moreover, we have not observed a generalized Emerging Market malaise. Certain appendices have been hyper extended to be sure, but inferring overall disaster from specific cases ignores many strong Emerging Markets (such as India) offering attractive long-term investment opportunities.

[This is *Taraksvasana* or Handstand Scorpion and no…I haven't even dreamed of attempting this one]

Back home in Toronto the feelings can be summarized in one word: resentment. Most Toronto Portfolio Managers resent having to position client assets in Canadian equities, and most Toronto citizens are reluctantly resigning themselves to the fact that our hot, lusty and gorgeous summer has now been replaced by a Fall that is as ugly (or uglier) than our weather. Nonetheless, the outlook is a positive one with Canadian and US trade uncertainties off the table.

And the Bond Market?

Bond markets inform Portfolio Managers about the prospects for both growth and inflation, and as such, go a long way towards reconciling the decisions investors make in their own portfolios. In particular, the slope of the yield curve has garnered much attention as short term rates rose more quickly than long-term rates, a situation some Economists define as yield curve inversion and a one symbolic of a recession. The MAAM investment team is a bit more sanguine about the reliance on lone indicators, much less one that has "correctly" (note quotes) called 11 of the past 6 recessions. A number of factors have held down long-term yields making any rise in short term yields "feel" more piercing than it otherwise may be. The factors include the gradual decade and a half long decline in "R-Star" or what Economists call the natural or "neutral" rate of interest. This interest rate supports the economy at full employment/maximum output while keeping inflation constant. Another factor is inflation targeting by Central Banks and we believe that it is too early to tell whether monetary authorities have ultimately succeeded in this endeavour. Finally, outright bond buying by Central Banks in an effort to reduce the effect of the global financial crisis have also contributed.

As we have quipped in the past, we believe the main issue with the bond market is the reversal of the decades long decline in yields, which regular readers will know bottomed out in or around July 2016. We would suggest that after years of accommodative monetary policy the risk of deflation is likely off the table. Investors are wise to expect that yields can no longer be suppressed by extraordinaire monetary measures.

When the winds of change blow into financial markets the MAAM investment team will be there for you. Sure, we are not investment gurus (or yoga gurus for that matter) but together we will help you reach your inner financial intentions.

The MAAM Investment Team

The A, B, Cs of Multifamily Residential Real Estate…

The MAAM investment team will be in Florida next week for a broad range of meetings and functions.

In addition to reviewing several corporate planning initiatives we will also be assessing the outlook for financial markets in 2019 to ensure client portfolios are also aligned with our clients' interests and market trends. Another thing we will be doing is touring several properties held in our 360 Degree Realty Income Fund and Alternative Asset Trust. We will be commenting on commercial real estate in a forth coming edition of ***The Monthly*** but the focus next week will be multifamily residential assets.

[Renting by choice or renting by necessity is still renting]

Whether you are a renter by choice (class A) or a renter by necessity (class B and C) the conclusion is that you are still a renter. Looking at the criteria the 360 fund sets out in the context of this product type is something we would advise investors to consider strongly. As a reminder to veteran real estate investors or a primer to those new to the space, interest rates are (far from) the only thing influencing this property type.

1. Population Growth
2. Employment Growth
3. Wage Inflation

In the end though it all boils down to valuations and NOI [Net Operating Income] risk. Overpaying for even the "prettiest" property will only serve to lengthen one's time horizon and achieve the minimum annual return you desire. In this context, the MAAM investment team focuses on assets we can effectively model in-house. Multifamily serves this focus well since cash flows are more reliable. But we aren't alone. In addition to holding assets outright, the fund also partners with leading Private Equity firms that offer a diverse array of talent management teams dedicated at finding, enhancing and realizing opportunities in a conservatively levered way.

Institutional Investors Taking Note

We recently did a call with an industry colleague of ours asking for guidance on a suitable real estate benchmark. We guided him to the NCREIF NPI [National Council of Real Estate Investment Fiduciaries National Property Index] a frankly long worded index we have used for years. Blake Eagle, index founder, summarizes the index as follows:

"Established over 35 years ago, NCREIF serves the institutional real estate investment community as its Data Central, representing the largest, most robust and diverse database of country-specific real estate assets in the world. NCREIF produced the first property level return index, the NCREIF Property Index (NPI), dating back to 1978 to capture investment performance records that meet the rigorous scrutiny and review of major investors and academia."

- **Blake Eagle, Founder NCREIF**

We consult the NCREIF NPI often, and in doing so, we have the following takeaways to report. First, multifamily residential real estate plays an extremely significant role in the portfolios of institutional investors

such as large pension plans and endowments. The multifamily sector represents nearly 25% of total institutional holdings.

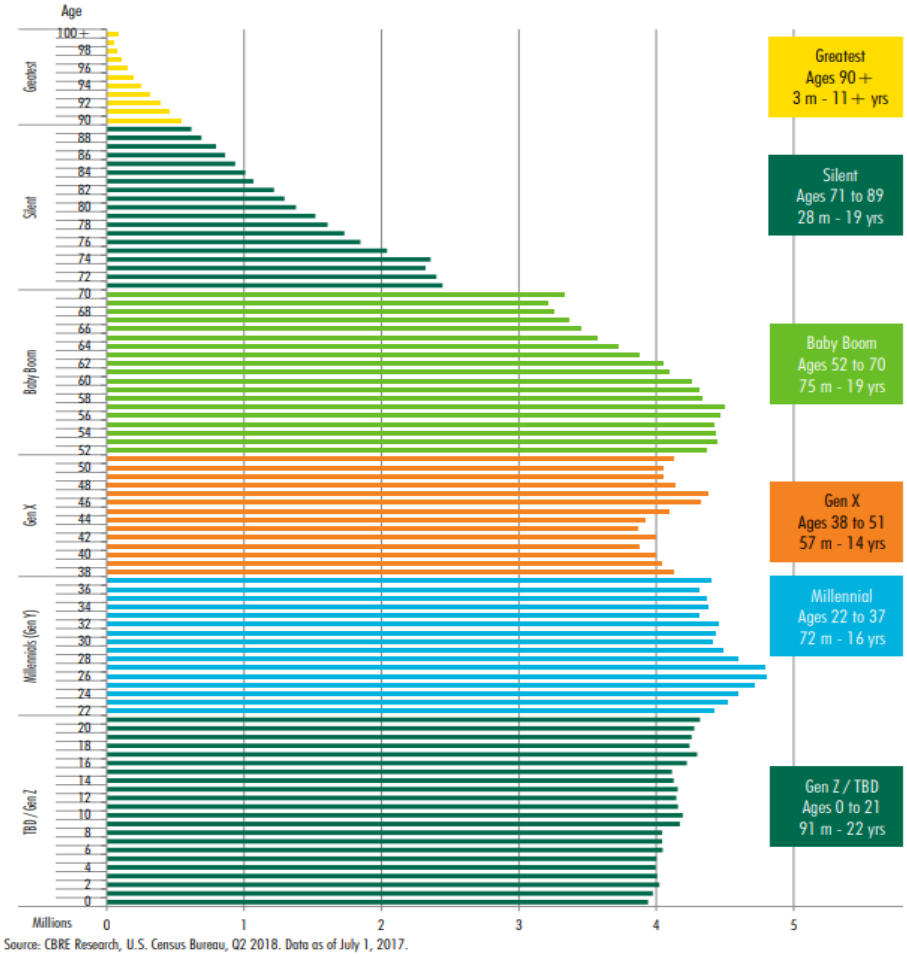
The prevalence of multifamily real estate in institutional portfolios recently comes at a time when valuations in many other areas of the market are perceived as stretched. The diversification benefits of multifamily in addition to attractive yields make the space a more suitable option for a broader swath of investors than other product types such as hotels or casinos.

This Wasn't Always the Case

Thirty-five years ago, when this Portfolio Manager was just a "trainee" multifamily residential real estate represented just 2.1% of the NPI index. Significant periods of change occurred in the late 1980's and the mid-2000's. We recall the 1980's well; in those days, our then home of Mississauga, Ontario seemed to double in value every 6-months. Market share gains in Multifamily following the 2008 global financial crisis were partly reflected by the sector's increased sophistication of management and reporting, but also since the sector did not experience anything close to the level of downturn experienced by other product types.

As the MAAM investment team visits properties later this November and formulates its views for 2019 we will be keenly observing the evolution of four (4) primary drivers of the space. First, the narrowing of the gap between supply and demand. With new product coming to market in certain areas of North America at levels some observers would judge as copious we suspect that we will continue to witness some residual weakness in markets heretofore viewed as "boom" towns, such as Nashville TN. An influx of new supply obviously caused some form of disinflationary rent pressures but as the city (and others like it) absorb new unit deliveries, we don't think it will be too long before demand "catches up" with supply. The second driver is buyer demand overpowering higher borrowing costs. While the team appreciates that the yield on the US 10-year may have difficulty negotiating the 3.35% level, which is the long-term trend, the fact remains that yields on the benchmark US note have risen by over 80 basis points (0.8%) since just last September. Still there continue to be more investors pursuing multifamily assets that before and since more equity capital is on offer.

Our view is that while tighter lending conditions exist cap rates should hold steady. Third is that workforce and labour market indicators are still very strong. Broad based market proxies for rent growth and occupancy don't tell investors the full story and we see this in terms of certain product types drifting further from their averages. Certain Class A products in Tier 1 submarkets has experienced moderating fundamentals while Class B suburban properties continue to show gains. Working Americans have less flexibility when it comes to choosing where they live than do independently wealthy Americans. The more attainable price point of Class B properties ensures some relative insulation from new supply given the higher rental premiums necessary to justify new builds. Job growth and household formation remain strong and this should support the sector. Tighter lending standards and rising home prices make purchasing a new home more challenging. Finally, a two-pronged demographic tailwind is likely to propel the sector for quite some time into the future. Specifically, millennials and those who retrained for new careers later in life, are opting to rent for longer periods of time. Increasingly, baby boomers are in many cases choosing to sell their homes and downsize to apartments that afford greater flexibility and reduced maintenance volumes.



Source: CBRE Research, U.S. Census Bureau, Q2 2018. Data as of July 1, 2017.

[There are now 72 million millennials in the United States and that's a lot. Younger millennials are still in their 20s and even the "oldest" millennials will just now be turning 39. Multifamily's focus on life-stage movements and the ensuing changes in housing selection could not be more acute]

As one of many growth markets for multifamily Florida represents an important anchor of the 360 Fund's geographic allocation to this free cash flowing product type.

The MAAM Investment Team

Orange face paint, orange suit jackets...market psychology

[Our Eye Doctors swear we are 20/20 but even with the medical community now unambiguously bullish on yours truly…telling which is <u>more</u> orange: President Trump's face paint or Nancy Pelosi's suit jacket is still quite tricky]

The MAAM investment team feels it is too early (not to mention difficult) to tell exactly what impact a Democratic House will have on stock, bond and currency markets. Very little data regarding how markets have performed following instances of the GOP being thrown out of the house in a US mid-term election are at our disposal to analyze. This sort of event has only happened twice with the most recent instance being a solid 90 years ago.

For our take though the MAAM investment team believes that the market psychology overall, remains unchanged because markets always loath uncertainty. The simple fact that US Mid-term elections are now over eliminates uncertainty in some areas while creating more in others. We certainly think markets have responded positively though and we are entitled to our opinion but we're sure keen readers will correctly point out that the S&P 500 has actually bottomed out around Halloween and has been recovering ever since, and we would be the first to agree with that point. The thing is, many of the S&P's heaviest heavy weights [like Apple] have actually been in retreat during the first week of November making the index's "achievement" in dealing with adversity under appreciated by investors. That the S&P was able to "soldier" forward in the face of a less than stellar contribution from select tech titans reflects confidence in future profit growth. As referenced earlier, we think that as rates continue to rise, that profit growth will have to be discounted by higher and higher rates, reducing the price investors will be willing to pay for stocks.

We certainly don't feel that Nancy Pelosi will be able to corral President Trumps rhetoric or Twitter account. We do believe she will be able to act as an effective check and balance on his policies, which taken together may in fact be better for America over the long-term even though markets "live in the moment" and prefer to view things over the short term.

While the President instructed reporter April Ryan to "just sit down" in the post midterm press conference, the MAAM investment team will never rest for our investors no matter what the market happens to be "feeling".

Firm News: We will be in Miami, Florida for corporate planning and investment related activities. During this period the firm will remain open and we will respond to telephone calls and e-mails in a timely manner.
MacNicol & Associates Asset Management Inc.