Investment Notes

December 31, 2017

GLOBEINVEST
CAPITAL MANAGEMENT INC.

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Overview

A year ago, we noted that while there were still a considerable number of cross-currents for stock markets, overall, going in to 2017, there was a more positive tone to both the economy and equities markets. That improvement led to the TSX Composite and the S&P 500 rising 9.1% and 21.8% respectively in total terms and in local currencies in 2017. As the Canadian and US economies picked up steam, particularly in the second half, government bond yields in both countries rose for the two and five year maturities.

For the 10 year maturity they rose in Canada and declined slightly in the US and for the 30 year maturities declined modestly in Canada and more so in the US. The government bond yield curves in both countries flattened considerably, but still remain positive. In currency markets, the $US as measured by the DX/Y index declined 7.6% for the year and declined 6.9% against the $CDN. Finally, in commodities markets hard commodities showed solid gains while soft commodities were mixed. As measured by indexes, The TRI-CRB index rose 0.7%, the GSCI 34.6% (heavily weighted by oil) and the Rogers International Index 4.4%. Please see the last page of these Notes for a full statistical review.

Commentary

For the past several years we have opined that given the severity of the 2007/08 recession, any recovery would be weaker and take longer to fully recover. And that forecast has proven to be correct at least until the second half of 2017, when growth started to accelerate, moving the US economy closer to a full recovery. For example, unemployment continued to decline, wages in real terms continued to rise and consumers opened their wallets. This acceleration of growth combined with improving economies in the rest of the world, resulted in solids gains in global stock markets.

We maintain our view that the US economy and corporate earnings can continue to increase both in 2018 and 2019 and possibly longer. Arguably, we are in the later stages of the recovery and with stock market indices trading above historical valuation levels, we remain cognizant of potential risks/negatives. So, what are the major ones?

- The geo-political situation is extremely dangerous especially with reference to North Korea and the Ukraine. Also, if Chancellor Merkel is unable to form a coalition government, it may prove problematical for not only Germany, but the rest of Europe. Finally, if NAFTA collapses, it will negatively impact Canada.

- The U.S. Fed is in the early part of the interest rate tightening cycle, which at some point could impact stock markets. Also, potentially impacting stock markets is the withdrawal of any quantitative easing and the sale of bonds from the Fed's portfolio. Finally, the Fed has a new and relatively inexperienced Board of Governors who may make policy mistakes such as raising rates too quickly.

- Wage rates are rising and if they continue, could put upward pressure on inflation and interest rates.
- Given the length of the recovery, the economic numbers are "as good as they are going to get" and has already been discounted by the stock market, thus raising the risk future economic data will not meet expectations.
- While the S&P 500 has traded at a higher price earnings ratio ("PER") in the past, some regard the current forward PER as excessive given the worries outlined above. Also, there is a view, that with the massive inflows of passive funds, exchange traded funds (ETFs) are now the "800 pound gorilla in the room" and if investors become disenchanted with them, the ensuing outflows could cause a major market decline.

On an overall market basis, we have continually warned that a 5% to 10% correction could take place at any time for any reason. As a correction of this magnitude has not taken place for some time, it is reasonable to expect the probability that one will occur to increase. Whether it would cause us to change our investment/strategy depends on the catalyst for the correction. As for the potential negatives:

- We agree that global geo-political risks continue to increase as does the uncertainty for the outcome of US mid-term elections in November. However, unless things go nuclear, any of the foregoing should have a limited impact on stock markets. The collapse of NAFTA would be problematical for the TSX, but is premature to assess the extent until details are known.
- In response to the lack of experience of the new Fed Governors, we think that worry is a "canard". These are intelligent, well-respected individuals, who can interpret and understand the Fed history.
- Looking at the potential for higher inflation, we see US wages continuing to rise. For example, minimum wages increase are scheduled to rise in 18 states in the US not only in 2018, but in many cases through 2020. Also, tighter labor markets should also lead to higher wage.. Wage increases will help the US consumer, especially if the gains exceed the increase in the inflation rate.
- Regarding overall inflation, the largest components of the US CPI, as of November, were Housing (about 32.8%), Medical Expenses (about 8%) and Food At Home (about 7.8%), which will continue to show moderate year over year increases. Energy at 7.4% of the CPI can be volatile and will impact the overall year over year changes.
- Given the outlook for the US economy and inflation, rising interest rates are inevitable. The extent of their negative impact, if any, will depend on to what levels they rise to and how quickly. While government yield curves are flattening, they remain positive. We will continue to monitor the slope of the yield curve closely.
- As for the worry that the US economic numbers are as good as they will get, we don't buy that for a moment. The US economy has an overall positive

GLOBEINVEST CAPITAL MANAGEMENT INC.
20 Queen St. West, #3308
Toronto, ON M5H 3R3
www.globe-invest.com
Tel. (416) 591-7100
Toll free. 1 (800) 387-0784
Fax: (416) 591-7133
info@globe-invest.com

momentum, which like an ocean liner, be hard to turn around quickly short of a catastrophic black swan event. Also, regardless of the fairness of the US Tax Bill, it should increase corporate profits for 2018 and 2019 and possibly 2020. Other sectors of the economy should benefit, thus continuing the economy's positive momentum.

- On the topic of US stock market valuations, we note the earnings per share of the S&P 500 companies are expected to grow 12% in 2018 and 10% in 2019. As of January 5/18 close, this corresponds to a price to earnings (PER) multiple of 18.6X and 16.9X respectively. In our view, given the potential for further economic growth and a relatively low interest rate environment, the current PER may be justified. However, given that the current valuation is elevated compared to the long term historical average, further market upside must come from earnings increases rather than PER multiple expansion.

Summary

We remain constructive but will remain vigilant about potential worries.

New Team Members

We would like to officially welcome and formally introduce two new members of the GlobeInvest team. Chris Blumas joins us after 15 years as an analyst and portfolio manager with a prominent research firm, a major mutual fund company and an investment counselling firm. Chris has a BComm from the University of Windsor, an MBA from the University of Toronto, and is a CFA charterholder.

Also joining us is Catherine Visicale after an extensive career as an administrative assistant in a number of industries including a major mutual fund company. Catherine has replaced Shirley Marks, who retired this past fall.

As we begin 2018, we would like to wish you and your family a Happy, Healthy and Prosperous New Year.

Peter Brieger, HBA, CFA
Christine Poole, MBA, CFA
Wendy Sanita, CFP®, CIM®

2018 BNN Dates for Christine Poole

January 25 @ 6:00 am – Guest host on The Street
February 13 @ 1:00 pm
March 8 @ 5:30 pm
April 10 @ 1.00 pm
May 8 @ 5.30 pm
June 8 @ 5.30 pm
July 10 @ 1.00 pm
August 8 @ 5.30 pm
September 11 @ 1 pm
October 10 @ 5.30 pm
November 13 @ 1.00 pm
December 11 @ 1:00 pm

December 31, 2017 Statistical Summary

STOCK MARKETS	**1 Year**
S&P TSX Composite Total Return (CAD)	9.1%
S&P 500 Total Return (CAD)	13.9%
S&P 500 Total Return (USD)	21.8%
DJIA Total Return (USD)	28.1%
NASDAQ Composite Price Return (USD)	28.2%
MSCI World Index Price Return (USD)	20.1%
D.J. Stoxx 50 Price Return (USD)	20.5%
France CAD 40 Price Return (USD)	24.7%
UK Price FTSE Index Price Return (USD)	19.4%
China S.E. Shanghai A Price Return (USD)	13.8%
India Sensex 30 Price Return (USD)	36.0%
Japan Nikkei 225 Price Return (USD)	23.6%
MSCI Emerging Markets (USD)	34.3%
COMMODITIES	
GOLD	13.1%
SILVER	6.4%
COPPER	31.3%
ZINC	29.7%
LUMBER	34.6%
NATURAL GAS	-20.8
WTI	6.2%
BRENT	14.2%
CURRENCY	
CDN/USD	6.9%
DX/Y	-7.6%

Government Bonds	**12/31/16 (%)**	**12/29/17(%)**
2 Year Maturity (CAD)	0.76	1.69
(USD)	1.19	1.89
5 Year Maturity (CAD)	1.09	1.86
(USD)	1.93	2.20
10 Year Maturity (CAD)	1.72	2.03
(USD)	2.44	2.40
30 Year Maturity (CAD)	2.31	2.24
(USD)	3.07	2.74
Inflation		
CPI (CAD)	1.2%	2.1%
(USD)	1.7%	2.2%

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