TRAPEZE
ASSET MANAGEMENT

IT’S NEVER ONE THING

We are amused when commentators cite just one factor for a market movement because there's almost always a confluence of factors influencing the markets at any one time.

For the recent correction some are blaming the increased prevalence of passive investing which they suggest has heightened the correlations of stocks and magnified their movements—forced indiscriminate buying on the way up and the opposite on the way down. Others argue that algorithmic trading is to blame.

It didn’t help that congressional leaders reached an agreement that would increase the deficit by well over $500 billion. Or that the market was dealing with a new Fed chair, Jerome Powell, who was sworn in February 5.

After a prolonged period of risk taking, the risk switch was abruptly turned off. Nearly everything was falling in the recent correction. Stocks in general declined, virtually regardless of country or sector. Even utilities and golds, normally counter-cyclical groups, along with most commodities such as oil and gold bullion, selling off too. Correlation of the S&P 500's 11 sectors was recently at its highest level since the fall of '16.

If we were forced to pinpoint the primary impetus for the correction, we'd have to blame the rise in interest rates where the 10-year U.S. Treasury had jumped from a low near 2% last September to just below 3% recently. As rates rise, bonds become a more competitive asset class to stocks. And January’s hourly wage rise was 2.9%, the biggest year-over-year rise since June '09, as the labour market tightened. So, inflationary concerns surfaced impacting anticipation of even higher interest rates.

That Was Something

Prior to the correction, the U.S. market experienced a period of over 400 trading days without a 5% drop in stock prices from the previous high—the longest such streak in market history with investor sentiment at historical highs. And the ascent steepened in December and January especially after the U.S. tax bill was passed in late December and its positive implications were being priced in—forward earnings estimates for the S&P 500 spiked about 8% in just 8 weeks. And there were pockets of excesses, for example, the crypto currency market which more than tripled in about 3 months until greed turned to panic.

Profit taking took place in the stock market too as the market just moved too far too fast leaving it susceptible to decline. Once selling begins, it often begets further selling which eventually leads to an oversold condition as markets move too far too fast to the downside.

This correction was likely caused, not by one thing, but by a combination of all of the above.

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It’s Always Something

There’s always something to be concerned about. The world is complex. It’s our task to distill the plethora of information in order to form opinions on the direction of markets, sectors and individual securities. To deal with the complexities, we’ve been using our two macro models since 2010. From a bottom-up standpoint, we focus on the highest quality bargains we can find.

The market is right to be concerned with the economy, interest rates and inflation. That’s what drives corporate values and in turn share prices. Interest rates have been rising, both at the administered short end, driven by central banks normalizing rates after a very long period of low rates designed to stimulate growth, and at the long end as the bond market reacts to the Fed’s actions and anticipates economic excesses.

Excessive growth leading to higher rates of inflation should be the primary concern. Some early signs of this are already present with wages. And government debt levels are almost certain to escalate from lower tax receipts and higher spending that the politicians refuse to rein in. Social Security and Medicare expenditures appear much too high at half of the annual budget deficit and growing. The Congressional Budget Office has forecasted that the U.S. budget deficit is on course to triple over the next 30 years, from 2.9% of GDP in 2017 to 9.8% in 2047. The budget deficit as a percent of GDP is expected to double from '15 to '19. Only with Trumponomics would one have seen enormous tax breaks and other fiscal stimulus in the form of a massive infrastructure bill when the economy is rolling along and unemployment at a 17-year low.

The good news is that this ought to prolong this cycle even further. Lower corporate taxes and the lower U.S. dollar have made the U.S. more competitive which should also attract capital from abroad—both from repatriation by domestic companies and from foreign corporations. U.S. growth should uptick. And worldwide too. The International Monetary Fund raised its estimate for '17 global growth to 3.9% from 3.7%. There appears to be synchronized growth too with most nations around the world growing. Most central banks remain accommodative and while interest rates around the world are rising, they are still historically low and are expected to increase gradually. Global credit is also abundant. China's record-setting loan data continues to make a case for spurring global growth. The bad news is that all of this won’t likely end with a whimper.

What’s the risk in the meantime that accelerating economic growth creates excessive inflation? It may take some time because of the overriding disinflationary multi-year trends from prevailing demographics—aging populations—dampening consumer demand pressure and the digital age which acts in many ways to keep consumer and producer prices under wraps. While the PCE price index figures are picking up, running at 1.8%, it’s still below the Fed’s target 2%.

At the corporate level, revenues are rising and profit margins are at record levels, both boosting earnings and overall values. Sales and earnings results have been coming in above average rates ahead of estimates. While some of the valuations of the market favourites appear to be overvalued and scare us, those market darlings are still reporting excellent fundamentals with Netflix, Nvidia, Amazon, Tesla and others continuing to produce metrics ahead of expectations.

Overall stock market valuations are elevated—at or above fair value. So the medium-term outlook for stocks in general is not favourable. At this stage we feel that bottom-up stock picking is essential to help offset the risk of holding positions that might be impacted unduly by negative revaluations.

Here’s The Thing

Stock market declines rarely turn into bear markets without the presence of a recession. And recessions are normally spurred on by a tightening of monetary policy—sufficient to invert the yield curve (where short rates are administered higher than long rates)—which then leads to economic declines. There are still no signs of that today.

There's a reason that what we just witnessed is typically called a correction—it’s a lesser setback than a bear market, and is temporary in nature as it brings the market back down from an extended level.

Bear markets tend to begin before the economy begins to decline. That’s why we constructed our macro tools to anticipate economic peaks. Since we are still mindful of the elongated economic cycle, we continue to closely monitor our proprietary tools for the next bear market. Our Economic Composite (TEC™) is not alerting us to a recession. Similarly, our market momentum indicator (TRIM™) is not suggesting an imminent bear market. Should our tools suggest caution, we would attempt to exit positions and hedge (where authorized by client accounts) in order to limit the impact of a significant market decline.

Though the monetary stimulus is waning (higher interest rates and bond sales to shrink the Fed’s balance sheet), the U.S. fiscal stimulus (significant corporate tax rate reductions and accelerated deductions for capital expenditures) should help propel the economy forward making a global recession less likely and allowing us to be more comfortable about being fully invested.

It’s certainly possible growth could downtick later in '18 or early '19 as the normal U.S. and global inventory cycle causes a slackening. However, any inventory correction should not lead to a recession as long as it’s met with central bank easing.

So we continue to analyze companies where we see competitive advantages and expect consistent growing earnings streams—the ones whose businesses have strong operations and financials (with a view to mitigating losses) and FMVs (fair market values) that are persistently growing. And when for any number of reasons, due usually to a temporary operational setback, the share price has fallen sufficiently below our estimate of FMV, we look to purchase. And we prefer to sell when positions rise to our FMV, especially when they coincide with ceilings in our TRAC™ work because we then become fearful of potential declines.

Our preference, as long as we can find a sufficient number of undervalued companies—stocks trading 20% or more below our estimated appraised values—is to be fully invested.

Our Strategy

While large cap bargains are still scarce, the correction has allowed us to purchase several holdings that passed our due diligence process. We found a few positions with favourable earnings outlooks trading at wide enough discounts to our estimates of their FMVs. We continue to add large cap positions to our All Cap portfolios and look to add more when our current smaller cap positions are sold once they rise close to our FMVs.

Until this recent correction the stock market has been abnormally buoyant. The S&P 500 experienced 15 consecutive up months through January, surpassing its former 11-month record. In '17 there were only a handful of days with 1% or more declines, the least in over 50 years, and only 8 days of more than 1% moves in either direction. We've already surpassed that so far this year. We prefer more normal volatility as it should allow us to sell into strength when our positions rise to our FMV estimates and buy on weakness when stocks fall to entry points far enough below our FMV appraisals that offer us sufficient potential upside and downside protection.

Of the dozen companies we bought in the last few weeks, as stocks corrected, we were able to buy these companies at prices just shy of 30% below their former highs. We believe our patience is being rewarded as we waited for bargains to surface. Now we need further patience to wait for the potential rise up to our estimates of their FMVs.

We continue to hold overweightings in both precious metals and oil & gas. The gold price has firmed, is on buy in our TRAC™ work and remains below where it ought to trade relative to the cost of production for the average producer. Though it corrected in the recent setback, oil is on buy too and we expect higher prices. Global oil inventories should revert to normal by Q2 as the market remains in deficit. Both commodities are in bull markets again in our view, and as long as we can find individual stocks in those sectors that are attractively valued and meet our risk-reward criteria, we intend to remain overweighted.

Our Portfolios

The following descriptions of the significant holdings in our managed accounts are intended only to explain the reasons that we have made, and continue to hold, these investments in the accounts we manage for you and are not intended as advice or recommendations with respect to purchasing, selling or holding the securities described. Below we discuss each of our new holdings and updates on key holdings if there have been material developments.

All Cap Portfolios and Recent Developments for Key Holdings

Our All Cap portfolios combine selections from our large cap strategy (Global Insight) with our best small and medium cap ideas. We generally prefer large cap companies for their superior liquidity and lower volatility. Importantly, they tend to recover back to their fair values much faster than smaller stocks, so they can be traded more frequently for enhanced returns. However, our small cap positions are cheaper, trading far below our fair value estimates; therefore, our All Cap portfolios currently hold a meaningful position in small caps.

Most of our small cap company holdings trade well below our estimate of their respective FMVs. These are smaller, less liquid holdings which are potentially more volatile; however, we continue to hold these positions because we find their risk/reward profiles favourable.

Orca Exploration announced a financing arrangement with Swala, a Tanzanian based public company. Swala has already invested US$26 million in an Orca subsidiary and up to around US$100 million more could follow. The company's FMV is about $15 per share and if Orca is successful in receiving additional Swala funds, a good deal of Orca's value would be net cash. The company already declared and paid a $0.60 per share special dividend last month so clearly there's also an initiative to return capital to shareholders. While progress has been made on a number of fronts the key risk for Orca continues to be an extended time frame for execution of its business plan.

Specialty Foods Group had a good year in '17. That, and other positive factors, allowed the third-party valuator to increase the value of our holdings at year end. The company continues to make good progress and we anticipate another return of capital later in the year, the timing of which remains uncertain.

Advantex Marketing International completed its reorganization in December. In exchange for the existing 12% secured debenture, we received a new 9% secured debenture due in December '21 and a significant number of additional shares. The company has an improved structure and good prospects should it merely regain the high merchant count it had a few years back.

Enerdynamic Hybrid Technologies is in the final stages of refinancing its obligations. We expect to receive a new short-term secured debenture due in July for most of the principal amount of the existing debenture and shares for the balance of the principal and all of the arrears owed. Meanwhile the company has made some material contract announcements and we believe the shares are depressed and undervalued.

Manitok Energy entered into receivership in mid-February stemming from its lender unusually requesting that its demand loan be repaid. The company struggled with that request beginning in mid-'15 but the bank again made a demand last November and the company was unable to find an alternate source of debt financing. We continue to work with other parties toward a refinancing to potentially reclaim a position in the assets that we still believe have upside potential. These are top-notch assets that should thrive with a better financial structure and partner.

All Cap Portfolio Changes

In the last few months we bought several new large cap positions including *Alaska Air Group*, *Schibsted*, *Medtronic*, *TJX Companies*, *Molson Coors Brewing*, *Siemens*, *Sanofi*, *Johnson & Johnson*, and *Howard Hughes*—all summarized in our Global Insight portfolio review below. We sold Cars.com, Honda, Berkshire Hathaway and Twenty First Century Fox as they ran up to TRAC™ ceilings, close to our FMV estimates. After running up and inflecting down from TRAC™ ceilings, triggering sell signals, we sold IAMGOLD and Alaska Air Group, before buying the latter back again at a floor. And we sold CVS when it broke down through a TRAC™ floor.

Global Insight (Large Cap) Portfolios and Recent Developments for Key Holdings

Global Insight represents our large cap model (typically with market caps over $5 billion at the time of purchase but may include those in the $2-5 billion range) where portfolios are managed Long/Short or Long only. A complete description of the Global Insight Model is available on our website. Our target for our large cap positions is more than a 20% return per year over a 2-year period, though many may rise toward our FMV estimates sooner should the market react to more quickly narrow their undervaluations. Or, some may be eliminated if they decline and breach TRAC™ floors. At about 80 cents-on-the-dollar versus our FMV estimates, our Global Insight holdings appear to be cheaper, in aggregate, than the overall market. Thanks to the recent correction we were able to find a number of new investment opportunities summarized below.

Global Insight (Large Cap) Portfolio Changes

In the last few months, we bought several new positions including *Alaska Air Group, Schibsted*, *Medtronic*, *TJX Companies*, *Molson Coors Brewing*, *Siemens*, *Sanofi*, *Johnson & Johnson*, *Howard Hughes,* and *Husky Energy*. We sold Honda, Berkshire Hathaway and Twenty First Century Fox as they ran up to TRAC™ ceilings, close to our FMV estimates. We had sold Alaska Air Group, before buying it back at a floor, as it ran up to a TRAC™ ceiling and inflected down triggering a sell signal. And we sold CVS when it broke down through a TRAC™ floor.

Alaska Air Group is now the fifth largest U.S. airline and is known for its intense focus on customer satisfaction. Industry capacity growth, aggressive price actions by competitors, and the ongoing integration of Virgin America took management's attention away from day-to-day business. As a result, customer satisfaction and employee morale—capped off by a contentiously negotiated labour contract for pilots—dipped. With the stock off 30% over the last year, we believe Alaska's issues are discounted into the stock price. Concrete steps have been taken to reclaim its number one spot for on-time performance. With some of the best metrics in the industry we believe the share price trades too far below our FMV estimate of $80.

Schibsted is an online classifieds and media company headquartered in Norway with a collection of dominant, high-moat, cash-rich global digital marketplaces and Scandinavian newspapers. While there's competitive risk from other online classified platforms, Schibsted is the leader in virtually all of its markets. Online classifieds are winner-take-all markets and several of its platforms are undermonetized relative to its own more mature Scandinavian businesses. The investment phase in its new markets is tapering off over the next few years and profitability levels will likely match that of its more mature assets, leading to significant profit margin expansion. The company's newspapers are in the process of transitioning to largely digital businesses, driven by growing digital content consumption. Our FMV estimate is over 490 kroner/share, substantially above the current share price.

Medtronic, a leading medical device company, commands a 50% market share of the cardiac rhythm management segment and dominant market positions in neuromodulation and structural heart. Medtronic's acquisition of Covidien not only broadened the company's product offering but positioned it as a key partner for hospitals. The market has been concerned with tougher hurdles for reimbursement rates for new technologies but the added diversification from Covidien should help buffer this risk. The company's next leg of growth should come from international expansion, currently only 14% of sales. Using conservative growth estimates, our estimated FMV is $100.

TJX Companies, the off-price apparel and home fashion retailer with approximately 4,000 stores, is one of the best merchandisers in the world. Powered by its inventory management system and global scale, TJX has achieved an average return on invested capital north of 40% over the last five years. Flat Q3 comparable store sales disappointed investors looking for a number on par with the 5% logged in the prior year. Stores in Florida, Puerto Rico, and Texas were significantly impacted by the hurricanes. Additionally, as noted by the company itself, apparel choices could have been better at TJ Maxx and Marshalls. TJX is optimistic about the coming year, citing fresh inventory flow, ample supply of high quality, branded merchandise from its more than 18,000 vendors, and continued global expansion. Longer term, we believe TJX's off-price "treasure hunt" strategy will continue to pull in shoppers looking for bargains even as more apparel and home goods shopping is done online. Our FMV estimate is $90.

Molson Coors Brewing, a leading global brewer, significantly strengthened its U.S. beer portfolio with the $12 billion purchase of its MillerCoors joint venture in '15. Though mostly known for its iconic Coors, Canadian and Miller brands, Molson also holds the number one craft brewer spot in the U.S. and several European countries and the acquisition of the JV will boost Molson's "premiumization" strategy. However, the added debt financing to complete the deal will require management to hold off on dividend increases and stock buybacks until debt levels return to pre-acquisition levels in '19/'20. The stock has fallen significantly from the $110 level reached after investors embraced the deal with enthusiasm perhaps attributable to higher leverage and lower domestic beer consumption. Now in the $70s, shares are trading at a discount to our $93 estimate of FMV.

Industrial conglomerate *Siemens* has repositioned its portfolio over the last few years to capitalize on emerging, high growth opportunities in areas such as self-driving cars, Internet-of-Things devices and services, digitalization, and smart building solutions. Siemens sees Power and Gas continuing to struggle in '18 as the global supply of turbines continues to significantly outstrip demand. As Power and Gas margins trough in the next 2 years and investments in new growth-oriented businesses bear fruit, we see EPS growth in the high single digits through '21. Our FMV is €140.

Sanofi, the French pharmaceutical company, lost patent protection for insulin glargine, marketed under Lantus, in '15. Representing close to 20% of '15 revenue, the loss of exclusivity for insulin glargine required Sanofi to search for a new strategic direction. Reinvigorating its industry-lagging R&D process was central to moving beyond Lantus. Sanofi's increased R&D spend has led to over 67 Phase 1, 2 and 3 projects in the pipeline, up from 54 in '15. Its recently announced acquisition of Bioverativ provides Sanofi with a world-leading rare blood disorders platform. As a result, sales are more balanced with Specialty Care, Vaccines, Diabetes & Cardiovascular and Consumer Healthcare all contributing approximately 25% each to total non-General Medicines revenue. Sanofi does not have any material loss of exclusivity events on the horizon. Excluding currency, '18 EPS is expected to grow 2 to 5%. Our FMV estimate is €89.

Johnson & Johnson's consumer brands such as Neutrogena, BAND-AID, Motrin, and Tylenol are well known around the world, but make up less than 15% of the company's pre-tax income. The bulk of JNJ's earnings comes from its Pharmaceutical segment, focused on areas such as immunology, cardiovascular, infectious and metabolic diseases, and its Medical Devices segment, which offers a broad range of products for orthopedic, surgery, cardiovascular, and vision care fields. The company's '18 earnings growth guidance was lower than expected and we believe the stock now reflects overly pessimistic growth assumptions. Our discounted-cash-flow valuation estimate is $160. This valuation is corroborated by a sum-of-the-parts valuation using the prevailing price-to-earnings multiples for JNJ's publically traded peers operating in Pharma, Medical Devices and Consumer sectors.

Howard Hughes primarily develops master planned communities in several sought after locations in the U.S including Honolulu, Las Vegas, Houston and New York. The company trades well below our Net Asset Value estimate in excess of $180. The company has significant undeveloped land but should also get to a point soon where recurring earnings are more meaningful. It has top-tier management who are highly incentivized to grow shareholder value. Concerns about the Houston area post Hurricane, Bill Ackman's firm's share sales which appear to have been technically motivated to avoid taxation implications elsewhere for his organization, and higher interest rates have all weighed on the share price. Offsetting this, the CEO acquired over $50 million of warrants last September. The prospects for housing in the U.S. remain sound, especially with supplies so constrained as illustrated by near-record low inventory levels. The company's sales volumes are robust and prices have been advancing nicely.

A buying opportunity emerged in *Husky Energy* after its stock price fell on news it was suspending operations at its SeaRose FSPO vessel, parked 350 kilometers off Newfoundland, in compliance with a suspension notice received from the Canada-Newfoundland and Labrador Offshore Petroleum Board. According to the regulator, Husky did not follow proper emergency response plans when an iceberg narrowly missed the vessel in March of '17. Representing 8% of '18 production estimates, a prolonged shutdown would have had a material impact. Husky was allowed to resume operations eight days after receiving the notice. Trading at just 4.9x EV/DACF versus peers at close to 9x, Husky shares are undervalued, especially so when considering its diversification and free-cash-flow generation. Though, its earnings power remains dependent on higher and stable oil prices. Our estimated net asset value is $21.

Income Holdings

The 10-year U.S. government bond yield has jumped to just shy of 3%. High-yield corporate bond yields have risen too, to 6.2%. The spread between the two, at about 330 bps, remains historically narrow. Over the last 20 years a more normal spread has been around 500 bps. So either 10-year governments are too high or high-yield bond yields have much further to rise, which is more likely the case.

We continue to hold a number of undervalued income positions and collect outsized interest income on these positions. Our income holdings have an average current annual yield (income we receive as a percent of current market value of income securities held) of about 9%. Though there is risk from higher interest rates, which would compete with our holdings, and specific business and credit risk for our corporate positions—bonds, REITs, preferred shares and income funds. We were finally able to put a bit more cash to work in income accounts as the recent correction sent prices down into our buy range for several securities and we bought the following:

Corporate Capital Trust, a $4 billion BDC (business development company) managed by KKR focused on the middle-market corporate sector. Having recently gone public, with a NAV of about $20 per share, we were attracted by the more than 20% discount it was trading at along with its 10% yield. With mostly first lien secured debt and floating rate structures to provide protection against rising rates, we were attracted to this holding. *Oaktree Strategic Income* is also BDC where Oaktree recently took the management contract and has begun to integrate it into Oaktree's credit platform. Like CCT above, Oaktree holds mostly first lien secured debt with floating rate structures. With the strong team at Oaktree, access to cheaper capital, a greater than 20% discount to NAV, and a 7.2% yield, OCSI appears compelling for both potential capital appreciation and yield.

Brookfield Real Assets Income Fund comprises a mix of credit and equity securities in issuers' hard assets which include real estate, infrastructure and natural resources. The fund trades at a meaningful discount to its NAV and provides a 10.8% yield.

Morguard Residential REIT owns over 13,000 apartments within multi-unit residential complexes in Canada and the U.S. It has recently expanded in the mid-west states and been able to recycle its capital accretively. Morguard trades inexpensively relative to its peers, and offers a high-quality management team and geographic diversification. Its current yield is about 4.8%, though it has a low payout ratio and our FMV is well above the price at $18.

Of note, regarding our holdings in our income accounts: *Enerdynamic Hybrid Technologies* debentures should benefit from its restructuring as we stand to receive a new short-term secured debenture for most of our bond's value with the balance and all arrears in common shares; *Advantex Marketing International* secured debentures were swapped for new secured debentures and a significant number of shares in the company which should be valuable as we anticipate the company recovering back to its profitability levels of a few years ago; *Manitok Energy* collateralized notes fell considerably prior to being halted in mid-December—we continue to work with other parties toward a refinancing to potentially reclaim a position in the assets that we still believe have upside potential; and, *Gran Colombia* is undergoing a refinancing which is nearly complete and which should see our bonds redeemed at par.

We Do Know One Thing

Last quarter we noted that market expectations were high and that an outsized correction could arrive spurred on by unanticipated events. The recent correction was welcomed as it allowed us to put more cash to work because several securities we had been following fell to our buy targets. Meanwhile, earnings estimates have taken off, with assistance from the U.S. tax bill. At the same time, inflation may be picking up, and therefore interest rates too, but they remain at historically low and seemingly manageable levels. And the government authorities appear to want to react gradually to any acceleration in growth and inflation.

Who knows, as some foresee, perhaps we're headed for a global melt-up before the party is over. We aren't counting on that but are aware that it's occurred in the last few cycles as euphoria can set in prior to the peak.

Because the economic cycle is protracted and stock market valuations full, we continue to closely monitor our overall market risk tools in an attempt to peg the end to this bull market. TRAC™, TEC™ and TRIM™ were designed to predict recessions and market panics that accompany negative growth. Alerts have not yet triggered; therefore, we continue to hold shares, and buy others, as long as they're trading below our FMV estimates. We are pleased that we were able to buy a number of new positions recently which met our criteria—well managed, high quality enterprises with ever-growing earnings protected by competitive advantages, appropriately leveraged balance sheets and at sufficient discounts to our estimates of their intrinsic value—with the confidence that the current economic cycle has not yet come to an end.

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