SEAMARK

THE LATEST

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CIO Commentary / Q2 2018

Investment markets recorded positive returns in the second quarter, continuing their recovery after the stock market correction in February. In fact, Canadian and U.S. markets made up lost ground, to finish the quarter at slightly higher levels than at year end. EAFE Markets didn't fare so well, still in negative territory year to date. A 2.1% decline in the value of the Canadian currency in the quarter buoyed valuations of U.S. dollar denominated assets for Canadian investors. Bonds advanced too, off their lowest prices reached mid way through the quarter. Canadian ten-year Government issues yielded 2.17% at June 30, after reaching a high of 2.52% on May 17th; U.S. Treasuries yielded 2.86% at the end of the quarter, after hitting a high of 3.11% on the same day.

The first quarter correction in share prices may have marked the beginning of a change in the market internals from 2017. Last year, an anomaly in our view, was characterized by a few large company names driving the stock market averages, particularly in the U.S. 2017 was definitely a year for risk-on assets to the detriment of more conservatively valued companies, despite the advancing timeline for the bull market that was born out of 2008/9. This year, the market has continued to be subject to the pull of just a few of the largest companies, but with the correction in share prices in February, the market has begun to show greater breadth with more industry groups participating in the rally, not just shares of big tech.

Broader participation has benefited SEAMARK portfolios that are typically well diversified as a means of managing risk for investors. Cash that had been building in our portfolios through 2017 was deployed in the first quarter of this year, taking advantage of the correction in share prices. Our fully invested portfolios participated in the stock market recovery this quarter, regaining most, if not all, that was lost in the first quarter.

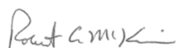
At mid-year, the U.S. economy continues to look strong. Corporate earnings are being buoyed by lower tax rates and the consumer continues to spend. Many U.S. multinationals are repatriating profits that had been stranded offshore, to reinvest stateside. It is ironic that President Trump would choose this particular time to turn insular, and protectionist even, with U.S. trade policies. A full out trade war could derail the economy that is the envy of the world.

The Canadian economic outlook is much less certain. The strength in consumer spending that we have witnessed in recent years is sure to slow, with household debt levels at very elevated levels, even catching the eye of international agencies like the Bank for International Settlements. Our energy sector continues to be assailed from outside interests as well as internal objectors. Business is watching warily as we attempt to renegotiate NAFTA. Two key factors must be resolved for Canada not to be disadvantaged. One, Canada must retain a robust Dispute Resolution Mechanism, absolutely necessary when we are an economy measuring only one-tenth the size of our southern neighbour. And two, the U.S. is advocating for a five-year sunset clause for the new NAFTA. The five-year clause introduces unnecessary uncertainty for corporations when they are deciding where to establish plant and equipment that would typically have a life of 40 years. A five-year clause tips the scale in favour of establishing new production facilities only on the U.S. side of the border, safe from potential rule changes every five years.

…CIO Commentary continued

Trade issues bear close watching. Negotiations are progressing, but aggressive rhetoric and tit-for-tat tariff impositions are concerning to industry. We expect that cooler heads will ultimately prevail, but it may be a bumpy road to conclusion. For now, we are avoiding the Canadian auto, dairy, and lumber industries in our portfolio construction. With this background, we expect market volatility to reflect a more normal level than the benign experience of 2017. SEAMARK equities remain tilted toward risk-off companies, as the best risk/reward positioning for today's uncertainties.

Sincerely,



Robert G. McKim, CFA
Chief Investment Officer

ARE WE THERE YET? A look at the road to interest rate normalization

Last time the team asked me to write an interest rate piece was a few years back, in June 2014 to be exact, six years into the recovery. The headline of the piece was "Waiting for Godot" after Beckett's famous play. The piece was about the tiresome wait for central banks to start rolling back the monetary accommodation that was put in place after the 2007/2008 financial crisis. the underlying question was: When was the low interest rate environment going to end? At that time, rates were effectively at zero. Although normalization did finally start the following year, in 2015, the pace of rate hikes never caught up with initial market expectations.

Normalization is a term used to explain the process by which Central Banks use policy to control interest rates and help rates reach a level considered to be 'normal'. If we use a standard transmission analogy, in order to go from first gear to third, we must first shift to two, this would be the normal progression. By comparison, if monetary policy achieves its inflation and its currency objectives in second gear, then there may not be a need to increase it further. But, if the inflation exceeds the central bank's objectives and causes the economy to overheat, the central bank would then use monetary policy for tightening (increase rates), shifting into third and cooling the economy.

What happened between the crisis and now?

Let's go back ten years, to 2008, right after the crisis. In the U.S., confidence was low, the economy was shrinking, and Americans were not spending. In response, the Fed used its expansionary monetary policy to calm the waters by reducing their target rate. It brought rates down to a level where they felt that it lubricated the market wheels with liquidity so that the wheels would not come to a grinding halt. In a way, it was successful, but the reduction of the target rate was not enough.

That same year, the Fed continued its expansionary behaviour and purchased bonds of housing related government sponsored entities (it purchased their debt). This approach is known as Quantitative Easing and its goal is to lower rates. Two rounds of quantitative easing were followed by another catchy named market operation: Operation Twist, in late 2011 to 2012. This time, the Fed sold bonds with short maturities to fund the purchase of bonds with long maturities, in a way twisting the yield curve.

After the third round of quantitative easing in the Spring of 2013, the Fed thought it was a good time to roll back its monetary accommodation and called it 'Tapering'. The intention was to move slowly, but the bond market reaction was as if the Fed was pulling the monetary accommodation rug out from underneath the market. With this overreaction, the tapering was delayed and did not start until the end of 2013. The Fed proceeded cautiously after the "Tapering Tantrum" and did only one hike a year in 2015 and 2016. It was only in 2017 that the normalization continued in a more regular manner.

What happened here at home?
In Canada, our road to normalization was less straightforward than of our southern neighbor's experience. Although we started the normalization earlier than the U.S., in the middle of it all we had to stop and actually cut rates back by 50 bps in 2015. This was characterized as an insurance to declining oil prices and its relative adverse impacts on the overall Canadian economy. In 2017, the Bank of Canada resumed the normalization, albeit in a much more uncertain way, due to concerns regarding trade discussions.

What does all this mean?
Now, let us put this all this into context. Currently, the new neutral long-term Fed Funds rate is expected to be 3.5%, and the Fed Target rate is at 1.75%-2.00%. In Canada, our neutral rate is forecasted to be 2.75%, and is currently at 1.50%. In the Spring of 1981, the Fed's target rate was around 19% (yes 15.5 points higher!) and the Canadian overnight rate hit 21% in the summer of the same year. So, for the three decades prior to 2015, bond yields had been falling steadily and the central banks had their fingerprints on this decline especially during the last decade. This gradual decline meant that bonds and bond portfolios had positive returns and people took advantage and got mortgages or renewed existing ones at favorable rates. Overall, the cost of capital was getting cheaper, but in return you probably weren't too happy with the rock bottom rates that your savings account was earning.

In the Spring of 1981, the Fed's target rate was around 19% (yes 15.5 points higher!) and the Canadian overnight rate hit 21% in the summer of the same year.

That was up until 2015, now the cycle is changing. This normalization of rates has a completely different effect on things. Rate increases will have an impact on fixed- and variable-rate debt, most significantly mortgages, making them more expensive. As a reaction to the increasing mortgage rates, the housing sector will either cool-down or, with significant changes in rates, will have a hard landing. The cost of debt will infiltrate the prices of goods and services, leading to inflation, cost-push inflation to be exact. Companies with high debt positions might find themselves in a difficult position, trying to meet their interest obligations. Asset valuations will fall because of the increase in cost of capital, especially for highly indebted companies. Bond portfolios won't be able to record gains, and in some cases will record realized or unrealized losses. Stocks dividend yields will have to compete with bond yields. And the list goes on…

The moral of the story though is to be aware of the changes and to respond to them accordingly, without overreacting. Our style at SEAMARK is conservative and incremental. We believe that being proactively defensive and making small changes in our portfolios, rather than calling the market, are prudent measures. The normalization of rates may be the direction and neutral (normal) rates are the destination, but the road is windy, and the best strategy is to be agile and incremental.

Beste Alpargun MBA, CFA
Vice President of Fixed Income

2017 Pooled Fund Capital Gains Tax Deferrals

	Tax Loss Carry Forwards*
SEAMARK Pooled U.S. Equity Fund	$ 21,834,243
SEAMARK Pooled Total Equity Fund	$ 17,788,240
SEAMARK Pooled Low Volatility Equity Fund	$ 4,946,610
SEAMARK Pooled Canadian Equity Fund	$ 4,962,722

*Audited Financial Statements, as at December 31, 2017

Some of these tax loss deferrals are significant compared to the assets in the respective Pools.

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Composite Performance Update[1]

As at June 30, 2018

	One Quarter	Six Months	Nine Months	One Year	Two Years	Five Years	Since Inception	Inception Date
SEAMARK Balanced Composite (%)	**3.10**	**0.93**	**3.92**	**4.00**	**6.07**	**8.51**	**7.76**	12/31/2009
Balanced Benchmark* (%)	3.25	2.57	6.26	6.88	7.34	8.21	7.24	
SEAMARK Low Volatility Equity Composite (%)	**3.42**	**-0.55**	**2.48**	**2.26**	**4.43**	**9.99**	**10.30**	12/31/2010
S&P/TSX Composite Index (%)	6.77	1.95	6.48	10.41	10.73	9.25	5.64	
SEAMARK Canadian Equity Composite (%)	**5.51**	**-1.09**	**2.37**	**4.24**	**6.87**	**8.60**	**7.25**	01/31/2011
S&P/TSX Composite Index (%)	6.77	1.95	6.48	10.41	10.73	9.25	5.57	
SEAMARK Total Equity Composite (%)	**4.28**	**1.13**	**4.79**	**5.54**	**8.12**	**11.07**	**12.58**	09/30/2011
Total Equity Benchmark** (%)	5.53	4.09	9.80	12.23	13.53	13.02	13.26	
SEAMARK Fixed Income Composite (%)	**0.48**	**0.78**	**2.51**	**1.28**	**0.66**	**3.54**	**3.00**	04/30/2012
FTSE TMX Canada Universe Bond Index (%)	0.51	0.61	2.65	0.76	0.39	3.48	3.14	
SEAMARK U.S. Equity Composite (%)	**3.09**	**4.01**	**8.57**	**7.94**	**10.35**	**13.20**	**15.16**	04/30/2012
S&P 500 Index (CAD) (%)	5.64	7.74	15.51	16.06	16.84	18.65	19.19	

*Effective 01 Jan 2018, the SEAMARK Balanced Composite Benchmark is 5% FTSE TMX 91 Day T-Bill Index, 40% FTSE TMX Canada Universe Bond Index, 27% S&P/TSX Composite Index, 20% S&P 500 Index, 8% MSCI EAFE Index; from inception to 31 Dec 2017 the benchmark is 5% FTSE TMX 91 Day T-Bill Index, 40% FTSE TMX Canada Universe Bond Index, 30% S&P/TSX Composite Index, 25% MSCI World (ex-Canada) Index.
**50% S&P/TSX Composite Index, 35% S&P 500 Index, 15% MSCI EAFE Index

Links to Q2 2018 Pooled Fund Profiles

Balanced | Canadian Equity | Low Volatility Equity | Canadian Bond | U.S. Equity | Total Equity

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[1]Performance data is calculated on an actual basis for periods of less than one year, and on an annualized basis for periods of one or more years. Performance data assumes the reinvestment of all distributions and does not take into account management fees or income taxed (except for withholding tax, if any, on foreign income) payable by any unitholder that would have reduced returns. Past performance is not necessarily indicative of future returns. For GIPS® presentation please email information@seamark.ca