QUARTERLY LETTER – FOURTH QUARTER OF 2017

The year 2017 unfolded in three parts. From January to June, we saw a noteworthy start to the year, marked by a rise in the stock markets and low volatility. At the end of June, the Bank of Canada's tone changed with regard to the strength of the Canadian economy. Good news in itself, but two rate hikes are decreed (in July and September), resulting in a decline in the bond sector and a boost in the Canadian dollar. Then, in October, November, and December, Canadian rates decline, the rise of the US dollar and stock market rally with, to top it off, the famous US tax reform. What a way to end the year!

In short, 2017 has had its share of significant events in financial and economic terms. Here are a few:

- After a slow start to the year, the S & P / TSX still posted 922 points (9.08%) growth. This correct performance in absolute terms is nevertheless lower than that of most foreign stock exchanges. Ten of Canada's 11 sectors contributed positively to this growth. Only negative sector: energy, which has amputated the index of 340 points. Of the 15 worst performers on the TSX, only one came from neither energy nor commodities.

- The woes of oil stocks are surprising, while WTI rose by 12.5% in 2017 and 42.1% since its June low, and even peaked at a high of $60 on December 29th. While short-term oil rose, future contracts maturing in 2025 fell by $4.60, passing to $52. This reversal of the oil future curve nevertheless accelerates the elimination of excess inventories. The ounce of gold, meanwhile, remained relatively stable seeing its price fluctuate by plus or minus $100 between January 1st and December 31st, 2017.

- Although the strengthening of the loony in the summer of 2017 hurt foreign earnings, the S & P 500, the most representative index on the US side, gained 13.5%.

- Despite a 94 basis point rise in Canada's two-year bond yields and a 33-basis-point increase in 10-year bond yields, Canadian investors' appetite for returns has not diminished. Companies took advantage of this windfall to issue a record amount of corporate bonds. This issuance of more than 115.4 billion bonds meant that the former summit of 107.4 billion (2013) was easily surpassed. This is an additional sign justifying our upcoming rate hike scenario for 2018.

- In the US bond market, the two-year and ten-year rates take opposite directions: while short-term rates rose by 69 basis points, ten-year rates fell by three points.

This flattening of the curve leads some bond marketers to be wary of a recession that seems to be approaching. While bond market history deserves the greatest of respect, this trend is likely more attributable to foreign capital inflows than a deterioration in the US economic environment.

A Solid Start to the Year

Eighteen years ago already, we celebrated the arrival of the new millennium year. In passing, we celebrated a historic high for the American stock markets of the time, propelled for the most part by the technological boom (read the “bubble”). However, the revival was rather brutal for many investors, who were convinced that the rise would last a long time. This "irrational exuberance" (a term popularized in 1996 by Alan Greenspan, then chairman of the US Federal Reserve) hit many savers in search of yield "at any price", prompting them to take unjustified risks, much like young children and teens in search of thrills. This year, children born in 2000 will reach their majority. However, "majority" does not necessarily mean "maturity". Among the definitions of the word "maturity", the Larousse gives this one: "Safety in the field of judgment, of reflection (especially according to age)".

After a few years of seeing the portfolios post returns that exceed all reasonable expectations, will investors be inclined to go unnoticed and become more daring? Will they show too much “caution” in their decision-making?

One thing is certain; the year 2018 begins with a relatively solid economic backdrop at the heart of the second longest expansion phase of modern history. On a global scale, growth is becoming widespread and there is no indication for the moment that a downturn in the economy will occur. Particularly positive since the crisis, the robustness of the economic data is supported. Fortunately, valuations are still far from the multiples attained in early 2000, when the longest phase of economic expansion of the modern era ended.

As our role consists of, now and always, to preserve the long-term capital, we sometimes have to temper the expectations of our customers, especially to avoid complacency in our investment choices. This brings us, again, to identify the various themes that will be our focus in the coming quarters.

As we did a year ago, here is a summary of these themes:

1) Normalization of rates, currency and inflation

After watching the Bank of Canada follow suit with two successive rate hikes, it will be interesting to watch what tone our big bankers adopt. It's a safe bet that they will be in a more wait-and-see mode and will be observing what our American neighbors will do over the next few months. The rise of the Canadian dollar following the increases in the third quarter of 2017 has somewhat slowed Canadian authorities. If oil, supported by solid economic data, continued its momentum in recent weeks, upward pressure could be exerted on our currency. The expected rise in early 2018 (the third since July 2017) seems already taken into account by the market. We believe, however, that for the coming quarters the Bank of Canada will be cautious in its rate normalization policy, watching closely what the US Federal Reserve will do.

Raising rates again before the Americans do it would put more pressure on our currency, a bold strategy in the face of uncertainty over NAFTA.

Remember that, in a context of rising rates, the fixed income portion of the portfolios is subject to certain adjustments. This makes the expected returns of this asset class much smaller. The bond component of the portfolios limit the expected returns due to interest rates that are already excessively low. Current low interest rates put imminent risk on high bond portfolios. It remains to be seen what will be the range and frequency of rate increases imposed by central banks. It is in the speed with which inflationary pressures are likely to find answers to these questions of major importance.

2) Tax reform and corporate profit growth

Expected with great fanfare, US tax reform can be a double-edged sword for the stock markets. The proposed tax break for businesses should fuel growth in their profits. As the rise in the last quarters is due in large part to the increase in price-earnings ratios (supported by falling interest rates, low inflation and the absence of market volatility), it is essential that corporate earnings growth take center stage in the near future. Since price-earnings ratios currently exceed their historical long-term average in some regions, it is highly unlikely that the growth of valuations alone will be enough to support a rise in the equity market.

At present, the evolution of domestic economic prospects in many parts of the world is conducive to earnings growth (rising public spending, easing of regulation, resumption of inflation, repatriation, US companies, cash held abroad, etc.). Given current valuations, we remain aware that markets could be corrected if earnings disappoint expectations.

This risk is important enough that we take it into account in this letter at the beginning of the year.

3) Canadian Issues

- **NAFTA**

Many Canadian observers have welcomed the acceptance of the tax reform proposed by the US president. For the Trump administration, this acceptance is timely, not because the US economy really needed it, but because the new resident of the White House can finally show an achievement worthy of the name. In this context, could we have more flexibility in the renegotiations of the North American Free Trade Agreement? Getting into the game of predictions is not easy. We will be closely following this file, which deserves our full attention. The NAFTA discussions may cast a shadow over the Canadian backdrop.

- **Read Estate and Household Debt in Canada**

In its mid-year quarterly report, Canada Mortgage and Housing Corporation (CMHC) stated that the Canadian real estate market still had “high signs of problem conditions”. Both the rental and resale market and the new homes market show a gap between supply and demand. This situation is sufficient for price acceleration, overvaluation and overheating in this important sector. The gradual rise in interest rates may well be the missing element in stopping this period of "irrational exuberance". Caution is required.

What about the debt of Canadian households? In an interview last September, Laura Cooper, an economist at the Royal Bank, said: “A decline in household net worth - even modest - combined with a sharp increase in consumer credit growth is notable, as he suggests that the ability of households to absorb an interest rate hike continues to deteriorate.”

The July 2017 rate hike imposed by the Bank of Canada will have encouraged Canadian banks to raise their prime rates, which are used to set rates for variable rate mortgages and other forms of loans. Fortunately, the job market is doing well. Households can therefore always count on remuneration and job security. Fortunately, as long as Canada has a low unemployment rate, the Central Bank is gradually normalizing rates, and the real estate market avoids the bursting of a bubble, we can avoid a US-style scenario. As for the rest, the future will tell.

4) Geopolitical Tensions

"What can we add on this point? To count on a decrease in tensions between the main economic and political world actors is utopian at this stage. The first step towards lightening the climate could possibly be the introduction of a ban on any elected president using "Twitter" to spread his moods. Is it not?"

Extracted from our January 2017 financial letter, these last lines are still relevant. It will be interesting to see the possible reconciliations ahead of the 2018 Olympic Games in South Korea, and it would be surprising if tensions between Trump and his counterpart in North Korea cease. After all, these two characters have long accustomed us to erratic behavior. We do not build our portfolios by wagering that a war will break out. If this were our prediction, all positions would be liquidated and the only asset held in our portfolios would be cash. On the other hand, we must admit and accept that volatility could be back if a diplomatic slippage occurred. The soap opera continues.

The transition to the new millennium and the next 18 years have seen many twists and turns and colorful events. Such a context does not make it easy for investors, but it is very instructive for young people just out of the university to which the world of finance opens its doors. My colleague Frédéric Gingras and I learned and grew up in this environment. Over the years, competent and passionate people have joined our team to do what it is today: the Gingras-Barrette Group. We are very proud to participate together in the management of your financial assets and wish to do so for a very long time. This mark of trust towards us, we recognize it, we appreciate it enormously and we thank you for it.

In this new year that begins, let us wish you and your loved ones a year in 2018 that lives up to your aspirations!

Sébastien Barrette and Frédéric Gingras
Portfolio Managers

OUR CONVICTIONS

No 1 : Each investor is **UNIQUE**.

No 2 : It is important to **DEFINE** your investing philosophy and to respect your investment process.

No 3 : **DISTRIBUTION OF ASSETS** is the main focus of performance.

No 4 : We must **CONTROL** and **MANAGE** what can not be completely eliminated (notion of risk).

No 5 : A transparent and coherent **COMMUNICATION** is essential.

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