GINGRAS BARRETTE GROUP
Portfolio managers

May 3rd, 2018

QUARTERLY UPDATE

For the quarter beginning on January 1 and ending on March 31, 2018
Volatility returned to North-American markets with a vengeance in the first quarter of 2018. After a mildly bullish January, the main indexes reacted negatively to a combination of factors including rising interest rates, global geopolitical tensions (no need to name the main culprits ...) and the spectre of a trade war. However, despite these jolts, we are not deviating from our strategy, which over the years has generated more than satisfactory returns for our clients and which involved investing in strong companies with outstanding management teams and a clear competitive edge. Experience has taught us that the markets behave in a way that differs little from the weather cycle, where storms and fine weather inevitably take turns, all too often without warning. Our goal is to build you a house with a solid foundation that will protect you from inevitable bad weather. Rest assured that we take that goal to heart.

Fixed Income portion

More transparency, lower management fees and variable rates
Exchange traded funds (ETFs) are fairly new products on the financial market but their immense popularity is largely justified. An ETF is an investment fund that trades like a stock on a stock exchange. The goal of most ETFs is to replicate the performance of an index (for example, the TSX Composite or the S&P 500) by buying the underlying securities of the index to which they are linked. According to data from research firm ETFGI, more than 5,000 ETFs are traded today on global markets and represent a variety of stock indexes ranging from sector to geographical indexes, and even bitcoin, proof that not all ETFs are risk-free investments.

Although an ETF is a great vehicle to access exposure to the returns of major indexes such as the TSX or S&P 500, they are less than ideal for exposure to fixed income indexes. While stock indexes are made up of a few hundred well-known, heavily traded stocks, bond indexes have thousands of securities in them, most of which are rarely or never traded. The result is less transparency, making it difficult for us to know all the securities that make up a given ETF bond index.

During the last quarter, we decided to stop using these ETFs in the Fixed Income portion of the portfolio. These positions have been replaced by direct holdings of bonds and preferred shares that have been carefully selected by our team. This change will eliminate the management fees associated with holding ETFs and make our portfolios more transparent.

We also increased the proportion of our portfolio allocated to variable rate instruments by adding a Québec government bond and increasing our exposure to floating rate preferred shares. These positions will allow us to take advantage of the expected rise in interest rates over the next few years.

Growth portion

It may seem counterintuitive, but as portfolio managers, we like volatile markets. In 2012, the Reuters financial news agency published a telling article in which the author pointed out that the average stock holding period had decreased from more than 10 years in the 1930s to less than six months. In a world where too many investors trade securities like they were merely pieces of paper, we take great pride in our long-term investment philosophy. For us, a stock is more than a piece of paper, it's a stake in a real company. We believe that investing is not just about selling a stock at a higher price a few months after buying it but about buying stocks in solid companies that pay dividends and whose profits keep growing year in, year out.

Consequently, we see a market correction as an opportunity to invest in great companies at lower prices. This is where long-term investors have a real advantage. It is therefore by remaining true to our philosophy that we took advantage of February's downturn to increase certain positions.

Recurring questions from our clients

We decided to try a new formula this quarter and answer our client's most frequently asked questions about the markets. Here then are the questions and the answers from our two portfolio managers, Frédéric Gingras and Sébastien Barrette.

How would you describe the first quarter of 2018?

Sébastien Barrette: The stock markets started off with a bang in 2018, breaking record after record and reaching an all-time high on January 26. Although the increase on the Canadian side (S&P/TSX) was more modest, the U.S. market (S&P 500) jumped 7% in three weeks. This unsustainable pace was followed by a selloff. Inflation data released on February 2 quickly brought the risks of a faster than expected rate hike to the fore. The following week was even stormier, erasing all the market's gains since early January. The rest of the quarter reintroduced the all too well known phenomenon of volatility.

How do you explain this resurgent volatility after the relative calm in 2017?

S.B.: To explain this change of course, we have to take a small step back. Midway through the summer of 2017, the stock market began to rise, fuelled by the prospects of tax cuts. When we look at the rising slope of the S&P 500, the main stock market index in the U.S., we see an increase of more than 17% between the beginning of August and the peak of January 2018. In hindsight, we see that stock market valuations soared in a way that cannot be simply explained by the expected tax cuts. In one of his publications, Jurrien Timmer, director of Global Macro at Fidelity Investment, said that the stock market gains over this period were twice as much as was justified by the recent tax cut, which led to an abrupt increase in earnings estimates.

Another point that must not be overlooked is the rise in interest rates. In our financial letter of the third quarter of 2017, we wrote: “The strength of the economy in the first half of the year, the evolution in economic potential and the outlook for inflation justified this decision to reduce monetary easing. While some issues remain, we are not ruling out another rate hike between now and the end of the year. As for 2018, the market is anticipating two or three increases. At this pace, the key rate will reach 2% at the end of 2018.” On the U.S. side, the 10-year Treasury yield rose sharply, from 2.01% in August 2017 to 2.86% in mid-February. The resulting pressure on the markets is therefore not surprising.

What’s a trade war and how will it affect the markets?

Frédéric Gingras: Globalization has led to some free trade between countries, but since Trump came to power, the word “protectionism” keeps coming up. The Trump administration is renegotiating NAFTA and is even threatening to withdraw from this deal; it has imposed tariffs on steel and aluminium imports from certain countries, including China, which has threatened to hit back with tariffs of its own. In other words, a trade war is launched when both countries start imposing tariffs on imports.

After Trump announced the steel and aluminium tariffs, he also talked about possibly imposing tariffs of more than $50 billion on Chinese technology products. China immediately implemented an equivalent strategy on other items, including agricultural products. Then Trump threatened to impose tariffs on another $100 billion of Chinese exports.

So for now, is this really a trade war or just a war of words? Let’s not forget that so far, only aluminium and steel tariffs have been imposed. Be that as it may, this situation creates market volatility that is being managed rather well. The danger is that by continuing to impose tit-for-tat tariffs, the two countries will only escalate their trade dispute.

We don't consider these tariffs catastrophic; however, could the threat of $50 billion in tariffs grow to five or ten times that amount? The Trump administration doesn’t seem prepared to accept any tariffs. We’ll find out soon enough whether this is just a negotiating tactic.

What can we expect now?

S.B.: At the beginning of the year, we were convinced that the bull market would continue but with soft patches here and there. These downturns, which can happen at any time and for any reason, would not spell the end of the bull market but are necessary corrections in a still very healthy market. Recent corrections have brought valuations to fairer levels. We’ll have to wait for the next wave of results in early April to see how the recovery will shape up.

We believe that the investment cycle will continue but that returns will be more modest. As a rule, four types of events signal the end of such a cycle: extreme valuations, commodity price shock, monetary shock and a recession. The recent market correction brought valuations down. At this point, we do not anticipate any commodity price risk. Although North America’s central banks are entering a period of rate normalization, borrowing costs are still low. We do not foresee any monetary shock. As for a recession, studies show that we should be thinking about what type it will be (cyclical, event-driven or structural) rather than trying to predict when it will happen. As you know, the best protection is still good asset allocation (cash, fixed-income securities, equities), good geographical diversification and most importantly, the right investment policy. Although the cycle is past its peak, we think it still has some life left in it. That said, a cautious approach is in order.

What are the market challenges and opportunities for the rest of 2018?

F.G.: We have to track the leading indicators to see whether a recession is on the horizon. While we don’t think there will be a recession in 2018, we will monitor the economic data to try and predict when it will happen and develop our investment strategies accordingly.

This year can be characterized as a return of market volatility, which presents both a challenge and an opportunity. Our job is to target good companies trading at low prices and to buy their stocks, which have gone down for no reason other than volatility.

The challenge is to buy these stocks at the lowest possible price and to continue believing in our investments when the market falters due to emotional rather than rational reasons. Even if we target the best stocks, they may continue to temporarily lose value before rebounding.

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Investing should be boring

Paul Samuelson, a Nobel Prize winner in economics, describes the discipline needed for successful investing: “Investing should be boring. It shouldn’t be exciting. Investing should be more like watching paint dry or watching grass grow.

Our portfolios are not designed to thrill you but rather to safely grow your assets over the long term. We can’t control the market but what we can do is select companies that will continue to generate profits year after year, regardless of market fluctuations. Like Paul Samuelson, we believe that patience and time are two essential elements for soundly managing your capital.

Sincerely,
Gingras Barrette Group

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ROUYN-NORANDA	TORONTO	VAL D'OR	VILLE-MARIE
75, avenue Québec, 2e étage	11 King Street West P.O. Box 23	450, 3e avenue Québec, bureau 201	33 rue Ste-Anne
Rouyn-Noranda (Québec) J9X 7A2	Toronto (Ontario) M5H 4C7	Val d'Or (Québec) J9P 1S2	Ville-Marie (Québec) J9V 2B6
819-797-5525 ou 1 800 797-5525	416-867-3578 ou 1 844– 467-3578	819-824-2266 ou 1 800 819-2266	819-629-2560 ou 1 877 629-2560