LEE, TURNER & ASSOCIATES INC. INVESTMENT QUARTERLY

REVIEW January 2019

We have always understood that matters of a political nature can often have economic and investment implications, but a multinational diplomatic drama that unfolded in Vancouver over early December certainly appears to be over the top in terms of its hold on global financial markets. Canada, at the request of the US, arrested a very high-ranking Chinese business executive while she was changing flights in Vancouver on December 1st. As news of the arrest was made public, investors immediately jumped to the conclusion that a major diplomatic crisis, with full blown economic reprisals and retaliations, would likely ensue given the status of the arrested executive. The initial reaction in global stock markets was a very sharp decline. Those early losses spilled and mounted over the rest of the month. Investors seemed convinced that this arrest will add friction to the already testy tariffs negotiations between the US and China, to further dampen global economic growth prospects. While the ultimate resolution of this political matter is far from certain, its immediate damage is very clear. December's retreat in the stock markets was severe and contributed largely to their year over year losses. The Dow Jones Industrials Average fell 8.7% in December to end the year with a 5.6% loss; the comparable figures for the S&P/TSX Composite Index were 5.4% and 8.9%. While the losses suffered in the North American indexes look bad, they were in fact very much lower than the double-digit losses suffered on every other global stock market. Bonds found favour with investors who fled stocks. The Canadian Bond Index achieved its entire year's return of 1.4% in December alone.

FORECAST

Two significant risks confront Canada's economy today, a trade war between the US and China, and profound weakness in the export price of our crude oil. The trade war has a tentative deadline of March 1st for the two combatants to settle their differences. Its worst possible outcome is an across the board tariff of 25% imposed at each other. The fallout in that event will be a crimping of economic growth on a global scale, Canada included. We put a 75% probability that this trade war gets settled before its deadline, if no further fallout comes of Canada's arrest of the above mentioned Chinese executive. On Canada's exports front, our federal leaders have inexplicably managed to suppress the price of our crude oil for export to lose out on billions of dollars of revenue. Save for political reasons, we cannot find any justification for our government to impose policies to deliberately harm its oil industry when the end game of such policies would surely be to the detriment of its overall economy. The straits which the Canadian oil patch is headed, as decreed by our federal leaders, is dire and we would concur with the Bank of Canada's assessment that, "it is already clear that a painful adjustment is developing in Western Canada and there will be a meaningful impact on the Canadian macroeconomy" when it referred to the recent price collapse in Canada's oil for export in a speech in December. We do not foresee a quick end to these made-in-Canada oil woes in the near term and expect a 0.5% reduction in our GDP as a result, thus giving the Bank a cause to pause in its planned interest rate hikes.

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INCOME STRATEGY

Bonds

Over the past twelve months, the Federal Reserve raised its interest rates 4 times for a total of 100 basis points while the Bank of Canada raised its rates 3 times to total 75 basis points. Both central banks cited strength in their respective economies and above target rates of inflation as support for their policy actions. While they seem satisfied with their recent rate hikes, they have made it known that it is still their intent to move interest rates up further towards normalized levels in the year ahead. They did, however, try to calm investors with the message that the pace of this year's hikes will be a touch slower than that of the past year. For us, we read their message as: expect at least 2 but not more than 3 rate hikes this year. Sensing some respite from rising rates, bond investors took the yield curve down slightly across the entire maturity spectrum, keeping the shape of yield curve flat from 2 years onwards. A flat yield curve is of note because it infers that North American GDP growth rates and inflation rates will not deviate far off of 2% throughout 2019. We do not necessarily disagree with that inference but still cannot see any merit in investing for a 2% rate of return, be it for a 2-year term or a 30-year term.

Income Trusts

Assets whose returns are negatively correlated to the overall market's returns are considered desirable in providing meaningful diversification to one's portfolio. The perfect example of negative correlation at work was how the Real Estate Income Trusts (REIT's) performed when compared to the overall TSX market over the past year. REIT's were the only sector of the TSX that came through last year with a gain, 2.0%, while every other sector showed losses. We always knew that REIT's were effective securities for our portfolios' diversification and we will continue to use them instead of bonds when the call for income and price stability is put to our portfolios.

EQUITY STRATEGY

The stock market is often irrational, that much is certain. A year ago, we pointed out how investors were being frenziedly swept up by the hype of cryptocurrencies and cannabis, and how they were piling into those companies' shares without regard for investment value. Today, we see a different, an opposite, side to investor irrationality. What is very evident to us over the past couple of months is that investors have been dumping shares of very solid investment grade companies without regard for their investment value. Perhaps spooked by trade wars, United Kingdom's pending exit from the European Union, rising interest rates or slowing economic growth, investors worldwide have been feverishly selling down their equities. While we understand that market corrections are frequent, normal course, and healthy for the stock markets, some sectors of the recent sell-off is in our view quite overdone and irrational. We are specifically calling out the utilities sector of the stock market. Right now, these shares are trading at very low earnings multiples and very high dividend yields. While these quantitative valuation parameters alone would suggest that these shares are worthwhile investments, adding support to their investment thesis is the often-overlooked fact that the companies behind these shares operate as monopolies in a regulated industry where their revenues and earnings are practically assured. We strongly believe that utility shares are very much undervalued at the moment. We will look for opportunities to add them to our portfolios.

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