MARKET REVIEW AND MANAGERS' COMMENTARY

Global Expansion Continues

It's official. We are now experiencing the third longest economic expansion ever recorded. If this continues into 2019 it will become the longest expansion in history, a fact that is disconcerting for many economists and those who analyze stock market performance. The performance measures which should be of most concern to our clients include investor sentiment, rising interest rates and equity price-to-earnings multiples.

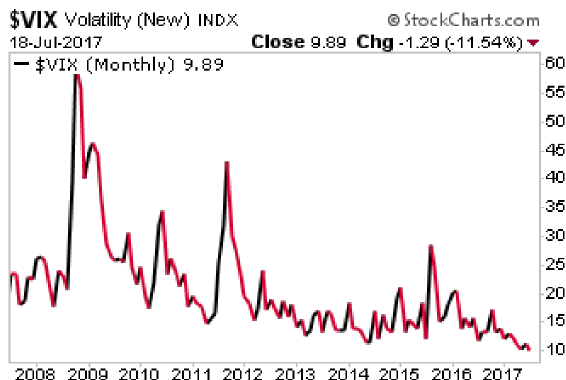

Figure 1 - CBOE Volatility Index (symbol VIX)

In terms of investor sentiment, we see two sides of the same coin. On one side, we note that data from the CBOE Volatility Index (VIX - figure 1) indicate that investors seem too complacent. The VIX measures the implied volatility on the S&P 500 composite index and acts as a gauge to quantify investors' tolerance for risk. When the VIX is low it is telling us that investors have a high tolerance for risk, which is simply another way of saying that investors are sanguine.

On the other side, we note that individual investors are worried about the speed and slope of the rally in stocks since the financial crisis. Among individual investors this has been the most unloved bull market in recent memory. Individual investors – not institutions – live in fear of a major market meltdown and for the most part, have been sitting on the sidelines – not fully invested and hesitant to make a leap of faith.

Rising interest rates are also a concern as is the perception of a flattening yield curve. The yield curve shows the interest rates on various government bonds for different terms to maturity (see figure 2).

Figure 2 – U.S. Treasury Yield Curve

When rates are rising at the short end of the curve, which is the part of the curve the Fed (and the Bank of Canada) impact when they raise overnight lending rates, that increase normally affects yields all along the curve. That has not been the case in the current environment, which leads some economists to opine that U.S. economy is not that strong.

If yields at the longer end of the curve are not rising in lockstep with the shorter end of the curve that can be an ominous sign. It is typically a precursor to an economic slowdown or recession. Until the first week in July that was a real concern. However, throughout the first week of July rates along the yield curve began to rise laying to rest, for the moment, fears of an immanent recession.

The third piece of this puzzle is equity valuations. The price-to-earnings multiple on the S&P 500 composite index has been rising since the financial crisis. The P/E ratio, which looks at historical earnings relative to current prices, is at a point that suggests stocks are not cheap. However, our view is that earnings continue to expand. On a forward-looking basis, fears of the historical P/E multiple may be overstating the risk. Not to suggest that stocks are cheap, but they are, in our opinion, not overly expensive.

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In our discussions around equity valuations we are comforted by recent commentary from the International Monetary Fund (IMF). According to the IMF's *World Economic Outlook* (WEO), expansion is being supported by "consistently good economic news since summer 2016. The economic upswing that we have expected for some time seems to be materializing: indeed, the WEO raises its projection for 2017 global growth to 3.5 percent, up from our recently forecast 3.4 percent."

The IMF's 2018 forecast holds steady, projecting 3.6 percent global growth next year. Moreover, "the expected growth improvements in 2017 and 2018 are broadly based, although growth remains tepid in many advanced economies, and commodity exporters continue to struggle."

We believe the IMF's 2017 forecast is, at best, moderate. Longer-term growth rates – both the trajectory being forecast and the actual rates experienced – are well below those of past decades, especially among G-7 economies. Hence, there is a slight chance that growth will exceed expectations in the near term, but as with any forecast, it is not without risks, the major concern being protectionism.

Notes the IMF, "one salient threat is a turn toward protectionism, leading to trade warfare. Mainly in advanced economies, several factors – lower growth since the 2010-11 recovery from the global financial crisis, even slower growth of median incomes, and structural labor market disruptions – have generated political support for zero-sum policy approaches that could undermine international trading relationships, along with multilateral cooperation more generally."

That position is more pronounced in the U.S. as noted by the FED which has been focused on stagnant wage growth. Given the low U.S. unemployment numbers and where we are in the economic recovery, one would expect that wages would be rising at a faster pace.

In our view that risk is also overstated. A couple of points to consider: 1) demographics and 2) disruptor technologies.

There is not much one can do with demographics. Retiring Baby Boomers are being replaced by younger, less experienced workers at generally lower pay rates. Consider as an example the impact of recent pension plan adjustments on total employee compensation.

Many Baby Boomers initially subscribed to so-called defined-benefit pension plans, in which the employee's projected retirement income was based on a fixed formula and actuarial assumptions, not the performance of the plan. Employers were required to top-up plans where there was a perceived shortfall.

Damage caused by the financial crisis created massive levels of un-funded pension liabilities among such defined-benefit plans, which have caused many employers, including governments, to transition newer employees to defined-contribution plans.

In a defined-contribution plan, both employer and employee contributions are fixed, which means that the retirement benefits are not defined. Instead the end pension is determined by the value and performance of the plan, moving the consequences of future under-funding from the employer to employee.

Technological disruptors have also influenced labor markets. In some cases, replacing workers with robotics which has been most pronounced in the automotive industry. New technologies make it difficult for less skilled employees to demand higher wages.

We also see examples of companies using technology to combat minimum wage legislation in industries once immune to such influences. Fast food is a classic case study of the unintended consequences that come from significant changes to minimum wages.

McDonalds, for example, is installing order stations where one can order their food and pay for it without having to deal with a cashier. Other fast food companies have computerized the entire customer experience from ordering

to the delivery of the end-product. This would likely have come about in time, but this process may have been accelerated by changes in minimum wage laws, notably in Washington state, California, Ontario and Alberta.

Then there are the politics. President Trump continues to play to his base of supporters. In his effort to "make America great again" he has engaged industries that have no long-term future (i.e. coal mining in West Virginia) at the expense of 21st century industries like technology.

His attempt to protect American workers, while admirable, is not necessarily having the desired effect. If companies cannot set up shop elsewhere for fear of a political backlash, they develop new technologies at the expense of new employees. President Trump would be doing those workers a big favor if he spent more on re-training them to be competitive in new industries rather than preserving obsolete industrial models.

The challenge for investors is to separate the political chaff from the economic wheat. On that point, be mindful that over the long-term, economics will always trump (sorry) politics. The best insurance for labor is when companies get the most production value for dollars spent, which requires a skilled workforce able to function in 21st century industries. What's good for business is good for investors, and that combination offers safeguards for labor.

The Case for Equities

Portfolio management is all about being able to dissect the news of the day and apply econometric thinking to take advantage of opportunities that are not always apparent. We have always focused on making certain our clients understand that equity valuations cannot be viewed in a vacuum. Much depends on competition from other asset classes – specifically bonds, cash and commodities.

Regarding bonds, we know that interest rates are low and will most likely rise. Typically, rising rates are negative for stocks, but with rates so low it is unlikely that increases over the next two years will have a meaningful negative influence on equities.

Consider financial institutions as a case in point. Currently one- to five-year GIC rates at your local bank range between less than 1% to perhaps a little more than 2%. Now think about these returns in context of what underpins a GIC strategy.

When you buy a GIC you are loaning money to your bank without the right to redeem it earlier than the stated period. At the heart of this is an assumption that the bank is of sufficient strength to pay back the GIC on time with interest. Currently Canadian banks are paying dividends on their common shares that range from 3.7% (Toronto Dominion) to 4.8% (CIBC).

In theory, then, the bank could take the funds from your GIC loan, and use it to buy back their own shares and be ahead of the game. Now if rates on GICs were normalized (i.e. in a range between 4% and 6%) all bets are off. But we are nowhere near that in the current environment.

So, if you believe the banks are solid to the point you are willing to loan them money, one would argue that they are strong enough to buy outright. The return is better on a nominal basis, and significantly better after tax in non-registered accounts.

It is metrics like this that support current equity valuations and, relative to current interest rates, we think equities are still the best place to be.

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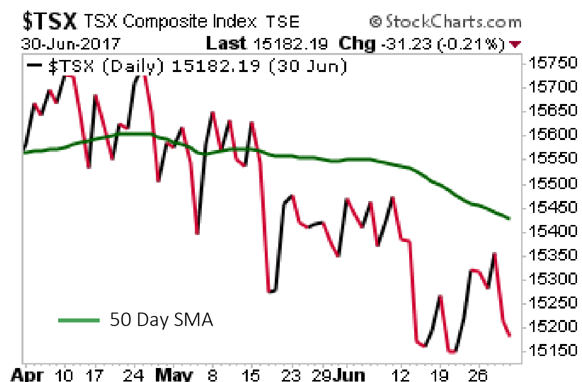
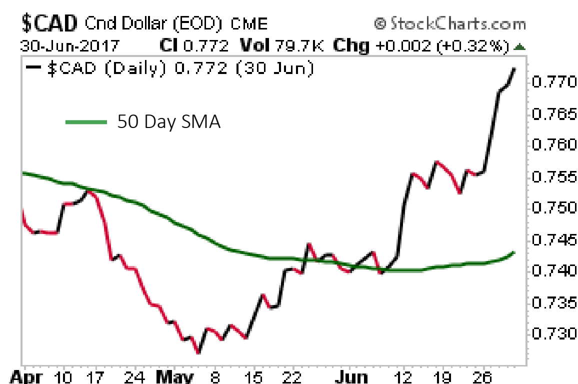
Canada

The S&P/TSX Composite ended the second quarter down 2.4%. The biggest sectors of the index – Energy, Materials and Financials – were all negative over the past three months, down 9.1%, 6.7% and 1.8% respectively. Gains came from the Health Care and Industrials sectors. The dividend yield on the S&P/TSX Composite of 3.1% continued to outperform the Canada 10-year bond at 1.76% (currently at 1.86% since the recent BoC rate increase).



The Canadian dollar reversed losses from earlier this year to end the quarter at $0.752 USD/CAD.



To the surprise of many investors, the Bank of Canada (BoC) shifted its tone at the end of the second quarter when Governor Poloz said he felt that the half-point low interest rate "insurance" he took out on the economy in the wake of the oil crash of 2015 had done its job. Strength in other parts of the economy coupled with a generally positive, G7-leading outlook for growth supports the notion that ultra-low-rate stimulus is no longer required. As good as his word, the Governor Poloz announced a 25-basis point rate increase on July 12th and implied there may be more to come.

When we look at the indictors that support the BoC's position it's not difficult to see why. The Canadian labor market is solid right now, creating an average of 26K jobs/month in the 12 months leading up to the end of May and pushing the Canadian unemployment rate down to an 8-year low. Adding to the quantity of job creation over this period is the quality – most of these jobs have come from the private sector and most have been full-time. The private sector hires when there is confidence in the future, and full-time jobs give consumers the security they need to go out and spend, both creating a very positive feedback loop for growth.

According to the results of the Business Outlook Survey published on June 30th, business activity continues to gain momentum. Across a broad range of sectors, capacity pressures are rising, firms expect sales to grow, plans to increase spending are on the rise, and labor shortages indicate slack is being absorbed. Business investment is becoming more widespread, demonstrating that the economy has decreased its dependence on certain key industries.

Although these indicators give confidence to higher-growth projections, certain risks remain. While downplaying their importance near-term, Governor Poloz acknowledged recent CPI numbers continued to come in well below the official 2% target. While the BoC may expect inflation expectations to pick up, the products of the

average wage rate and total hours worked indicate overall wage growth is only 1%.

High household indebtedness also remains a headwind to growth. In the face of higher interest rates, consumers normally scale back their borrowing. Further, an analysis conducted by National Bank revealed that for every 1% increase in the 5-year mortgage rate, they would expect home prices to decline by 7%. Declining housing values and credit contraction could cause a negative wealth effect resulting in less consumer spending and detract from future economic performance.

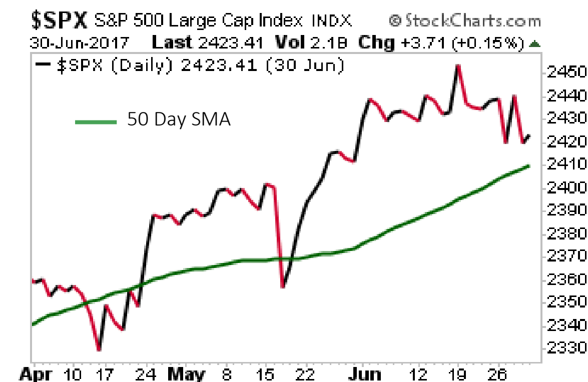
In response to expectations of higher short-term rates, the slope of the yield curve has flattened recently. If prospects for future growth looked good we would expect the yield on the long end of the curve to increase proportionally, but the yield on the Canada 30-year bond has fallen. It seems the market may not share the BoC's optimism for long-term growth.

Finally, trade is always a significant contributor to Canada's GDP and longer-term prosperity. However, with the prospect of higher rates, since the end of Q2 the Canadian dollar has continued to strengthen against its U.S. counterpart. Furthermore, the Trump administration's determination to renegotiate NAFTA remains a serious concern, especially if the final terms are less favorable for Canada.

On balance, however, the outlook is still favorable for Canadian equity markets. Although the S&P/TSX remains one of the worst performing global benchmarks, the economy is strong and the forward P/E of the index has fallen back into line with its 5-year average, meaning the index is "cheaper" overall than it was a year ago. In addition, the Canadian index is a relative value opportunity, as it is currently trading at a discount relative to the S&P 500. Looking at market valuations from a different angle, the composite price to book ratio remains near historic lows while the composite return on equity remains strong. Translated this means investors are paying a low price for companies that are offering a lot of return. Adding to the value of Canadian stocks is that earnings growth remains positive and analysts have been revising their expectations higher.

When we sum all of this up, it appears Canadian stocks may offer a good opportunity for investors given the risks they would have to bear. Even if it takes longer for this thesis to play out, given that the dividend yield on the S&P/TSX still exceeds the yield on a Canada 10-year bond, investors can be comforted that they're being paid to wait.

United States



U.S. equity markets extended first quarter gains at a slower pace in the second quarter. The S&P500 and NASDAQ started the quarter strong with low but steady single-digit monthly returns in April and May, and then faltered in June, with the Dow increasing 1.52% and NASDAQ turning negative. Consequently, at the end of Q2 as investors moved out of high risk technology stocks and into American blue chips fewer U.S. stocks were trading at or hear their 52-week highs compared with Q1.

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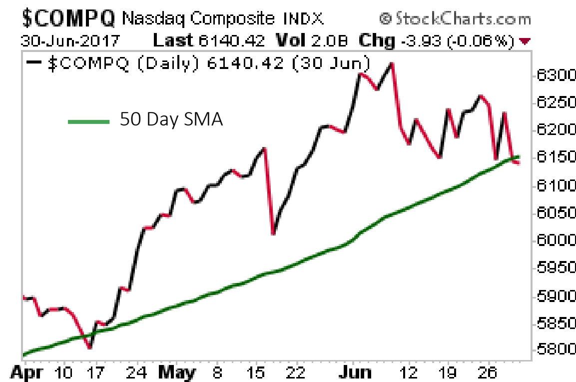
This equity market slowdown was in line with U.S. economic fundamentals. American GDP growth slowed in the first quarter, standing at an annualized 1.4% after its third and final revision. Also, after steadily increasing throughout 2016 from its most recent trough in the fourth quarter of 2015, growth in after-tax corporate profits as tracked by the Federal Reserve Bank of St. Louis turned negative in the first quarter.



Finally, despite reaching its highest level since the dotcom bubble in December 2000, the consumer confidence index as tracked by the Conference Board seems fragile. Much of that forward-looking indicator relies on the hope of tax and regulatory reform from Trump administration, which has yet to materialize (Economist April 8, 2017, p.23).

The other reason behind equity market's pause is the decision of Federal Reserve officials to raise interest rates by a further quarter point on June 14th. Their rationale is that the slowdown in economic growth is temporary and will soon return to normal and that inflation will approach the Fed's 2% target in the 'medium term'.

To be sure, the Fed is worried more about future inflation than what it, or anyone else for that matter, is seeing in the data today. Coupled with the continued reduction in the unemployed rate (a somewhat anomalous occurrence in the U.S. by historical standards), the Fed is concerned that this prospect of future inflation will slow an economy that still has room to run.

On the other hand, Fed Chairwoman Janet Yellen has also indicated openness to calls from Economists outside the FOMC to increase the fed's targeted interest rate beyond 2% (Economist June 24, 2017, p.70). Moreover, central bankers these days try to provide as much transparency to market participants as possible, so at most another interest rate hike (likely by another quarter point) remains on the table for 2017 unless, unexpectedly, inflation really does get out of hand before then.

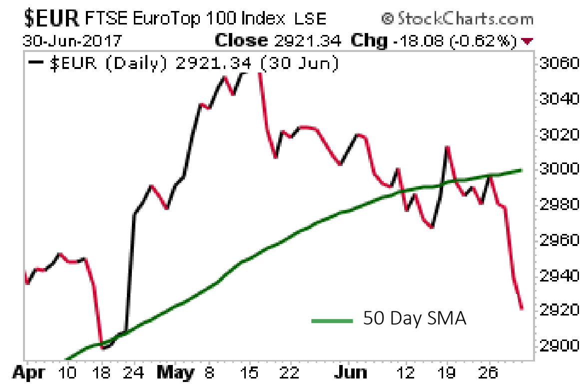
Stepping back, this increase is the second of three originally promised in 2017 and third in the last six months. U.S. equity markets have taken the previous two interest rate hikes in stride, and should do so for the remainder of 2017. While the loose monetary policy is no longer supplying a convenient excuse for markets to hold onto inflated valuations, barring any shocks to the global financial system, such policy should no longer be necessary for investor to remain confident in the outlook for the U.S. economy, which can continue to grow on its own momentum. Any extra stimulus Washington is ultimately capable of providing will come as a welcome surprise.

Europe, Asia & Emerging Markets

Europe

Europe has maintained its gradual growth with retail sales, industrial production, and job growth all exhibiting positive figures. Private consumption increased at the fastest rate for the past decade, but is expected to fall back as the effects of still-modest inflation reduces

consumers purchasing power. The overhanging populist political and trade risks have subsided as European election results eased fears of a Eurozone breakup. Unemployment rates continue to improve with market expectations of 9.4% in 2017 and 8.9% in 2018. The debt-to-GDP ratio is also expected to improve through lower interest payments and a stagnate public sector wage environment, with forecast figures expected to fall from 91.3% in 2016 to 90.3% in 2017 and 89.0% in 2018.

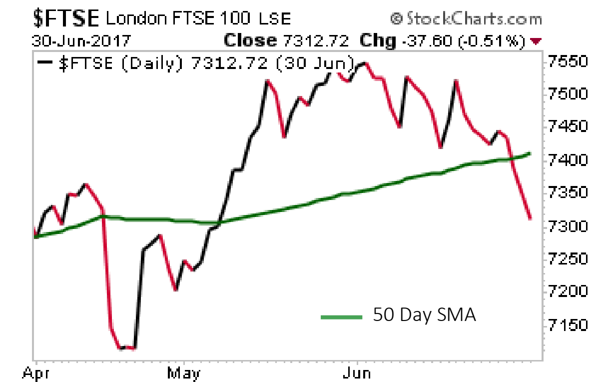


Germany

The German economy continues to grow supported by strong employment, consumption, construction and exports. GDP is expected to grow by 1.6% in 2017, slightly above 2016 figures. The staggering number of refugees that have been arriving for the past 3 years have not shown a material effect on unemployment, as employment figures have been revised upward with the strong economy and demographic changes have reduced the overall labor force.

United Kingdom

The UK election created additional Brexit uncertainties with Theresa May's new minority government; only the second hung parliament since 1974. Chaos reigns on the British negotiating side and risks mount as "no deal Brexit" becomes a real possibility. It there is no agreement by the March 30, 2019 Brexit deadline, the UK's existing trade or security agreements would become void. Additionally, the expected bill for the exit from the EU is reported to be €60-100 billion range. Both factors put considerable strain on the UK economy and are hampering business spending as they wait for critical uncertainties to be resolved.



France

Despite his stunning parliamentary victory for En Marche, President Macron is expected to face strong opposition from the powerful trade unions, which are adamantly opposed to any reforms that make it easier for French businesses to fire employees. President Macron's re-commitment to the EU's mandated 3% deficit target will only be achieved if both spending cuts and freeing up the labor market are enacted.

CROFT FINANCIAL GROUP

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China & Emerging Markets

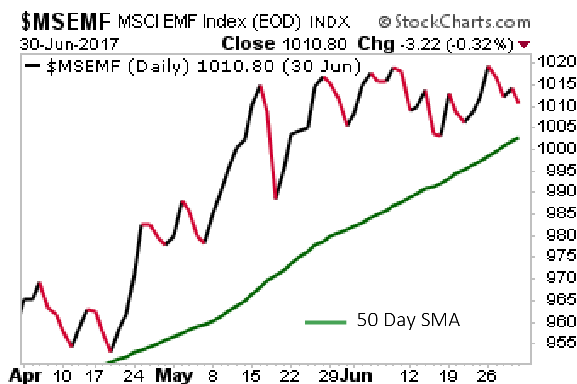
China

The Chinese government has been increasingly dependent on debt, with levels climbing to 250% of GDP compared to 150% before the 2008 global financial crisis. Due to of debt default concerns and possible negative spillover effects on the economy, Moody's downgraded China's credit rating. There is some reassurance that a majority of this debt is domestically financed, which reduces currency risk. Surprisingly consistent Q1 GDP figures beat market expectations but investors remain concerned about any additional tightening of monetary policy.

On the positive side, almost U.S. $17B or more of foreign capital could flow into Chinese stocks as in June MSCI announced that beginning next year it will add Chinese A shares to its benchmark emerging markets index. Further, the initial rhetoric during in the U.S. elections has diminished as the US-China trade negotiations commenced with lowering trade tensions and Trump's tax reform plan omitting any mention of a Chinese border adjustment tax.

Emerging Markets

Emerging Markets indexes posted impressive Q2 returns, which were driven by a combination of strong developed-economy demand on the back of reflation and growth, a pause from the decline in commodity prices (excluding oil), and a weaker U.S. dollar. Compelling valuations combined with local economic reforms tempted investors to ease back into emerging market stocks.



Locally, there continue to be some risks in the emerging market countries, including shifts in currency policies and possible trade conflicts. In Latin America, Brazil's chaotic political environment renewed threats of a possible second recession. In contrast, Mexico's outlook has improved as the peso that rebounded from the 15% drop that followed uncertainties surrounding last year's U.S. election.

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Sector Report

S&P Sector	Q2 Returns
Consumer Discretionary	2.31%
Consumer Staples	1.42%
Energy	-6.61%
Financials	4.28%
Health Care	7.03%
Industrials	5.16%
Materials	3.16%
Real Estate	2.71%
Technology	3.08%
Utilities	2.15%
S&P 500	2.57%

The extended period of declining commodity prices may be finally stabilizing. With modest economic growth in the U.S. and Europe there should be sufficient demand to put upward pressure on the Materials sector, which has a high correlation with interest and inflation rates because of strong economic growth. On the negative side, there are concerns stemming from with reports of large buildup of commodities in Chinese ports, which will take some time to absorb.

The hunt for yield is causing a flow of money from the Utilities sector into Bonds as recent short-term interest rate hikes finally make fixed income more appealing. Increasing inflation would also add additional pressure on the traditionally defensive Utilities sector. Large Capital expenditures are typical in the Utilities sector which will result in high debt levels and interest burdens as rates rise. In contrast, the improving U.S. housing sector will provide some relief and with additional demand for electricity.

In the Consumer Discretionary sector confidence has improved to a nearly 16-year high as a strong U.S. economy pushes average hourly earnings up 2.5% for the past year according to the Bureau of Labor Statistics. U.S. household debt levels now exceed the previous record set in 2008, but the average mortgage credit score is the highest it's been since 2015 at 764. Despite the increase debt levels, consumers are hesitant to increase spending. Online retailers are a bright spot with solid 11% gain year over year returns but at the expense of traditional department stores with sales dropping 4.7%. A highly competitive, rapidly changing retail environment is now resulting in compressed and even negative margins for traditional retailers.

Market Summary

	31-Mar-17	30-Jun-17	Q2 2017	YTD 2017
S&P/TSX Index Composite	15,547.75	15,182.19	-2.35%	-0.69%
S&P 500 Composite	2,362.72	2,423.41	2.57%	8.24%
Nasdaq Composite	5,911.74	6,140.42	3.87%	14.07%
MSCI EAFE	1,792.98	1,883.19	5.03%	11.83%
MSCI Emerging Markets	958.37	1,010.80	5.47%	17.22%
MSCI World	1,853.69	1,916.43	3.38%	9.43%
CBOE Volatility Index	12.37	11.18	-9.62%	-20.37%
FTSE TMX Bond Universe	1,023.90	1,035.30	1.11%	2.36%
Gold	1,244.85	1,242.25	-0.21%	8.41%
WTI Crude Oil Spot Price	50.60	46.31	-8.48%	-13.84%
CAD:USD FX	0.75	0.752	0.66%	0.24%
RWI Income	3,109.10	3,106.25	-0.09%	0.91%
RWI Balanced	3,258.59	3,264.76	0.19%	2.27%
RWI Growth	3,346.68	3,335.07	-0.35%	2.42%

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