Total Return Investor

October 22, 2018

Market Commentary

Market Overview

The global economy is facing numerous economic headwinds including higher interest rates and falling fiscal stimulus. TRI expects an increased level of volatility and re-pricing of risk assets in 2019 and early 2020. TRI encourages investors to assess liquidity levels in their portfolios along with risk exposures to weather the potential economic slowdown that we believe is building steam.

TRI recommends investors move their portfolios into a defensive structure to preserve capital and source income from highest quality and liquid assets. TRI expects great buying opportunities in late 2019 or early 2020.

Macro Trends

- Global economic headwinds are building
- Equities appear to be in a classic topping formation
- Interest rates are leaking higher
- USD strength is real
- Commodities are in a typical late cycle phase

Total Return Investor Cycle & Trend Signals

The TRI Cycle and Trend Signals are shown below. These signals are as of market close on October 19, 2018. Please see the TRI Overview document for further information.

Market	Market Symbol / ETF	Signal		
		Daily	Weekly	Monthly
10-Year Gov't Canada Bond Futures	CN1	bullish	bearish	bullish
iShares Core Canadian Universe Bond Index ETF	XBB	bullish	bearish	bearish
10-Year US T-Note Futures	TY1	bearish	bearish	bearish
30-Year US T-Note Futures	US1	bearish	bearish	bearish
iShares iBoxx Investment Grade Corporate Bond ETF	LQD	bullish	bearish	bearish
iShares iBoxx High Yield Corp Bond ETF	HYG	bearish	bearish	bullish
S&P/TSX Composite Index	TSX	bullish	bearish	bearish
S&P 500 Index	SPX	bearish	bearish	bullish
iShares Russell 2000 ETF	IWM	bearish	bearish	bullish
iShares MSCI ACWI ex U.S. ETF	MSCI ex US	bearish	bearish	bearish
iShares MSCI Emerging Markets ETF	EEM	bullish	bearish	bearish
US / Canadian Dollar	USDCAD	bullish	bullish	bearish
Euro / US Dollar	EURUSD	bullish	bearish	bearish
US Dollar Index	DXY	bullish	bullish	bullish
Crude Oil (WTI) Future	Oil	bearish	bearish	bullish
Gold Futures	Gold	bullish	bullish	bearish
Silver Futures	Silver	bearish	bullish	bearish
VanEck Vectors Gold Miners ETF	GDX	bullish	bullish	bearish
Thomson Reuters/CoreCommodity CRB Commodity Index	CRB	bearish	bullish	bearish

** TRI Cycle and Trend Signals are dynamic and may change on a daily, weekly and monthly basis, without notice. The indicators are at a point in time and do not imply that the current trend will persist and should not be considered investment advice.*

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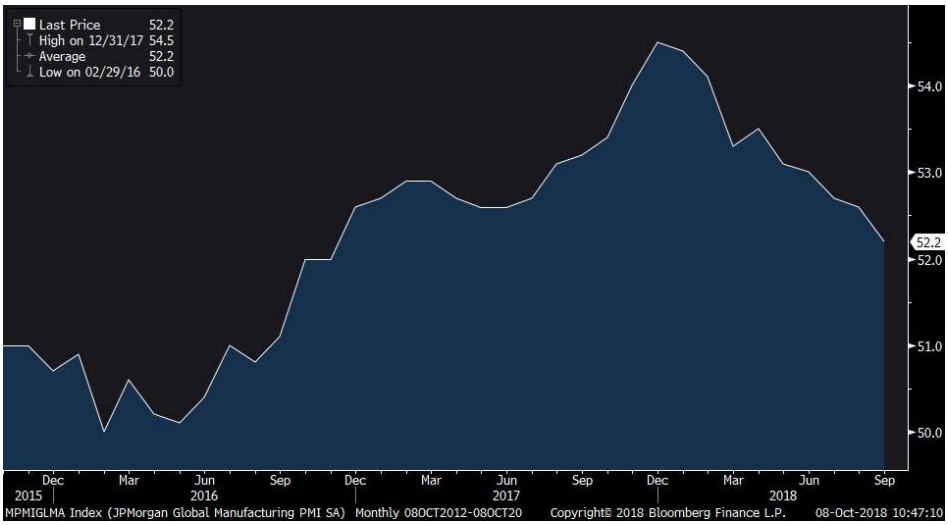
Global Economic Growth – Headwinds Are Building

Global PMI's peaked in early 2018 and most global equity markets followed the global PMI's lower as economic growth rates appear to be slowing. The US markets had been the exception with many US indices hitting all time highs in late September. The US tax cut stimulus and excessively easy monetary policy initiated from the 2008/9 Great Financial Crisis are both still positively flowing through its economy.



However, as we look forward into 2019 and 2020 the increase in both short term and long-term US rates since 2016 are now becoming economic headwinds. The US 2-year interest rates are 2.3% higher and US 10-year rates are now 1.7% bps higher than the 2016 lows.

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The above chart shows the correlation of the annual change in US manufacturing levels with the US 10-year interest rates (2 year change advanced by 18 months). If this historical relationship continues, it's likely we are on the verge of potential sub-50 Global PMI and ISM PMI readings into late 2019 or early 2020.

What impact would a sub-50 PMI print have on risk assets?

Equity – Classic Topping Formation in Process

The MSCI World Index is flat year-to-date, after falling almost 6% from recent highs. The S&P 500 is up 5% year-to-date. Most global markets have diverging performance compared to the US markets. In Canada, the SPTSX Composite is 3% lower for the year, while in Germany the DAX Index is lower by 10% and China and Emerging Markets have dropped by more than 20% year-to-date. All returns are in local currency terms. TRI expects the US markets to continue their relative outperformance versus its peers.

As seen in the above weekly chart, world markets tend to oscillate in similar rhythms, with cycles topping and bottoming near each other, albeit it at different levels.

The most recent weekly cycle high in Equity markets was in late September 2018. Expectations are for equity markets weekly cycle to bottom between early October 2018 and mid-December 2018. The move out of this weekly cycle bottom will be crucial in assessing how much life is left in this cyclical bull market.

Currently, investor sentiment has tilted towards a more bearish posture, making TRI wonder if we are on the cusp of another squeeze higher in equity markets. A move higher out of the current weekly

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cycle low is in the making. This move higher would be contrary to defensive positioning many have initiated over the past few weeks. Will it be the last gasp higher into early 2019 be a big bull trap?

TRI's current outlook is for the S&P 500 to at least test recent all-times highs in the first half of 2019, once this weekly cycle has completed its downside phase. The S&P 500 Index still has the potential to even break out to new all-time highs above 3,000.

If the S&P 500 does break out to new all-time highs above 3,000, then S&P 500 is likely to encounter 15 to 25% correction beginning in 2019.

Fixed Income – Rates Are Leaking Higher

Central banks are removing excessively easy monetary policy introduced during the Great Financial Crisis. The short end of the yield curve is rising as the Federal Reserve increases overnight lending rates, and longer-term rates are moving higher with robust US economic growth. The US10 Year Treasury yield is at its highest levels in 4 years with Canada 10-year rates moving to the higher end of the 4 year range.

The flattening of the yield curve and the potential negative impacts it may have on economic prospects has been a hot topic of debate. It is widely believed an inverted yield curve is a precursor to a potential recession. The yield curve is flattening as short-term yields (2 year) are rising faster than longer term yields (10 year). The yield curve is flattening because short-term rates rise faster than longer-term rates as Federal Reserve to raise short-term rates from historical lows with the US economy growing robustly.

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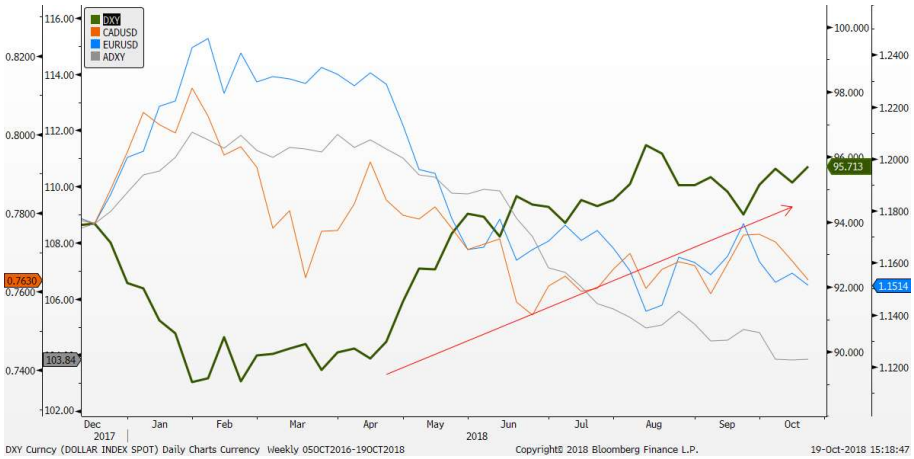
Source: Bloomberg

TRI is not as concerned about the yield curve is flattening as a result of a strong economy. However, we will be concerned when the yield curve begins to steepen again from short rates falling. Once this type of curve steepen begins, we will then have first indications of a potential topping of longer-term rates and a slowing economy.

Until then, longer-term rates are positioned to increase another 25 to 50 bps from these levels before they start to cause real economic headwinds. At those higher levels sovereign rates will become attractive.

Currencies – USD Is Strengthening

In 2019 the USD has strengthened. The USD move higher has been one of the strongest moves over the past 20 years. In fact, the cyclical phasing points to the February 2018 as marking the 4-year low. We expect the USD to have at least another seasonal cycle higher, if not two more years of strength. This will ultimately depend on central bank interventions and their intentions later in 2019.



Currently, the USD is at a medium-term consolidation range as there are early indications of a potential annual cycle top in August. So far, the June and July lows have held support and we will be

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looking for the daily cycle to exceed the August high and/or peak in a right translated manner to indicate further medium-term strength.

North of the border in Canada, the CADUSD is consolidating in the 0.76 and 0.79 range. Cycles phasing points to a weekly cycle high in the making with lower levels for the CADUSD to be seen into 2019.

Commodities – Typical Late Cycle Action

The Thomson Reuters CRB Commodity Index last major top was in 2011. Many market participants call this 2011 high a "super cycle top" which occur ever 25 to 30 years. The price action and cyclical phasing since the 2011 high has been lackluster to say the least. Each shorter, 3-year cycle has failed to surpass the prior cycle highs. The continued cyclical failures are telling of the underlying weak economic backdrop and deflationary backdrop. The longer-term outlook for commodities is challenging from a secular perspective. Notwithstanding, short and medium-term counter-trend rallies in between can provide good trading opportunities.

Oil is a major constituent within the CRB Index and has recently broken out to 4-year highs. Oil price action since it's 2008 high has been lackluster as well. A move above the 2008 high is very unlikely over the next several years.

Stepping back to see the bigger picture, the weakness in the commodity prices can be tied to lower infrastructure investment in emerging markets and trade wars causing a drop in global trade with fewer goods moving throughout the global supply chain.

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How Fed Tightening Cycles End

The Federal Reserve interest rate tightening cycles tend to end with a crisis. Interest rates tightening cycles tend to cause interest rate differentials between countries, leading to currency movements. Generally, when the Federal Reserve is increasing short term interest rates, the US Dollar tends to rise in value against global currencies. A stronger USD and weaker global currencies tend to put a strain on non-US economies as their depreciating currency makes servicing their US dollar obligations more expensive, thus straining their liquidity and credit worthiness.

In parallel, as credit stresses increase outside the US, within the US borders, rising interest rates reduce monetary stimulus and chokes off domestic consumption and investment incentives. The interest rate increases tend to take 18 to 24 months to flow through the system before they impact final demand.

Deutsche Bank's macro strategist Alan Ruskin[1] explained this sequence of historical events:

- Every Fed tightening cycle creates a meaningful crisis somewhere, often external but usually with some domestic (US) fall out. Fed tightening can be likened to the monetary authorities shaking a tree with some overripe fruit. It is usually not totally obvious what will fall out, but that there is 'fall out' should be no surprise.
- Going back in history, the 2004-6 Fed tightening looked benign, but the US housing collapse set off contagion and a near collapse of the global financial system dwarfing all post-war crises.
- The late 1990s Fed stop start tightening included the Asia crisis, LTCM and Russia collapse, and when tightening resumed, the pop of the equity bubble.
- The early 1993-4 tightening phase included bond market turmoil and the Mexican crisis.
- The late 1980s tightening ushered along the S&L crisis.
- Greenspan's first fumbled tightening in 1987 helped trigger Black Monday, before the Fed eased and 'the Greenspan put' took off in earnest.
- The early 80s included the LDC/Latam debt crisis and Conti Illinois collapse.

[1] Source: Zerohedge.com. Oct 18,2018.
https://www.zerohedge.com/news/2018-05-24/deutsche-every-fed-tightening-cycle-creates-crisis-somewhere

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Investment Philosophy

The **Total Return Investor** investment objective is to:

- Protect capital and limit drawdowns while delivering better risk-adjusted total returns.
- Actively invest across a wide range of asset classes.
- Provide comprehensive risk management, focusing on how risks relate to each other and not limited to how risks relate to benchmarks.

TRI process is a disciplined and flexible asset allocation framework seeking total returns by managing tail risks, exploiting market volatility and minimizing drawdowns

Profile

Rabbie Gill, CFA, MBA has 16 years of investment management and capital markets experience, specializing in total return, risk management and overlay solutions. He has built a variety of investment programs for fixed income, equity and managed account mandates.

Rabbie is a CFA charter holder and has an MBA in Management of Technology and a BBA with a double major in Finance and Economics from Simon Fraser University.

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