October In Review:

By Rob Edel, CFA

Highlights This Month

- October 2017: scary month for equity markets?
- Is the current market overheating?
- One more factor to extend the economic cycle further.
- Should you most up the risk curve and chase higher returns?
- Diversification: the best strategy?
- Ten strategic industries China plans to dominate.
- Will the markets continue to move higher?

The Nicola Wealth Management Portfolio

Returns for the **NWM Core Portfolio Fund** were up 2.2% for the month of October. The Core Fund is managed using similar weights as our model portfolio and is comprised entirely of NWM pooled funds and limited partnerships. Actual client returns will vary depending on specific client situations and asset mixes.

The Canadian yield curve benefited from a nearly parallel shift lower last month, with 2-year Canada yields declining 0.12% and 10-year Canada yields -0.15%. This move retraces about half the parallel shift upwards experienced in the previous month. By contrast, U.S. yields continued their move higher, with 2-year treasuries increasing 0.12% and 10-year treasuries +0.05%. For the month, the **NWM Bond Fund** was up 0.5%. Delayed price reporting from some of our managers likely depressed this return slightly, and we estimate 30-40 basis points of performance that should have been reported in October could end up in November's numbers. This doesn't mean, however, the NAV won't be correct until November. As soon as price data is obtained from our managers, the NAV of this daily priced fund is updated. In a year where 2-year yields have increased nearly 65 basis points, we are very pleased with the 2.8% year to date returns this short duration fixed income portfolio has produced.

NWM High Yield Bond Fund returned +1.6% in October, compared to +0.4% for the Bank of America Merrill Lynch U.S. High Yield Index. The monthly outperformance came from the fund's 33% exposure to the Oaktree Global High Yield Bond Fund, which benefited from the stronger USD. Strong demand in October for CLO (collateralized loan obligation), AAA-rated tranches continued to provide strong technical support to non-investment grade fixed income markets (leveraged loans and high yield bonds), and our sub-managers remain defensive. Yield and duration of the fund is currently 3.6% and 2.6 years, compared to 5.5% and 3.9 years for the index.

Global bond returns were strong again last month, with the **NWM Global Bond Fund** returning 1.9%, benefiting from the 3.4% decline in the Canadian dollar.

The mortgage pools continued to deliver consistent returns, with the **NWM Primary Mortgage Fund** and the **NWM Balanced Mortgage Fund** returning both returning +0.4%. Current yields, which are what the funds would return if all mortgages presently in the fund were held to maturity, with all interest and principal repaid and in no way is a predictor of future performance, are 4.4% for the primary fund and 5.4% for the balanced mortgage fund. The primary fund ended the month with cash of $4.4 million, or 2.7%. The balanced fund ended the month with $44.1 million in cash or 8.9%.

The NWM Preferred Share Fund returned 1.8% for the month of October, matching the return of the BMO Laddered Preferred Share Index ETF. The rate reset preferred share market rose, despite 5-year Bank of Canada yields moving lower by 13 basis points. New issuance continues to be quite muted, continuing the trend last quarter when only $1.25 billion was issued versus a historical quarterly average of around $2 billion. A hybrid security debt offering from Scotiabank was met with significant demand and raised over $1.25 billion. This security serves a similar role in terms of the capital bucket filled by preferred shares and would likely mean less bank preferred share issuance in the future, as regulated financial entities have made up 60% of annual issues recently.

Canadian equities were stronger in October, with the S&P/TSX +2.7% (total return, including dividends). The **NWM Canadian Equity Income Fund** returned +2.0, while the **NWM Canadian Tactical High Income Fund** was +0.3%. Our underweight position in the materials sector hurt performance last month, particularly our decision to have no exposure to Potash and Agrium. Detracting from relative returns were our holdings in Aritzia, Hudson's Bay, and Medical Facilities. These losses were partially offset by good results from our holdings in Heroux Devtek, CNQ, and Alimentation Couche-Tard. The equity income fund exited its position in Rogers Communications after the strong year to date performance of the stock. In the Canadian tactical high-income fund, the underweight in the financial and real estate sectors detracted from relative performance last month. The fund still maintains a low net equity exposure (current delta adjusted exposure is 37%), which helps the fund's relative return in a down market, but hurts relative returns when the S&P/TSX is strong.

Foreign equities were also higher last month, with the **NWM Global Equity Fund** up 4.9% compared to a 5.3% increase in the MSCI All World Index and a 5.7% increase in the S&P 500 (all in Canadian dollar terms). Results for our external managers were all higher last month, with Lazard Global +5.2%, Pier

21 C WorldWide +5.2%, BMO Asia Growth & Income +5.0%, Edgepoint Global Portfolio +4.9%, and Pier 21 Value Invest +3.2%. Our new internal Europe Australasia & Far East (EAFE) quantitative investments returned an index-like +4.8% (the iShares MSCI EAFE ETF was +5.0%). **NWM U.S. Equity Income Fund** increased 3.2% in U.S. dollar terms, and the **NWM U.S. Tactical High Income Fund** increased 1.0% versus a 2.3% increase in the S&P 500 (all in U.S. dollar terms). In the NWM U.S. Equity Income Fund, relative performance was helped by strong performance in Adobe, Estee Lauder, Sherwin Williams, and not owning General Electric. Poor results from Newell, Synchrony Financial and Verizon weighed on results, as did not owning big cap high flyers Facebook and Amazon. We trimmed our position in Bank of America and used the proceeds to establish a new position in M&T Bank. We also trimmed Sherwin Williams to add to our holdings in DowDuPont. As for the NWM U.S. Tactical High Income Fund, we were "called away" on our Costco, Dollar Tree, L-Brands, Sherwin William, Union Pacific, and Delta Airlines positions and were "put" for the stock of The Cheesecake Factory. We also established a new short put position in Dave & Busters. The net equity exposure (delta) in the NWM U.S. Tactical High Income Fund is down to a very defensive 21%.

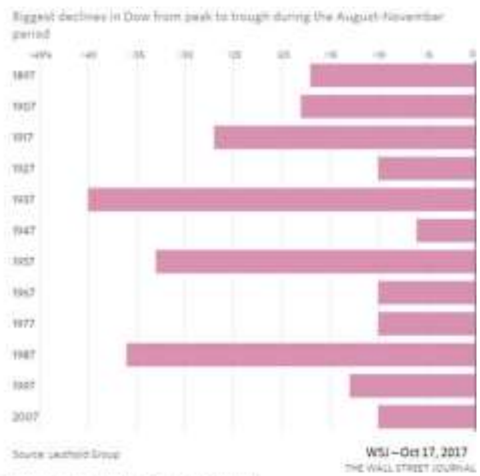
In real estate, the **NWM Real Estate Fund** was up 2.6% versus the iShares REIT Index +2.0%. We report our internal hard asset real estate limited partnerships in this report with a one month lag. As of October 31st, September performance for SPIRE Real Estate was +1.3%, SPIRE U.S. +1.0% (in US$'s), and SPIRE Value Add +1.6%.

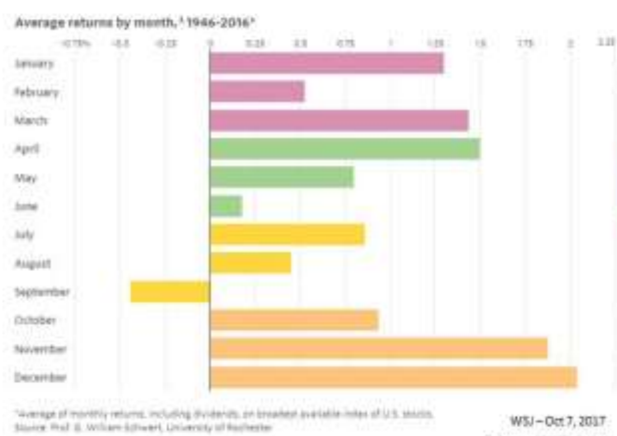
The **NWM Alternative Strategies Fund** was up +3.4% in October (these are estimates and can't be confirmed until later in the month), with Winton +7.3%, Citadel +5.3% (this position is being redeemed at the request of the manager), and Millenium +4.1%. The 3.4% appreciation in the U.S. dollar certainly helped, but these are still good returns. Of our other alternative managers, all had positive performance with RP Debt Opportunities +0.8%, Polar North Pole Multi-Strategy +1.0% and RBC Multi-Strategy Trust +1.2%. Precious metal stocks were weaker last month with the **NWM Precious Metals Fund** -2.7%, while gold bullion increased 2.7% in Canadian dollar terms.

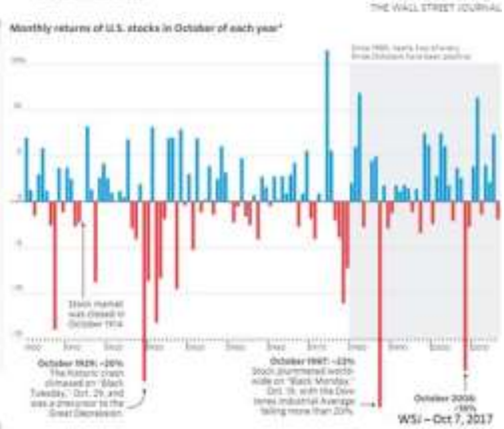
October In Review

Last month we detailed some key economic variables to watch in order to gauge where we are in the current economic cycle. In particular, we took a deeper dive on inflation and what it may or may not be saying about when the next recession will occur. The month previous, we highlighted some longer-term concerns we have with the global economy. We referred to them as grey rhinos, very visible but non-threatening, until they're not. This month we are going to take a quick inventory of these short and long-term issues and tie them to market action last month.

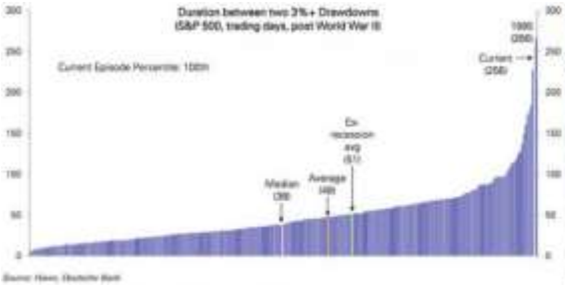
There was a lot working against equity markets as they entered October. It's a scary month, and not just because of Halloween. Three of the biggest market crashes in history have taken place during the tenth month of the year, namely 1929, 1987, and 2008. Barring these obvious setbacks, however, October returns have actually been middle of the pack. Since 1946, in fact, October has ranked 6th out of 12 months in terms of total return. Given every year ending in a seven has historically produced negative returns averaging -13% for the past 130 years (or the last 13 times a year has ended in seven), the fact the Dow Jones Industrial Average entered the month up over 15% year to date, put a lot of pressure on October returns to crash in order to keep the streak alive. Instead, however, the Dow soared +4.4% (in U.S. dollar terms) last month and is now up 20.6% going into the historically strong November and December time period, putting the 130-year streak in serious jeopardy. For the record, the S&P 500 was also stronger, gaining 2.3% in U.S. dollar terms and 5.7% when translated into Canadian dollars (the C$ fell 3.4% against the U.S. dollar), while the S&P/TSX gained a respectable 2.7%.







One streak that looks to be on much firmer ground is the number of days the market has gone without a 3% drawdown. As of early November, the S&P 500 is only a couple of weeks away from matching the record for the number of trading days between 3% drawdowns of 266 days set in 1995. Historically, the market experiences a 3-5% correction every 2 to 3 month on average but hasn't declined more than 3% since the nine-day swoon starting October 25th of last year took the market down just over 3%. Increased volatility can be a predictor of future market corrections. A recent analysis by BMO's investment strategy group pointed out that most bear markets start after a period of elevated volatility, which in BMO's analysis was defined as the six-month trailing number of daily market moves of 1%, either up or down. In the 6 months prior to the past five bear markets, the S&P 500 experienced an average of 36 days with a 1% move. Over the past six months, markets have produced a 1% move only eight times.



Business Insider Markets Chart of the Day – Nov 14, 2017

Source: BMO Investment Strategy Group, FactSet. BMO US Strategy Snapshot – Oct 26, 2017

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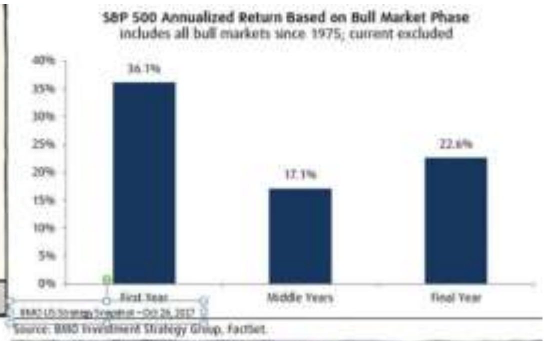
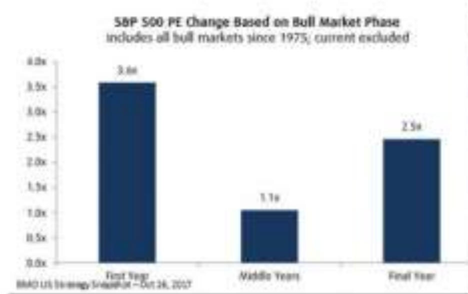
Bottom line, while the rally may look extended, the market isn't trading like it is in a bubble and nearing a correction. In fact, the greater risk for investors currently might be missing out on a melt-up rather than experiencing a melt-down for risk assets. Historically, the final year of a bull market has rewarded investors handsomely, with returns in excess of 20% due largely to sizable increases in valuations. For the retail investor that has been slow to dip their toe back into the market after the financial crisis, selling too soon could lead to significant seller's remorse.





Of course, we are not suggesting investors overstay their welcome in hopes of capturing the last gasps of an overheating market. Our point is we don't see the market overheating yet. While the current bull market is long in the tooth, age has historically not been a good indicator for forecasting the end of a bull market. Stocks cycles typically follow economic cycles, with about a six to nine-month lag. Like the current stock market cycle, the current economic expansion cycle is one of the longest in history, but it's also one of the slowest.

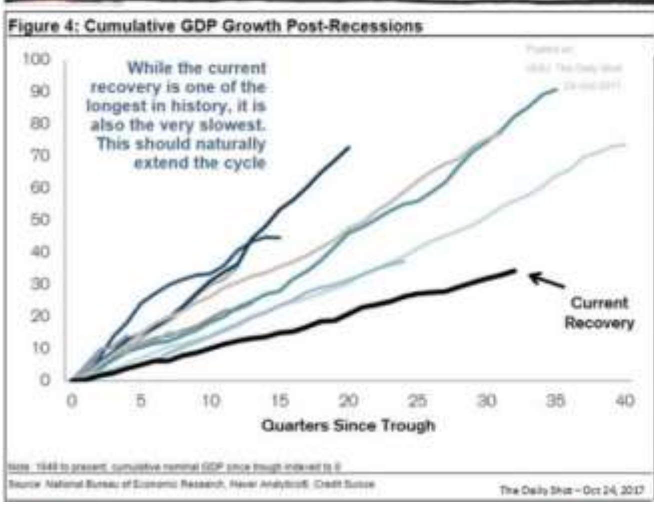
Looking at the economic indicators that have historically been used to determine where in the economic cycle we are, most are still pointing towards expansion. The shape of the yield curve, namely the difference between long and short interest rates, is typically considered one of the most accurate predictors of a recession. The lower the spread, the flatter the yield curve, and the more likely the economy will fall into recession. The last seven times the yield curve has actually inverted, with short rates rising above long rates, and the economy has gone into recession. Currently, while the yield curve has flattened, it remains well above zero.

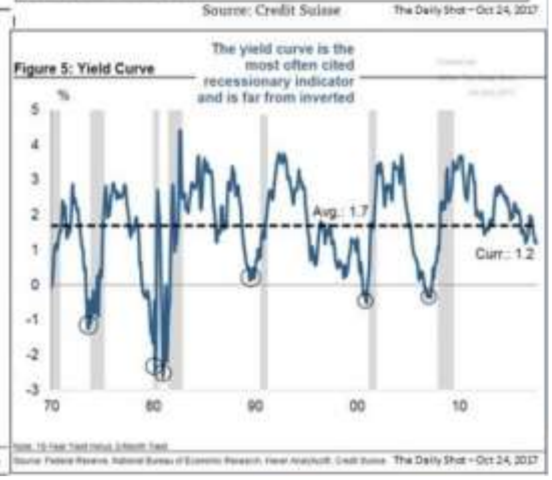
Figure 2: Credit Suisse Recessionary Indicators Dashboard

Start of Recession	Yield Curve	Inflation Trends	Labor Market	Credit Perform	ISM Mfg	Earnings Quality	Housing Market
Nov-73	⇩	⇩	⇩	⇩	⇩	–	⇩
Jan-80	⇩	⇩	⇩	⇩	⇩	–	⇩
Jul-81	⇩	⇧	⇧	⇩	⇩	–	⇩
Jul-90	⇩	⇩	⇩	⇩	⇩	⇩	⇩
Mar-01	⇩	⇩	⇩	⇩	⇩	⇩	⬌
Dec-07	⇩	⇩	⬌	⇩	⇩	⇩	⇩
Present	⇧	⇧	⇧	⇧	⇧	⇧	⇧

Key: ⇩ Recessionary ⇧ Expansionary ⬌ Neutral

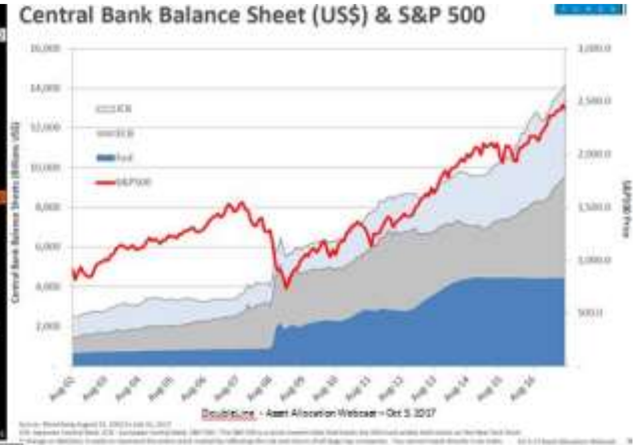
Source: Credit Suisse The Daily Shot – Oct 24, 2017

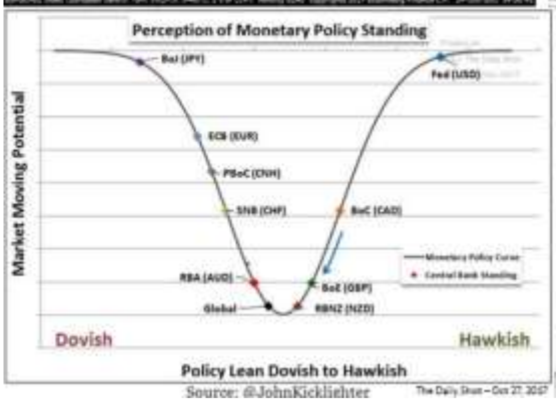


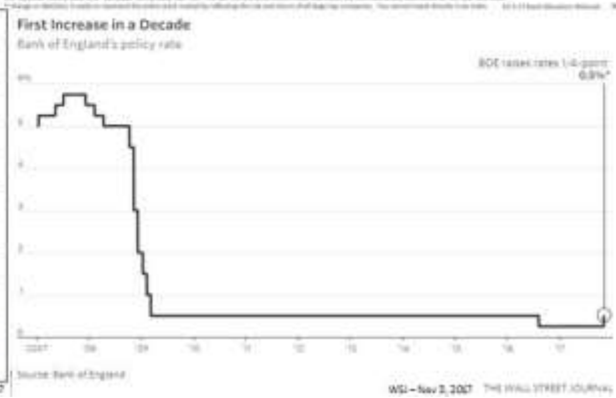


One of the key variables influencing the future shape of the yield curve is monetary policy and decisions by the world's central banks in regards to short-term interest rates and the size of their balance sheets. The U.S. has been on a slow tightening program and has recently announced plans to start shrinking their balance sheet by progressively repurchasing less and less of the maturing securities they purchased during their quantitative easing programs.

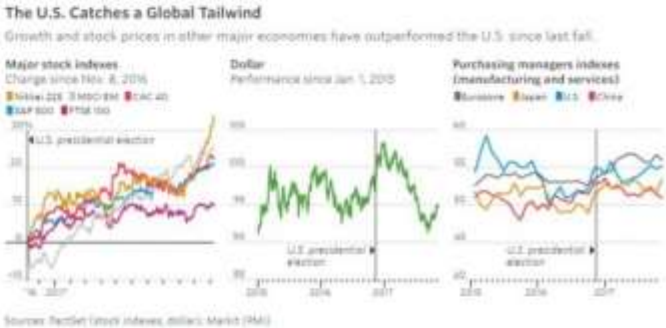
The recent announcement by President Trump that he intends to nominate Jerome Powell to succeed Janet Yellen as Chairman of the Federal Reserve, should ease investor concerns given Powell shares Yellen's dovish views on rates. Canada has raised short-term interest rates a couple of times but appears set to take a more measured approach going forward, while the UK increased rates last month for the first time in a decade, but also signaled caution going forward. It could be a case of one and done for their Canadian central bank Governor Mark Carney. Most other developed country central banks are either neutral in regards to monetary policy, or still in loosening mode. The ECB detailed plans to cut in half their monthly QE program last month but gave no visibility as to when they would move overnight rates, which remain below zero, higher. Japan appears content with the status quo, with overnight rates at 0.1% and a bond-buying program that has grown the Bank of Japan's balance sheet to nearly equal the size of their GDP. Global liquidity is good for the yield curve, and thus good for the markets.

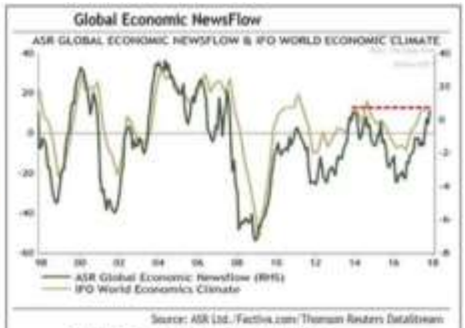


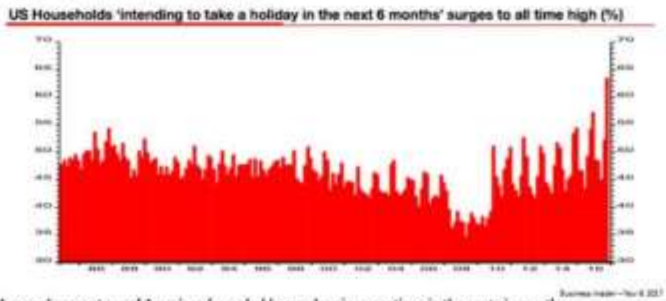




And what about the long end of the yield curve? Why are 10-year yields not moving higher, or even falling? As we highlighted last month, we think it is due to stubbornly low inflation. We agree with Janet Yellen that transitory factors are holding inflation down and it should firm over the coming months as the global economy continues to recover, especially with the unemployment rate at a 17-year low of 4.1%. Inflation, after all, is a lagging indicator. In the meantime, investors have the best of both worlds, low-interest rates, and stronger growth. Developed world purchasing manager indices have moved higher and news flow for both global economic stories and corporate earnings have turned significantly higher. In the U.S., the number of households planning to take a holiday in the next 6 weeks recently surged to an all-time high. No one plans a trip unless they are feeling good about their financial situation.







A record percentage of American households are planning vacations in the next six months.

Even when inflation starts to move higher and monetary policy tightens, there is one more factor that could extend the economic cycle even further, fiscal policy. In early November, the Republican-led House of Representatives finally unveiled their tax reform bill, officially called the Tax Cuts and Jobs Act, followed about one week later by Senate Republicans with their plan for tax reform. Now the real hard work begins. Both plans follow a similar theme, namely reduce corporate taxes in order to make U.S. companies more competitive against their global competitors who have been aggressively cutting corporate tax rates for years. Each plan cuts corporate tax rates from 35% to 20% (though the Senate's plan would take effect with a one-year lag), which would be good for corporate earnings and thus good for the market. In order to accomplish this feat without raising personal rates or increasing the federal deficit by more than $1.5 trillion over the next 10 years, there are inevitably winners and losers. The losers will not give up without a fight, making the process and ultimate outcome less certain. For example, the elimination of State and local income and sales tax deductions, one of the most controversial components of both plans, has drawn the ire of high tax states, like New York and California, while the House Republican's plan to eliminate mortgage interest deductibility on loans greater than $500,000, means the National Association of Realtors and the National Association of Home Builders are unlikely to lend their support to the bill.

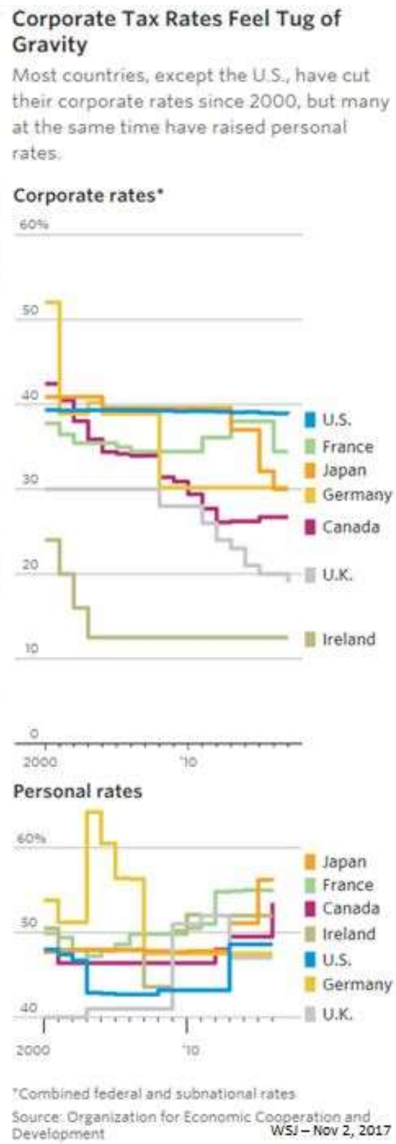
Probably the biggest hurdle will be to reconcile the House and the Senate Bill and consolidate them into a single bill both can agree on. They are similar, but the winners and losers impact each differently. Senate Republicans will find it particularly difficult given their slim majority and the need to comply with the Byrd Rule. If the tax overhaul increases tax deficits beyond the first 10 years, the Senate would not be able to pass the Bill with a simple majority. Chances of any Democrats lending their support are virtually zero. Republicans need a win before the 2018 mid-term elections, and tax reform would be a big win, for them and the markets.

Reconcile This

Republicans' House and Senate tax plans differ significantly.

	House bill	Senate bill
Top individual tax rate	39.6%	38.5%
Number of individual tax brackets	Four	Seven
Estate tax	Expands exemption to about $11 million per person, repeals in 2024	Expands exemption to about $11 million per person
Corporate rate	20%	20%
Corporate tax rate reduction starts	2018	2019
Top pass-through rate	25% with caveats	Above 30%
State and local deduction	Preserves for property tax up to $10,000	Eliminates
Medical expense deduction	Eliminates	Preserves
Student loan interest rate deduction	Eliminates	Preserves
Personal exemption	Eliminates	Eliminates
Standard deduction	Nearly doubles	Nearly doubles
Alternative minimum tax	Eliminates	Eliminates
Child tax credit	$1,600 per child	$1,650 per child

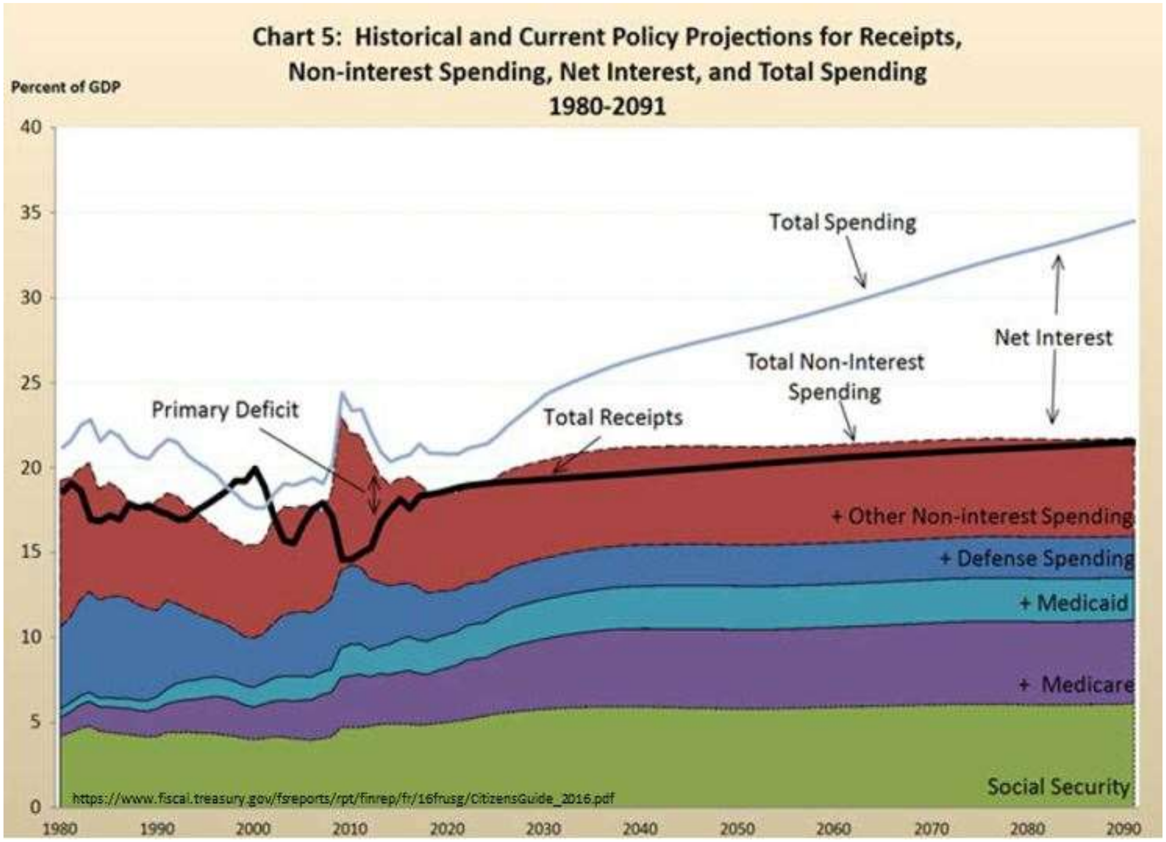
Sources: U.S. House and U.S. Senate WSJ – Nov 10, 2017 THE WALL STREET JOURNAL.



The current economic cycle will end at some point, but to quote former Citigroup CEO Charles Prince (made before the financial crisis), "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." Global liquidity is still pretty good. We will keep a watchful eye on inflation, but so far, global central banks seem content to let the band play. And the possibility of fiscal policy finally sharing some of the burden, means the band might stick around for an encore, or two. A word of caution, however, just because the band is still playing, it doesn't mean you have to try any fancy new dance moves.

Resist the temptation to move up the risk curve and chase higher returns. According to a recent Bank of America Merrill Lynch fund manager survey, a record number of investors are taking higher than normal risk, with cash holding falling to their lowest levels since October 2013. **We believe diversification is the best strategy, especially given the economic as well geopolitical uncertainties that exist today.** We also believe volatility will increase as central banks continue to remove monetary stimulus. Next year is unlikely to be as calm as this year. This market will eventually turn, as could those grey rhinos we mentioned earlier. Unlike black swans, that are low probability events that no sees coming, grey rhinos are problems or issues that are very visible but don't cause any damage or danger, until they do. A couple of months ago, we focused on four longer-term concerns, debt, China, the Canadian housing market, and the Euro-zone. Let's get an update on all four.

Our concern with debt is that the deleveraging process after the financial crisis has not progressed as expected. Global GDP has slowly recovered, but debt has continued to grow faster. One of the major criticisms of the proposed U.S. tax reform is it won't boost growth as much as projected, and the resulting higher budget deficits will put the U.S. in an even worse fiscal position. Healthcare and social security spending remain the biggest challenge for the U.S., and there is zero political appetite to tackle either. What happens during the next recession when neither monetary nor fiscal policy is available to help stimulate economic growth? A fiscal policy like the Republicans are proposing might have been useful a few years ago when monetary policy was struggling to turn the economy around. An aggressive fiscal policy at this point in the cycle might just serve to push interest rates up sooner than would have happened, otherwise as the economy starts to overheat the Fed races to catch up. Tax reform is always good if it leads to greater efficiency and higher productivity. Pure tax cuts, however, are like a sugar rush; great in the short term, but not sustainable.



Debt is also an issue for China, but unlike the U.S., it is corporate rather than government debt that has investors worried, particularly the large increase in debt of unproductive but politically powerful state-owned enterprises. The 19th National Congress of the Communist Party of China wrapped up in mid-October, with President Xi granted a second 5-year term as General Secretary. While not unexpected, the conclusion of this twice a decade event could usher in a period of greater change and volatility.

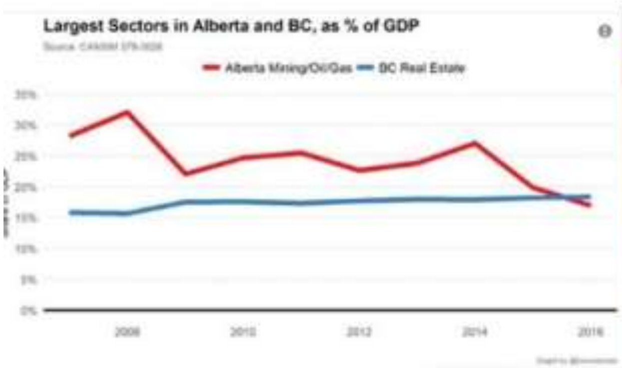
Chinese leaders were very careful to avoid any surprises before or during the Congress, but with Xi consolidating his grip on Chinese leadership, he is now free to push forward with his vision for China and the Chinese economy. So what is that? President Xi understands that Chinese growth has been unbalanced and underpinned by debt, but he is also cautious of the volatility a market-based economy can generate. Stock market crashes and capital outflows were an unwelcome distraction. State-owned enterprises might grow more slowly than private companies, but they are easier to control.

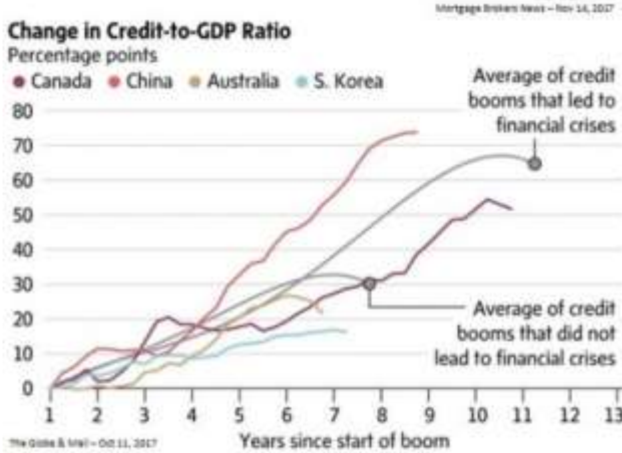
Mr. Xi is attempting to push even greater state control over the economy, by trying to embed the Communist Party deeper into the economy and taking direct ownership stakes in private companies. President Xi and China's advantage over the U.S. and President Trump is his ability to push through his vision without needing approval by either the markets of Congress. Case in point, the Made in China 2025 initiative that prioritizes ten strategic industries China hopes to dominate: electric vehicles, new materials, artificial intelligence, integrated circuits, biopharmacy, quantum computing, 5G mobile communications, and robotics.

State-controlled economies, however, have a poor track record in the long term, as the market tends to be a better allocator of capital than the State. America better hope this is the case, as it looks increasingly unlikely President Trump is going to outsmart President Xi and China. China has a defined plan and has carefully groomed a leader with the abilities to execute it. America, not so much. Perhaps President Xi will continue with market reforms now that the Party Congress is over. The market certainly hopes so, as the current trajectory of the corporate debt levels are unsustainable.

If the U.S. has a government debt problem and China's issue is corporate debt, Canada's challenge is consumer debt. In the IMF's recent global stability report Canada was given special mention, and not in a good way, for its longer than normal credit boom. While the IMF highlights China's credit boon as being steeper than normal, Canada's debt binge has been longer than the average of other benign credit booms. Mortgage debt is the main culprit, of course, with dramatic housing price increases in Vancouver and Toronto the main area of concern. Higher debt levels make Canadian borrowers particularly vulnerable to a move up in interest rates or an economic recession. Also, potential risks are Chinese capital controls and the NAFTA trade negotiations.

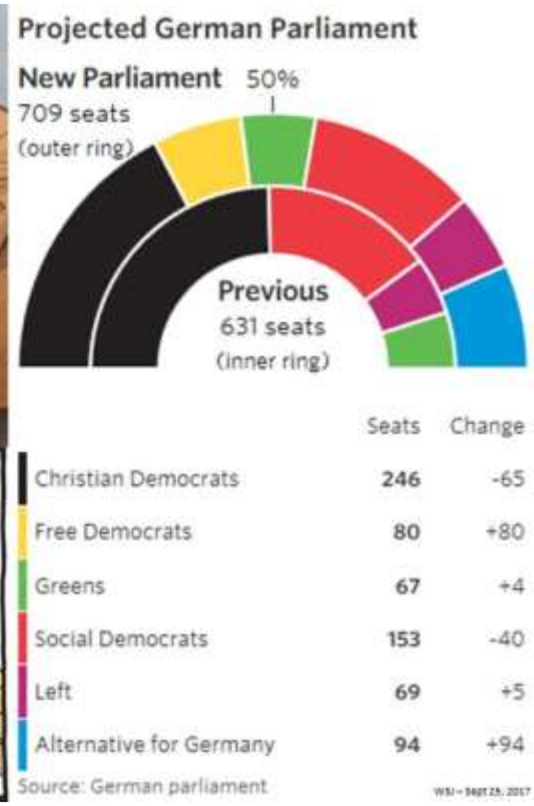
We don't know when or if the housing market will correct, but we are concerned with the reliance the Canadian economy which has to the real estate sector. Case in point, Calgary Professor Trevor Tombe recently pointed out the B.C. economy is more heavily dependent on real estate than Alberta is on oil. In 2016, the real estate, rental and leasing sectors comprised 18.4% of B.C.'s GDP versus the 17.0% mining, quarrying, oil and gas made up of Alberta's economy. There wasn't any news on these issues last month. If anything, good employment growth and a weaker loonie were positive for economic growth. It remains a grey rhino, however, and a longer-term concern worthy of continuous attention and debate.





The last grey rhino is the Euro-zone, where we did see some developments last month. Demonstrations by Catalonian separatists in Spain were the latest setback for greater Euro-zone unity, but it was German elections in late September that provided the biggest disappointment. Angela Merkel may have won the election and will remain Chancellor, but the ruling coalition she will be forced to cobble together to remain in power will diminish hopes of future political and financial union in the Euro-zone.

Gone is the old coalition with the center-left Social Democrats, who lost 40 seats and have signaled they will join the official opposition, leaving Merkel's Christian Democrats to seek common ground with the Green Party and the business-oriented Free Democrats. One of the Green Party's key demands is the phase-out of the internal combustion engine, which is tough to swallow given the German automobile industry employs 800,000 workers. The Free Democrats, for their part, are skeptical of deeper ties to the European Union, which many feel is necessary if the Euro is to survive long term. Merkel's hands will be effectively tied when it comes to working with France's new President to strengthen the bonds between Euro-zone countries. If Germany can't be counted on to provide leadership for the Euro-zone, who can?



Stronger economic growth and central bank supplied liquidity have given the markets ample fuel to continue moving higher. Any news on tax reform in the U.S. would just help reinforce this trend. We continue to watch for signs the current economic cycle is nearing a turning point, but believe current conditions favor risk assets. This doesn't mean investors should take more risk, however. Volatility should increase with inflation next year as we move closer to the end of the business cycle. The music will eventually stop, and longer-term issues and challenges haven't gone away.

What did you think of October's economic activity? Let us know in the comments below.

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