July In Review: Inflation and Trade Wars Keep Us Cautious, but We're Not Yet Ready to Scream.

MARKET COMMENTARY

By Rob Edel, CFA

Highlights This Month

- Inflation and trade wars worry investors
- China plays the long game, and time is on their side
- A trade war would negate Trump's greatest political achievement

Nicola Wealth Management Portfolio

Returns for the **NWM Core Portfolio Fund** were up 0.8% in the month of July. The NWM Core Portfolio 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.

Both Canadian and U.S. yield curves shifted higher last month, putting pressure on fixed income returns. Due to favorable positioning in credit, the **NWM Bond Fund** still managed a positive return and was up 0.3% in July.

The **NWM High Yield Bond Fund** gained 0.2% in July, but lagged the general U.S. high yield bond market which returned +1.0% in the month. Credit spreads tightened significantly across the high yield spectrum, supported by strong corporate earnings and the lack of new issuance to absorb market inflows and reinvestment demand. We remain defensive since we do not believe the credit spreads of the market, particularly at even tighter levels this month, sufficiently compensate investors for the risks. The NWM High Yield Bond Fund has returned +3.2% year to date, and is yielding 4.4% net with a low 2.7 year duration.

The **NWM Global Bond Fund** was up 0.8% in July despite US dollar weakness (~50% of Fund is in USD$). Emerging Markets bounced back in July with the Templeton Global Bond Fund returning 1.7% vs JP Morgan Global Government Bond Index -1.6% (CDN$).

Templeton's negative duration exposure to U.S. Treasuries (rose 3%) and EM currency exposure (Brazil & Mexico currencies strengthened vs USD) contributed to performance.

The Manulife Asset Management Strategic Income Pooled Fund's hedging strategy immunized the NWM Global Bond Fund from a strengthening CDN$ and benefited from their large weight in the high yield space; The NWM Global Bond Fund was +0.7%. PIMCO monthly income performed well in local currency, as part of The NWM Global Bond Fund, but was hurt by the USD/CAD translation; in total The NWM Global Bond Fund was down 0.5%.

The Mortgage Pools continued to deliver consistent returns, with the **NWM Primary Mortgage Fund** and the **NWM Balanced Mortgage Fund** returning +0.4% and +0.5% respectively last month. Current yields, which are what the funds would return if all mortgages presently in the fund were held to maturity and all interest and principals were repaid, and in no way a predictor of future performance, are 4.4% for the NWM Primary Mortgage Fund and 6.0% for the NWM Balanced Mortgage Fund. The NWM Primary Mortgage Fund had 0.3% cash at month end, while the NWM Balanced Mortgage Fund had 14.6%.

The **NWM Preferred Share Fund** returned 1.7% for the month while the BMO Laddered Preferred Share Index ETF returned 1.3%. It was a busy month in the preferred share market as Moody's upgraded the big six banks due to a change in ratings methodology. Preferred shares were untouched, but NVCC sub-debt was upgraded making relative value based on ratings more attractive for preferred shares. Enbridge announced the sale of its Canadian natural gas gathering and processing business along with Alliance Pipeline to Brookfield Infrastructure Partners, further shoring up their balance sheet. The Bank of Canada hiked another 25 bps from 1.25%

to 1.5%. While, TD announced they are acquiring Greystone Management Investments which slightly weakens their CET1ratio.

Canadian Equities were strong in July with the **NWM Canadian Equity Income Fund** +1.1%, nearly matching the S&P/TSX's +1.2% return. Our Financials overweight finally paid off and was our top contributing sector. This was offset by our retail holdings in Consumer Discretionary where Hudson's Bay, Gildan, Spin Master, Dollarama, and Sleep Country were weak in July. We added Diversified Royalty and sold Industrial Alliance, Westshore Terminals, and Quebecor Inc. Top contributors to performance were Air Canada, Intact and Alimentation Couche-Tard. Detractors were Interfor, Spin Master, and Dollarama. We are covered on 7% of the portfolio currently and the yield estimate is 4.2%.

The **NWM Canadian Tactical High Income Fund** returned +0.8% in the month which trailed the S&P/TSX's +1.2% return. The main reason for relative underperformance was due to being underweight in Financials & Industrials, which were the strongest contributors to the market's return. Option volatility decreased 2.7% in July, down to a level not generally considered a good environment for option writing; however, the NWM Canadian Tactical High Income Fund was still able to write double-digit annualized premiums. No new names were added during the month, but we did purchase more shares of IGM Financial, which has an attractive 5.7% dividend yield and cheap valuation.

The **NWM Global Equity Fund** returned +0.9% in July, vs +2.0% for the MSCI ACWI (in C$'s). Index returns by region, in descending order: the US was strong with the S&P500 returning +2.7%, MSCI Europe +2.3%, MSCI Emerging Market Index 1.2%, MSCI AC Asia Pacific -0.2%.   Large caps outperformed, with MSCI World Large Cap Index returning +2.3%, while small caps underperformed, with the MSCI World Small Cap Index returning +0.2%. In terms of style, Value outperformed Growth, with MSCI Value Index +2.6%, vs MSCI Growth Index at +1.6%. Performance for **NWM Global Equity Fund** was not as strong as the MSCI ACWI due to both 1) region weights –with 33% in the US, we are underweight relative to the MSCI ACWI during a strong month, and with 32% weight in Greater Asia, we are overweight there when the region was relatively weak; as well as 2) style: global small cap, where we have exposure through Lazard Global Small Cap, and global growth, where we have exposure through C Worldwide, also underperformed. Performance of our managers in descending order: NWM EAFE Quant: 2.0%, Valueinvest: +1.9%, Edgepoint: +1.6%, C Worldwide: +1.0%, BMO Asian Growth and Income Fund: +0.5%, and Lazard: -0.5%.

NWM US Equity Income Fund returned 4.6% while the S&P500 returned 3.7%. Our overweight in Banks and stock selection, owning Google while not owning Facebook, and positions in HCA and L3 Communications, drove our outperformance. In terms of new names, we added Proctor and Gamble, and exited Mohawk Industries and Zimmer Biomet.

The **NWM U.S. Tactical High Income Fund**'s performance was +1.4% during the month; whereas, the S&P 500 posted a +3.7% return. The NWM U.S. Tactical High Income Fund's underperformance was mostly due to being underweight in financials, health care & industrials. Option volatility decreased in July to levels not generally considered a good environment for option writing; however, the NWM U.S. Tactical High Income Fund was still able to write high single digit annualize premiums. The two new names added were Proctor & Gamble and Electronic Arts.

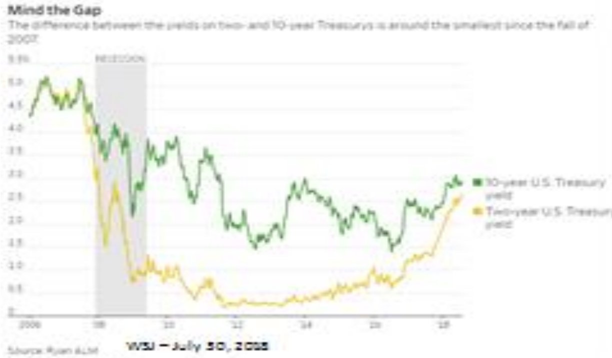
The **NWM Real Estate Fund** was +0.7% for the month of July vs. the iShares (XRE) +1.2%. The Brookfield takeover of GGP was approved by shareholders (we voted to approve as well). We believe it was a bit of a relief for GGP shareholders because the downside was probably close to $18 if no deal was done (US retail REITS were down since the announcement). Closing date is mid-August. It's a bit disappointing that we didn't do better on the GGP trade and that no higher bids emerged, but we believe GGP ran an exhaustive process and no other buyers emerged. WPT Industrial REIT was also an outperformer as they announced a new private capital venture with CPPIB and AIMco, as well as the internalization of management, which the street likes even if it may be dilutive in the short-term. The USD was down around 1% which hurt the returns of our US denominated investments, which comprise 42% of the fund.

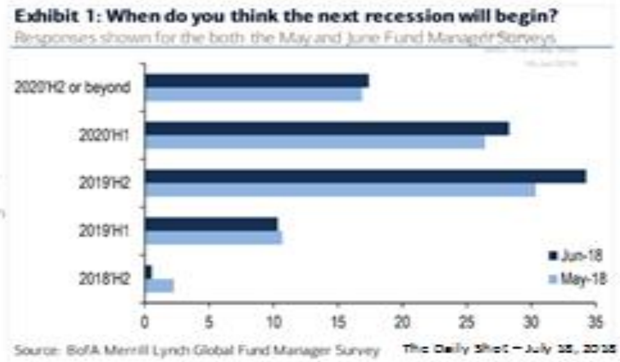
We report our internal hard asset real estate Limited Partnerships in this report with a one month lag. As of July 31st, June performance for **SPIRE Real Estate LP** was +0.6%, **SPIRE US Real Estate LP** +0.8% (in US$'s), and **SPIRE Value Add LP** +1.6%.

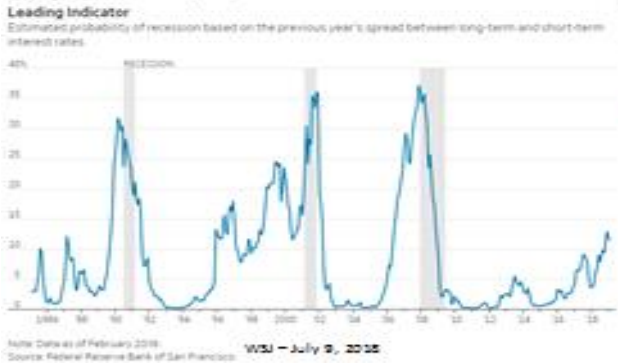
The NWM Alternative Strategies Fund returned -0.6% in July (these are estimates and can't be confirmed until later in the month). Without currency fluctuations, the fund would have been flat for the month as a strengthening Canadian dollar caused a -0.6 drag on returns. In local currency terms, Winton returned -0.1%, Millennium -0.6%, Apollo Offshore Credit Strategies Fund Ltd 0.0%, Verition International Multi-Strategy Fund Ltd +0.3%, RPIA Debt Opportunities +0.8%, and Polar Multi-Strategy Fund was -0.2% for the month. The strength of RPIA's returns came as credit spreads performed well over the month, particularly for cross over credit. One of the larger drivers of returns was short dated financial paper with Euro and UK based lenders that had initially sold off due to Italian sovereign fears. The NWM Precious Metals Fund returned -1.2% as precious metals stocks were lower for the month. Gold bullion was also lower, declining 3.2% in Canadian dollar terms.

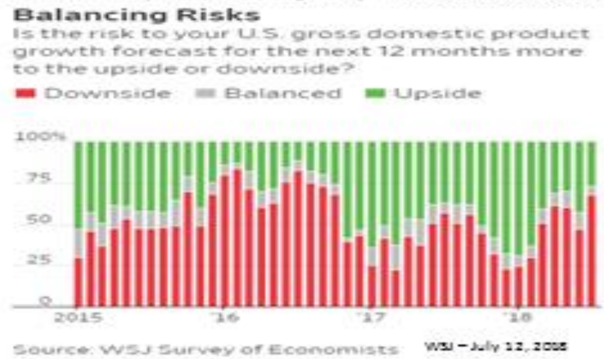
Both stocks and bond yields were higher last month, with the S&P 500 gaining 3.7% (2.6% translated back into Canadian dollars) and 10 year U.S. Treasuries ending the month near the psychologically important 3% level (they closed the month trading at 2.96%). Canadian markets followed a similar path, with the S&P/TSX rising 1.2% and 10 year Canada's trading just above 2.3% at months end. While it appears the stars continue to align for the markets, there are concerns investors need to keep a close eye on. In looking at events over the past month, we will distill these down to two general issues, inflation and trade wars. Because we believe the economy and corporate earnings is the more important factor driving the market right now, we will start with inflation.

Inflation is important because higher prices will be the signal the economy is overheating and monetary conditions will need to be tightened. Unfortunately, predicting precisely when inflation becomes a problem for the market is not an exact science. One of the best indicators economists have in predicting a recession is the slope of the yield curve. A normal yield curve is upward sloping, with long rates higher than short rates. Investors are compensated for locking up their money for longer time periods and potentially having their purchasing power eroded by higher inflation with higher yields. Alternatively, an inverted yield, where short term bonds yield more than longer term bonds, is more unusual. By accepting lower yields on a 10 year bond than a two year bond, for example, investors are signaling they not only don’t believe inflation will be a problem, but they see yields falling in the future. In reaction to an over-heating economy and rising inflation, central banks raise short term interest rates to the point the economy rolls over and contracts, thus lowering inflation and interest rates in the future. Over the past couple of years, and particularly this year, we have seen short rates move higher as the economy has firmed, but longer term rates have remained largely range bound. Typically we would have expected 10 year yields to move higher as well, reflecting the improved prospects for the economy. Even if the bond market and 10 year yields didn’t believe inflation was a risk, the removal of deflation as a threat to the economy should have helped move the 10 year yield higher. Based purely on the flattening on the yield curve, many forecasters have been increasing the probability of the U.S. economy slipping into recession.

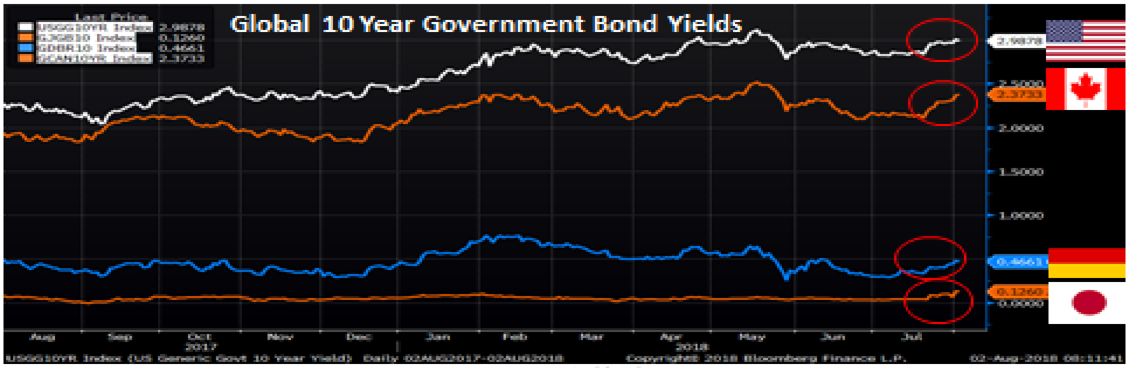


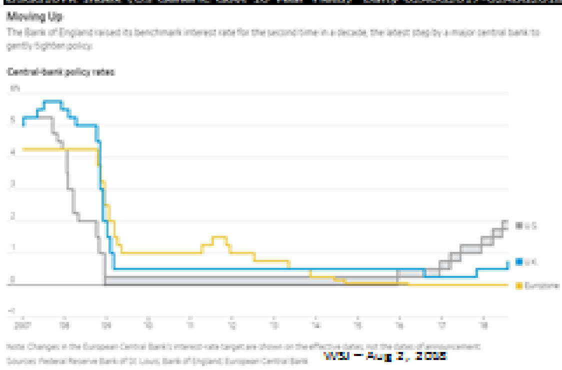


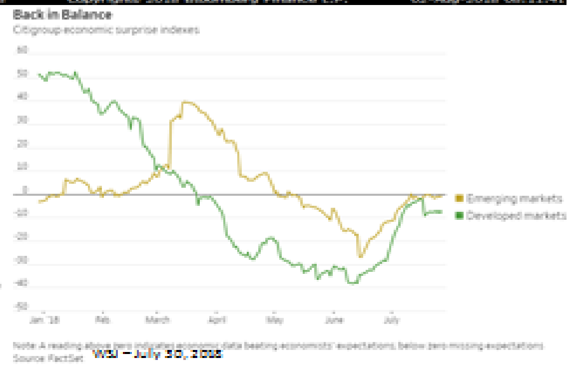




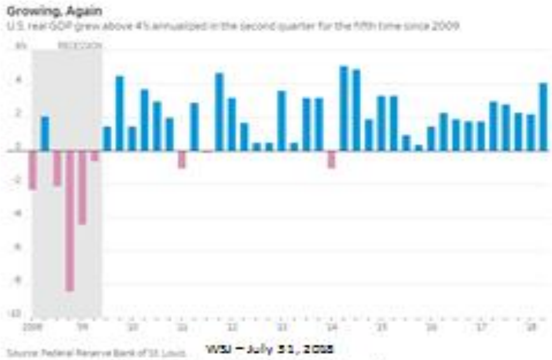
Last month, we got a bit of a reprieve. Like we saw in April and May, 10 year yields started increasing and approaching the 3% level. Short term rates kept pace so the yield curve didn't steepen, but at least it didn't continue to flatten. Why 10 year yields increased is important in determining whether they will continue to move higher. One explanation as to why U.S. 10 year yields have remained low is that yields in other developed economies have remained even lower, thus making U.S. bonds more attractive to foreign investors and capping U.S. yields. Last month, led by the Bank of Japan's decision to let the upper threshold on the yield of 10 year Japanese government bonds increase from 10 basis point (0.10%) to 20 basis points, there was continued talk of other central banks moving rates higher (the Bank of Canada and the Bank of England both raised overnight rates recently) which helped push global yields higher. Increasing the cap on 10 year Japanese Government bonds by 0.1% doesn't sound like much, but it resulted in the biggest percentage-point gain in the Japanese benchmark bonds since August of 2016.

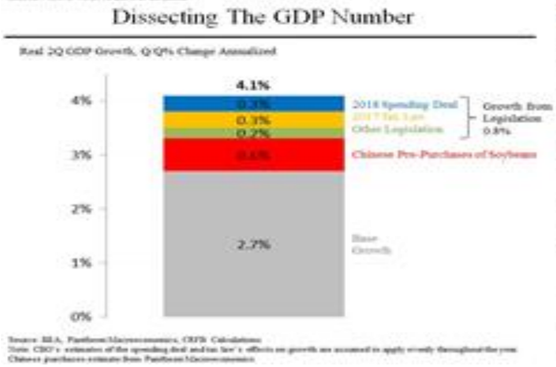






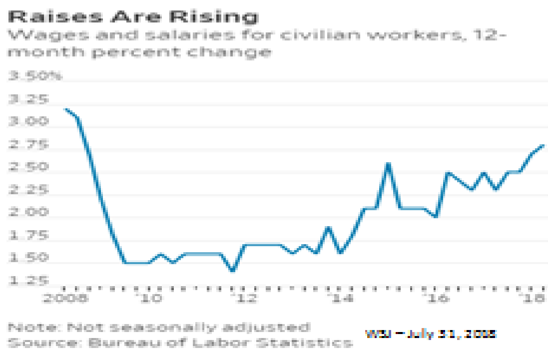
Another equally valid explanation for the move higher in bond yields is the strength in the U.S. economy, which reported Q2 GDP growth of 4.1% last month, only the fifth time it has exceeded 4% growth since 2009. How sustainable this growth will be is debatable. Nearly a fifth of the increase is likely attributable to U.S. tax reform and thus will not be duplicated next year, and pre-sale of goods expected to be hit by tariffs likely inflated growth by another 0.6%. Partially offsetting these, inventory destocking in the second quarter means some future inventory re-stocking will bolster growth in future quarters. Soft data indicators, like consumer sentiment and purchasing manager indices continue to point to a resilient economy.

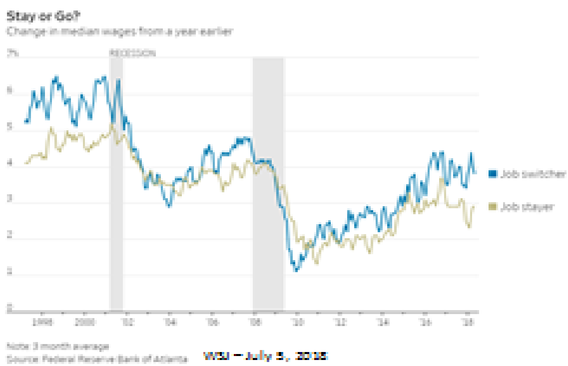


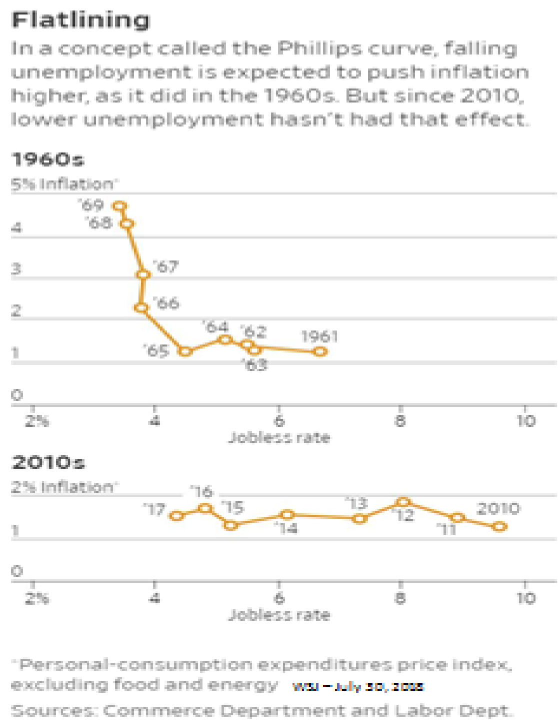


If investors believe economic growth is sustainable, we should also start to see a rotation or change in leadership in the equity markets. When growth is scarce, the few companies able to deliver consistent earnings growth trade at a premium. During a broader economic recovery, a rising tide should lift all boats. Growth stocks have outperformed value since the financial crisis, especially the so called FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google). Last month, however, the FAANG stocks corrected while the Russell 1000 Value index beat the Russell 1000 Growth Index for the first time since March and by the widest margin since September 2017. The valuation for growth stocks have become very stretched so it could be the market action last month was just a select few names taking a much needed break before proceeding to trade even higher. Value continuing to outperform, however, could be a sign investors believe the tide has turned and economic growth is sustainable. Under this scenario, we would expect the 10 year bond yield to continue to drift higher. This would be a good thing.

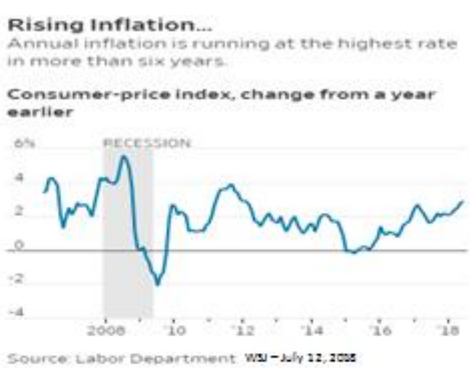
Perhaps the strongest indicator of how well the economy is doing and how strong inflation might be remains in the job market. With July's unemployment rates dropping below 4% to 3.9%, it seems inevitable that wages will start to move higher, as the 4% level has historically proved to be an inflection point for higher wage growth. Also, workers who switch jobs typically get higher wages, and more workers are voluntarily leaving their jobs.

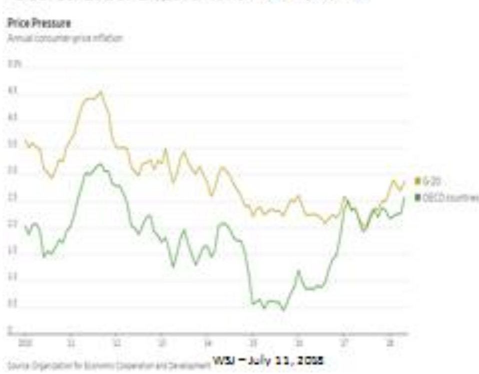


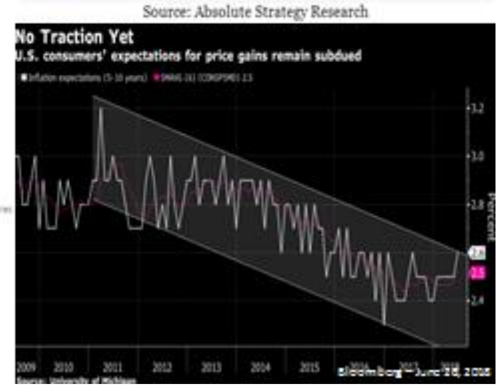




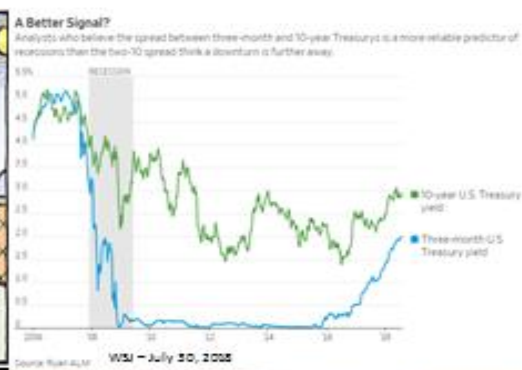
So this is where things start to get interesting. Inflation has finally reached the Federal Reserve's 2% target. News flow on inflation has increased, and not just in the US, but consumer inflationary expectations remain subdued. What's a central bank to do?

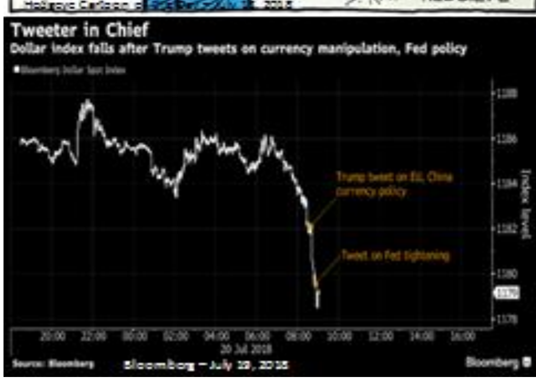






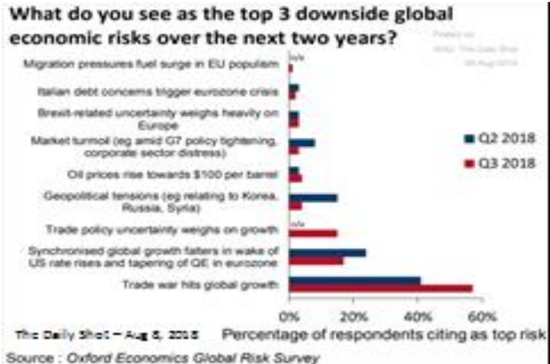
Wait too long and the Fed risks higher inflation and an overheating economy that will require even more aggressive tightening. Tighten too much, too early and risk slowing the economy before it's really able to gain some steam. The yield curve is telling the Fed to slow down. Unless longer term yields start to increase, a few more hikes in the overnight rate will invert the yield curve. The Federal Reserve knows what this means. Last month, they tried down playing the significance of the shape of the two year versus 10 year yield curve and argued the difference in current three month Treasury bills versus three month rates expected in 18 months was a stronger predictor of a recession occurring in the next 12 months. This indicator is currently showing there is little risk of recession, thus giving the Fed a bit more room to increase short rates. In an unprecedented move, President Trump also weighed in on the debate, tweeting that he's "not happy" about the Fed rate increases. This is considered taboo, breaking nearly two decades of tradition whereby the White House refrains from commentating on monetary policy or the dollar. The executive branch is not supposed to influence central bank policy and doing so brings the central bank's independence into question. Along with tweets on potential currency manipulation by the EU and China, Trump's comments on Fed policy helped weaken the dollar, which was maybe Trump's goal all along.

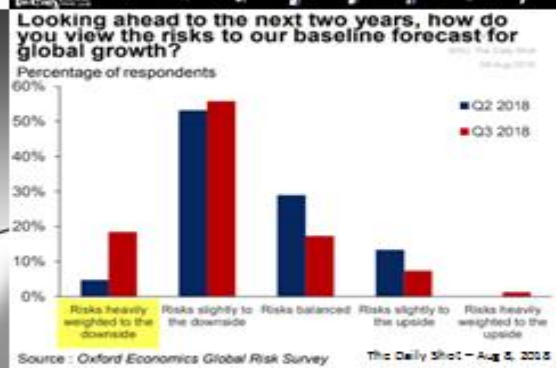




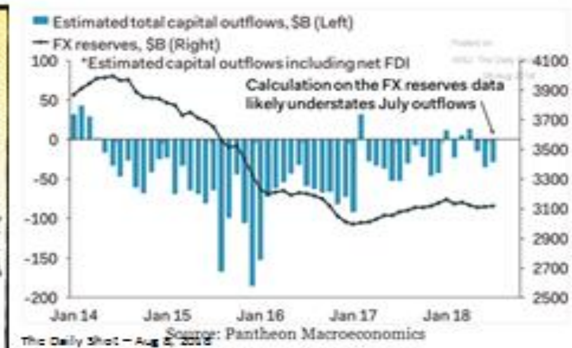
Higher inflation and the resulting tighter monetary policy (higher interest rates) are bad for economic growth. A weaker economy would also hurt America's bargaining position in gaining trade concessions from China and avoiding a full blown trade war, which is our second highlighted risk this month. Despite our view that higher rates are the bigger threat to markets, Oxford Economics' Global Risk Survey pegs the threat of a trade war negatively impacting global growth as the top economic risk over the next two years.

What’s more, respondents believe the risk has increased over the past three months and is skewed to the downside over the next couple of years.

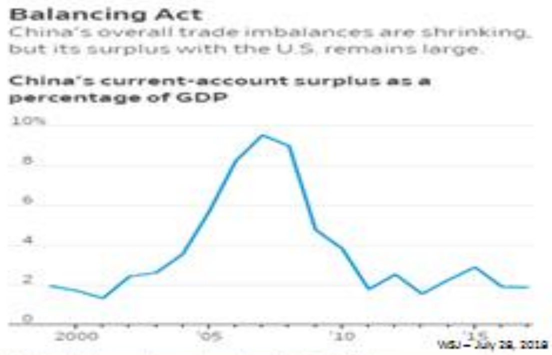




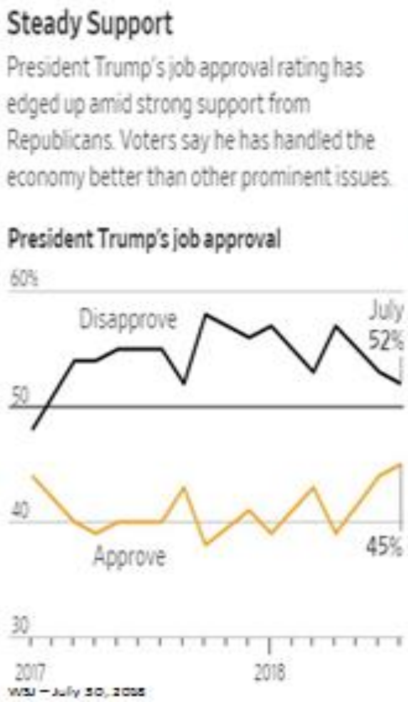
We believe higher interest rates are the greater threat to the market because of our perhaps misguided belief the current trade skirmishes are just part of the bargaining process, and cooler more rational heads will eventually prevail. With the strong U.S. economy, American negotiators believe they have the upper hand in trade negotiations with China because a stronger economy will give the U.S. a greater ability to absorb the negative economic consequences of a trade war than China. The declining Chinese stock market and falling Chinese Yuan would appear to back these views up. A weaker Yuan could actually help China’s economic growth by making their exports more attractive, but it could also prompt an exodus of capital from the Middle Kingdom.

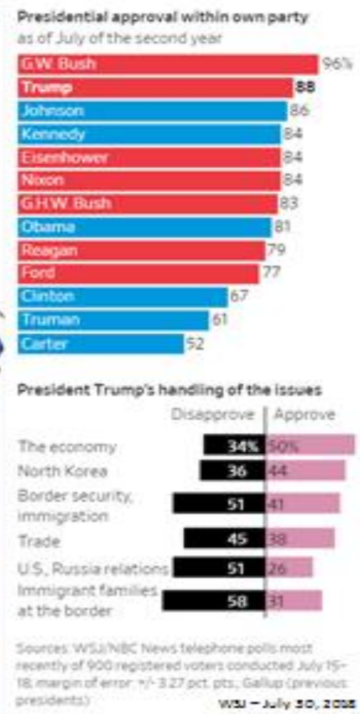


While it's likely true China is in a weaker position when it comes to tariffs given it runs a sizable trade surplus with the U.S., it's not so clear China is at a big economic disadvantage. China's slowing economy is due more to intentional internal policy decisions than uncertainty over the potential trade war with the US. China has been trying to rebalance their economy to become less reliant on exports and investment. China's current account surplus had already fallen dramatically over the past decade with exports declining as a result of the great recession, next up was to reduce their exposure to investment and curtail the growth of corporate debt used to finance investment, which has been increasing at an unsustainable rate. China has some flexibility in the timing and pace of this rebalancing, however. In the face of a trade war and slowing growth, they have the option of reducing interest rates and bank reserve rates in order to spur increased lending and investment, which is exactly what they have been doing. China will likely make some concessions in order to avoid a full blown trade war, but they won't agree to any deal that will make their leaders appear weak. They are fine to buy more American goods and work with the US in reducing the US trade deficit with China, but they won't agree to any deal that would limit their ability to continue to develop higher value added industries. China's trade practices will need to be refined to adhere to global trade rules, but limits on their economic growth and military power will likely end up being non-starters. If the Trump Administration misreads the short term economic advantage they think they might have, we could end up in a stalemate with tariffs becoming a permanent drag on global economic growth. In this scenario, tariffs would essentially act as an additional tax on American consumers and corporations, and negate the benefit of last year's tax reform. This isn't our base case scenario, but it certainly needs to be monitored. At the very least, we agree with the Oxford Economics' survey that the odds of a trade war have increased. Last month the U.S. appeared to reach an understanding of some kind with the EU and progress appears to have been made with Mexico in drafting a new NAFTA deal (Canada has been kept on the sidelines) so it doesn't look like Trump has given up on global trade. China has always been the main target, however, and most developed economies, including the EU, would agree changes are needed.

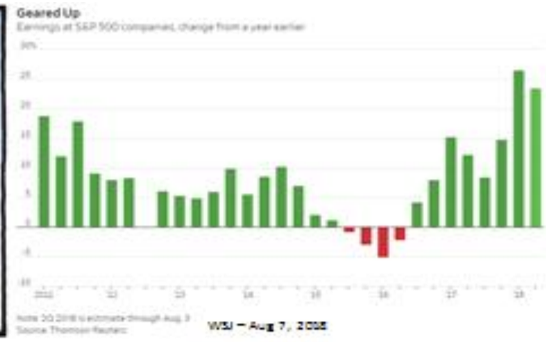


China has always played the long game, however, and time may be on their side. U.S. midterm elections could see the Republicans lose control of the House, and possibly the Senate. Trump continues to say stupid things, and his position on Russian meddling in the 2016 Presidential election is just plain puzzling. Perhaps Trump is trying to improve relations with Russia in order to prevent Russia from siding with China, but the optics are terrible. Trump believes he can do no wrong in the eyes of his base Republican supporters, and famously stated during the election that he could "stand in the middle of 5th Avenue and shoot someone and not lose any voters". The midterm elections will be a good test on whether this is still true or whether even his base has had enough. Siding with Russia against his own intelligence agencies is bad form, even for the Donald. His base is holding, but if the economy falters, so will his base.





Inflation and trade wars keep us cautious, but not yet ready to scream. Higher inflation and rising short term interest rates would invert the yield curve and start the shot clock in terms of signaling the next recession. A trade war would result in slower global growth and negate the benefit of President Trump's greatest political achievement, namely U.S. tax reform. For the time being, however, a strong economy and higher corporate earnings keep us constructive on the market. Strong corporate earnings, in fact, have resulted in valuations becoming more attractive, which is likely why hedge funds and other investors have increased bullish bets on the market.



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