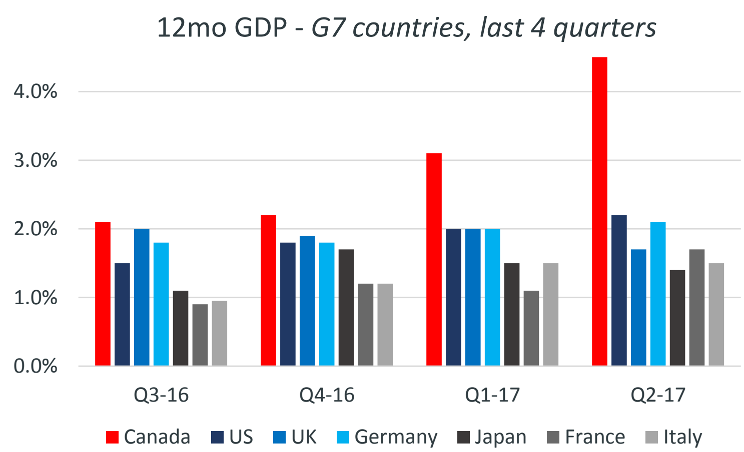
DM Portfolio commentary
3rd QUARTER 2017

Best economy, worst market

In last quarter's edition of this report, we lamented that Canadian stocks hadn't been doing much for investors in the months preceding, despite our economy having posted some of the strongest growth in the developed world. We also noted, however, that the silver lining of this stall in prices was that the valuation of the TSX had been pushed down to an uncommonly attractive level relative to the S&P 500, which we felt would eventually catch the attention of capital allocators around the world. Up until the last two weeks of September, though, it looked like the Canadian equity story would be little changed for this report.



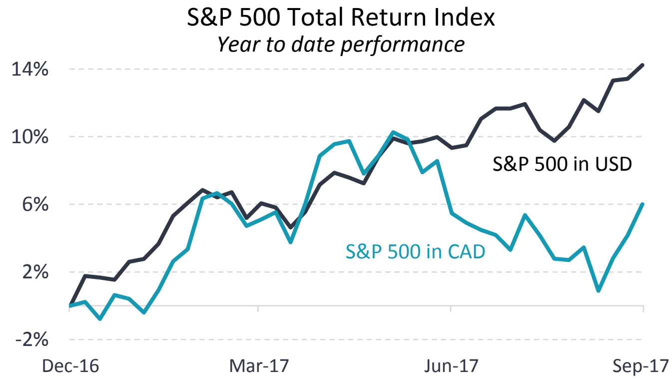
Source: *Bloomberg*

As the chart on this page illustrates, Canada's economic momentum most definitely hasn't abated since our last communication. In fact, not only have we exceeded the *average* growth of the other G7 countries in each of the past four quarters, we've ranked first among the group in every single one of the measurement periods. What's more, Canada's advantage over the next best performer has grown in each stanza, with the 4.5% year-over-year growth rate registered for Q2 of this year positively lapping the field.

As was the case over the first half of 2017, however, Canadian stocks continued to largely disregard what should be a favourable backdrop for business activity and earnings growth. In fact, without a strong close to the quarter's final month, the TSX would have been virtually unchanged on a year to date basis and, as it is, we were still the lowest performer among G7 markets over that period.

Though there are several plausible explanations for the seeming disconnect between our economy and stock market – *ongoing concerns about key Canadian housing markets, uncertainty surrounding the fate of NAFTA, indications that Ottawa is about to make our tax code decidedly less business friendly* – the divergence between the two is probably just as attributable to the reality that they often don't move in sync. In fact, this tendency was writ large as recently as 2016 when Canadian economic growth was mixed (and actually included a negative figure in the second quarter), but the TSX nonetheless sprinted ahead to a total return of more than 21%.

Even though our current economic strength isn't being translated into market gains in real time, Canada's GDP performance is undoubtedly positive for the domestic equity component of portfolios moving forward. Intuitively, when national output is rising at a brisk pace, the conditions for corporate profitability should also be improving, a trend which has been generally confirmed by the companies we own through recent earnings reports, dividend increases, and our ongoing meetings with management teams. The other reason to cheer a rising economy is because of how it has typically correlated with – or rather, *against* – market downside. In the US, for example, 9 of the past 10 bear markets (i.e. declines of 20% or more) have coincided with recessions and, based on the direction and magnitude of recent data, it's difficult to imagine our economy falling into a prolonged downturn anytime soon.



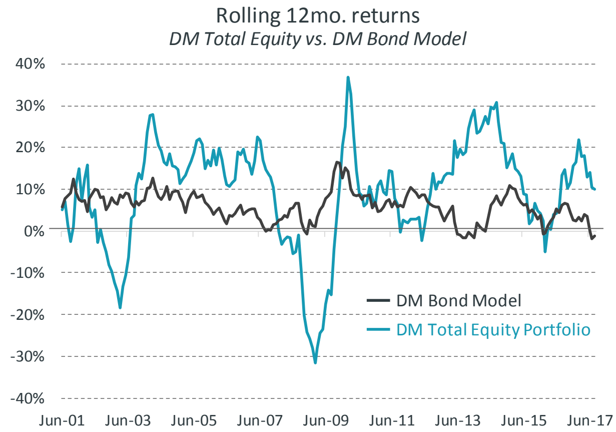
Source: *Bloomberg*

If Canadian stocks have been mostly unmoved by our strong economy, the same certainly can't be said for our central bank. Wary of overheated growth leading to destabilizing inflation, the Bank of Canada raised policy interest rates twice in the summer, catching most observers by surprise. The corresponding uptick in bond yields pressured fixed income returns during the quarter and put a charge in the previously beleaguered loonie. In fact, the gain in our dollar vs. its US counterpart was so great that it offset the lion's share of an otherwise excellent 2017 return for the S&P 500 (see chart to left).

While most analysts don't anticipate the Canadian dollar rising significantly from current levels, thus potentially reducing the headwind on USD denominated holdings going forward, the same can't be said for interest rates. Markets now assign a better than 60% probability to the Bank of Canada boosting rates once more before the end of the year and few expect bonds to resume their previous winning ways in the foreseeable future. Of course, this outlook combined with the still meagre yields offered by most fixed income vehicles naturally begs the question, *"Why own bonds at all?"*

Judged solely from the perspective of potential upside, it's certainly difficult to make a case for bonds over stocks at present; that said, few of us think in such narrow terms when it comes to our investments. Rather, we also consider things like the risk of a sharp decline, the ability of assets to comfortably fund income needs, and accessibility to capital in the case of unforeseen needs. In this broader context, bonds become much more integral to a portfolio, even when it seems likely that their contribution to total return will be muted at best. The following graph, which shows the rolling 12 month returns of the DM Total Equity Portfolio vs. the DM Bond Model, helps to illuminate these points.

As the eye can plainly see, our typical equity mandate has imparted a great deal more periodic fluctuation on an investor's asset base than has our fixed income portfolio; to be precise, DM Total Equity has been about 2.6 times more volatile than our bond mandate, as measured by standard deviation. Though the reward for having taken on the risk of the equity portfolio has been about an extra 2% in annual return since our inception 17 years ago, this higher performance didn't come in a uniform fashion and there were many periods, some of them extended, when stocks lagged bonds by a significant margin. On those occasions, which will most certainly come again at some point, many investors would have been quite grateful for an allocation to fixed income.



In recent days, our investment committee has met extensively to discuss portfolio strategy in light of the predominant variables which now characterize the investment landscape: the attractive valuation of the TSX relative to the S&P 500; Canada's economic rebound and the accompanying reversal in interest rates; the stronger loonie and what its likely future path will mean for the translated value of non-Canadian investments. After much dialogue and examination of data, we decided to change very little in asset class and geographic allocations. Canadian stocks seem well-positioned and, even if they just catch up to their US counterparts from a valuation perspective, returns will be attractive. At the same time, our foreign equity allocation provides exposure to industries that are fast growing, relatively less capital intensive than other sectors, and which are not well-represented in the TSX, most notably healthcare and technology. As such, we have a difficult time reducing allocations to this equity component from an opportunity and diversification perspective. Though fixed income yields are hardly attractive and interest rate behaviour is not likely to help in the months ahead, the first job of a bond allocation is portfolio risk mitigation, not return optimization. Mindful of this consideration, we don't feel it prudent to recommend reducing exposure to this area, regardless of near term hurdles. We'll keep monitoring market and financial conditions as they evolve but, for the moment, we don't believe that any of the developments of the past nine months warrant significant policy changes to client accounts or any deviation from our strategic tack.