DECEMBER 2018

Q4 report

The most impactful (yet under-reported) driver of global asset value declines is the sheer amount of net tightening in the world. U.S. monetary tightening often leads to significant global tightening.

During the fourth quarter of 2018, U.S. markets – and most global markets – experienced pressure over concerns about trade disputes and rising interest rates. This pressure was acutely felt among previous U.S. market leadership groups. While rising rates are coincident with economic strength, the market does not like the uncertainty that accompanies the potential trajectory of such increases. Likewise, the longer that the U.S. and China trade dispute remains unresolved, the more investors will worry about the implications of a negative outcome.

As market pressure increased, liquidity became an issue in the fixed-income market, particularly for high yield issuers and the lowest tranche of investment grade bonds. Bond pricing declined, as both yields and spreads over government bonds increased. Credit spread increases can be an early sign of recession. While it is possible that the activity in this period was driven by the issues of General Electric Company and companies in the energy sector, Barometer is monitoring spreads closely. It should be noted that credit spreads are not currently at alarming levels and are not showing stress at this time. For the most part, the credit market continues to function normally.

The most impactful (yet under-reported) driver of global asset value declines is the sheer amount of net tightening in the world. U.S. monetary tightening often leads to significant global tightening. Once the U.S. Federal Reserve hikes rates, there tends to be a domino effect. Countries that import commodities, have U.S.-dollar debt, or have large external funding needs may feel pressure to raise rates as well. The net effect of these actions – along with the

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balance sheet normalisation at the U.S. Federal Reserve – is a significant amount of liquidity being removed from global capital markets. This results in less capital to maintain the value of assets – especially potentially risky assets, like equities and credit.

Market Highlights

The withdrawal of liquidity has put pressure on a wide variety of asset classes. In fact, as the month of November concluded, approximately 90 per cent of asset classes were in negative territory for the year.

Source: Deutsche Bank

The withdrawal of liquidity has put pressure on a wide variety of asset classes. In fact, as the month of November concluded, approximately 90 per cent of asset classes were in negative territory for the year (source: Deutsche Bank). December followed with considerable damage being done to virtually any risky asset class. Q4 2018 was the third worst fourth quarter since 1950 for the S&P 500. Many of the best performing sectors and stocks year-to-date before the drawdown were the worst performers in October and December. A number of investors were clearly in liquidation mode.

Despite what occurred within the equity markets in Q4, many fundamental indicators remain positive or benign. Throughout the year (including the difficult fourth quarter), companies were, for the most part, exceeding earnings and revenues estimates. While lower U.S. corporate taxes have helped to propel growth, there remains strong growth on top of these tax fueled results.

Economic indicators, such as the Purchasing Managers' Index (PMI), have remained in the growth range and unemployment sits at multi-year lows.

However, as in all corrections, market sentiment plays a role in how things unfold and sentiment has clearly been negative. As has always been the case in the past, the market will find a level from which it can stabilize and rebound. As markets reprice – and uncertainty is removed – markets will begin to heal and recover.

Portfolio Updates

Barometer Tactical Income Pool

The Barometer Tactical Income Pool added bonds and defensive stocks throughout the quarter as the leadership groups began to break down. Telcos, utilities and government bonds all contributed positively to returns in Q4. Losses in the quarter were most notable in the industrials, information technology and the energy sector. The pool's holdings in those sectors sold off despite owning defendable business models, such as railroads and payment processors. This is evidence of how broad-based the selling became in late December. During the quarter, we exited numerous positions as they broke down – particularly in cyclical sectors, such as information technology and industrials. This group included quality companies, such as Apple Inc., Visa Inc. and the Boeing Company.

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We added to positions in U.S. government bonds as an alternative to having a large cash position. As we enter the new year, the fund remains defensive and has a large portion of holdings in government bonds, utilities and healthcare stocks.

Barometer Equity Pool

The Barometer Equity Pool experienced considerable volatility as the leadership group sold off dramatically. This included the pool's holdings in information technology and healthcare. Most of the losses occurred in October. As names broke trend, they were sold as per our process; however, not before the pool experienced losses. It should be noted that many of the names that were sold, such as Nvidia Corporation, Align Technology and Square Inc., continued to trade down considerably afterwards. As the market decline continued, market breadth contracts and indices traded below moving averages and the pool became progressively more defensive. In December, the pool aggressively hedged the equity exposure in the portfolio, reducing volatility and limiting losses. Heading into the new year, the pool is holding a considerable amount of government bonds as we wait for a more attractive environment and a new leadership group to assert itself. The fund's largest sector exposure is in healthcare stocks.

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Barometer Balanced Pool

The Barometer Balanced Pool's equity holdings contributed to losses in the quarter as the leadership group broke down in October. At that time, a number of names were sold. The fund became more defensive in the second half of the quarter and replaced certain equities with government bonds. Preferred shares did not provide as much protection from losses as we had anticipated. A temporary loss of liquidity in the market caused the shares to lose some value. Given the strong credit profile of the issuers of the preferred shares held within the Balanced Pool, most of these shares were retained.

Going into the new year, the pool is conservatively positioned. It has a mix of government bonds, preferred shares and leadership companies in defensive sectors.

Barometer Long Short Pool

The Barometer Long Short Pool's market leader positions in the healthcare and information technology sectors hurt performance, particularly in October. As breadth declined, the Long Short Pool reduced net exposure by selling long positions and increasing short positions. The use of shorts helped to offset some losses in the quarter.

As 2019 begins, the pool holds a considerable amount of bonds, a diversified portfolio of long positions in market leaders across sectors and several tactical short positions. At such time that markets improve, the fund will redeploy capital from bonds into leadership groups, as they emerge.

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Market Highlights

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Barometer Global Macro Pool

Over the course of the fourth quarter, the Barometer Global Macro Pool exhibited greater than expected volatility. In December, index hedges were put in place to protect against further downside as the market's oversold condition continued to worsen.

Economically sensitive exposures, like transportation, contributed negatively to performance, as did exposures to biotechnology, media, industrials, information technology and consumer discretionary sectors. As investors adjusted to the possibility of decelerating economic growth, investors took profits in these positions, which had performed well throughout the first three quarters of the year.

Positive contributors to performance were the pool's exposure to natural gas, emerging markets (including India, Indonesia and Brazil), U.S. home builders and the Russell 2000, as well as a short position in U.S. preferred shares.

In Q4, there were very few asset classes that were not dragged down by the broader market selloff.

Looking Ahead

It has been a difficult period for investors as equities have been repriced during this recent correction. However, if we look at the fundamentals typical in bear markets (such as in 2000 and 2008), we see marked differences from what is happening today. Previously mentioned indicators, such as credit spreads, corporate earnings, economic growth and unemployment levels, provide evidence that this correction will pass, and that the market may find its footing at current levels.

The Federal Reserve Chair's ambivalence to markets in his speech in December was obviously not well received by investors. An indication that the Fed is sensitive to current market conditions and a stronger signal that the Fed is willing to be flexible would have garnered a much different reaction. Regardless of the volatile trading that ensued, we do think it is reasonable to expect that the Fed will be flexible and will pause rate hikes going forward – as long as inflation remains under control at approximately two per cent.

Trade is the other concern and the markets would react positively to a resolution in trade talks between China and the U.S. While recent headlines suggest reasons for optimism, market dynamics continue to call for caution. Barometer's portfolios remain defensively positioned and will remain so until further improvements in breadth and other technical factors occur.

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