RICHARDSON GMP

QUARTERLY OUTLOOK

Third Quarter - October 2016

Investors Wait for Earnings Direction

The Canadian stock market is having a fantastic year (+15.8%* YTD). Investing outside Canada, however, hasn't been so good. The American market is up only slightly (+2.3%**) from a Canadian dollar perspective. Global stock markets are marginally down (-1.6%***). The strength in the Canadian dollar had a significant negative impact on performance for Canadian investors.

Underlying earnings of the companies that make up the Canadian composite were down 15% in 2015 and are down a further 6% year-to-date this year. American earnings were flat in 2015 and are down 1% this year.

What does it mean that the Canadian stock market has moved strongly higher while underlying earnings for the last two years are lower? Either investors are right and Canadian earnings are about show a very strong rebound, or stocks have a higher risk of correction due to their more expensive valuation. Or some combination of the two.

The current rally in the stock market looks "tired". Trading volumes have been decreasing on the S&P/TSX since March. For the past eight weeks, trading has been range bound where the market index has not really moved up or down. The range of trading prices over most weeks has also been tight. Overall, this shows less demand for stock as the market has risen. Investors seem to be waiting for a catalyst.

The largest developed countries have experienced weak stock market performance this year, especially the U.K., Europe, and Japan. At the same time, investors have flocked to Brazil, Russia, and emerging markets economies. Commodities like gold and oil and countries that produce them (like Canada) have enjoyed significantly above average performance this year. When will the earnings of these commodity investments catch up with investor's optimism? And how will these earnings materialize given the larger developed world is facing significant challenges trying to grow?

* S&P/TSX Composite Total Return, 9 Months Ended September 30, 2016, Source GMP Securities, M3
** S&P500 Composite Total Return, in Canadian Dollars, Source GMP Securities, M3
*** MSCI World Index, in Canadian Dollars, Source GMP Securities, M3

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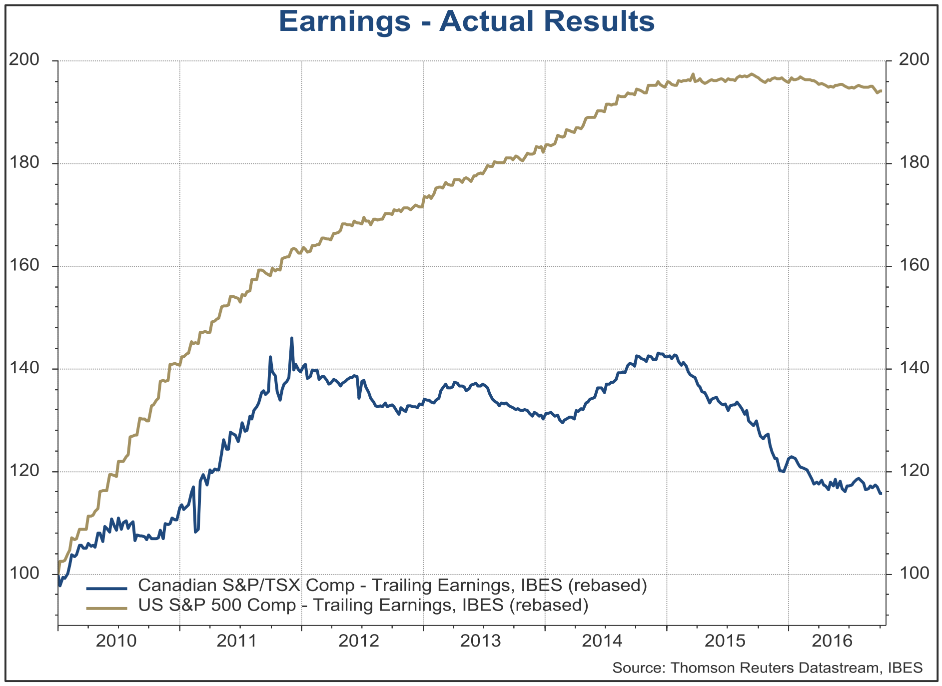
Earnings and What They Mean to Your Portfolio

One of the challenges I face as an investor and Portfolio Manager is trying to find investments that make money, but also make fundamental sense to own.

Investing fundamental: **The more a company earns, the more it is worth.**

A stock's price can move upward simply because its earnings are increasing. There is something solid-feeling about shares moving upward because of an actual improvement in the amount of business it has proven it can do. Actual revenues, earnings, and cash flow are proof of success.



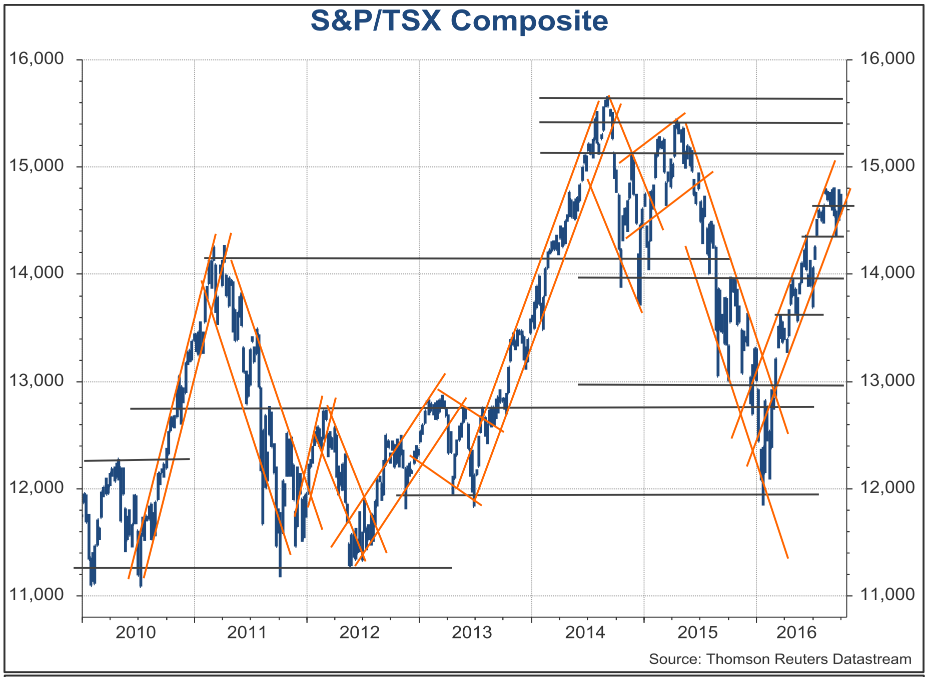
But share prices can also move up if investors become more optimistic about the company's future potential before actual earnings materialize. The price an investor is willing to pay for underlying earnings can be subjective and influenced by factors outside of a company's control. Prevailing interest rates, economic growth, and the performance of other companies are a few factors that can significantly expand or contract the valuation an investor is willing to pay for a company or basket of companies.

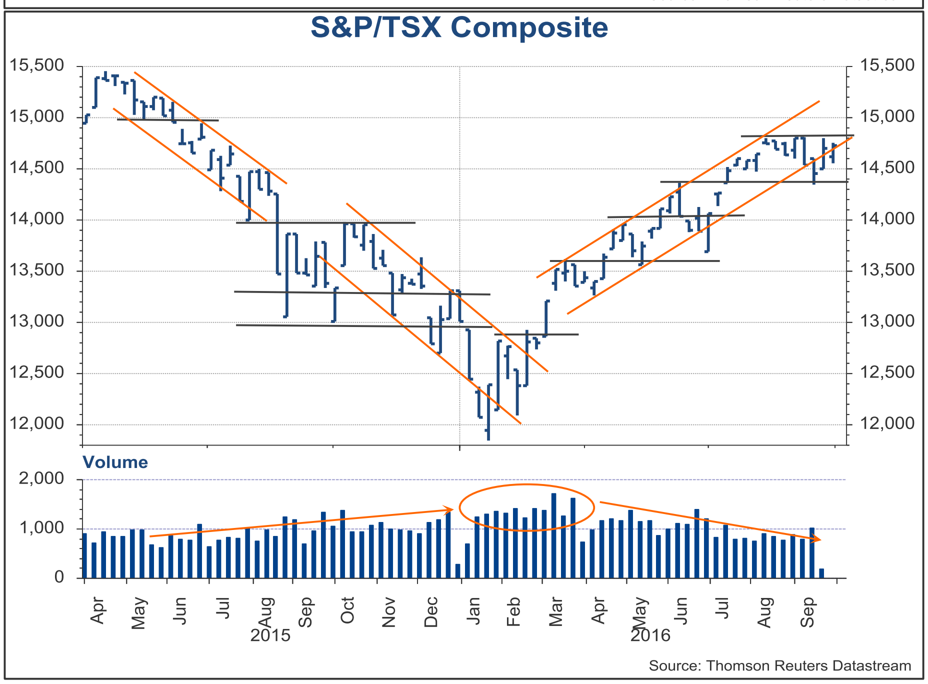
Valuations of companies and markets often do have common ranges. In broad terms, analysts will refer to securities as being expensive, cheap, or fairly valued. One would think that buying securities that are cheap would make the most sense. Unfortunately, securities that are cheap are often cheap for a reason – something is wrong with them that is making them underperform. Poor management and products don't always turn around. This does happen more often in cyclical industries where revenues are influenced more by global prices. And expensive securities similarly outperform for a reason, whether that be leadership, consistency in their business, or above average growth potential. Should an investor bet that the current valuation paradigm for a security is going to change (a weak company will suddenly turn around or a leader will fail) or should they anticipate that the current trend will continue?

My experience is that trends can continue for long periods until they end. The underlying earnings for the American market had a trend of strength from late 2009 until the end of 2014. The trend then changed to stagnation where earnings have been flat. The expectation for 2017 is for double-digit earnings growth (seems like analysts always are optimistic about the next year). From an investment point of view, I'd suggest being neutral about the potential of the U.S. market until there is some <u>evidence</u> of either actual earnings growth or contraction. This means less than full investment but much more than minimum investment.

Underlying earnings for the S&P/TSX in Canada are less than they were five years ago. The shorter trends for earnings within this longer trend seem to constantly change direction. Canada has not been a great place for consistent investment growth the last few years. The Canadian market lacks industry diversification. I'd suggest owning less of the Canadian stock market in portfolios. Longer-term core stocks that have consistent earnings and dividends can form the base of a portfolio, while the cyclical nature of much of the index is more suited to a trading strategy.

Canadian Market





The S&P/TSX composite has seldom stayed in any kind of trading range. Trends have steep rates of increase and steep rates of decline. The direction of a trend changes dramatically, sometimes in only a couple months. Trends in the S&P/TSX don't seem to stay in place very long.

In the two years since Sept., 2014*:

- The CRB commodity price index is down 17%.
- Earnings in the materials sector is down 40%
- The price of oil is down 50%
- Energy earnings are down 92%
- Financial sector earnings grew by 10% to the end of 2015, but have been flat to down in 2016.
- Earnings for the overall S&P/TSX index itself are 16% lower.

Yet the Canadian stock market has had one of its best years, approaching 2014 highs.

Notice how trading volume increased in 2015 as the market fell, putting more and more downward pressure on prices. Trading volume was very high for several weeks in January and February, 2016. The spike in trading volume in March at the same time as the stock market surged upward was a very positive confirmation of strong demand for stock. Since April, trading volume has been declining. Lower volumes today suggest potential exhaustion in demand. Over the last few weeks, the market index has been drifting sideways in a tight range, testing the rate of increase in the current trend. It seems likely that commodity prices bottomed early this year and may have room to grow. But have investors already priced in too much optimism that earnings will follow?

My current expectation is for the Canadian market to remain in the current 14,375 to 14,820 range. A period of "absorption" where investors are digesting the 15% market gains without much underlying earnings improvement makes sense. Look for a breakout, or breakdown, as a signal on the market direction. Large volume with a wide price range in the week of breakout would help provide confidence in direction. Having some cash gives flexibility to react.

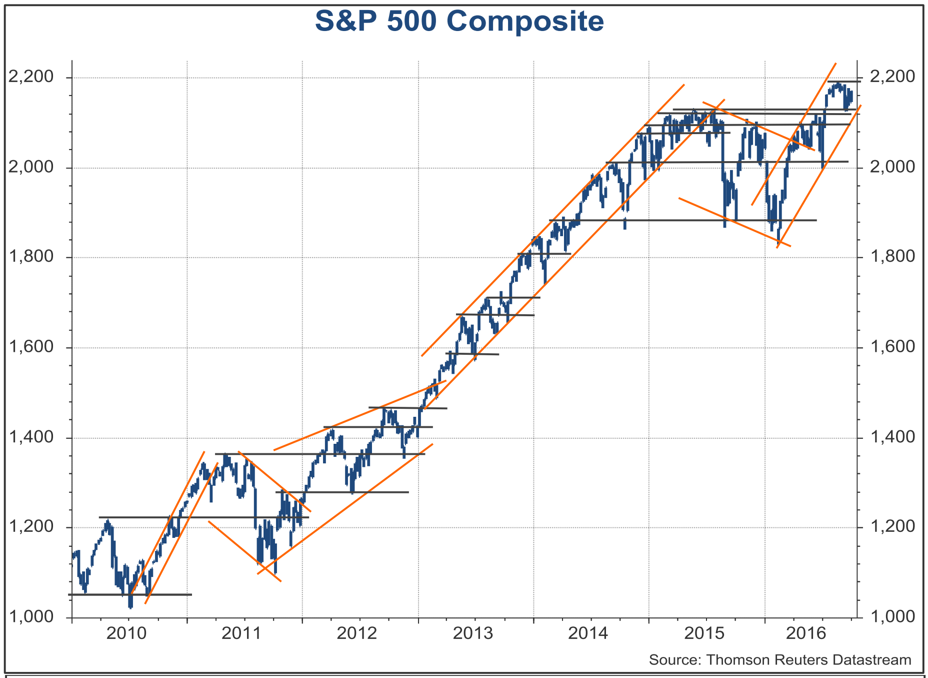
* Source: Thomson Reuters and Thomson Reuters IBES

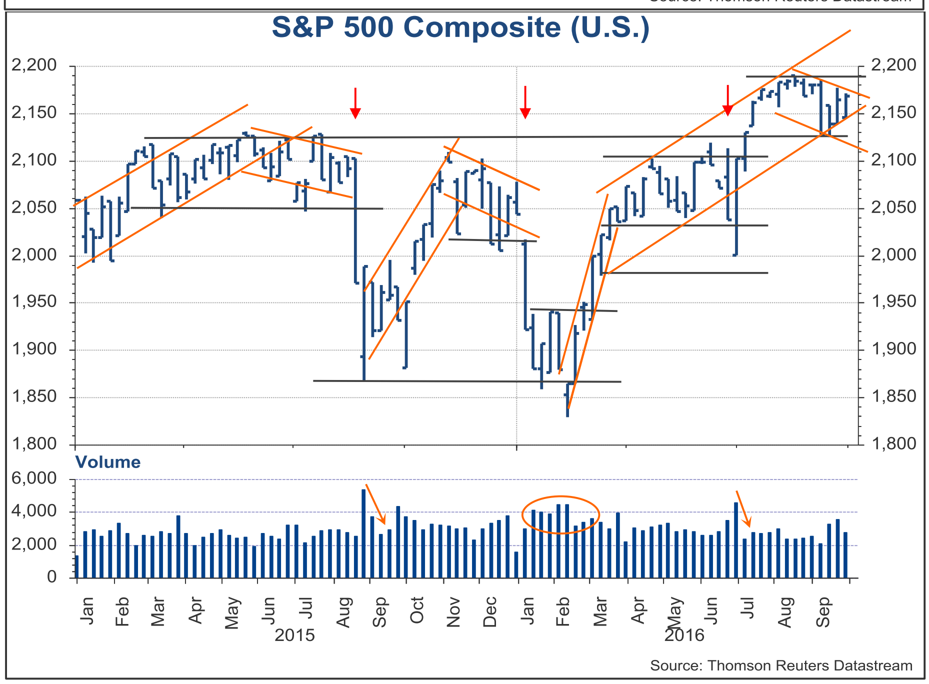
American Market

It was easy to invest in the American market in hindsight. From 2010 to 2015, every time the market fell, it was a buying opportunity. The market never went to a lower point than the previous low during that period. Going long and holding on always won.

Many Canadians didn't participate in this U.S. market boom. Memories of the strength in from the early 2000's to 2011 kept Canadians from globally diversifying. Every dip seemed to remind investors about a potential crash, rather than an opportunity to buy companies with growing earnings on sale.

Easy street for investors in the U.S. ended in 2015. The S&P 500 went nowhere for the 17 months from Feb/2015 to Jun/2016. To make it more difficult, there were <u>**three**</u> shocks during that period. In periods of only a few hours to a couple days, the market experienced rapid collapse. To make things more challenging, the second shock in Jan/2016 pushed the market below the lows set in the first crisis during Aug/2015. Hitting lower lows questioned whether the longer-term growth trend had broken down. Then, after seeing how two shocks played out, the third one (Brexit) acted completely differently by *not* collapsing for 4-6 weeks as the prior ones did.





American investors drove the S&P 500 to new highs in July, 2016. But demand for stock appears weak without much volume or upward follow through. The very narrow weekly trading bar ranges, particularly in late July and August, accompanied by low volume suggest there is not much conviction in the new highs. A new trading range is being established between 2,130 and 2,190. Look for a move above or below this range as a hint of the next market direction. Volume and size of movement are factors that provide confirmation.

My recommendation is to be cautious. There are good arguments for the American market to resume its global leadership and growth. But the graphs show how repeatedly, <u>months</u> of hard work selecting investments are crushed by a one-day surprise. Investors are walking on eggshells more than ever. This suggests holding some cash.

Principal Protected Notes

This month, I added principal protected notes ("PPNs") to managed portfolios which form a part of the Alternative Investments asset class. I was able to participate in the construction of two series of PPNs issued by J.P. Morgan Bank Canada, that provide 100% principal protection and an attractive potential return much less correlated to financial markets and interest rates.

J.P. Morgan manages a portfolio they call an ETF Efficiente DS 5 Index. This "Index" is tactical traded within a universe of 12 exchange-traded funds and a cash index. The portfolio is run by an optimization algorithm whose design is to maximize returns and target a 5% volatility level. The portfolio may include US, global, and emerging market equities, various bond funds, commodities, gold, real estate, inflation-protected securities, and cash.

Money invested in the Canadian dollar JPM PPN is placed in the ETF Efficiente DS 5 Index. At the end of each year, the growth of the Index is tested against a hurdle rate. **The Canadian dollar note has a 5.0% hurdle rate.** If the Index has grown more than the hurdle rate on the annual review date, the note is automatically called and fully repaid, ending the note. **The investor also receives a return, called the "Call Premium", of 8.65%.** The returned principal and the Call Premium are currency hedged and are paid in Canadian dollars. If the return doesn't exceed the hurdle rate on a review date, the note is not called and continues on. And the end of the each subsequent annual review date the Index is similarly tested and potentially called. If the cumulative Index return from inception exceeds the hurdle rate times the number of years held, then the PPN is called, principal is returned, and the Call Premium is earned multiplied by the number years the PPN was held. If the note is not called before the end of the seventh year, it will mature at that time and all principal will be repaid plus any positive cumulative return from the managed Index.

J.P. Morgan ETF Efficiente DS 5 Index Performance

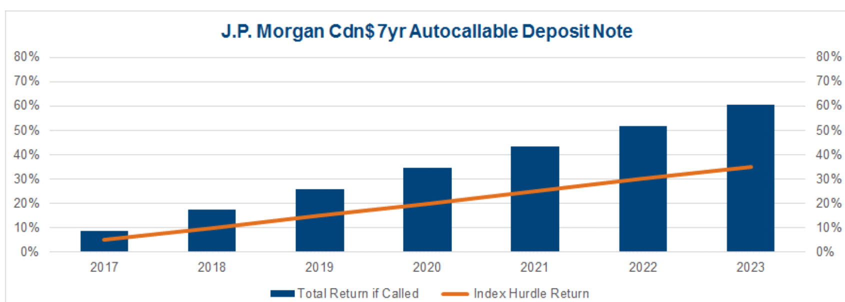
2006	5.76%
2007	2.03%
2008	2.46%
2009	7.10%
2010	9.60%
2011	10.33%
2012	5.84%
2013	1.45%
2014	5.84%
2015	-9.79%
2016 YTD*	8.62%

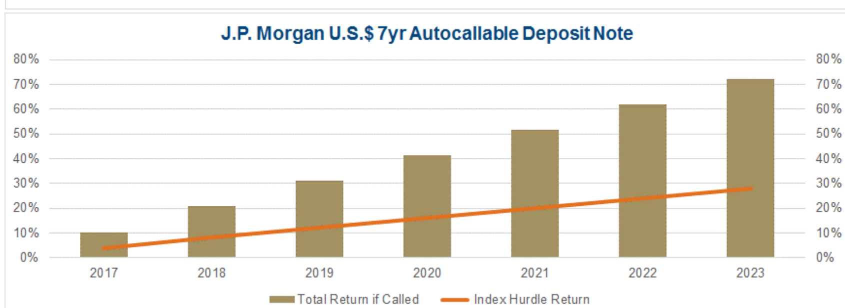
Past performance is not a guide to future performance. The levels of the index incorporate an adjustment factor of 1.0% per annum. Represents the full Calendar year performance of the Index based on as applicable to the relevant measurement period, the hypothetical back tested daily closing levels from December 31, 2005 through September 24, 2012, and the actual historical performance of the Index based on daily closing levels from September 25, 2012 through August 31, 2016. The hypothetical historical values have not been verified by an independent third party. The back-tested, hypothetical historical results have inherent limitations. These back-tested results are achieved by means of a retroactive application of a back-tested model designed with the benefit of hindsight. No representation is made that an investment linked to the index will or is likely to achieve returns similar to those shown. Hypothetical back-tested results are neither an indicator nor a guarantee of future returns. Actual results will vary.

*2016 YTD reflects the year to date performance from the last business day of the previous calendar year to August 31, 2016

Source: J.P. Morgan

The charts to the right show the cumulative hurdle rate the Index must beat, and the resulting cumulative Call Premium the investor earns if the note is called. **The U.S. dollar note has a lower annual hurdle rate of only 4.0% with a larger Call Premium payout of 10.3%.** The U.S. dollar note is not currency hedged – the initial investment, the principal repayment, and any Call Premium or Index return earned are provided in U.S. dollars.





The Call Premium payouts on these notes are attractive. Commissions have been stripped out of these notes because they were built for fee-based accounts. Note that the fund itself charges a 1% annual fee for actively managing the funds, which is included in the Index level they report and the performance data shown.

Round Table Discussion

Join me over an interactive lunch discussion where we will discuss the financial issues you are most concerned about. I will present a brief overview of what has happened in financial markets over the year and relate them to how investments and portfolios have been affected. Then together with you and other participants I hope to address questions and issues of a financial nature most important to you.

Topics of discussion will include:

- A review of financial events that took place in 2016
- U.S. Election possible outcomes and effect on markets
- Interest rates and gaining yield
- A discussion of portfolio strategy and current positioning
- Issues you would like to discuss

Date:	**Thursday, October 20th, 2016**
Time:	**11:45am – 1:00pm**
Location:	**Richardson GMP (Main Boardroom)** **47th Floor, 525 - 8th Avenue SW**
RSVP:	**Rita Penno by telephone 403.355.6034 or** rita.penno@richardsongmp.com

Lunch and refreshments will be provided.

I hope you have to opportunity to join us. Please pass this invitation to anyone who may benefit from attending.

Regards,

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