Second Quarter 2018

"Five, Six, Seven, Eight, Aren't Trade Wars Really Great?"

Yes, the United States Slapped Tariffs on Critical Imports of Steel and Aluminum from Canada and Elsewhere, Yes, Canada and Elsewhere Retaliated, and Yes, It Could End up Hurting the Economy, Eventually

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Quarterly Summary and Musings on Quarterly Happenings

The global commodity economy kicked into high gear in the second quarter resulting in Canadian equity market (S&P/TSX composite index) outperformance relative to the US and global equity markets. The S&P/TSX composite index finished the quarter up 6.8% versus the US (S&P 500) and global (MSCI World) markets which were up 3.4% and 1.1% respectively.

The energy, materials, information technology, health care and industrials sectors led the S&P/TSX composite index while the consumer discretionary, consumer staples, financials, real estate, telecom and utilities sectors trailed.

US Tariffs

In March, the Trump administration announced tariffs on steel and aluminum imports but provided Argentina, Australia and Brazil permanent exemptions and provided Canada, Mexico and the European Union with temporary exemptions expiring on May 31. These temporary exemptions have come and gone and tariffs on Canadian, Mexican and EU steel and aluminum have been in place since June 1.

Naturally, these close allies were not happy with this form of economic warfare and responded in kind. Effective July 1, Canada has implemented tariffs on CAD$16.6 billion in US imports including aluminum and steel as well as 79 other products ranging from prepared meals to shaving products to insecticides. On June 6, Mexico announced tariffs on US$3 billion in US imports of various produce products, pork and bourbon. Effective June 22, the EU imposed tariffs on US$3.3 billion in US imports including shoes, rice, orange juice and hundreds of other products. India and Turkey have also responded retaliatory tariffs as a result of the US steel and aluminum tariffs.

In late June, the Trump administration announced that it is considering much higher tariffs on auto imports. While tens of billions in new tariffs on various goods is obviously not positive for global trade and the global economy, the recently imposed tariffs are marginal enough that the impacts are expected to be negligible over time. Broad and punitive auto tariffs would likely have a significant effect on car prices, auto investment and global trade. The EU warned of US$300 billion in new tariffs in retaliation if the US went ahead with a 20% tariff on auto imports.

This is how friends treat friends in the Trump era.

Moving on to the China-US front of the US-led trade war, which is far more meaningful to global trade and the global economy.

In our first quarter commentary, we noted that the US initiated tariffs on solar panels and washing machines which singled out China to a certain degree. China is also a major steel and aluminum exporter and was one of the bigger casualties of those tariffs. China responded in kind, applying tariffs to US$3 billion in US imports of wine, fruit, pork, steel pipe and over 100 other products. The US temporarily applied sanctions to Chinese hardware firm ZTE Corp sending its shares down over 50% and putting the Qualcomm-NXP takeover deal in doubt. China hosted US delegates for talks in May in an effort to defuse the tit-for-tat dispute and the talks appeared to be successful for a short time but the status quo reemerged. On July 6, the US began charging tariffs on US$34 billion in Chinese imports and China responded in kind.

While a full scale trade war was seen as unlikely in the first quarter, it appears we fell further down the rabbit hole in the second quarter. If we arrive in Wonderland, we hope that Trump has been playing the role of the mischievous but logical Cheshire Cat, and not the vindictive and irrational Queen of Hearts.

> *"If you don't know where you want to go, then it doesn't matter which path you take"*
>
> *-Cheshire Cat*

We remain fairly optimistic that the Trump administration does not want to be single handedly responsible for an economic downturn. As a result, we believe they are nearing the end of tariffs on US allies and will stop short of imposing significant tariffs on Chinese imports as well.

NAFTA Negotiations

All of the above is very bad for NAFTA negotiations. If the Trump administration is willing to impose tariffs on Canadian and Mexican aluminum and steel products, that is not a good sign for what it is willing to do with NAFTA.

NAFTA negotiations are effectively on hold until the fall as the Trump administration announced that it is in no rush to finalize NAFTA before the US mid-term elections. Additionally, a new Mexican government is set to take office in December, which could result in a reset of trade negotiations. From our point of view, assuming the Trump administration is truly playing "4D chess", (so far unsuccessful) NAFTA negotiations are a symbol of how far Trump is willing to go with its closest friends, acting as a totem of intimidation in its more justifiable trade discussions with China and Europe. Or the Trump administration is simply playing checkers and NAFTA is simply collateral damage in the Trump administration's broad trade war. Let's hope for 4D chess.

Subsequent to quarter end, the Trump administration pulled a 180 and began to float the idea of a zero tariff world for auto imports which would provide a boost to the global auto sector rather than a blow. There is a chance that Trump is using his nationalist base of support to covertly push traditionally Republican ideals of true free markets and free trade.

Oil Price Summary and Outlook

The price of oil shot higher, finishing the second quarter at ~US$74 (WTI) versus ~US$65 (WTI) at the end of the first quarter. There were several moving parts pushing and pulling oil prices throughout the period.

Most importantly was a rapid and major decline in Libyan oil production as attacks on two port facilities reduced Libyan oil production by over 400,000 barrels per day in June. The attacks ensure that this supply will be offline for an extended period and raise doubts about the sustainability of Libya's other ~600,000 barrels per day in oil supply.

With the oil market in a notable deficit (i.e. demand greater than supply), OPEC+ (OPEC plus Russia and its non-OPEC oil market allies) agreed to a one million barrel per day boost in production. This boost was less than expected and may be difficult to achieve quickly considering Libyan supply issues. Nothing has yet been finalized about a long-term supply deal between Saudi

Arabia, representing OPEC, and Russia, representing the rest, but they have shown increasing solidarity in oil market actions and guidance.

In May, the Trump administration pulled the US from the Iran nuclear deal and stated that it would penalize any nations that deal in Iranian oil. The cancellation of the Iran nuclear deal puts one million barrels per day of Iranian oil production at risk and could further worsen the oil market deficit.

Canadian energy stocks continue to struggle with transportation issues. The oil price spread between Canadian Western Select (CWS) and WTI has not improved and is currently sitting at ~US$27 per barrel relative to ~US$25 per barrel in March. In May, the Canadian government announced its intent to effectively nationalize the Trans Mountain Pipeline project to ensure that long-term energy transportation issues are attended to. In the short-term, crude-by-rail capacity has not yet caught up with Canadian oil supply and the cost of crude oil transportation remains inflated.

We remain constructive on energy prices and energy stocks given the Libyan supply shock, waning but still robust economic growth and the growing likelihood of a long-term supply deal between OPEC and Russia.

Manufacturing

The JP Morgan Global Manufacturing PMI hit a four month high in June and economic activity now sits at the average level for most of the past 18 months. A significant divergence has emerged between the global services and manufacturing economies. Concerns about a global trade war are clearly having a negative effect on the global manufacturing economy, with new export order growth grinding to a halt and manufacturing activity hitting a one year low. In contrast, the global service economy is firing on all cylinders, sitting close to a four year high.

Eurozone Sovereign Risk Reemerging

After three months of negotiation, a governing coalition was formed between Italian populist parties M5S and the League. As a result, the tradition of centre-right versus centre-left has been upended in favour of populism versus establishment. Approximately 57% of Italian votes were cast in favour of populism parties in the Italian election. A ruling coalition of populists in Europe's third largest economy and most highly indebted nation is a major threat to the European Union. The coalition has already stated that they intend to run a large budget deficit, disregarding EU-mandated fiscal policy rules and challenging the EU's current fiscal framework. The uncertainty created by coalition's formation caused the Italian 10-year government bond yield to spike to 3.2% from 1.7% in less than a month.

PIMG Balanced Growth Model

Gained 2.6% during the quarter. Performance figures for other periods are in the appendix.

During the quarter, we bought new positions in CVS Health (CVS) and Vermilion Energy (VET) and added to our position in CIBC (CM). Please see the reasoning for our purchases below.

CVS Health Corp (CVS)
CVS is the largest pharmacy chain and the third largest pharmacy benefit manager in the US and is in the later stages of acquiring Aetna, one of the largest health insurers in the US. CVS and its peers came under attack from Trump in his presidential run as he has vowed to lower pharmaceutical pricing and this could impact CVS's prescription revenues. That said, the push to reduce drug pricing appears to have shifted to simply restricting the pace of drug price increases rather than lowering the price of all drugs.

CVS trades at a historically low valuation of ~10x pro forma earnings, assuming completion of the Aetna acquisition and $750 million in deal synergies as anticipated by management. This figure is deemed somewhat conservative by analyst estimates and it is expected that long-term synergies could be higher. This valuation is more than a 50% discount to the broad equity market and a ~30% discount to CVS and Aetna's combined historical valuation. CVS's acquisition of Aetna will provide it with a captive audience for its products, reducing the risk of both CVS and Aetna's respective businesses. As a result, there is a good case to be made that CVS-Aetna should eventually trade at a premium to their historical valuations given their improved earnings stability, diversification and size.

Vermilion Energy (VET)
Vermilion is one of the better capitalized mid-cap Canadian oil companies and as a result should be able to self-fund its production capex and make highly accretive acquisitions in most oil price environments. We bought a half position in Vermilion as it had barely budged despite oil's impressive rally and the WCS-WTI differential falling below $20 from over $30 just a couple of months ago. Further, Vermilion had not received any credit for its recent acquisition of Spartan Energy which is a light oil producer in Saskatchewan and should benefit from rising oil prices.

Vermilion is one of the lower cost operators in Canada but also has a meaningful oil and gas business in the North Sea. We think Vermilion's meaningful exposure to Brent crude oil prices as well as premium European natural gas prices set it apart from Canadian peers. Its very low debt load also means its shares will be less sensitive to oil and gas prices over time and it has historically been much less volatile than other Canadian pure play energy producers. We believe energy producers offer the most value in the energy sector currently as many pipeline and integrated energy companies trade near cycle highs.

CIBC (CM)
We added to our CIBC position as it continued to look undervalued relative to Canadian bank peers. We believe investors remain overly bearish on Canadian housing and the Canadian economy in general and that CIBC will benefit the most when this bearish sentiment subsides. CIBC is the most Canada-centric bank with above average exposure to the Canadian housing market, interest rates, consumers and businesses.

During the quarter, we sold our positions in iShares 1-3 Year Treasury Bond ETF (SHY), TFI International (TFII), TD Bank (TD) and SNC-Lavalin (SNC). Please see the reasoning for our sales below.

iShares 1-3 Year Treasury Bond ETF (SHY)

This ETF was a place holder for US dollar cash. We sold this position to fund the purchase of CVS Health (CVS).

TFI International (TFII)

We sold our position in TFII as it now trades at 8.5x forward EV/EBITDA, a premium to its less-than-truckload peers and roughly in line with truckload peers that typically trade at a material premium due to their more stable revenues and higher margins. We do not see this valuation as justified. We believe investors are forgetting that TFI is primarily an inefficient less-than-truckload operator that experiences extreme margin volatility relative to truckload peers. We think the current economic environment is close to the best it can get for TFI and we expect TFI to experience much greater downside than peers if the economy turns. As global economic activity peaked in February (at least temporarily), we see the possibility for a negative revenue/earnings surprise in the near-term. Finally, we initially purchased TFI for its willingness to perform large acquisitions but after acquiring many of its larger Canadian peers over the past five years, we see few meaningful acquisitions going forward.

TD Bank (TD)

We sold our position in TD Bank due to our overexposure to the banking sector, rising financial contagion risk stemming from Europe (i.e. many major banks are at 52-wk or all-time lows – SAN, DB, CRZBY, BBVA, UBS, SCGLY, BNPQY) and TD's outperformance relative to Canadian peers. We still like the value presented by Canadian banks in general but thought it was prudent to reduce exposure to financials due to rising global financial sector risk. TD now trades at a ~10% premium to RY and a 30% premium to its more Canada-centric peers, the widest margins in over a year. The new Italian coalition government is fairly anti-EU and anti-euro and could eventually spark financial contagion similar to the 2011 European debt crisis.

SNC-Lavalin (SNC)

We sold our position in SNC-Lavalin due to its high valuation relative to peers, particularly the high valuation of its infrastructure business. Assuming that SNC's engineering and construction business trades at 7.5x forward EV/EBITDA (which is liberal given this is the industry average and above SNC's E&C multiple of the last five years, despite the unit's poor operating performance and declining EBITDA), SNC's infrastructure business trades at over 30x EV/EBIT. This is roughly double the valuation of most other infrastructure, utility, pipeline and royalty peers and ~40% above the second highest valued peer. It appears the market has continued to provide SNC's 407 ETR business with a very high multiple despite decidedly turning on all other comparable stocks due to concerns about rising interest rates.

PIMG Balanced Income Model

Gained 1.9% during the quarter. Performance figures for other periods are in the appendix.

In line with trades in the Balanced Growth model, we bought new positions in CVS Health (CVS) and Vermilion Energy (VET) and added to our position in CIBC (CM).

In line with trades in the Balanced Growth model, we sold our positions in TFI International (TFII), TD Bank (TD) and SNC-Lavalin (SNC).

Due to the Balanced Income model's overexposure to equity relative to our target allocation and benchmarks, we sold part of the model's position in the National Bank SmartData International Equity Fund (NBC491). This fund held up incredibly well this year and we felt it was an ideal time to right-size the position.

Our View Going Forward

Toward the end of the second quarter, we sold a few of our more cyclical positions that appeared expensive relative to peers. We have not reinvested this cash due to the limited number of attractive buy opportunities and in response to markets trading near all-time peaks despite the numerous risks that could impact equity markets such as an anti-EU Italian government, tit-for-tat tariffs and a perpetually weak and essentially nationalized European banking sector.

The asset allocation of the Balanced Growth model is currently 12% cash, 17% fixed income, 6% preferred equity and 65% common equity and the Balanced Income model is currently 10% cash, 34% fixed income, 7% preferred equity and 49% common equity. The cash balances are up 10% and 6% for the Balanced Growth and Balanced Income models, respectively. While we are cautious in the very short-term due to looming macroeconomic risks, we remain constructive on equity markets looking six to twelve months out. Global economic activity remains robust, unemployment rates are stuck at cycle lows and corporate credit standards appear to be loosening further (as per US Senior Loan Officer Survey data) so the medium-term economic and equity market outlook remains positive. We are keeping a keen eye on corporate credit standards and if they begin to tighten alongside consumer credit standards (US consumer credit standards have been tightening for five of the past six quarters). Only when consumer and corporate credit standards begin to tighten would it warrant a shift toward a more defensive stance.

As a result of our still optimistic view of the equity market, we are on the prowl to redeploy our cash reserves and will likely do so when individual stocks separate from the pack and provide us with a one-off buy opportunity or following a broad, but presumably brief, market pullback.

There are a select few, mostly industrial, stocks that have sold off due to NAFTA and tariff related tensions and could see material upside if those tensions started to wane. We will be closely watching for positive trade developments as a catalyst to buy these undervalued industrial companies. While these companies appear undervalued assuming the status quo, we would prefer not to own them if there is a paradigm shift in trade relations. We think it is prudent to see some confirmation that the status quo will remain before investing in many of these industrial names. We remain fairly confident that the Trump administration will not want to single handedly be the cause of a recession, and that the administration will become more amiable with time. That said, we admittedly did not think the trade war would get this far and have concern that it could go a bit further before settling down.

We remain constructive on defensive stocks and are already overweight the defensive utilities and telecom sectors. Given their 10%-20% pullback from the cycle highs, we see further downside as unlikely. A significant rally in the utilities and telecom sectors would likely mark a major downshift in interest rate expectations and could mark the end of the equity bull market. We would look to sell some of these positions into strength provided we are also seeing other hallmark end-of-life signals in the economy and equity market (i.e. tightening credit conditions, inverted yield curve, etc).

Another area of the market that still carries some value is energy. US oil prices are back to a three and a half year high. Investors appear hesitant to assume that oil prices will remain at current levels for an extended period of time and many energy stocks look inexpensive relative to oil prices. This is particularly true for smaller Canadian energy stocks assuming the CWS-WTI differential can be reduced over time. The energy sector is also the only cyclical sector that hasn’t had an extended run the most recent equity market rally (2016-now). Now that the industrials, consumer discretionary and to some degree the technology sector are threatened by the trade war, and interest rate expectations are already high, limiting upside for the financial sector, the energy sector could become the sector of choice for all types of investors: value, growth, momentum, dividend. Like defensive stocks, if the energy market had a strong push higher, this could indicate that the end of the equity bull market is near and we would look to sell these positions into strength provided we are also seeing other hallmark end-of-life signals in the economy and equity market.

In the first quarter and early in the second quarter, we effectively doubled down on Canada as we thought Canada's long period of underperformance was coming to an end. Canadian stocks outperformed US and international stocks by 3.4% and 5.7% in the second quarter. We believe this outperformance can continue as the energy sector has room to move higher and a booming energy sector should spill into other parts of the Canadian economy. For this reason, the Canadian equity market often outperforms in the later part of the market/economic cycle.

CVS Health and DAVIDsTEA shares experienced high volatility in the second quarter but largely finished where they started.

We purchased CVS Health in part because we believe the "Amazon threat" was overblown and the stock was trading at a large enough discount to account for the worst case scenario. CVS shares rallied shortly after we purchased the shares after Amazon announced that it wouldn't be getting into wholesale prescription drug sales. The shares then gave back those gains when Amazon announced that it was acquiring PillPack, the largest online pharmacy in the US. We have conviction that investors will eventually see the value of CVS's model and profitability.

DAVIDsTEA management lost a proxy vote to co-founder Herschel Segal, and Segal took control of the DAVIDsTEA board. The shares rallied in response likely as new board members built positions in the company. DAVIDsTEA continues to struggle operationally. The company retains a large cash reserve which should limit downside in the near-to-medium term. We think there is opportunity for material upside should the sales trend turn positive but we would be sellers if the shares climb much higher without an improvement in sales.

We significantly cut our exposure to the industrials sector in the second quarter as a result of individual security valuation and trade concerns. We are actively looking for new opportunities in this space. We cut our financial sector exposure in the second quarter but remain constructive on the Canadian financial sector in particular. Canadian financials should benefit from the potential for improvement in energy sector activity but we harbour concerns about several "global systemically important banks" in Europe and are unwilling to be overweight financials. We added to our energy exposure in the second quarter and will continue to look for buy opportunities in the sector. We continue to like the utilities and telecom sectors but are maxed out in terms of exposure for now.

As at the end of Q2, the models yield 3.1% (Balanced Growth) and 3.3% (Balanced Income), from 3.2% and 3.4% at the end of Q1. The decline is due to a higher cash allocation at the end of Q2.

Sincerely,

Steele Wealth Management

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Appendix

Model	3-mos	6-mos	1-yr	3-yr	Since Inception
Balanced Growth	2.6%	0.2%	4.9%	3.5%	5.3%
Balanced Income	1.9%	0.1%	4.8%	4.7%	5.7%

The above performance data is current as of June 30, 2018. The returns above incorporate a 1% annual investment management fee, charged monthly, which is also subject to 13% HST, charged monthly, for a total cost of 1.13% annually. Inception date for the Balanced Growth model and Balanced Income model is January 15, 2014. Performance figures for periods greater than 1-year are annualized.