Fourth Quarter 2018

♪ Why Can't We Be Friends ♪

NAFTA Negotiations Wind Up, US-China Negotiations Begin, Brexit Negotiations Ramp Up

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PIMG Balanced Growth Model

The model lost 8.3% during the quarter. Performance figures for other periods are in the appendix.

During the quarter, we bought a new position in Fairfax Financial Preferred C (FFH.PR.C) and added to our positions in Embraer (ERJ), Enbridge Preferred E (ENB.PF.E), Power Corp Preferred D (POW.PR.D) and Sun Life Financial Preferred C (SLF.PR.C). Please see the reasoning for our purchases below.

Embraer (ERJ)

Embraer is a Brazilian aerospace company that produces commercial, military, executive and agricultural aircraft. Embraer is the third largest producer of civil aircraft after Airbus and Boeing. Embraer currently trades at ~7x trailing EV/EBITDA and ~4x 2020 EV/EBITDA based on consensus estimates. Embraer is currently in the midst of a ramp up cycle that should result in well above average growth over the next two years. Embraer trades at a 50%-70% discount to peers Boeing, Airbus and Bombardier based on current and future EV/EBITDA multiples. This discount is unusual considering Embraer is the least leveraged company in the sector, the market leader in the narrow-body plane segment with ~70% market share and its market leadership is defensible due to meaningful switching costs for airlines and labour/production cost advantages not available to its competitors. Embraer recently signed a non-binding joint venture agreement with Boeing that would monetize a large part of its commercial aircraft business at a much higher valuation while providing global reach and improving earnings consistency. Embraer shares should appreciate from current levels if the joint venture agreement is finalized and approved. Further, Jair Bolsonaro won the Brazilian presidential election in late October which could ignite a period of prolonged economic growth in Brazil, benefitting Brazilian defense companies in an outsized way.

Preferred Shares (FFH.PR.C, ENB.PF.E, POW.PR.D, SLF.PR.C)

At the time and price of purchase, we believe these preferred shares offer some of the highest returns in the investment universe without taking a significant amount of risk. We believe these preferred shares should rebound 10%-25% if the economy avoids recession and interest rates return to their path of gradual increases. As global economic activity/growth appears to be at the post-2008 average and banks continue to lend to corporations at a healthy level, the economic outlook remains positive. Canadian preferred share yields currently sit at the highest levels seen outside of the 2008 financial crisis and 2016 energy market downturn.

Security	Symbol	Type	Buy Price	Yield	Yield-to-Call	Probability of Call	Reset/Call Date	Rating
Fairfax Finl Preferred C	FFH.PR.C	Fixed Reset	$20.73	5.52%	23.3%	High	31-Dec-19	Pfd-3H
Enbridge Preferred E	ENB.PF.E	Fixed Reset	$17.84	6.17%	29.3%	Low	01-Jun-20	Pfd-3H
Power Corp Preferred D	POW.PR.D	Perpetual	$21.00	5.95%	n/a	n/a	n/a	Pfd-2
Sun Life Preferred C	SLF.PR.C	Perpetual	$19.38	5.74%	n/a	n/a	n/a	Pfd-2

During the quarter, we sold our positions in DAVIDsTEA (DTEA-US) and PIMCO Monthly Income Fund (PMO005), Artis REIT (AX.UN) and Ninepoint Energy Fund (NPP006). Please see the reasoning for our sales below.

PIMCO Monthly Income Fund (PMO005)
We sold our position in PIMCO Monthly Income to fund the purchase of the aforementioned preferred shares. We opted to sell PIMCO Monthly Income over the other bond funds held in the model as it will likely experience the least upside during an equity market rally and we believed the equity market downturn was long in the tooth. It is conceivable that we would re-allocate to PIMCO Monthly Income after we have fully capitalized on the preferred share anomaly.

DAVIDsTEA (DTEA-US)
We sold half of our small position in DAVIDsTEA after it spiked on cannabis related speculation. DAVIDsTEA retail outlets and its easy-to-infuse product line make it an obvious partner in the cannabis sector. That said, as the stock price movement was based solely on investor speculation we sold half of the position. We retained half the position as rumours can often drum out information from management and the potential upside is high if DAVIDsTEA confirmed its entry into the cannabis sector. We subsequently sold the remaining position in late December during the equity market downturn to reposition the portfolio toward higher conviction ideas.

Artis REIT (AX.UN)
We sold our position in Artis REIT as it had outperformed other indirect energy plays during the equity market downturn. Many indirect energy plays in the real estate, trucking and other sectors experienced significant declines as oil prices fell alongside stock prices. We saw a high probability of Artis underperforming its indirect energy peers in all environments. We sold Artis to reallocate to stocks that will likely experience greater upside during an equity market rally.

Ninepoint Energy Fund (NPP006)
We sold our small position in NPP006 as the valuation gap had narrowed between small- and mid-cap energy producers and large cap energy producers. While we have not yet pivoted to large cap producers, we think the significant decline in large cap energy producers could signal further declines for undercapitalized small- and mid-caps if energy market sentiment remains poor.

PIMG Balanced Income Model

The model lost 6.2% during the quarter. Performance figures for other periods are in the appendix.

In line with trades in the Balanced Growth model, we bought a new position in Fairfax Financial Preferred C (FFH.PR.C) and added to our positions in Embraer (ERJ), Enbridge Preferred E (ENB.PF.E), Power Corp Preferred D (POW.PR.D) and Sun Life Financial Preferred C (SLF.PR.C).

In line with trades in the Balanced Growth model, we sold our positions in PIMCO Monthly Income Fund (PMO005), Artis REIT (AX.UN) and Ninepoint Energy Fund (NPP006).

To partially fund the new preferred shares purchases, we sold our position in Great West Lifeco Preferred H (GWO.PR.H).

Quarterly Summary and How We're Positioning for Q1

2018 was the worst year for US stocks since 2008 and December 2018 was the worst December for US stocks since 1931. Over 90% of global assets experienced negative returns in 2018, the highest percentage in modern history. While one might jump to the conclusion that the economy is struggling and the outlook is dire, this is not at all the case.

Global economic activity, as measured by the JP Morgan Global Composite PMI, has slowed to the average level of the post-2008 period but remains well above the lows reached in the 2008, 2011 and 2016 slowdowns.

Access to credit for mid-to-large businesses, as measured by the Senior Loan Officer Opinion Survey on Bank Lending Practices, sits at a five year high as of Q4 2018. Access to credit for US small businesses and households remains at normal, non-recessionary levels. According to similar surveys, access to credit for Canadian, European and Japanese firms remains at normal, non-recessionary levels. Limited access to credit is a necessary precursor to recession as it forces businesses and households to withhold and/or reduce spending. We are not experiencing a credit crunch by any means.

Commodity prices have come under pressure similar to stock prices during the recent market downturn. In Q4, crude oil (WTI) was down 38% and base metals were down 5%-15% Q4 in US dollar terms. While rapidly falling commodity prices can hurt economic growth in the short-term as commodity producers react by reducing spending on employment and investment, falling commodity prices are generally seen as neutral to slightly positive for long-term economic growth. The decline in commodity prices reduces inflation pressures around the world, resulting in less urgency to raise interest rates. Lower interest rates and lower input costs mean higher profitability for virtually all non-financial businesses.

A key point to remember is that many stock markets, including the TSX composite index and the S&P 500, hit all-time highs in mid-2018. While the declines were broad, deep and fast in late 2018, the losses in context of the past few years are not all that significant.

Given the current strength of the global economy, the recent downturn is likely adjustment to market values rather than a signal of impending recession.

US-China Trade War

The US-China trade war remains top of mind for the majority of investors. This is reinforced by President Trump's daily tweetfest complaining about Chinese policies and how the American people are infinitely disadvantaged by them.

After eleven months of tit-for-tat tariffs and harsh words between the two nations, on December 1, Presidents Trump and Xi agreed to a 90-day truce and negotiation period. December's equity market weakness may be enough to push both sides closer to the middle and put the trade dispute behind them. After a rocky start in December, meetings in January reportedly were fruitful. The US-China negotiations appear similar to the NAFTA negotiations that started very slow and with much animosity in the beginning but tangible progress started to be made when a deadline was set. We think there is a reasonable possibility of the US-China negotiations being finalized by the end of February or March.

New NAFTA

The new NAFTA, dubbed the Canada-US-Mexico Agreement or CUSMA, was signed by the leaders of Canada, the US and Mexico in December but has yet to be ratified. The deal is widely accepted to be final with little pushback expected from each country's congress, parliament and/or senate.

The new NAFTA should provide certainty for North American businesses and revive business spending once ratified. In combination with a US-China agreement, the major trade disputes would be behind us and long-term business investments can be made once again.

Oil Price Summary

The price of oil fell significantly during Q4, finishing the fourth quarter at ~US$45 (WTI) versus ~US$73 (WTI) at the end of the third quarter.

Oil demand expectations have fallen considerably since Q3 as investors priced in slower global economic growth as well as growth related risks due to ongoing trade disputes. On the supply side, the three largest oil producers – the US, Russia and Saudi Arabia – all saw all-time highs for oil production this year and volatile small producers such as Libya and Nigeria experienced relatively high production in 2018 as well. The US sanctions enacted on Iran in Q3 have not had much of an effect on Iranian production as exemptions allow most Iranian oil consumers to avoid the sanctions.

In response to the oil price decline, OPEC+ is debating another oil supply cut. That said, OPEC+ may be unwilling to cut supply when the US is likely now the world leading oil producer and US oil producers may simply increase production and offset an OPEC+ production cut.

The oil price spread between Canadian Western Select (CWS) and WTI has narrowed hitting ~US$10/bbl in early January down from a mindboggling ~US$52/bbl at one point in in Q4. An Alberta government mandated supply cut of ~8% for large producers as well as growing oil-by-rail capacity has created optimism about Canadian oil prices.

Eurozone Sovereign Risk Tamed After a Rocky Q3

Last quarter we highlighted the risk that the current populist Italian government poses to the European financial sector and eurozone as a whole. Defying European Union (EU) budget rules was a key pillar of the reigning Italian administration's policy platform. Following a short-lived crisis in Q3 whereby Italian policymakers attempted to skirt budget deficit limits and effectively demand that the rest of the EU pay for Italian public spending, Italian policymakers conceded. We see Italian policymakers' willingness to bend to EU demands as incredibly surprising and positive for the eurozone as a whole.

Brexit Deadline

The UK is scheduled to leave the EU on March 29, 2019. PM May's administration and EU officials came to terms in late 2018 but May has had difficulty drumming up parliamentary support for the deal. The key point of contention concerns the Irish border. The current plan allows for Northern Ireland to be exempt from new customs and immigration rules, thereby creating an official border in the middle of the Irish Sea. This creates a litany of problems with effective and eventual loss of sovereignty over Northern Ireland being number one. It is unclear how the Brexit drama will play out but economic damage should be limited at this point.

Model Positioning Heading into Q1

The asset allocation of the Balanced Growth model as of December 31, 2018 is 12% cash, 12% fixed income, 13% preferred equity and 63% common equity and the Balanced Income model is currently 8% cash, 24% fixed income, 25% preferred equity and 43% common equity.

Our positive view on the economy means we will be deploying at least some of our cash holdings fairly early in Q1. There are interesting opportunities in the consumer discretionary, industrials, energy, financials and even technology (finally) sectors. We will pounce on these opportunities as we gain confidence in short-term market direction.

Assuming US-China trade risk goes away early in the year, the only near-term risk to equity markets is Britain's exit from the EU. Considering Brexit is an entirely political creation, it will likely not be accepted by any party if it comes with significant economic damage. We expect Brexit to be reversed or be completed with limited economic effects.

In late December, Chinese policymakers announced it will be more aggressive in stimulating the economy including reducing restricting on property investment. Subsequent to quarter end, the People's Bank of China announced the largest cut in bank capital requirements since March 2016 and China Railway Corp announced it will boost 2019 railway investment by 40%. We think these actions, along with further stimulative announcements, will boost Chinese growth and global growth in general. This reinforces our positive view and belief that the temporary market bottom may now be in place.

We doubled the preferred equity allocations in the models in Q4 as the preferred share market experienced unprecedented losses when incorporating interest rates and fixed income credit spreads. We see the outsized preferred share allocation as being temporary and expect the preferred share trade to last 6-18 months. We expect to reinvest the proceeds in low risk fixed income once the trade is complete.

One stock worth highlighting is Embraer SA (ERJ-US). Embraer was by far the best performer during Q4 rising 13% while the TSX composite index and S&P 500 fell 11% and 14% respectively. Embraer's performance was primarily due to the pending joint venture deal with Boeing making market noise fairly unimportant to Embraer stock. The election of Jair Bolsonaro in Brazil boosts the odds of the Embraer-Boeing deal going through and is generally seen as good for Brazilian businesses in general. Despite its significant outperformance of late, Embraer shares still trade at a significant discount to peers and remain one of our favourites.

There is plenty of reason to be optimistic going into 2019.

Sincerely,

Steele Wealth Management

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Appendix

Model	3-mos	6-mos	1-yr	3-yr	Since Inception
Balanced Growth	-8.3%	-7.4%	-7.1%	2.6%	3.1%
Balanced Income	-6.2%	-5.0%	-5.1%	3.5%	3.6%

The above performance data is current as December 31, 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.