First Quarter 2019

China to the Rescue, Maybe, For Awhile

New NAFTA in Limbo, US-China Trade Negotiations Continue,
Europe Slumping and China Injects Nearly Unprecedented Stimulus

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PIMG Balanced Growth Model

The model gained 4.0% during the quarter. Performance figures for other periods are in the appendix.

During the quarter, we bought new positions in Sleep Country Canada (ZZZ) and North West Company (NWC). Please see the reasoning for our purchases below.

Sleep Country Canada (ZZZ)
Sleep Country is Canada's leading mattress retailer with an estimated 35% national market share. Sleep Country has a stranglehold on the high end mattress market competing against only Leon's and regional brands in this segment. Sleep Country, through its Bloom mattress brand and with the recent acquisition of Endy (*and subsequent to our purchase, a partnership with the UK's leading mattress-in-a-box brand Simba*), also has a commanding share of the mattress-in-a-box market that has experienced rapid growth in recent years. Sleep Country trades at ~7x trailing EV/EBITDA versus US mattress peers at ~10x. Sleep Country has historically traded at a premium to US peers. Further, Sleep Country's trailing earnings have been impacted by restrained household formation over the past year as a result of tight mortgage regulations. Sleep Country has very little debt ($77 million net) relative to a market cap of ~$720 million and carries very little inventory making it less cyclical than the average retailer.

Sleep Country shares are down ~50% from their June 2017 highs as constrained household credit and the resulting weak housing market has ratcheted down Sleep Country's same-store-sales growth from over 10% to just 0.4% as of last quarter. That said, Sleep Country still experienced top-line sales growth of over 4% last quarter indicating that it can still find ways to grow in a difficult environment. We believe there is a high likelihood that the federal Liberal party will adjust or reverse some of the housing/mortgage market rules leading up to the October 2019 election to boost housing market activity and Canadian economic growth as a whole. *This was confirmed in late March after we purchased shares in Sleep Country.* This would provide a major boost to Sleep Country's near-term sales growth. In the long-term, we see Sleep Country as an inexpensive way to directly play Canada's rapid population growth, which hit a two-decade high of 1.4% last year.

To sum, we see Sleep Country's high end market share remaining fairly stable and tied largely to Canadian housing market and we see opportunity for Sleep Country to grow rapidly in the low-to-mid range market where it has only sparsely operated before.

North West Company (NWC)
North West is a multinational retailer with operations concentrated in northern and western Canada, Alaska and the Caribbean under the banners Northern, Giant Tiger, AC Value Center and Cost-U-Less. North West trades at ~9x trailing EV/EBITDA, a ~10% discount to larger Canadian grocery peers. We believe North West deserves to trade at a premium to its peers given the lack of competition in the remote areas North West serves and in turn the pricing power North West maintains. Further, recovering commodity prices should boost capital investment in and around many of the communities that North West serves, improving store traffic and profitability over time, driving us to anticipate higher than average growth for the foreseeable future. Finally, we see optionality in North West shares due to the fact that the majority of smaller grocery and pharmacy chains have been acquired over the years (e.g. Shoppers Drug Mart, Safeway Canada, Uniprix, Jean Coutu, Farm Boy).

During the quarter, we sold our positions in Recipe Unlimited (RECP), CIBC (CM), Enbridge Preferred E (ENB.PF.E) and half of our position in Open Text Corp (OTEX). Please see the reasoning for the sales below.

Recipe Unlimited (RECP)

We sold our position in Recipe as the economic outlooks for Canada and abroad have worsened and Recipe shares will come under pressure in an economic downturn. Recipe shares held up fairly well during the recent market decline and we see upside as limited now that the Canadian GDP is expected to grow less than 2% per year for the foreseeable future. Since purchasing the shares, to our disappointment, Recipe management has not capitalized on its broad portfolio of leading brands by developing a strong loyalty program or retail product offering. We do not think Recipe will be able to extract sufficient value from its brand portfolio before the next economic downturn to justify holding the shares at this point.

CIBC (CM)

We sold our position in CIBC following the inversion of the US yield curve. Global financials tend to peak in line with the inversion of the US yield curve and we thought it would be prudent to bring our financials exposure below market weight. Falling long-term interest rates are negative for banks as their entire business involves accepting short-term deposits and offering long-term loans. If the cost of short-term capital exceeds that of long-term capital, banks begin to avoid lending long-term, or become more scrutinizing of loan customers, and this has a material impact on bank profitability.

From a more tactical point of view, when rates fall to the point of yield curve inversion, the recession clock starts (or it has for the last nine recessions since the 1950s) and it is highly unlikely that long-term interest rates will rally enough to improve financial company profitability before a recession hits.

Enbridge Preferred E (ENB.PF.E)

We sold our position in Enbridge Preferred E following the inversion of the US yield curve. Declining interest rates will have a negative impact on the trading price of Enbridge Preferred E and a recession will further push down the trading price of credit sensitive securities like Enbridge Preferred E. As a result of the US Federal Reserve pausing interest rate hikes, we see limited upside for these shares in the short-to-medium term.

Open Text Corp (OTEX)

We sold half of our position in Open Text as it was trading at the high end of its valuation range and the shares held up incredibly well throughout the recent market downturn. Open Text continues to trade at a discount to peers but our conviction that this discount will disappear is waning. We may look to sell the remaining half of the position as we approach Open Text's seasonally weak period in the late summer, early fall, depending on its share price.

PIMG Balanced Income Model

The model gained 3.2% 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 Sleep Country Canada (ZZZ) and North West Company (NWC) and sold our positions in Recipe Unlimited (RECP), CIBC (CM), Enbridge Preferred E (ENB.PF.E) and half of our position in Open Text Corp (OTEX).

Quarterly Summary and How We're Positioning for Q2

After a weak 2018, 2019 started with a bang! Global stocks rallied more than 12% and global bonds rallied more than 3% in Q1, rewarding anyone invested in almost anything. This widespread rally was largely the exact opposite of what happened in Q4 2018 when 90%+ of global assets experienced negative returns. While the rally certainly helps 'soothe what ails ya' from a rough 2018, it is worth picking through the market action, and what it means, with a fine toothed comb.

The weak equity market throughout 2018 and the rapid decline in Q4 2018 was a signal that global economic growth was sputtering. In Q1 we saw data points that confirmed the eurozone manufacturing sector is in recession and economies around the world are growing at a much slower rate than in early 2018. Disruptions to global trade, largely driven by the Trump administration's trade war campaign, have suppressed global manufacturing activity. The JP Morgan Global Manufacturing PMI has slowed to just 50.6 (50 demarcates expansion from contraction), meaning the global manufacturing sector is barely growing. This is the lowest level since mid-2016 when incredibly low oil prices froze hiring and investment in energy economies around the world.

A hallmark recession indicator – an inversion of the US yield curve – was triggered in late March. An inversion of the US yield curve occurs when long-dated US Treasury bond yields fall below short-dated US Treasury bill/bond yields. The 10-year US Treasury bond yield fell as much as 0.12% below the 3-month US Treasury bill yield. US yield curve inversion has preceded nine of the last nine US recessions by six to twenty four months. While the US yield curve inversion certainly puts us on 'recession watch', it does not mean a recession is necessarily imminent. In fact, the equity market has historically performed well in the twelve months after yield curve inversions. That said, the financial sector tends to perform poorly after yield curve inversions as falling long-term bond yields impact financial sector profitability. We have therefore reduced financial sector exposure in the expectation of middling or poor performance over the next one to two years.

Our favoured indicator, the US Senior Loan Officer Opinion Survey on Bank Lending Practices, indicated a significant change in the lending environment leading into Q1 going from an environment of rising loan demand, rising loan access and declining cost of capital to falling loan demand, stable loan access and rising cost of capital. While this indicator does not yet indicate economic contraction, it does highlight the fact that the US banks are starting to scrutinize loan applications a bit more. We have found that a uniform deterioration in the US Senior Loan Officer Opinion Survey on Bank Lending Practices is by far the best signal for estimating the start of a recession and a short-term equity market peak. We will continue to monitor this indicator very closely and it will be the key force driving future sector allocation and asset allocation decisions going forward. The survey is released quarterly in the fourth week of January, April, July and October.

The key wildcard with respect to when a recession will arrive is China. While China has indicated that it does not want to overheat its economy by unleashing massive stimulus, it has unleashed a considerable amount of stimulus so far in 2019. After China saw falling manufacturing activity in January and February, this stimulus appears to have kicked in in March. This stimulus-fueled jolt to the Chinese manufacturing sector could spill over to economies around the world and prolong the current economic cycle. China's stimulus is likely a major reason why stock markets around the world rallied so vigorously.

US-China Trade War

The deadline for US-China trade negotiations was March 31. President Trump pushed this self-imposed deadline out indefinitely as it became clear that the Chinese were playing hard ball and a hard deadline would only deter any future progress.

It is rumoured that China has made some concessions including enhanced intellectual property protection, a vow to crack down on fentanyl production and distribution and pledge to buy more US products to better balance the trade flows. That said, concessions to date have been underwhelming and are so far well below the aspirations of US trade negotiators.

New NAFTA

New NAFTA, dubbed the Canada-US-Mexico Agreement or CUSMA, remains unratified by the Canadian, American and Mexican governments. Canada and Mexico appear to be drawing a line in the sand on US metals tariffs by making removal of these tariffs a pre-requisite to ratifying CUSMA.

The trade limbo that exists in North America, months after leaders in the US, Canada and Mexico signed CUSMA, certainly does not bode well for the potential upside scenario for US-China trade negotiations.

Oil Price Summary

The price of oil recovered alongside other assets in Q1, finishing the fourth quarter at ~US$60 (WTI) versus ~US$45 (WTI) at the end of 2018.

The rise in oil prices seems to be driven largely by rising investor demand for risk assets like oil rather than a fundamental change in the oil market. Physical oil demand expectations are weaker now than any time in the past three years due to the poor outlook for global manufacturing activity.

Eurozone Sovereign Risk

Eurozone sovereign risk appears under control as per country-by-country bond yields. That said, the eurozone economy appears to be on the precipice of a recession which could stir up new fiscal problems that soon become political problems. The entire Italian banking sector and the large German banks (Deutsche Bank and Commerzbank) remain canaries in the coal mine for the eurozone.

Brexit Deadline

The Brexit process has been an utter mess. The Brexit deadline was March 29, 2019 but this was extended due to UK Parliament's inability to agree on anything. PM May vowed to step down after securing a soft-Brexit in an effort to secure more votes but missed by a wide margin. It is difficult to tell how the Brexit process reach its end without a new referendum vote or snap elections. An unfavourable Brexit scenario could push the eurozone categorically into recession and remains a key risk to the economic cycle.

Model Positioning Heading into Q2

We have pulled back our risk profile of the models mostly in response to the US yield curve inversion. We focused on reducing positions that perform poorly in a low interest rate environment like financials and fixed reset preferred shares. We continue to maintain exposure to these areas but will opportunistically reduce this exposure as we see fit.

The asset allocation of the Balanced Growth model as of December 31, 2018 is 17% cash, 12% fixed income, 9% preferred equity and 62% common equity and the Balanced Income model is currently 16% cash, 24% fixed income, 18% preferred equity and 42% common equity.

Our equity market outlook has become less bullish over the past quarter, particularly due to the significant economic downturn in Europe, which we view as the epicenter of risk globally at the moment, and China's cautious approach to fiscal stimulus which is unlikely to spark rampant economic growth in Europe or elsewhere. While Chinese stimulus has been greater than most investors expected, we have to take Chinese policymakers at their word. Even if the market cycle is nearing its end, we think there is still opportunity to make money in defensive sectors – telecom, utilities and consumer staples – as well as some of the beaten down cyclical sectors – industrials, consumer discretionary and energy.

While our key concern is Europe, we will continue to look to the US Senior Loan Officer Opinion Survey on Bank Lending Practices to detect spillover from an ailing Europe. We expect any future downturn to be especially hard on Europe and Japan due to limited stimulus options and potentially Canada, Australia and China due to high debt levels and inflated real estate markets. We expect the next US downturn to be fairly tame given the amount of restructuring the US financial sector enduring following the 2008 financial crisis. The aforementioned economies did not experience the same reckoning and restructuring and remain vulnerable to financial stress.

If we get confirmation of further economic weakness on the horizon, we may look at rotating out of some of our more cyclical exposure and adding to high quality and low volatility ETFs to attain broad based defensive positioning.

Sincerely,

Steele Wealth Management

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Appendix

Model	3-mos	6-mos	1-yr	3-yr	Since Inception
Balanced Growth	4.0%	-4.6%	-1.2%	4.5%	3.8%
Balanced Income	3.2%	-3.1%	-0.0%	3.9%	4.2%

The above performance data is current as March 31, 2019. The returns above incorporate a 1.0% (Balanced Growth) and 1.25% (Balanced Income) annual investment management fee, charged monthly, which is also subject to 13% HST, charged monthly, for a total cost of 1.13% and 1.41% annually, respectively. 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.