PORTFOLIO MANAGER COMMENTARY - SEPTEMBER 30, 2018

US markets were as buoyant as ever during the quarter. Economic growth and strong earnings overshadowed concerns of an escalating trade war. Canada meanwhile spent another quarter in limbo muddling through an unresolved trade agreement, widening oil price spreads and fears of slowing global growth. It was another difficult quarter for value managers as growth stocks continued to outperform. This and the fund's overweight exposure to an out-of-favour Canada detracted from returns. Escalating trade wars weighed on the fund's materials, auto parts and consumer discretionary holdings. Whirlpool Corp. struggled with higher raw material costs. Steel and metal tariffs are driving costs up and hurting demand. The stock is very attractively valued and we believe valuations are not sustainable. It could be a leveraged buy-out candidate at these levels. Martinrea International Inc. and Stelco Holdings Inc. both suffered on NAFTA uncertainties and Trump's steel and aluminum tariffs. Looking ahead we expect both stocks to benefit from an improving trade environment with the resolution of the USMCA trade deal and ongoing negotiations to settle the metals tariff dispute.

There were some bright spots during a difficult quarter. MBIA Inc., Labrador Iron Ore Royalty Corp. (LIF) and Baylin Technologies Inc. (BYL) each had a strong third quarter and were the fund's top individual contributors to returns. MBIA is benefitting as Puerto Rican bondholders make progress in restructuring the commonwealth's debt. We expect a strong recovery in the price of bonds backed by MBIA. The Puerto Rico bond index rose 6% during the quarter and 26% year-to-date. MBIA returned 17% for the fund during the quarter. LIF's stock price advanced on improving prices for high quality iron ore. China's clamp down on pollution is fuelling demand for higher grade iron ore like that produced by Iron Ore Company of Canada (IOC); LIF owns 15% of IOC and receives a 7% gross overriding royalty. Rumors that Rio Tinto, IOC's majority shareholder, may sell or take its 59% share public are also having an impact on valuation. LIF returned 19% for the fund during the quarter. BYL stock rose 30% during the quarter as a few investment dealers initiated research coverage of the company and the market reacts positively to recent strategic acquisitions. We continue to hold as the company is well positioned for the upcoming shift to 5G wireless technology.

With the new USMCA trade deal, we expect the tide to turn for Canada's equity market. How well Canada fared in the agreement is the subject of considerable debate. Regardless, having a deal is better than not. We expect global sentiment and domestic confidence to improve, and the Canadian dollar to strengthen. The agreement removes a lot of uncertainty for foreign investors and business leaders and should help to narrow the valuation gap between US and Canadian equities. Canadian equity fundamentals are the strongest they've been in years. Earnings are beating expectations and estimates are being revised higher regularly. Profitability is near peak levels and the economy is doing well. Yet, Canadian equity multiples are well below historical norms and are extremely low for this stage of the cycle. The spread with US valuations is at levels not seen since 2001. The trade overhang isn't solely to blame but it's been a prominent player.

Slowing global growth could be concerning for Canada's resource sector. The US however, is a key market for Canada and it doesn't appear to be losing steam. In fact, many indicators suggest the economy is gaining momentum. Consumer confidence is high, employment is rising, wages are higher, unemployment claims are at their lowest in almost 50 years, and while inflation is rising, it is still relatively low. We are sticking to our strategy to invest based on fundamentals and valuation. We are confident with our overweight exposure to Canada heading into the fourth quarter – traditionally the strongest quarter for Canadian equities. We like the fund's exposure to resources at this stage of the economic cycle. We believe there is considerable upside in a number of the portfolio's names based on our estimates of fair value, particularly in an improving trade environment.

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