MARCH 4, 2019 MONTHLY

Global Investment Letter

Notable in this Issue…..

Table of Contents:

MARCH SHOULD BE INTERESTING

Several converging issues should make the headlines this month, with Brexit being top of mind for your editor. The deadline of March 29th is fast approaching, with markets reflecting a belief that an extension to negotiations will be sought, with the possibility of a second referendum being held. This outcome was discussed in past issues and still seems the most likely. However, one shouldn't discount incompetence on the part of the May government and a "hard" Brexit with no deal remains a possibility. We reiterate our view that it remains premature to take meaningful positions in either the FTSE or the pound until after a resolution to the deadline. The government response to the deadline may provide a trading opportunity in the pound and British equities, which we elaborate on in the Equities and Currencies sections of this Letter.

The outcome of the second Trump/Kim Jong Un meeting - absolutely nothing was agreed upon or accomplished - should not surprise readers of the Global Investment Letter. We remain of the view that the Trump administration will eventually realize that North Korea has no intention of disarming and has been practicing the stalling tactics that have served it so well with previous U.S. administrations. That realization may have geopolitical consequences given the notably hawkish Trump cabinet. The prospect of military action involving North Korea in the next 18 months is higher than many people realize and carries with it a raft of potential geopolitical consequences.

The China/United States trade talks continue, after having been extended by President Trump. Optimism is building that a mutually satisfying agreement is within reach. That seems to be the case particularly in China, where the Shanghai and Hang Seng stock markets have recently changed trend to a bullish mode. Concerted government stimulus measures (discussed in a later of this issue) are also supporting the rebound. While the consensus is that a deal will be reached, it is important to remember that the trade agreement is part of a larger struggle between the two nations that has many moving parts and thus there remains significant risk that talks will be compromised by a non-trade consideration. Keep in mind that a new trade deal with China on better terms for the United States would be a significant win for President Trump.

The Fed's pausing of interest rate increases appears more and more like it will become permanent as economic benchmarks around the globe continue to weaken. Perhaps the most eloquent chart is that of the global Purchasing Managers Indices, which is included in the equity discussion. Global growth is slowing quickly, and with it, the risk of recession is rising. We have long maintained in these pages that the primary motivation of the Fed rate increases was an effort to restore rates to normal levels to provide a tool to combat the next recession through rate cuts. If the Fed rate increases are at an end, they will have failed to raise interest rates to a level where they represent an effective tool. Our view that the next recession will be particularly sharp is reinforced by the limited toolkit that central banks will have at their disposal.

On a more positive note, we remain bullish of U.S. dollar-denominated assets, which we elaborate on in the following pages.

I suspect there will be no shortage of topics to discuss for the April issue.

EQUITIES COMMENT

S&P 500

The sharp rally in the S&P 500 continued in February, carrying the index over the important 40-week moving average. The ongoing rally owes much to the chart we discussed in last month's issue of the Global Investment Letter that illustrated the extreme pessimism of investors at the end of 2018. That chart was one of the most dramatic we had seen for some time. As we mentioned at the time, such extremes of negative sentiment almost always present relatively low-risk buying opportunities and produce strong rallies that continue until investor confidence returns to more normal levels.

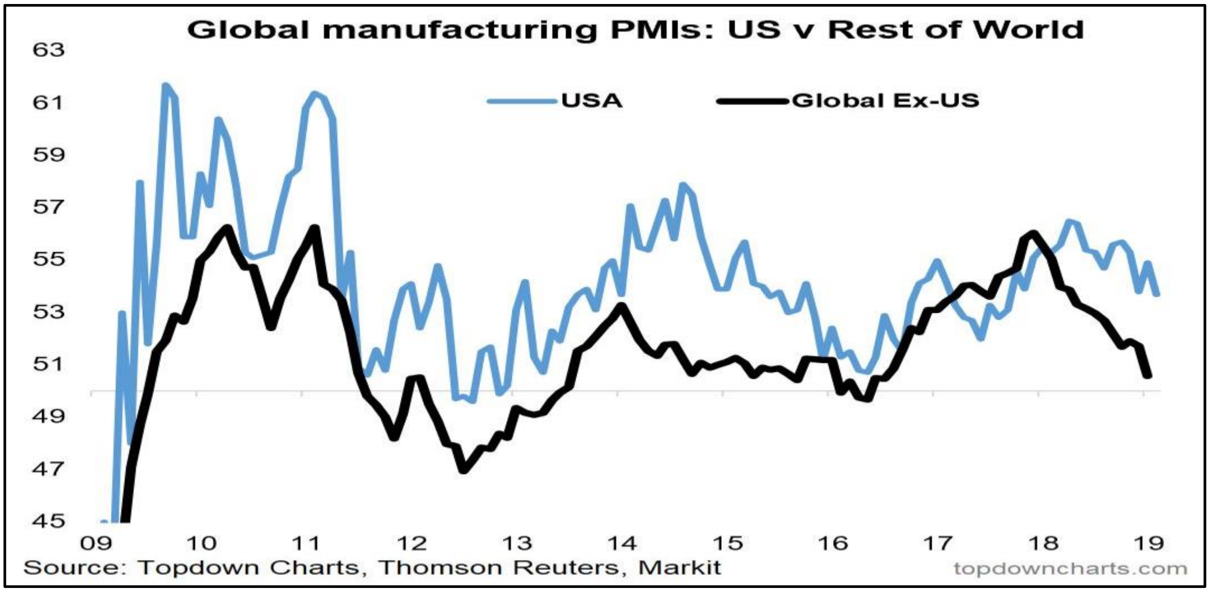
It is, therefore, reasonable to expect the rally to continue, aided by the positive seasonality of March and April and an, at least temporary, pausing of Fed interest rate increases.

However, in the short-term, it would not be unusual to see a pullback in the S&P within the context of expected continued strength given the very steep rise of the past two months. A pullback would not be bearish in itself unless the S&P trades below the 2600 level, which would be very bearish and suggest another change of trend.

U.S. stocks continue to be our preferred exposure to equities given our continued positive view on the prospects for the U.S. dollar and the relative strength of the American economy. In addition, U.S. dollar-denominated assets benefit from foreign capital flows due to their reputation as a safe haven.

In summary, we continue to believe U.S. equities may surprise to the upside this year. It is, however, important to remember that we are in the late stages of the global economic expansion and thus investors must be attentive to any signs of a change in trend.

The following chart suggests how late in the cycle it is getting for the global economy.



The outperformance of the U.S. economy versus the rest of the world is evident in the Purchasing Managers Indices (PMIs) illustrated above. The economic leadership of the United States since the 2008 financial crisis is a reflection of the depth and resilience of the American economy and the stimulative measures employed by the Fed.

It is important to note that the trend of the PMI line for “rest of world” tends to be a leading indicator for the PMI in the United States. Though both lines remain above the 50 level (which indicates growth), the global ex-US line is getting very close to 50 and the steepness of its decline suggests it may move below 50 in 2019 and signal a recession. The U.S economy might well be pulled into recession as a consequence.

To reiterate, the global economy is in late innings, which the recent strength in U.S. bonds may be signaling. The S&P and Nasdaq still retain the potential for surprising upside in these later stages, but investors must remain attentive rather than slipping into complacency.

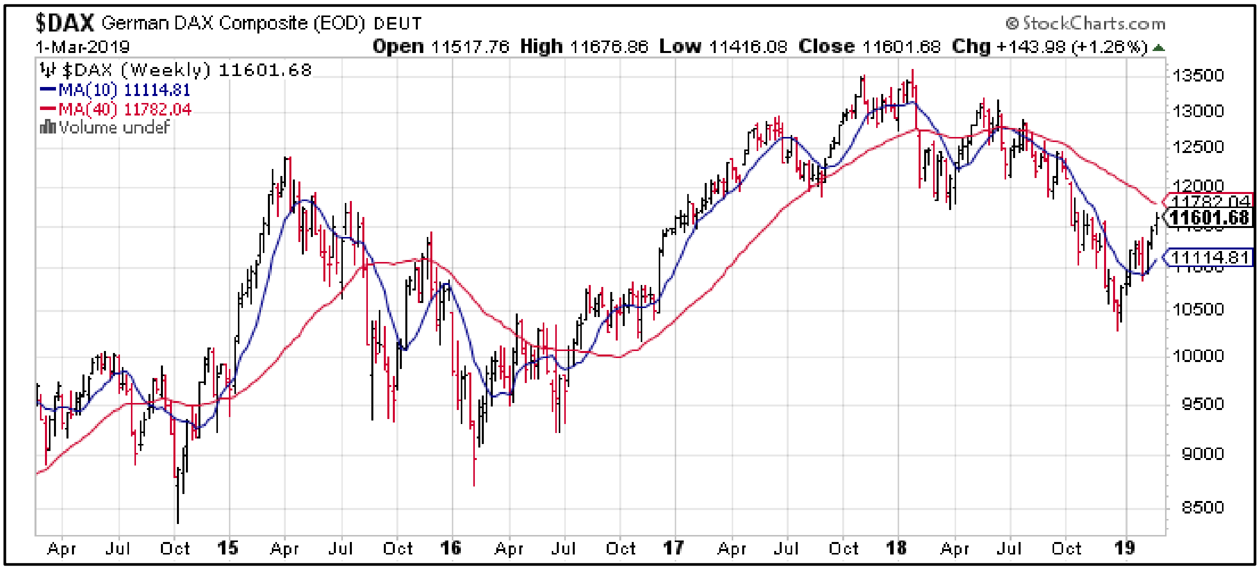
FTSE 100 (DAILY)

The London FTSE 100 index, which had been posting a strong rally since Christmas, failed to follow through in late February. The FTSE has yet to trade higher than its 200-day moving average, which indicates that this market is still in bearish mode from a technical perspective. Indeed, the 200-day average may act as resistance, as it appears to have done last month.

Of course, the major influence on this market remains Brexit. It appears more likely that an extension of negotiations and/or the announcement of a second referendum on the topic will occur before the March 29 deadline. While it may be likely, it is by no means a certainty, and thus a "hard" Brexit (with no deal) is still a possibility.

As we have commented, this market holds the opportunity to produce tradable market moves based on an extreme reaction to either an extension or a "crash" no-deal Brexit. A "hard" Brexit with no deal or the announcement of an extension of negotiations or a second referendum could produce emotional declines or rallies that can be traded against. In the meantime, there is little to recommend this market until some clarity is provided re Brexit.

DAX INDEX (WEEKLY)



The DAX has enjoyed a strong rally in concert with other major equity indices, though it has yet to recapture the 40-week moving average and thus remains technically in a bearish mode. It is also quite some distance from its 2018 high, which illustrates just how weak a 2018 this market had.

The sharpness of the recent rally leaves this market susceptible to a pullback. However, more troubling for the DAX are the growing indications of softness in the economy of the European Union (EU). Economic measures such as the Purchasing Managers Index for the EU has weakened sharply over the past year, as can be seen on the graph on Page X and is close to signaling a recession.

We maintain our bearish view of this market. Economic weakness in Europe and a rising likelihood of a global recession will impact this export-dependent nation more than most.

CAC 40 (WEEKLY)

The CAC 40 has posted a most impressive rally since Christmas, recapturing the long-term 40-week moving average, a bullish achievement. A pullback can be expected given the steepness of the recent rally.

The CAC cannot be considered to be in a bullish mode until it trades above its 2018 high, which will be a notable achievement given the economic headwinds confronting Europe currently.

The continued relative weakness of the euro versus the U.S. dollar makes this, and other European markets, less attractive for unhedged investors than U.S. stocks.

NIKKEI INDEX (WEEKLY)

Despite recent strength, the Nikkei has failed to trade above its long-term 40-week moving average and remains an unexciting vehicle for investors. While expectations of further yen weakness may aid the Nikkei, currency weakness will offset at least some of the prospective stock market gains for non-yen based investors.

We continue to find this market less than compelling.

SHANGHAI COMPOSITE (WEEKLY)

The Shanghai market leapt in February, triggering a buy signal. After confirming a market bottom at year end, the strength of the move above the 40-week moving average was sufficient to establish a new bullish mode for this market. Attractive valuation metrics also provided a fundamental rationale for higher prices.

The rally was primarily fueled by two factors. First, expectations for a trade agreement between China and the United States have risen substantially in the past month. It has been reported that China is prepared to ease tariffs and other restrictions on American agricultural, chemical and auto products in exchange for the removal of most U.S. tariffs imposed on Chinese imports. A trade deal on these terms would be positive for both nations and would constitute a major political triumph for the Trump administration.

A second and perhaps ultimately more important factor driving Chinese equities has been the announcement of plans for considerable economic stimulus by the Chinese government. Substantial tax cuts and plans for infrastructure spending have been announced and the government has suggested that further plans to spur Chinese domestic demand will be forthcoming.

Though Chinese economic growth is still strong by the standards of developed countries, it has been falling as the law of diminishing returns asserts itself. China will be hard-pressed to maintain its rate of growth by virtue of the enormous size of its economy.

A pullback after the sharp rise would not be surprising and would provide an attractive buying point. Ideally, a pullback would not trade below the 40-week average. This market is still susceptible to geopolitical shocks. In particular, the failure of China to reach a trade deal with America would have negative consequences for this market.

Those seeking exposure to this market would do best to establish positions in increments, with the bulk of the position being established after results of the trade negotiations are announced.

HANG SENG (WEEKLY)

The Hang Seng also appears bullish for much the same reason as its cousin, the Shanghai. The move above the 40-week average after establishing a double bottom is very bullish.

The same caveats apply here as with the Shanghai market as the factors that drive the Shanghai market will ultimately dominate the Hang Seng.

SENSEX (WEEKLY)

Our view on the SENSEX is unchanged. We remain concerned about the compression of market volatility and the muted nature of its rally compared to other markets. As we have commented before, as volatility tends to be mean reverting, the current low volatility environment is likely to be followed by a period of above-average volatility, which is usually associated with falling markets.

We commented fairly extensively on the SENSEX index in last month's issue. The upcoming Indian general election in April and May is expected to have a major influence on the SENSEX in the year ahead. The opposition Congress party has made strides again Prime Minister Narendra Modi's BJP party. The Modi government has retaliated with various inducements, including a tax cut for the middle class and incentives for farmers, and has engaged in a campaign to get the Reserve Bank of India to cut rates.

While there is evidence of softness in the Indian economy, we continue to believe that India is, and will likely remain, the fastest growing economy over the next five years. We initiated a recommendation on this market in May of 2017 and then suggested caution in the October 2018 issue. Though we remain bullish for the long-term, we feel a more attractive buying opportunity will present itself later.

EMERGING MARKETS ETF (EEM) (WEEKLY)

Emerging markets, as represented by the ETF proxy above, continued to post generally positive results in February. The sector continued to trade above its 40-week moving average, which is technically bullish, during the month.

The EEM chart represents one of a handful of attractive equity markets in the world currently. A position in EEM merits consideration for those seeking equity exposure.

FIXED INCOME COMMENT

10-YEAR US TREASURY NOTE(WEEKLY)

We continue to believe that U.S. treasuries hold appeal in this environment. Economic measures, such as the Purchasing Managers Index (PMI), are in decline around the world, suggesting that the probability of a recession is rising. We have commented that the next major buying opportunity in bonds will occur coincident with a recession. The price action in the chart above may be signaling such an event, although most economies are not yet technically in recession.

In addition, U.S. Treasuries will gain support from capital flows into U.S. dollar-denominated investment vehicles.

Of course, Fed policy will play a role. The current pause in rate increases by the Fed is clearly constructive for bonds. The economic softening evident in the United States and elsewhere increases the chances that interest rate increases are at an end and will likely decline in the event of a recession. Unfortunately, interest rates are not yet at a level such that the Fed or other central banks have much leverage in combatting a recession through rate decreases. As we have stated numerous times throughout this Letter, the next recession will likely be more severe as a result.

CURRENCY COMMENT

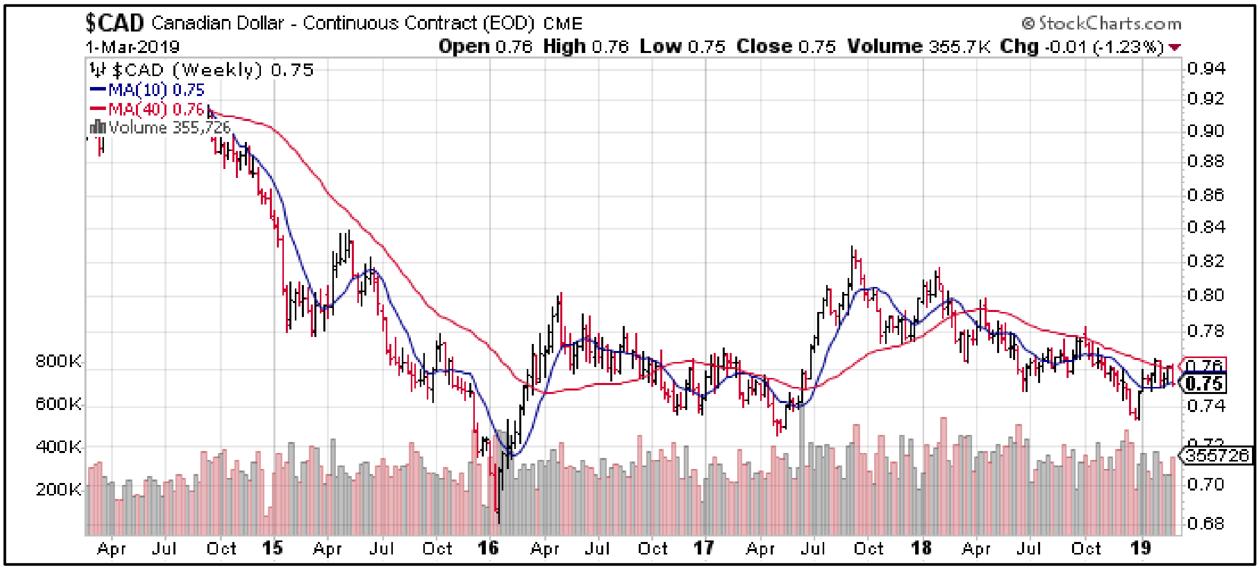
US DOLLAR INDEX (DXY) (WEEKLY)

The U.S. dollar index traded in a narrow band in February while continuing to trade above its 40-week moving average.

The decision by the Fed to at least temporarily pause its interest rate increases has played a role in limiting the dollar's upside. However, the United States continues to demonstrate greater economic strength than other developed markets and retains higher interest rates, which should continue to support the U.S. dollar. Moreover, there remains no logical alternative to the U.S. dollar, another factor that should assure its continued strength.

As we have suggested for some time now, the longer-term prospects for the US dollar remain positive.

CAD/USD(WEEKLY)



The Canadian dollar has rallied versus its American counterpart since Christmas largely due to the rally in the price of oil. The recent announcement by the Fed that it is, at least temporarily, pausing its rate increases likely also played a role in a stronger Canadian dollar given the easing of pressure on interest rate differentials.

The Canadian dollar ended February very near its long-term moving average. While a move up through the long-term average would be bullish, the 40-week average seems more likely to act as a barrier to a stronger dollar. The long term expectations for the Canadian dollar continue to be bearish based on our long-term expectation of lower oil prices. As well, a lower dollar continues to be in Canada’s interest in trade with the United States. The Bank of Canada will likely keep Canadian interest rates below American rates and may use the pause by the Fed and soft Q4 GDP numbers to cut Canadian rates.

In sum, we believe the odds favour a weaker Canadian dollar over the long=term. The caveat being a sustained spike in oil prices.

EUR/USD (WEEKLY)

The euro has traded in an increasingly narrow range against the U.S. dollar in the past few months, which raises the probability that we will eventually see a large move given the fact that volatility tends to be mean reverting.

It is difficult to anticipate notable strength in the euro versus the dollar given the higher interest rates available with dollars and the more buoyant economy enjoyed by the United States. The United States continues to benefit from positive capital flows.

Renewed euro weakness is the more likely outcome. A move below the long-term 40-week moving average would be decidedly bearish. Only a move above the 40-week moving average would cause us to reconsider our bearish view.

POUND/USD (WEEKLY)

Like so many markets currently, the level of the pound is being influenced more by geopolitics than by economic matters.

The pound has strengthened in 2019 as expectations grow that the end of March deadline for Brexit will be extended and/or a second referendum will be called. It is looking more likely that a "hard" Brexit with no deal will be averted but is still not impossible.

How would the more likely scenarios play out? The announcement of an extension of Brexit talks would bolster the pound, but an announcement of a second referendum would likely produce a spike in the pound given current expectations that a second ballot would vote against Brexit.

A strong rally in the pound may present an opportunity to short market euphoria. The long-term prospects of the pound versus other major currencies remain bearish based on economic fundamentals. There is still no compelling reason to enter unhedged positions in the pound until more clarity is present with Brexit. There may be either a purchase or sale opportunity in the pound very soon as we near the historic deadline should an emotionally charged reaction produce a price extreme on which a contrary position can be taken.

YEN/USD (WEEKLY)

The yen continued to weaken versus the American dollar in February. As discussed in previous issues of the Global Investment Letter, we believe yen weakness will continue based on interest rate differentials, economic performance and the threat of the Trump administration turning its attention to matters of trade with Japan. The chances of the Trump administration seeking to review the trade situation with Japan will rise with the conclusion of trade talks with China.

YUAN/USD (DAILY)

The yuan held its recent strength versus the U.S. dollar in February as optimism rose that a comprehensive trade deal with the United States was probable. Positive sentiment was further bolstered late in the month when the Americans extended the March 1st deadline.

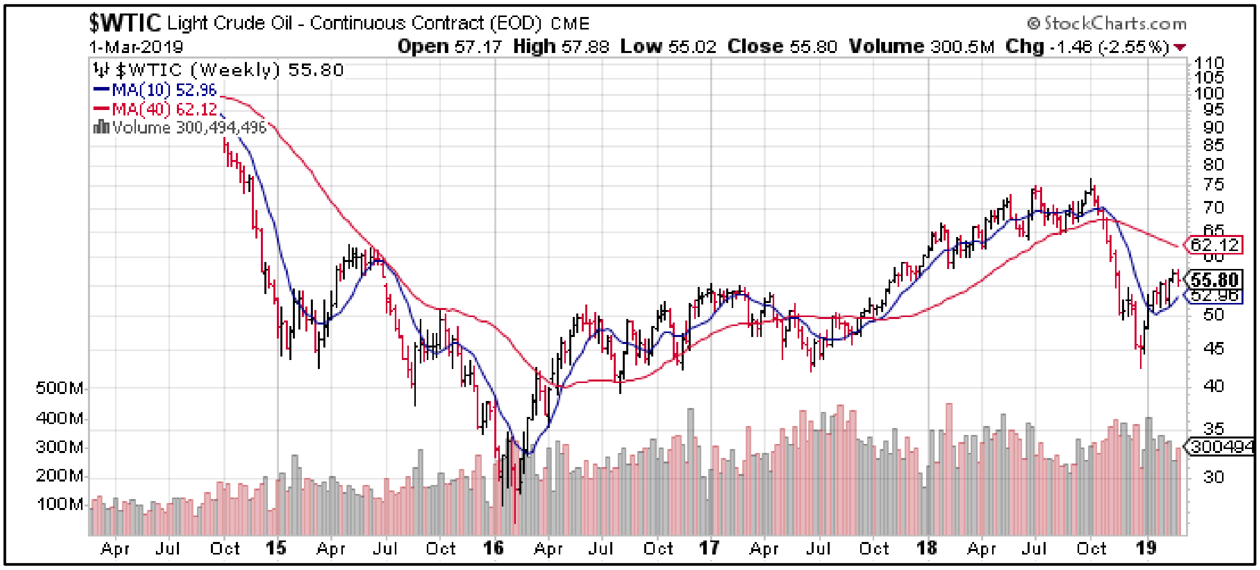
The shorter-term fate of the yuan rests with the prospect of a trade deal. A favourable trade deal would suggest continued yuan strength, while a failed negotiation would likely send the yuan for a retest of the 7 level.

The yuan exchange rate is less a function of trade and more a political tool. Only about 15% of the Chinese economy is export-dependent, far lower than most people assume. The German economy is much more reliant on exports than China because of Germany's much smaller domestic market.

The level of the yuan is an extension of the sentiment of the Communist Party of China and, therefore, will be influenced by Chinese perceptions of the results of the trade negotiations. As we have stated previously, these talks are about more than just trade, but part of a larger play for global influence.

OIL COMMENT

CRUDE OIL (WTI)(WEEKLY)



Oil continued the price rebound that commenced in late 2018 in February. The price of oil was supported by continued discipline by OPEC and Russia in maintaining production cuts, a continued decline in inventory levels and optimism that a trade agreement between the United States and China will avert the escalation of the trade war. The effect of sanctions on Iranian and Venezuelan production has also served to support oil prices. As usual, geopolitical developments have played an important role in producing a rally in oil prices.

It is important to note that the price of WTI remains significantly below its long-term 40-week moving average following the sharp decline in prices last year. There remain important caveats to an expectation that prices will move through the long-term trend line and signal a bull market.

Though Donald Trump has extended the negotiating deadline in trade talks with China, the current air of optimism will not be justified until the terms of a deal are announced. There remains substantial potential for disappointment. China may prove to be a more difficult negotiator than the Trump administration anticipates. The trade deal is part of a larger struggle that the two countries are engaged in for global influence. Matters such as national prestige will play a role in negotiations. As well, the Chinese economy is now much less dependent on exports than it has been. Oil prices will come under pressure should a deal not be reached and additional American tariffs be imposed. Alternately, oil prices can be expected to reflexively move higher on the announcement of an agreement as traders feel relieved that a major threat to a global economic downturn is averted. In that event, the upside of the move will likely be constrained by the 40-week moving average, which will act as significant resistance from a technical standpoint.

The supply of oil appears more likely to increase through the year, which will weigh on prices. Additional production cuts from OPEC plus Russia is not likely, and existing cutbacks may eventually be relaxed. Production from Venezuela will eventually rebound. Lastly, but by no means least, added pipeline capacity from the Permian Basin in the second half of the year will relieve the current bottleneck in shale oil production. Current shale oil production is greater than 12 million barrels per day and is likely to grow further. While it is true that decline rates from shale wells are much steeper than for their traditional counterpart, current oil prices are driving a level of drilling activity that is more than replacing lost shale production volume.

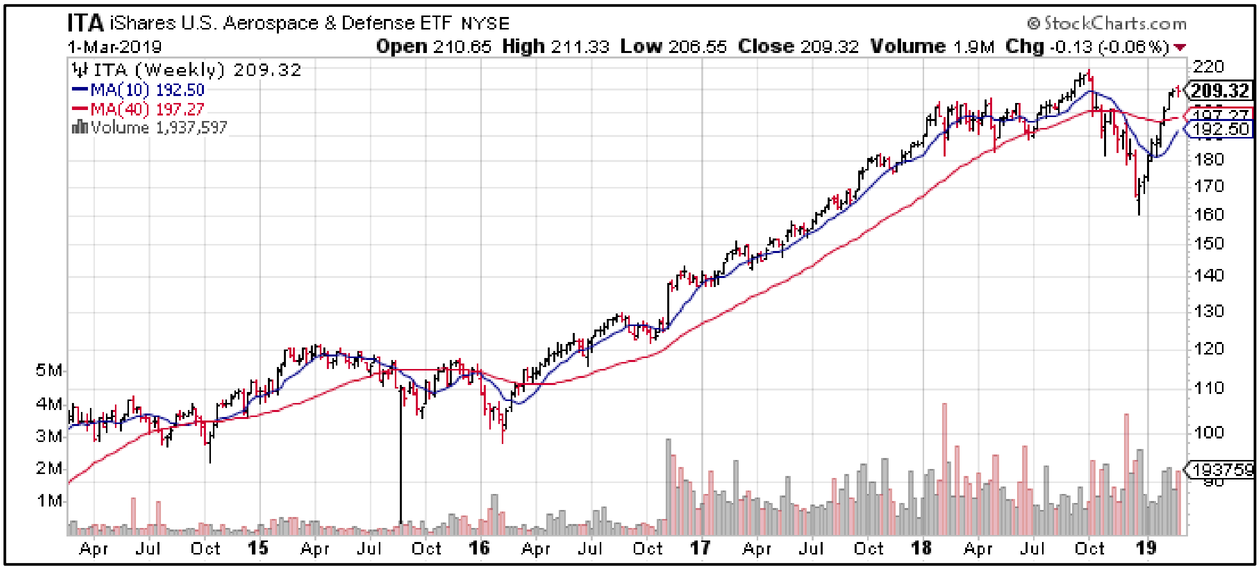
The future of oil demand remains a concern. Falling PMI measures around the world are signaling a slowing of economic growth. Moreover, we are at a late stage in the current economic expansion and the prospect of a global recession is rising.

The canary in the coal mine for the potential decline in oil demand may be Europe. The economic slowdown of the European Union resulted in a dramatic 755,000 barrel per day decline in oil demand in December 2018. The decline in demand would be considerably larger in the event of a confirmed recession. Oil demand is expected to remain under pressure through the year.

In conclusion, we remain bearish on the price prospects for oil with the usual caveat that geopolitical events can produce price spikes.

DEFENCE SECTOR COMMENT

US AEROSPACE & DEFENCE ETF (ITA)(WEEKLY)



The U.S. Aerospace and Defence ETF, which we use as a proxy for the defence sector, continued its strong rebound from late 2018 lows. The strength of the rebound has been impressive. For example, ITA rose 12.3% in January which constituted its best monthly performance since April 2009.

Our investment premise of concentrating exposure in the defence sector to companies producing the most technology-intensive products continues to be vindicated. Companies on our list of preferred investment vehicles in the sector continue to be awarded the largest contracts.

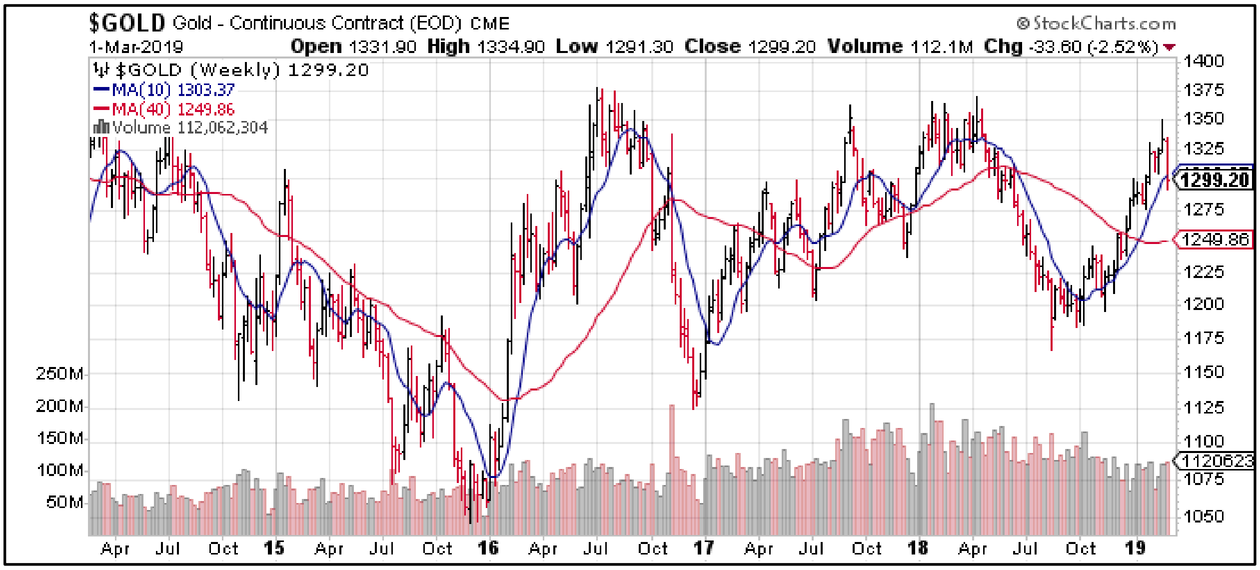
For example, Lockheed Martin won both of the recent contracts tendered concerning hypersonic missiles by the U.S. military. We have written about the importance of developing hypersonic missile technology in the West given the belief that China and Russia are early leaders in the field. Lockheed continues to deliver F-35 fighters which have the distinction, among others, of being the single most expensive weapons system in the U.S. military.

Boeing, although it is best known for its commercial aircraft, is the second largest defence company. Boeing reported very strong fourth-quarter earnings, with the defence segment contributing $6.1 billion in revenue in the quarter, which represented more than 20% of total revenue. Boeing reported strong results overall and has been building its defence-related order backlog, winning over $13 billion in new contracts last September alone.

We continue to believe that the convergence of geopolitics and technological change will drive defence spending for some time in the future. Along with LMT and BA, we continue to suggest that BAE Systems, General Dynamics, L3 Systems, Thales, Rolls-Royce, Northrup Grumman, Raytheon and ITA deserve consideration in diversified exposure to this sector.

GOLD COMMENTARY

GOLD (WEEKLY)



The price of gold ends February near an important inflection point in the $1360-$1375 area. Many gold bugs have adopted the view that a new bull market in the "barbarous relic" is underway. I believe it is premature to adopt that view.

A solid breakout above the circa $1360 level would certainly be bullish and would suggest much higher prices, assuming the breakout doesn't fail (which would be very bearish indeed).

However, the breakout has yet to occur, and prices are approaching a level where a number of previous rallies have stalled and reversed. The risk/reward for the purchase of gold at current prices is not attractive and should be deferred until a clear breakout is confirmed.

The major publicly traded gold mining companies have been garnering an unusual amount of attention of late as the industry is undergoing the final stages of a major consolidation process that will leave little choice in major publicly traded gold producers for investors.

Barrick has announced a hostile takeover offer for Newmont which endangers Newmont's own takeover offer for Goldcorp. The merger of Barrick and Newmont makes business sense since they have a number of properties in close proximity and the economies of scale would be significant. However, Barrick's stated attempt to purchase Newmont for no premium is obviously doomed. The hostile bid by Barrick and an implicit takeover premium will be reflected in the price of Newmont's stock.

The Philadelphia Gold and Silver Index (XAU) has underperformed the price of gold over the past five years by roughly 20%. This would presumably suggest that opportunities are present in gold shares in the event of a confirmed bull market in gold. The opportunities exist, but investors should be aware of risks in gold shares, particularly geopolitical risk. Gold mining companies with assets in jurisdictions where the rule of law is not respected face increasing threats of adverse geopolitical developments as the price of gold rises, be it the imposition of onerous new taxes or outright expropriation. Investors should restrict their attention to companies operating in stable countries. Of course, the quality of a company's management, its financial strength and the quality of its assets must also be considered.

On balance, owning gold bullion offers the best risk/reward if, as, and when a bull market in gold is confirmed.

ABOUT THE EDITOR

The Editor and Publisher of the Global Investment Letter is Jonathan Baird CFA. Prior to founding the Global Investment Letter, Jonathan spent more than 25 years as an award winning money manager in Canada, most recently winning a Lipper Award in 2010 for managing the #1 Global Equity Fund in Canada. Jonathan managed several #1 ranked funds over the course of his career as a money manager, investing in all major industries, asset classes and markets. Along with his interest in the world of investment, Jonathan has been a lifelong student of history and uses the lessons of history to help interpret and provide context to current events. Jonathan no longer invests money for others, managing only his own account. The Global Investment Letter represents his personal thoughts and opinions.

Jonathan well understands the difficulty of the investment process, and the essential role that quality information and opinion play in successful investing. Each monthly issue will contain comments on major markets, economics, geopolitics as well as investment ideas. There may also be discussion of investment philosophy or practices and reviews of books deemed of potential interest to readers.