

NOVEMBER 10 2019

MONTHLY



Global Investment Letter



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CHARACTERISTICS OF NEXT MARKET PHASE SURFACING

The major challenge facing global economies and capital markets is how to cope with the current slowing of the world economy in an era when central banks, having largely used their traditional tools in addressing the financial crisis of 2008 and its aftermath, have a diminished capacity to combat a recession. How the current long-lived economic expansion will be extended, given the tenuous nature of the global economy and markets, has been much on our mind. We believe we have identified the strategy that will be used to avert a recession in the short-term and provide capital markets with one final leg higher.

The effort to extend the current economic cycle will be a combination of two factors.

The first factor will be the use of tools such as the lowering of interest rates and monetary expansion by central banks. In the U.S., the Fed has enacted a series of rate cuts in 2019 and more can be expected if the U.S. economy weakens further. Interest rates in the United States remain positive so the Fed presumably has some further room to cut rates. In Europe, which is already experiencing negative interest rates, a new strategy is surfacing. The European Central Bank (ECB) recently announced what it is calling a “tiering system” to help Eurozone area banks cope with negative interest rates by reducing the amount of capital subject to negative rates. The ECB’s short-term benchmark rate was unchanged the day after the announcement, suggesting that money markets took the policy change in stride. The calm acceptance of the capital tiering system for banks will presumably allow the ECB to lower interest rates further into negative territory, which was likely the point of the test. The European banking system is the sector that has suffered the most from negative interest rates, which have compromised balance sheets and slashed stock valuations. The help was much needed as many European banks were nearing collapse.

An example of the effect of negative rates on European banks can be found in Danske Bank. At the time of the announcement, it was trading at just over half its book value compared to a 5-year average of 1.17 times book value. Danske Bank is an important component of the Danish economy, holding \$575 billion in assets, which is the equivalent of 164% of Denmark’s 2018 GDP!

This move by the ECB will produce a bid for European bank stocks, while also suggesting that lower interest rates will continue to be used as an economic stimulus in the Eurozone. It should be noted that efforts are already underway to forestall a recession as monetary growth by the ECB is currently higher than at any time since 2009.

Other central banks can be expected to mimic the efforts of the ECB to wring what they can out of the tools available.

The second factor that will be used to extend the current expansion is fiscal spending, which may ultimately be more impactful. The United States has been an early adopter of this strategy through the Trump administration's tax cut and increased spending on defence. The result has been record-high

budget deficits, but the tax cut has been credited with adding 0.3% to American GDP this year. With an election looming in 2020, further tax cuts in the United States are possible.

It has been reported that a number of central banks have been encouraging governments to implement fiscal spending programs to complement their own efforts. It appears, for a variety of reasons, that a large number of governments are embarking on an expansion of fiscal spending. The spending plans may not be coordinated, but the effect will be as if the move was synchronized.

The United Kingdom will surely embark on a dramatic program of fiscal stimulus regardless of who wins the December 2nd election. Boris Johnson has already announced an increase in government spending, which will serve to win votes and soften some of the harsh economic realities of Brexit. Labour leader Jeremy Corbyn has aspirations of nationalizing wide swaths of the British economy and augmenting social programs.

The trend to increased government spending does not end with the United Kingdom. In September the Modi government in India announced a surprise cut in the corporate tax rate from 30% to 22%. South Korea also recently announced its most expansionary fiscal program since the 2008 crisis, raising spending by 8%, with its emphasis on job creation and social programs. In Japan, the finance minister submitted a record budget request for 2020, in addition to that attached to the 2020 Olympics.

In France, the government announced over 10 billion euros in new tax cuts for 2020, ostensibly to be paid for by lower borrowing cost through interest rate declines. In addition, nations such as Germany, Indonesia, Italy and the Netherlands have announced increases in fiscal spending.

The net effect of fiscal spending will be significantly stimulative and may postpone the next recession. Global equity markets are clearly responding favourably to this stimulus.

The use of fiscal stimulus, in addition to monetary policy, could produce a powerful final rally in equity markets. This environment is also likely to encourage inflationary pressures, which will benefit cyclical sectors such as commodities and gold.

The combination of monetary and fiscal stimulus will ultimately produce the means of its own demise. This policy will send debt soaring from already elevated levels, both throughout the economy and for governments themselves. As well, we expect this policy to eventually produce inflationary pressures.

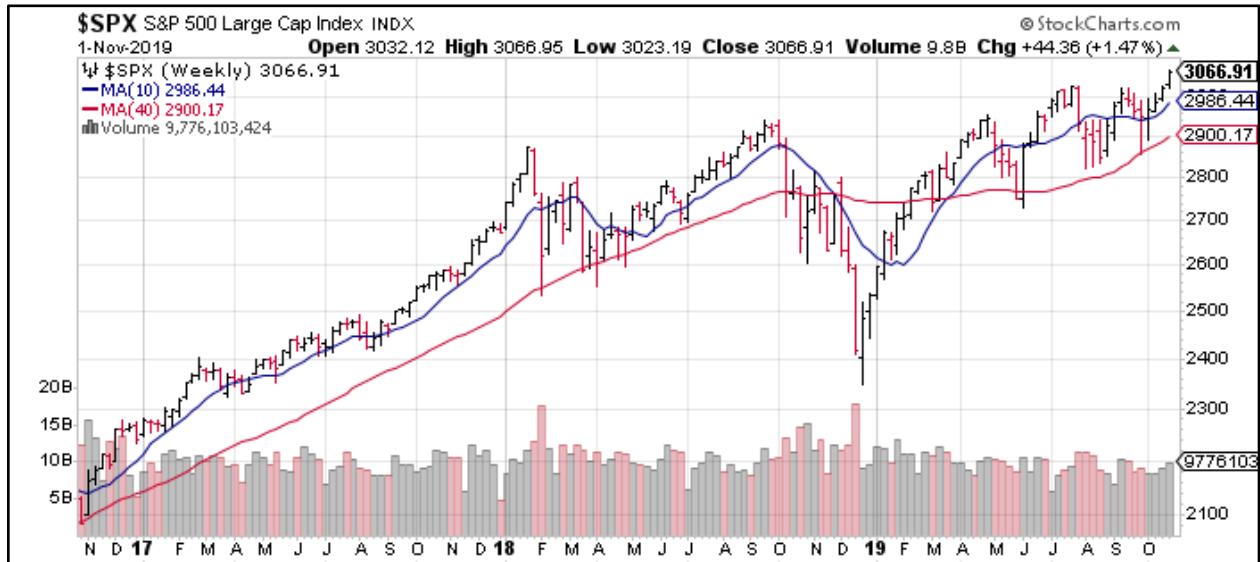
The end result of this cycle will likely be a stagflation environment. Inflation will gradually force interest rates up, which will prove devastating to an economy mired with enormous debt levels.

The resulting recession will be especially sharp and likely require an economic reset of a type last seen in the early 1980s, when interest rates rose to unprecedented levels.

The end of this economic cycle is going to be dramatic and unpleasant. However, the combination of monetary and fiscal stimulus appears bullish for investors in the nearer term.

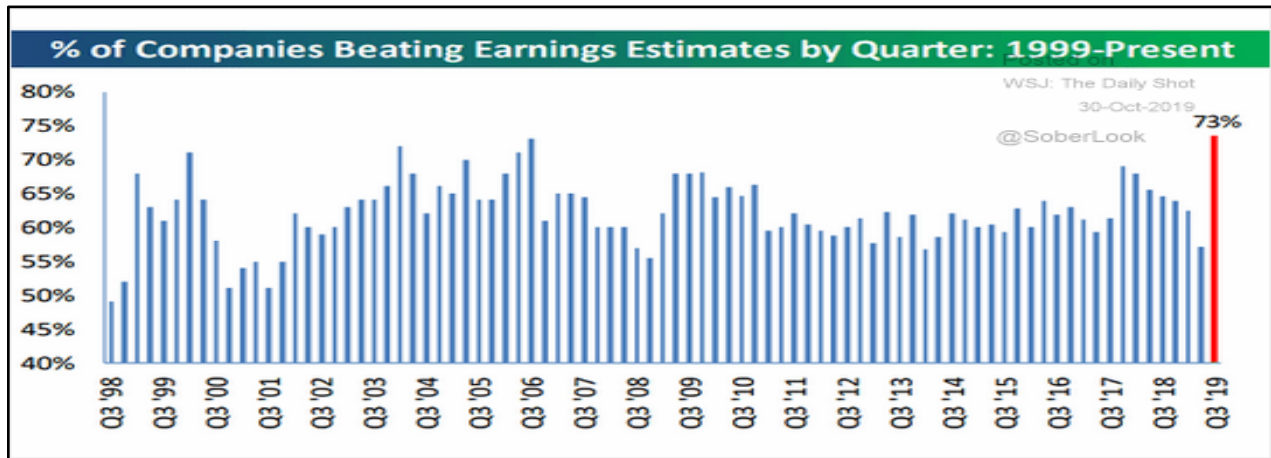
EQUITIES COMMENT

S&P 500 (WEEKLY)



The combination of the closing of the seasonally weak period for equity markets and a breakout to new highs by the S&P 500 compels us to re-establish our bullish view of equities. While we have become more bullish on equities generally because of the apparent coordination of monetary and fiscal stimulus by central banks and governments, U.S. stocks remain our preferred asset class given our continued bullish view of the U.S. dollar.

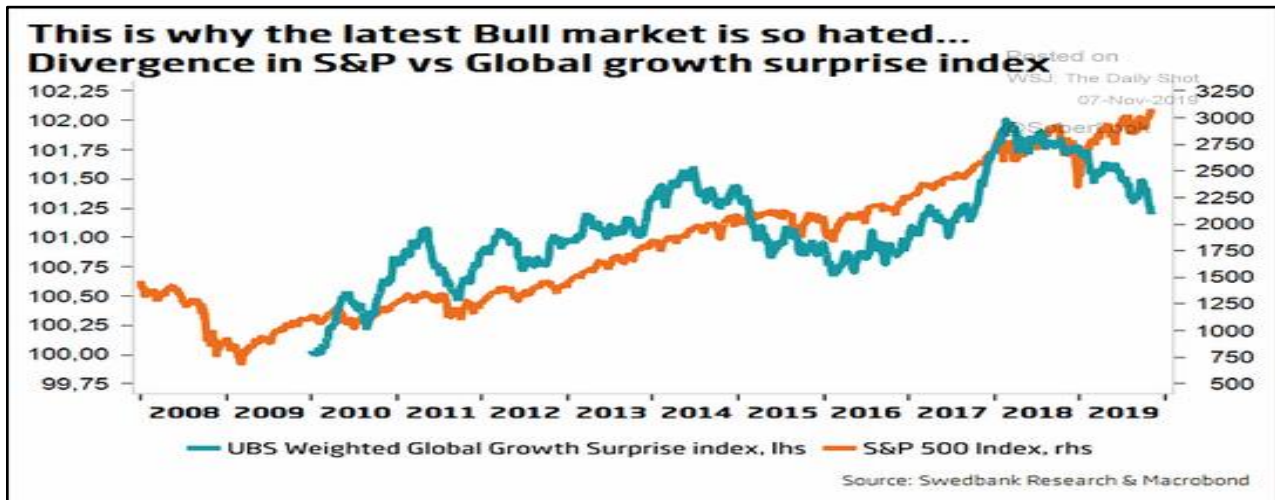
If one were looking for a rationale for the advance in equities beyond the macro factors discussed, the chart below demonstrates that more companies exceeded earnings expectations in the third quarter than at any time in the past 21 years.



An additional expected driver of equity prices is described by the chart below. Over 50% of S&P 500 stocks have dividend yields higher than the 10-year Treasury note. While Treasuries are notionally a less risky investment, the strong appetite for investment yield by investors, both retail and institutional, will produce a demand for dividend-paying stocks.



The final chart below illustrates why we have long maintained a preference for U.S. denominated assets over those of other nations. The chart depicts the strong performance of the S&P 500 despite a plethora of economic reports that indicate a slowing of the global economy.



The S&P 500 has benefited from the strong relative growth of the American economy but has also been helped by a deteriorating global geopolitical environment that has heightened the United States' role as a safe-haven for capital and produced demand for U.S. dollar assets.

As has been our projection for some time, we believe that capital will continue to flow to U.S. dollar denominated assets.

THE VOLATILITY TRADE

S&P 500 VOLATILITY INDEX (VIX) DAILY



The VIX traded lower in October in response to stock market strength and an associated increase in investor optimism. The VIX is once again trading at a level that suggests significant investor complacency.

S&P 500 VOLATILITY ETF (VXX) DAILY



The decline in the VIX produced a corresponding decline in the VXX VIX ETN.

While we expect the bull market in equities to continue, we don't expect it to do so without periodic price retreats. The elevated investor complacency suggested by the VIX increases the probability of a normal bull market correction, particularly as the market didn't experience a common Fall pullback.

Experience has taught us that volatility is mean-reverting, suggesting that volatility will eventually rise to compensate for the presently complacent levels.

Buying volatility at the current low level represents an attractive risk/reward trade.

We believe holding VXX until the next market pullback will produce an attractive return. In our experience, buying volatility when at low levels has yielded consistently positive results.

FTSE 100 (DAILY)



We continue to be wary of the FTSE because of the ongoing uncertainty surrounding the terms of Brexit. We also anticipate negative economic consequences for Britain regardless of what agreement is reached. We remain hopeful that Brexit can be averted, but that seems unlikely.

As discussed in previous issues, we are watching for a trading opportunity associated with Brexit. We would trade against a sentiment-driven extreme in price produced by a resolution to the issue. Such emotionally charged moves often produce attractive risk/return opportunities.

DAX INDEX (WEEKLY)



The DAX moved sharply higher in October, as did other European Union economies. The actions by the ECB discussed earlier played a significant role in the bullish move.

The German economy will be a major beneficiary of stimulative efforts by the ECB as its economy has been very near to formally entering a recession.

The strength of the DAX in 2019 has been surprising, though the results are mitigated somewhat by the weakness of the euro for non-euro-based investors (we have favoured U.S. equities over those of other markets because of the strength of the U.S. economy and dollar). Still, the gains are noteworthy because they are counter-intuitive. The weakness of the German economy and the vulnerability of its auto sector would suggest lower equity prices. That it has not is noteworthy.

However, we continue to favour other markets. The DAX is approaching important resistance at the price level of the January 2018 high. Experience suggests it is best to wait for a clear break above that level.

CAC 40 (WEEKLY)



The Paris CAC 40 is our favourite European bourse and we have turned bullish on this market following its breakout in October. The CAC has broken through price levels that have rebuffed a number of previous rally attempts, which is very bullish.

In addition, the CAC will benefit from announced tax cuts and efforts by the ECB to aid the European banking system. Moreover, the French economy is less dependent on exports than Germany, which provides a measure of insulation from the effects of protectionist trade policies.

Once again, our view of the CAC is now bullish though non-euro investors should consider a currency hedge.

NIKKEI INDEX (WEEKLY)



The Nikkei moved higher in October, in concert with other markets. The weakening yen was helpful, given the traditional inverse relationship between the yen and the Nikkei. The Bank of Japan is also clearly going to continue with its robust stimulus efforts.

While we are generally bullish of equities, our view of the Nikkei is like that of the DAX. The best risk/reward for buying the Nikkei would be on a clear breakout above the twin highs of 2008. Purchasing the Nikkei now exposes an investor to the prospect of a failed breakout attempt of what has proven to be a strong resistance point. The risk/reward is, therefore, less than optimal.

SHANGHAI COMPOSITE (WEEKLY)



The Shanghai market looks interesting on the chart above, having coiled itself into a wedge pattern that usually suggests sharply higher prices on an upside breakout of the wedge.

The primary driver of the near-term performance of the Shanghai market is obviously the state of trade with the United States. If a trade deal is reached, even a partial agreement that suggests improving relations, this market could have a significant move.

We remain warier than most on the prospects of a comprehensive trade deal, but we recognize that it does serve the political interests of both governments to reach a deal. The key to reaching an accord is for both parties to be able to characterize the deal as a victory at home.

The downside for the Shanghai appears modest given the likelihood that the People’s Bank of China will continue to supply stimulus, as needed, to the Chinese economy.

We would turn bullish on the Shanghai market on a clear break higher out of the wedge formation on the chart above.

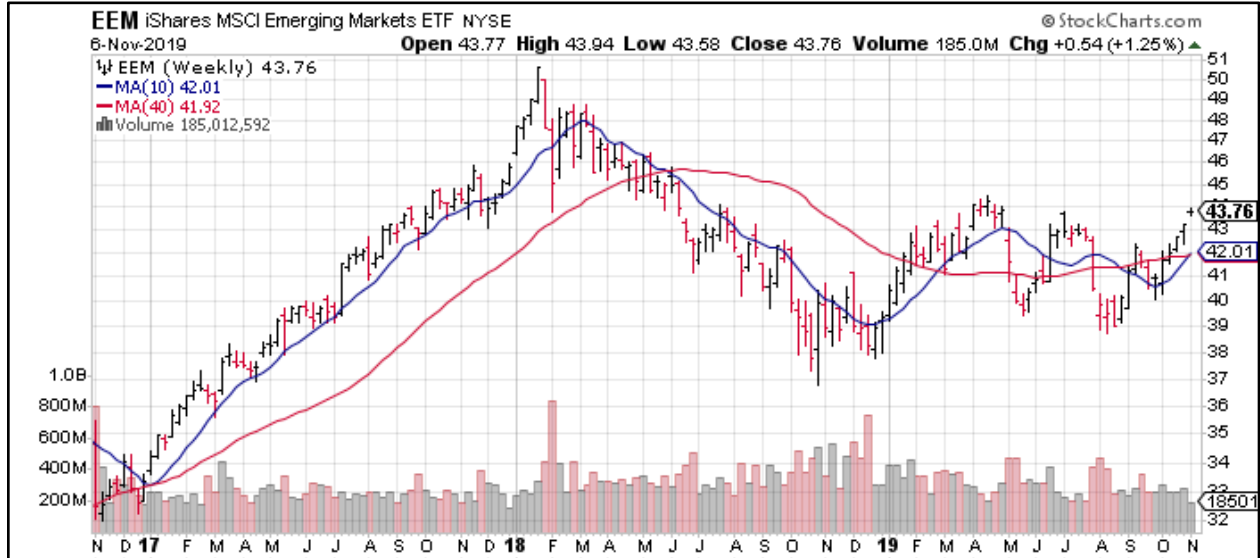
SENSEX (WEEKLY)



The bearish behaviour of the SENSEX index was arrested in September by the surprise cut in corporate taxes from 30% to 22%. The positive effect of the tax reduction on corporate earnings had a predictably beneficial impact on equity prices.

We will re-instate our bullish opinion of the SENSEX on a break above the 2019 high set last May.

EMERGING MARKETS ETF (EEM) WEEKLY



Emerging markets, as represented by our proxy ETF above, performed strongly in October.

The widespread use of fiscal stimulus by governments will be of particular benefit to emerging markets, whose exports, such as commodities, tend to be tied to the more cyclical aspects of the global economy.

We would adopt a bullish view on this sector on a break above the circa 44.50 level on the EEM chart above.

FIXED INCOME COMMENT

10-YEAR US TREASURY NOTE (WEEKLY)



U.S. Treasury bonds, as illustrated by the 10-year note chart above, continues to consolidate its sharp gains of earlier this year.

The Fed struck a more cautious tone on the prospect of further interest rate cuts in the near term, which will act as a constraint on further short-term price gains. As stated earlier in this Letter, the global economy has been slowing for some time, which will ultimately produce a global recession. The American economy has been remarkably resilient thus far and remains the only major economy demonstrating a modicum of strength. However, the United States economy will be unable to resist the effects of a general slowing of the global economy without the aid of the Fed, which suggests further rate cuts can be expected.

We remain bullish of U.S. Treasury bonds and anticipate much higher prices during the next recession.

CURRENCY COMMENT

US DOLLAR INDEX (DXY)(WEEKLY)



The U.S. dollar index retreated in October and now sits at its long-term 40-week moving average, which has provided reliable price support for the index thus far in 2019.

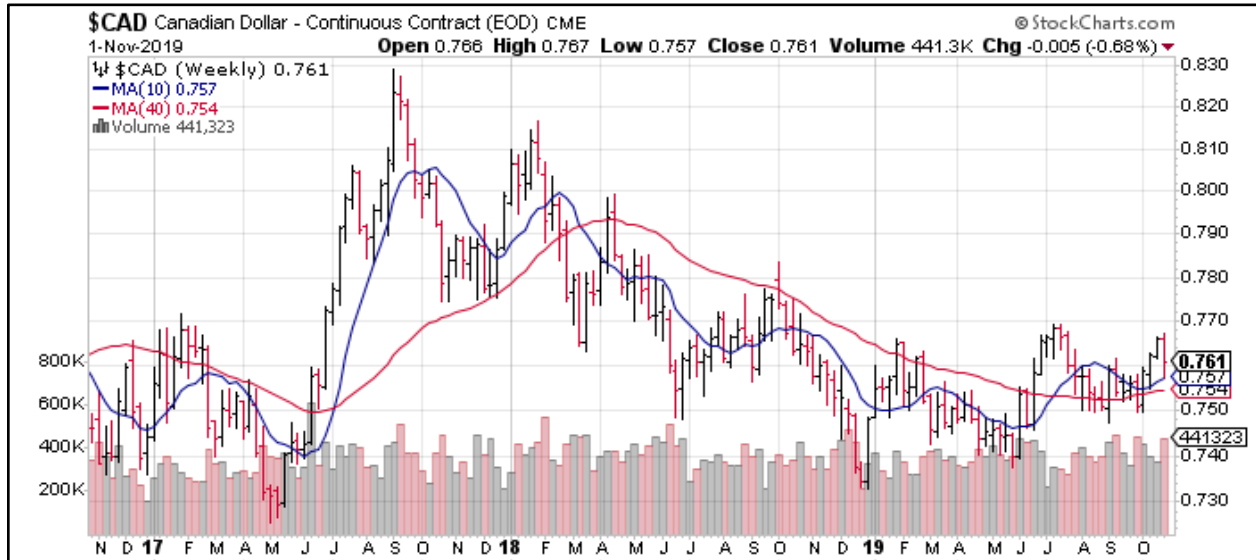
The weakness in the U.S. dollar is primarily the result of the series of Fed interest rate cuts, the last being 25 basis points (a quarter percent) in October. The Fed rate cuts are serving to narrow the positive interest rate differential enjoyed by the dollar against other major currencies.

The U.S. dollar index was also negatively impacted by strength in both the British pound and the euro. These currencies rose as sentiment grew that a negotiated Brexit agreement would be reached rather than a “hard” or no-deal alternative that would maximize economic disruption. The exact terms of Brexit remain to be seen. In addition, the dollar index was pressured by the rise of the Canadian dollar as the Bank of Canada held rates steady in October.

We remain bullish on the U.S. dollar, reminding readers of our oft-repeated phrase that “it is the best of a host of flawed currencies.”

The factors that contributed to weakness in the dollar index are likely short term. The optimism that produced a rise in the pound and euro may be short-lived. Both Britain and the European Union have long-term economic and political challenges that will exert downward pressure on their currencies over time.

CAD/USD(WEEKLY)



The Canadian dollar rallied strongly against its American counterpart in October before surrendering some of its gains in the last week of the month. The strength of the Canadian currency can be largely attributed to the decision by the Bank of Canada not to cut interest rates in tandem with the Fed. At month end, the Bank of Canada overnight rate was 1.75% versus a Fed target of 1.5-1.75%, making Canada the nation with the highest interest rates in the developed world!

The current interest rate policy by the Bank of Canada is surprising to us. We had expected that Canadian interest rates would be kept lower than American rates to facilitate a weaker Canadian dollar that would serve to make Canadian exports more competitive into American importers. A lower Canadian dollar would offset, at least partially, the effects of American tariffs on steel and aluminum and potential future trade sanctions from the notably unpredictable Trump administration.

The only rationale we can imagine is that the Bank of Canada wants to preserve interest rates at a level where reducing them to combat the next recession will have a meaningful impact. It remains to be seen if the lowering of rates from the low level at which they currently reside will achieve the desired effect. Our concern is that both Canada and the United States may have to resort to negative interest rates to counteract the next recession.

We do not expect the Bank of Canada to maintain interest rates at their current levels for long. This view, combined with our expectation of continued softness in oil prices, suggest more downside than upside potential in the Canadian dollar versus the U.S. dollar. We, therefore, remain bearish on the Canadian dollar.

The 77-cent level is an important level. If the Canadian dollar should trade above it more than temporarily, it could signal a change of trend.

EUR/USD (WEEKLY)



The euro displayed a rare period of strength against the U.S. dollar in October. The gains were due largely to increased optimism that a comprehensive Brexit deal could eventually be reached, lessening the economically disruptive effects of Brexit on the European Union. A general weakness on the part of the dollar in October also served a role in the euro’s advance.

We remain bearish of the euro, which has thus far been a gratifyingly profitable point of view. The euro traded near its long-term 40-week moving average at month end. The 40-week moving average has proven to be a strong resistance level in 2019.

The exact terms of Brexit remain to be seen, though a “hard” no-deal departure by the U.K. appears less likely now than previously. In any event, Brexit will prove to be economically disruptive to both parties and will eventually be reflected in their respective currencies.

We remain skeptical that the euro will exist in a decade. The challenges facing the European Union, both economic and political, suggest that the terms of the European Union will change, which may well include a return to separate currencies.

POUND/USD (WEEKLY)



The British pound enjoyed a month of very strong gains against the U.S. dollar in October. The strength of the pound was almost entirely due to political factors, i.e., Brexit. Optimism over the prospect of a negotiated Brexit generated a wave of short-covering in the pound, which pushed the currency above its long-term 40-week moving average, an ostensibly bullish development.

Despite the recent strength in the pound, our view remains unchanged. The continued lack of clarity surrounding the terms of Brexit, or even if Brexit will occur, suggests standing aside from exposure to this currency.

We remain alert to a trading opportunity in the pound based on a reaction to a definitive Brexit deal. We anticipate that an attractive risk/reward trade may appear in the form of an opportunity to trade against a sentiment-driven price extreme. That opportunity has yet to occur.

YEN/USD (WEEKLY)



The yen continued to weaken against the U.S. dollar in October, unlike most other major currencies.

The yen had posted a significant reversal bar in August which, at least partly, explains the subsequent weakness. The yen traded to its long-term 40-week moving average in October before reversing at month end. This moving average is likely to represent important resistance to further yen weakness.

A sustained move through the 40-week moving average would suggest a trend change to a weaker yen.

However, until there is more evidence that a trend change has occurred, we will maintain our view that outright long or short exposure to the yen should be avoided. We have had an expectation that the next clear trend in the yen would be weakness versus the dollar, given the advantages to Japan of a weaker currency for trade purposes with the United States. We also expect the positive interest rates available in the United States versus the negative rates of Japan to continue to encourage demand for dollars over yen.

YUAN/USD (DAILY)



The yuan can be seen currently as a barometer for the health of trade talks between China and the United States. The move back toward the key 7 level in October suggests the Chinese feel the chances of achieving an acceptable deal have risen.

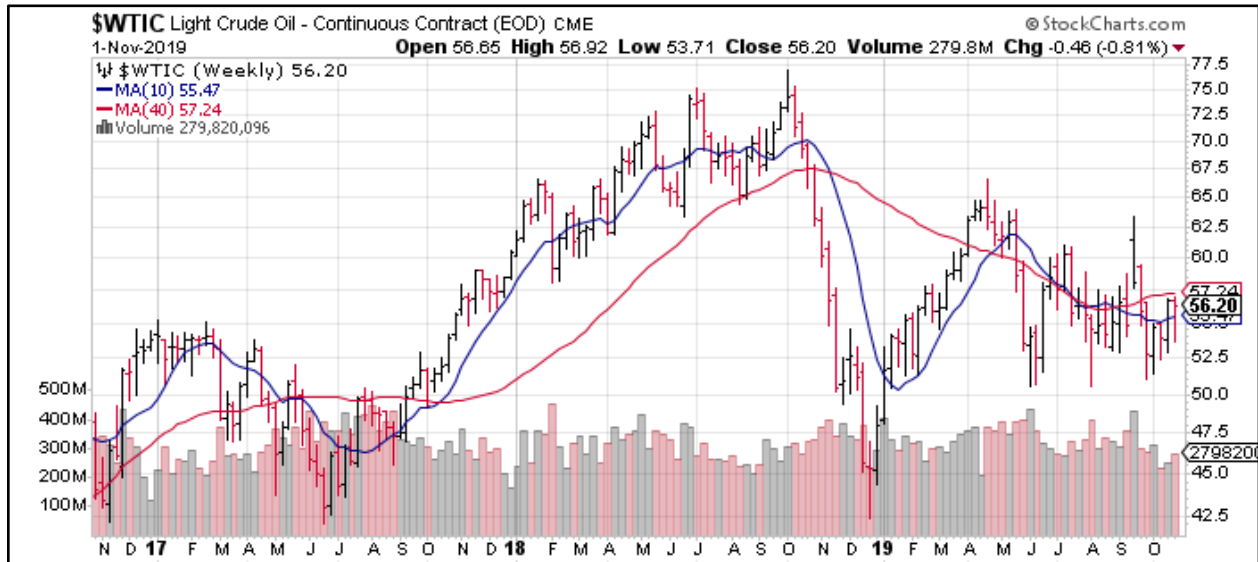
We continue to be more skeptical than most, and our skepticism has so far been warranted. It will not be surprising to see a deal that restores trade between the two countries to a less contentious level. However, it will be surprising to see a comprehensive deal this year. The Chinese know that their leverage increases as the U.S. election draws nearer, so 2020 would seem a more favourable period for Chinese negotiators. As well, it is unlikely that the terms of trade will revert to those extant previous to the current trade war. As we have noted previously, trade is just part of a larger contest for global influence between China and the United States.

A move below 7 yuan to the dollar would be a meaningful signal that at least a partial deal was near.

Our view remains the same. We would await more clarity on the trade issue and avoid unhedged exposure to the yuan.

OIL COMMENT

CRUDE OIL (WTI) (WEEKLY)



The price of oil rose in October, following a sharp decline after the short-lived spike in prices caused by the attack on Saudi oil production facilities.

We remain bearish on oil, with our standard caveat that geopolitical developments have the potential to create price spikes, as witnessed in September.

The fundamental picture is not conducive to higher oil prices. The slowing global economy will serve to constrain oil demand. The supply of oil continues to be more than adequate, notwithstanding the ongoing production cutbacks by OPEC plus Russia.

There has been speculation in recent months that we are approaching “peak oil” in terms of U.S. shale production. The rate of oil production growth has slowed recently, but the slowing is due primarily to a lack of strong oil prices to drive drilling. It is also not realistic to expect shale oil production to match the dramatic increases seen in the past few years. In addition, technological development has steadily reduced the cost of shale production. We anticipate the costs associated with shale production to continue to fall over time, making shale production profitable at lower oil prices.

U.S. oil production continues to increase. The U.S. Energy Information Agency (EIA) expects that U.S. crude oil production will reach 13 million barrels per day (bpd) in December. The EIA expects 2019 U.S. production to average 12.3 million bpd, with 2010 production rising to an average of 13.2 million bpd.

The long-promised Saudi Aramco IPO appears closer to being realized, though not in the form initially imagined. A key change is the decision to list the company only in Saudi Arabia rather than on major international exchanges. The amount of the company being sold is small which, combined with the Saudi-only listing, leaves investors largely exposed to the politics of Saudi Arabia. For example, investors will have to balance the effects of Saudi oil production cutbacks in concert with other OPEC members with the interests of their investment in Saudi Aramco.

We look forward to reading the prospectus for information on the giant Ghawar field. The Saudis have been traditionally secretive about their oil fields. Insight into the state of Ghawar and other major sources of production will be most interesting. It has been speculated that Ghawar has been producing oil with the aid of water flood stimulation for over two decades. We hope that the decision to list solely in Saudi Arabia was not made to limit the disclosure requirements in the prospectus.

DEFENCE SECTOR COMMENT

US AEROSPACE & DEFENCE ETF (ITA) (WEEKLY)



The defence sector, as represented by our proxy ETF above, continues to trade bullishly above its 2018 high. The recent price consolidation was not unexpected given the strong price appreciation the ITA ETF has enjoyed throughout much of 2019.

Defence stocks remain one of our key investment themes going forward. The defence sector will continue to be driven by the deteriorating global geopolitical climate and the demands for evolving technology to upgrade weapon systems.

We continue to favour companies producing products with the highest technological features, such as aerospace. We also believe that geographical diversification in defence holdings is prudent, given the possibility that shifting strategic alliances will alter traditional government spending patterns.

The following companies are worthy of investor attention: Thales, Rolls-Royce, BAE Systems, Northrup Grumman, Lockheed Martin, General Dynamics, Boeing, Airbus and Raytheon.

GOLD COMMENTARY

GOLD (WEEKLY)



Gold continued to consolidate in October, following the sharp breakout earlier this year. Further price weakness, though likely minor, may occur before a catalyst for the next phase of the bull market presents itself. We anticipate that the next major driver of higher gold prices will be inflationary expectations produced by escalated fiscal spending on the part of governments to counter the next recession, given the diminished tools available to central banks.

We remain bullish on gold. While gold continues to consolidate, we expect much higher prices over time. Our bullish view will be tested, however, should gold trade under the \$1460 level, which represents an important level of price support.

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.

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