Market Commentary
Third Quarter 2018

Harbour Fund
Harbour Global Equity Corporate Class
CI Canadian Investment Fund

Financial advisors are often asked: "Will the Canadian stock market outperform global peers?" It's a pertinent question given the fund industry broadly has recommended in recent years that clients increase global exposure – a fair recommendation if said global exposure included a heavy weighting to the U.S.

The answer to this question may seem flippant: "If you tell me what the price of oil does, I can tell you if Canada outperforms". Canada's stock market is as lopsided as ever with almost 20% of the S&P/TSX Composite Index exposed to the energy sector, 13% to materials and 23% to banks. To be sure, Canadian banks are blue-chip businesses but, like any other nation's bank stocks, they ultimately reflect the fortunes of the underlying economy. To that extent, the banking sector's stock performance is also tied (indirectly) to the direction of commodity prices. If we examine other sectors that make up the S&P/TSX, we find that natural resources permeate many businesses. Our real estate companies have varying exposure to Alberta, our engineering firms such as SNC-Lavalin have large commodities segments, and Canada's rail companies – a large weight in the index – haul everything from coal to lumber to oil to destinations all over North America.

Of course, there is always the chance that the Canadian market outperforms if high-flying global markets such as the Nasdaq sell off for some reason. In such a case, it's quite possible that the likes of CN Rail, Royal Bank and Loblaws hold up better. Outperforming against a problematic backdrop, however, is not usually an enduring phenomenon. Rather, preferable outperformance is the result of innovation, global category leaders, or bold steps by government to transform the economy.

If we leave aside natural resources for a moment, what are the big drivers of Canada's benchmark index? There are the Big Banks which could indeed continue cranking out their steady high single-digit to low double-digit returns (including dividends). However, anyone in the business of dealing with the finances of Canadian consumers must concede that, at some point, growth will become a challenge. The Canadian household has consistently increased leverage for over 30 years – a boon for Canada's banks. Now, however, stress is beginning to show with mortgage lending slowing dramatically.

Next, we have the insurance and rail sectors, making up about 5% of the index apiece. Rail stocks are trading towards the upper end of their valuation range so, similar to banks, they could post decent returns but fireworks are unlikely. Considering reasonable valuations and an upward trend

in interest rates, the insurers could certainly post outsized returns; however, the macro scenario that could deliver such an outcome would also benefit other countries' rate-sensitive sectors.

Canada's entire technology sector currently represents just over 3% of the S&P/TSX. Let's consider this for a moment. We are in the midst of a full-blown technology revolution. Corporations are scrambling to digitize their businesses, artificial intelligence (AI) and ever-expanding data applications are changing our daily lives, and tech companies are now the largest and most powerful companies in the world. Unfortunately, there are less than a handful of ways to gain exposure to these mega-themes through the S&P/TSX. It is worth noting that Constellation Software, the second-largest Canadian technology company that makes up almost one-third of our tech sector, buys low-growth legacy software businesses and milks the cash. In other words, it is a roll-up – a good one to be sure, but not exactly a bastion of innovation.

As we go down the list of large-cap Canadian stocks, most names such as our grocers or retailers, are low-growth businesses. The odd name with a "story" pops up, such as Dollarama or Canada Goose; however these are too few and far between to move the needle on the overall index.

So, we are left with health care. Well here we certainly have a story as this sector has gone through radical transformation in recent years and is the home to one of the best-performing sub-sectors globally year to date – the cannabis sector. Yes, it is true, many (if not most) of these listed companies will probably not exist in coming years. And yes, frenzied valuations in most of these companies make absolutely no sense. But behind all the froth and speculation is indeed something very real and very exciting. Further, Canada is without question the aggressive and innovative leader in this burgeoning industry.

We think that the cannabis story is misunderstood by most investors. That is, most of the discussion focuses on the upcoming recreational legalization in Canada. What will be the size of the market? Will consumers forgo their long-standing black-market dealer relationships? To what extent will companies be allowed to brand and thus boost margins? All of these questions miss the bigger picture – that cannabis is going to be a global phenomenon with a market that dwarfs the most optimistic estimates of Canada.

Already, Germany has legalized cannabis for medicinal purposes and four other European countries look ready to do the same (it should be noted that Germany is currently supplied by Canadian leader Canopy Growth). We think that once several other European countries join Germany on the medicinal side, most of the rest of the continent will quickly follow suit, if for no other reason that they don't want to miss the desperately needed tax revenue. Most studies of the industry conclude that once a country legalizes cannabis for medicinal use, recreational legalization (or at least a debate around it) will follow relatively soon as the product is destigmatized in the eyes of the public.

Europe is a continent of 500 million people and it isn't hard to imagine a fully legalized market within 10 years. While the U.S. is a bit trickier to handicap, the trend is the same. Attitudes are rapidly shifting and states are not waiting for federal laws to change.

The rollout of cannabis legalization around the world will create massive opportunity for the Canadian players, many of which already have operations (or at least "beach heads") in countries around the world. It turns out that producing pharmaceutical-grade marijuana on an industrial scale is a fairly hard thing to do and the Canadians have a huge head start and will no doubt be leaders in the industry for years to come.

Having just touched on the one sector in Canada of true innovation and excitement, Harbour has yet to invest directly in this sector but we're monitoring it closely. We currently have indirect exposure through a U.S. company. That is, we own a medium-sized position in Constellation Brands, one of the World's largest alcohol companies and maker of well-known brands such as Corona, Svedka vodka and Robert Mondavi wine. Constellation is a fantastic company that has many of the qualities that we look for at Harbour, although admittedly, when we purchased the stock, we were not really expecting a big Marijuana exposure! That is what we got, however, when the company recently announced a massive $5 billion investment in Canopy Growth for what amounts to a controlling stake in the largest Canadian cannabis producer.

After thorough due diligence, we have become comfortable with this investment and retained Constellation in the Harbour equity funds. Certainly, it is a far more conservative way to gain exposure to the Cannabis opportunity than owning a weed stock outright. Doing so exposes the investor to the wild ride that will no doubt unfold as numbers start rolling in following Canada's legalization in mid-October. Considering sky-high valuations, any disappointment relative to projections could cause stock prices to correct significantly. Our indirect exposure, however, would be significantly sheltered as it is diluted within a diversified company and was purchased at a price far below Canopy Growth's current trading level.

Turning now to the somewhat more mundane topic of attribution, Harbour Fund as well as CI Canadian Investment Fund posted positive performance against a slightly negative S&P/TSX in the third quarter. Harbour Global Equity Corporate Class, meanwhile, underperformed the MSCI World Index. Harbour Global Equity Corporate Class underperformed due almost entirely to our elevated cash position. Thus, the funds performed as expected, outperforming in a negative market and underperforming in a strong up-market despite decent upside capture.

As mentioned, cash remains elevated across the Harbour equity funds, with levels approximating 25%. This has been a result of tight risk management at the security level. As 2018 wore on, we became increasingly uncomfortable with our start-of-the-year positioning which contemplated a continuation of global synchronized growth. As this powerful theme, which had propelled stock markets for the previous two years, fell away, we reduced exposure to stocks and sectors that

would be on the receiving end of the slowdown unfolding in many parts of the world. However, the proceeds accumulated as cash since we have found it difficult sourcing new ideas that trade at reasonable valuations. In this context, our cash position is a natural result of Harbour's value-oriented process combined with the fact that we are possibly in the later innings of the cycle.

Cash aside, stock and sector allocation were generally good across the portfolios last quarter. Within the consumer sector, both discretionary and staples, were excellent performers that benefited both the Canadian and global funds with big contributions from favourite stocks such as Sony, O'Reilly Automotive and Costco. An underweight to Canadian energy and materials helped the Canadian funds. The one significant detractor from a stock and sector standpoint was the technology sector in our global fund. Here, we were both underweight the sector and also underweight some of the big high fliers within the index. We note, however, that returns were still positive.

One final note on our stock and sector attribution was our performance within the health care sector as it related to the Canadian-focused funds. Here, our 17% return generated by favourite stocks such as Pfizer and Gilead were no match for the marijuana sector-fueled 31% return for the Canadian health care sector.

Looking forward, as always, the direction of asset prices will surely be influenced by central bank action, the related movements in rates markets, and the related moves of the U.S. dollar. Against the backdrop of a red-hot U.S. economy, the U.S. Federal Reserve looks poised to raise interest rates further and continue its withdrawal of dollars that were created during its extensive quantitative easing programs.

Many, if not most, of the rest of the world is in a definite economic slowdown. This set-up (a tightening U.S. combined with a global economic slowdown excluding the U.S.) could propel the U.S. dollar higher and thereby exacerbate problems that have been festering all year, especially within emerging markets. With U.S. interest rates up, the U.S. dollar higher, and central banks continuing to withdraw stimulus, a substantial tightening of global financial conditions is currently under way – a state of affairs that usually warrants a high degree of caution.

Cautiously is how we continue to proceed in this environment.

Thank you for your continued support.

Ryan Fitzgerald, CFA
Senior Portfolio Manager

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Class F Returns (in %) as at September 30, 2018	Year-to-date	1 year	3 year	5 year	10 year
Harbour Fund	1.4	3.0	3.3	3.5	4.2
Harbour Global Equity Corporate Class	5.3	6.3	5.7	7.1	7.2
CI Canadian Investment Fund	2.9	6.1	9.1	7.6	7.0

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