Market Commentary
Second Quarter 2018

HARBOUR ADVISORS

Harbour Fund
Harbour Global Equity Corporate Class
CI Canadian Investment Fund

Global synchronized growth provided a favourable backdrop to market action for the better part of two years – up until the beginning of 2018. Throughout this year however, it has become apparent that global growth may be "desynchronizing." Despite developed market equity indexes posting respectable performance in the second quarter, consider the following:

- The iShares MSCI Emerging Markets ETF (EEM US), a broad measure of emerging market equities measured in U.S.-dollar terms, was down over 10% during the quarter and is down over 16% from its January peak.
- The Shanghai Stock Exchange recently entered a bear market, defined as a 20% plus decline from the most recent high.
- Copper, considered a barometer of global (and especially emerging market) growth, declined sharply at the end of the quarter and, as of this writing, has yet to stabilize.
- European banks are down almost 20% from their January highs.
- The capital goods sub-index of the S&P 500 is down approximately 14% from its January high.

Before getting too depressed, let's examine some bright spots:

- The Nasdaq was up over 6% on the back of the usual blockbuster earnings.
- The consumer discretionary sub-index of the S&P 500 was up almost 8%.
- Interest rate sensitive sectors such as utilities and REITs posted solid positive performance.
- The Russell 2000 Index, a broad measure of medium-sized domestically oriented U.S. companies, was up over 7%.
- The U.S. dollar, measured against a basket of global currencies, was up approximately 5%.

The bullet points paint a very familiar picture to any market participant who was active in the post financial crisis years. The U.S. posts steady, and even accelerating, growth while the rest of the world grapples with a variety of problems and an uneven economic recovery. Coincident, on-the-ground measures in the U.S. such as employment, home prices, inflation, consumption, and corporate earnings all appear to be rock solid. Industrial data in Europe, China, and Japan, by contrast, is decelerating. Meanwhile, pockets of consumption data, in places such as Spain and Germany, are downright terrible.

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To be sure, it is too early to tell if certain non-U.S. geographies are in any serious trouble, or if they are merely experiencing a temporary slowdown within a broader expansion. Recall that most of the world has experienced an entirely different cycle in recent years as compared to the U.S. Commodities, emerging markets, and by extension, the industrials sector, had a pronounced contraction during 2014-15. Management teams of capital goods and materials companies appear bewildered regarding how poorly their stocks are currently performing since they consider their sectors to be only two years into an expansion.

Even as it relates to U.S. growth, not all markets seem to agree. Bond market yields have stopped going up and the yield curve has flattened dramatically, both signals of waning long-term growth expectations. Certainly, the bond market does not seem to share the prevailing view that inflation, having recently perked up, will continue to steadily increase. Rather, a flat yield curve is probably reflecting the view that inflation in the short term will ultimately sow the seeds of its own destruction as central banks take short term rates up and thus subdue longer term growth. Such is the thinking in an extremely indebted world.

While the markets are perceiving reality in one way, corporate executives are perceiving it in quite another. Corporate management teams, both in the U.S. and around the world, are for the most part bullish on their businesses. Order books are full, customers are happy, supply chains are healthy, and profit margins are excellent.

One could be forgiven for being completely confused.

Is this an example of the noted phenomenon where markets seem to know something of which no individual participant is aware? Is the market accurately predicting an end to this very long expansion? Or, is it all just noise? Are market participants simply thrashing around and overreacting to every minor data point as if it were a matter of life and death?

To be honest, it is impossible to know whether recent market divergences are just noise or the sign of something more ominous. One thing however cannot be forgotten – we are indeed well into a monetary tightening cycle in the U.S. Thus, the U.S. Federal Reserve has raised overnight rates seven times to 2% – a low level to be sure, but still a long way up from the lows of 0.25%. Canada has raised rates three times since bringing rates back down in 2015 as an emergency response to the plunge in oil prices.

Alongside this methodical process, the Fed is unwinding its massive quantitative easing program whereby it sells (currently) $30B worth of bonds to the market each month. This amount is set to increase to $50B in the fourth quarter of this year. Without getting into an arcane discussion on the dreadful topic of central banking, the only thing an investor really needs to know is that growth in U.S.

money supply is declining rapidly. Since the U.S. dollar serves as the global reserve currency, this means that global monetary conditions are tightening substantially. This, combined with the fact that we are nine years into a bull market and valuations are high, has us comfortable with a cautious posture in the Harbour equity funds.

On that note, the Harbour Fund, Harbour Global Equity Corporate Class, as well as CI Canadian Investment Fund, posted positive returns but underperformed during the quarter. The largest detractor from performance was the substantial cash position held across the portfolios. The largest security-specific detractors from performance were found within our industrial holdings with names such as Caterpillar and Japanese industrial, Nabtesco, underperforming broad markets. In an ongoing effort to tightly control security-specific losses, Nabtesco was eliminated and Caterpillar reduced. Specific to the Canadian funds, our underweight in a soaring energy sector also detracted despite solid security-specific performance. Consumer staples was a bright spot with favourite names such as U.S. Foods and Costco posting solid performance.

The major activity during the quarter was a material decline in our industrials exposure. At the end of 2017, we too subscribed to the global synchronized growth narrative. However, now we are not so sure. As previously discussed, there are enough signs in both markets and real economies to seriously question the robustness of non-U.S. global growth, something to which large-cap industrial stocks are highly exposed. Yes, we are long-term investors and attempt to invest with high conviction. But, as it turns out, high conviction is a double-edged sword – high conviction about the wrong thing doesn't exactly get you very far. Our perception of the future is in question so we have adjusted our market position.

In Harbour Fund and CI Canadian Investment Fund, activity on the buy side was minimal. We did however add two favourite pipeline companies, Pembina Pipelines and TransCanada. Performance of the energy infrastructure sector (the second largest sub-component of the S&P/TSX Composite Index after banks) has been terrible in recent years. The downdraft in oil prices, political indecision surrounding major projects, and more recently, rising interest rates, have all been factors contributing to the underperformance of this sector. At the most recent bottom in early 2018, the sector was essentially at the same price it was at four years earlier despite material dividend and cash flow increases. In other words, from a valuation perspective, the sector has de-rated considerably.

We feel that the period of underperformance may be coming to an end and there is perhaps a perfect fundamental set-up taking shape. The pipeline sector thrives when two conditions persist – oil prices are high (or at least high-ish and stable) and interest rates are low. The high oil price solidifies counterparty contracts and encourages development while low interest rates reduce capital costs and boost returns on equity. An added benefit is that low rates make the high dividends attractive for those

investors seeking higher yields compared to traditional fixed-income securities. As investors flock to the sector, valuations rise.

The price of oil as well as interest rates are both macro factors that are notoriously difficult to predict. However, even if we are wrong on these variables we feel that downside is limited given that both companies currently sport dividend yields approaching 5% and will grow these payouts by up to 10% per year over the next three years.

In Harbour Global Equity Corporate Class we added several names, our favourite of which is American Homes 4 Rent (AMH). This U.S.-domiciled REIT is one of the largest owners of single-family rental homes in the country. While the business of renting single-family homes has always been around, it was typically consigned to do-it-yourself investors. Only in the years following the financial crisis did institutions begin to get involved. The sector started out as a "trade," for lack of a better word. Large investors descended on the U.S. housing market with the intention of purchasing foreclosed homes at a fraction of replacement costs and waiting until, one day, they could flip them for substantial profit. What some of these investors learned along the way was that there was an attractive business to be conducted in simply owning the houses forever and renting them out in similar fashion to apartments.

In recent years, the sector has matured and evolved. Companies such as AMH have been able to achieve scale and use technology in order to bring profit margins close to those of apartment buildings (a notable feat considering the scattered nature of the assets). Meanwhile, there are powerful thematics underpinning the investment in our opinion. Millennials are approaching peak start-a-household age. Yes, it is true that millennials live with parents longer, are delaying marriage, and seem to want smaller families. However, the sheer size of this demographic (larger even than the boomers) will still propel a massive need for single family housing over the next five to 10 years. In addition, housing supply and affordability are at all-time lows. Young people simply do not have the means to afford a down payment the way previous generations had. The list goes on: today's young people have far less interest in home ownership than previous generations. For the first time ever, over 50% of the country's babies are born to single mothers. And finally, contrary to common perception, millennials are not at all adverse to living in suburbs.

Despite these strong fundamentals and thematics, AMH's share price has suffered in recent years alongside most other interest rate sensitive names as investors positioned themselves for the inevitable rise in interest rates. This has AMH trading at a substantial discount to its intrinsic value in our opinion, a value that we project to grow materially in the coming years.

I will end there. To sum up, we are defensively positioned. We do not know what the future holds, and there is certainly the chance the markets and economies resume their upward trajectory. If this happens

we will no doubt miss some of the rebound but will endeavor to adjust accordingly to achieve a satisfactory upside return. In other words, we have taken somewhat of a "wait until the coast is clear" approach. We feel that this is prudent considering recent turbulence and high valuations, especially since Harbour clients look to us for downside protection.

Thank you for your continued support.

Ryan Fitzgerald, CFA
Senior Portfolio Manager

Class F Returns (in %) as at June 30, 2018	**Year-to-date**	**1 year**	**3 year**	**5 year**	**10 year**
Harbour Fund	0.3	3.3	0.8	3.9	2.9
Harbour Global Equity Corporate Class	2.6	4.4	2.6	7.6	5.3
CI Canadian Investment Fund	1.3	6.0	6.1	8.7	5.3