Market Commentary
Second Quarter 2018

Harbour Growth & Income Fund
Harbour Global Growth & Income Corporate Class

The second quarter of 2018 was marked by divergence – divergence in asset class performance, divergence in investor expectations, and mostly, divergence in the narrative that investors had been using as their guidebook until now.

Coming into 2018, the accepted view was that the world was enjoying global synchronous growth and that after a period since the financial crisis in which the United States offered the best returns in equity, debt and currency markets, there were now many more – and often cheaper – options for investors. This had created an environment in which capital fanned out around the world, seeking better returns in Europe, Asia and emerging markets. Global stock markets enjoyed a steady run from the lows in early 2016 to late January 2018, but when markets corrected in February, the tone started to change. The S&P 500 Index corrected 10% from its January peak, and five months later has yet to reclaim that level. Most global markets are churning sideways and, outside of the Nasdaq, most of the global stock exchanges have generated little in the way of return thus far this year.

There have been many culprits, but two factors seem to be dominating the minds of investors. The first is that global liquidity likely peaked in January, and after a decade of easy money, we are now in a global tightening cycle, removing the oxygen that asset values breathe. The second is that increasingly volatile trade rhetoric voiced by U.S. President Donald Trump's administration, now embroiled in trade disputes with all of America's major trading partners at the same time, has become a scenario that investors are having difficulty deciphering.

The result is that there has been a divergence between investor sentiment and the current business reality. In their quarterly commentaries, corporations are reporting that operating conditions are favourable, yet investors are skeptical – effectively driving up the equity risk premium. Those investment themes linked to global growth (primarily industrials and commodities) have suffered as investors fretted that the trade rhetoric would lead to growth-damaging tariff policies, and emerging markets sold off 10% as the trade-weighted U.S. dollar strengthened 5% in the quarter. All of a sudden, growth everywhere outside the U.S. looked less of a sure thing as either the tighter liquidity imposed by the rising U.S. dollar or the possible trade-related growth slowdown caused stocks in many markets to de-rate. Bucking the trend were U.S. domestic consumption names, large cap U.S. technology companies, and the energy and utility sectors. Broadly speaking, investors have once again become more conformable investing in the United States – and to companies not

exposed outside the country, in favoured momentum growth names, and in interest sensitives like utilities that would benefit in a risk-off, slowing global environment.

The dollar, as always, is relevant as a barometer and arbiter of global growth. A hawkish U.S. Federal Reserve and a protectionist administration are reinforcing U.S. dollar strength. This remains problematic in a world that is largely run on dollars. Asian borrowers have added $10 trillion in debt since 2009, much of it borrowed in U.S. dollars. As the dollar strengthens – from rising U.S. rates, growing protectionism and capital repatriation – borrowing costs increase in much of the world and crowd out growth. This is why we have seen weakness in commodities and considerable volatility in non-U.S. markets. The two $64,000 questions for the balance of this year are 1) will the Trump trade rhetoric have as much bite as it has bark, and 2) will the Fed maintain a tightening profile if there are adverse consequences globally from the liquidity reduction? A "yes" to either or both of those questions would be incrementally negative to stock prices at the margin.

Our two cents? Inflation remains low but as the U.S. economy approaches full employment, we will need to see productivity growth to offset wage inflation or the Fed will be pressured to keep raising interest rates. Whether companies will invest in productivity enhancing capital remains to be seen – to this point they have a declared preference for debt reduction, buybacks and mergers and acquisitions before they think about capital investment. The trade rhetoric is disruptive, and irrespective of whether larger and broader tariffs are implemented, we imagine that there is already an effect on the pace of business investment. It is very difficult as a CEO outside of the United States to consider investing in new capacity if you don't know what the terms of trade are going to be with one of your biggest global customers. As long as there is uncertainty around those terms, there will be an overhang that will cause companies to defer spending, and that could cause growth to slow among America's trading partners, further reinforcing dollar strength. It is also important to remember that we are almost a decade into the cycle and stocks are no longer as cheap as they once were. Corporate buybacks are at record levels and tax changes are driving a big part of the earnings beat. Typically, when a company beats earnings based on tax changes and stock buybacks, analysts call that a "low quality beat." Strangely, we don't hear that expression anywhere these days. According to one of Warren Buffett's favorite indicators, market cap to GDP, U.S. stocks are at their second highest valuation level ever, and very close to their 2000 peak – this coming at a time when two-year treasuries (risk-free short-term money) now yield more than the S&P 500 Index dividend yield. Suffice to say, we are not all-in equity bulls.

Our underperformance during the quarter can be attributed to three broad sources: style bias, adverse impact from stock selection in industrials, and a range of other factors including overall equity exposure, fixed income and currency.

Our conservative investment style certainly plays a role in this market. In the second quarter, more than 50% of the return of the MSCI World Index came from five stocks (all U.S. technology stocks),

and 72% of the market's return came from the top 20 names in the index (of 1,681 total). The trend to passive investing continues to exacerbate a narrowness to the market, favouring high-quality growth companies, a number of which trade at valuations that are not consistent with Harbour's traditional style. This market phenomenon is also borne out in the comparison of growth versus value indexes, which continue to heavily favour a growth style. Will this persist? It is difficult to say, but historically when liquidity is withdrawn from markets, investors become more discerning, and a value style returns to favour. After a long run for growth stocks, we would caution investors not to "put all their eggs in one basket."

Our investment result during the quarter was impacted by price volatility in a number of our foreign holdings. In this regard, we would make a distinction between short-term pricing fluctuations and long-term value. Shares of our Japanese industrial exporters were adversely impacted by slowing year-over-year orders and by the perception that trade issues may cause the Chinese economy to slow. As a result, these names have exhibited considerable volatility. These companies have been very strong contributors to our portfolio performance and we continue to see these names as secular growth stories with long-term merit.

During a quarter in which risk assets performed well, our lower levels of equity exposure and our investment-grade fixed-income portfolio also worked against us. Our equity exposure has been at the lower end of our notional ranges, with both the domestic and international funds maintaining equity weights in the low 60s. In a mirror of the equity markets, high-yield bonds outperformed significantly during the period, with CCC bonds returning a positive return of 385 basis points for the quarter, while U.S. investment-grade bonds returned -94 basis points. We consider our bond portfolio to be a key capital protection element of the portfolios, and not a place where we take risk. In exuberant periods such as the past quarter, this conservative view results in opportunity cost versus our peers.

During the quarter the funds increased their exposure to Sony, a company that we have met with multiple times over the past few years. Sony, long recognized for its consumer electronic brands, has been a company in transition for at least a decade and is now finally moving to tangibly maximize the value of the enterprise, reducing headcount and asset intensity and exiting businesses that generate substandard returns. As a result, the company is finally transforming from a low valuation consumer electronics business to one that looks more like a media and technology company, and we expect it will ultimately be more profitable and trade at a higher valuation as a result. Sony remains a player in high-end television, cameras and handsets, but these businesses are increasingly less important to the value of the overall company as its gaming, movie, music and image sensor businesses become larger, more profitable shares of the overall company. Sony is a leader in multiple businesses with attractive trends: in music, where streaming and the diversification of delivery models continues to grow at a time when the number of labels is contracting; in gaming, where the synergies between its movie and game businesses can drive

margin expansion; and in image sensors, where mobile phones are increasing integrating multiple cameras and utilizing image capture as part of their data ingestion. Under the leadership of new CEO Ken Yoshida, we expect Sony to continue to move along the transformative road of value creation.

We are appreciative of your continued confidence and welcome your questions at any time.

Roger Mortimer
Senior Portfolio Manager
CI Global Investments Inc.

Class F Returns (in %) as at June 30, 2018	**Year-to-date**	**1 year**	**3 year**	**5 year**	**10 year**
Harbour Global Growth & Income Corporate Class	-1.6	4.8	6.7	10.1	6.7
Harbour Growth & Income Fund	-2.3	1.9	2.9	5.3	3.4