Harbour Fund
CI Canadian Investment Fund
First-quarter 2019 Commentary

Market Overview

- The main themes of the first quarter of 2019 were liquidity and shifts in central bank monetary policy. During much of 2018, monetary conditions were tightening significantly, driven by two main factors: 1) the U.S. Federal Reserve (the "Fed") withdrawing money from the financial system, and 2) China's inability to create money due to changes in global capital flows in recent years.

- The effects of tightened monetary policy began appearing in the global financial system early in 2018 – notably, in emerging markets. By year-end, they had clearly spread into other economies and asset classes. U.S. housing, global auto sales and semiconductor demand, for example, had all weakened. Many market commentators believed these conditions were signalling a recession was imminent. Certainly, investors seemed to agree, with equities selling off sharply and credit spreads rapidly widening throughout the fourth quarter of 2018.

- How things have changed in just one quarter! The sharp recovery from the market lows of December 24 marks one of the steepest stock market advances in history. This remarkable recovery was driven primarily by a surprising U-turn on monetary policy by Fed Chairman Jerome Powell. As recently as mid-December, Powell had been sticking to an autopilot approach of gradually rising interest rates and a gradual reduction of the Fed's balance sheet; in other words, a withdrawing of U.S.-dollar liquidity. This narrative changed 180 degrees within a matter of weeks as global markets entered "crash" mode. The new guidance from the Fed called for an indefinite pause on interest rate hikes as well as a gradual cessation of quantitative tightening, the effects of which would leave far more money in the financial system than if the Fed had not reversed course.

- Meanwhile, Chinese authorities, who had been incrementally stimulating the Chinese economy through much of 2018, substantially stepped up these efforts during the first quarter of 2019 as the extent of the slowdown in global economic growth became more evident. With the world's two largest economies moving quickly to stimulate their economies, and by extension the global economy, we believe the chance of a recession was significantly reduced.

- Markets reacted swiftly to the upside during the quarter. Since earnings growth has slowed in many sectors, we attribute the stock market rally to a valuation re-rating. In other words, even though earnings will no doubt underwhelm for a short while, market participants are betting that earnings growth will quickly resume once the stimulus measures work through the system. Therefore, we believe it is reasonable to assume earnings growth, rather than the valuation attributed to those earnings, will drive markets higher going forward.

- The current market setup, in many ways, seems to be a reversion to an environment that existed for several years post the global financial crisis of 2008-09. Similar to the middle years of the previous decade, investors have reset their expectations to lower growth, while monetary policy remains loose and unconventional. Following is our review of the distinct time-frames since the crisis:

  2009–2013: This period is framed by the end of the global financial crisis (March 2009) to then end of quantitative easing by the Fed (the May 2013 “taper tantrum”). This was a time of uneven and slow economic recovery coupled with extraordinarily accommodative monetary policy. Pretty much all “risk” asset classes worked well in this period since the starting point was marked by “bankruptcy-type” valuations. Perhaps the most distinguishing factor was how well yield asset classes worked. Asset classes such as real estate investment trusts (REITs) and high-yield debt, which both benefit from low interest rates and improving credit, were among the best performers.

  2013–2016: During this period, economic reality began to set in. Growth was not accelerating, and subpar gross-domestic-product (GDP) growth of 2% became the consensus “new normal.” In addition, the Fed signalled it would eventually end its campaign of printing money, which had helped fuel asset price inflation. Against this backdrop, several high dividend-yielding sectors in the stock market began to falter, kicking off a multi-year period of underperformance. Value investors, meanwhile, frustrated themselves attempting to buy cheap or reasonably priced stocks in sectors such as banks, industrials and commodities. The fortunes of companies in these sectors are tied to the global economy and, given that valuations were no longer at rock-bottom levels, the sectors struggled in the absence of meaningful earnings growth. Structural growth stories, however, did exist. This was the beginning of the multi-year outperformance of growth stocks. With earnings growth scarce, money poured into FAANG (Facebook, Apple, Amazon, Netflix and Google) stocks, semiconductors and certain health care sub-sectors.

2016–first-quarter 2018: This is really an extension of the previous time-frame, the only difference being Donald Trump was elected U.S. president, which gave a boost to certain sub-sectors that had previously been underperforming; most notably, banking. Here, investors thought Trump would unleash the true potential of the U.S. economy through lower taxes and deregulation. In 2017 and 2018, higher GDP did indeed come to pass; however, with the passage of time, skeptics were proved correct. The boost to GDP was probably nothing more than a tax cut-fuelled sugar rush.

2018–first-quarter 2019: The end of the cycle looked to be approaching fast. Several years of tightening monetary policy began to catch up with the real economy. This was first seen in emerging markets and then spilled into other cyclical sectors. There were two corrections in the stock markets that reflected this change in narrative, one in February of 2018 and a far more violent and all-encompassing correction this past fall. For the first time in years, defensive yield stocks worked well. Structural growth stories got hit, too, but they held up better than many old-economy cyclicals such as banks and industrials.

Year-to-date 2019: As mentioned above, stock markets during this period soared on the back of central bank guidance of looser monetary policy. Cyclicals rallied hard from very depressed valuations, REITs posted strong performance on the expectation of a "lower-for-longer" interest rate environment, and structural growth stories, such as information technology stocks, went up, too.

- Did we just have a mini-cycle? One where we experienced a very typical monetary-driven economic slowdown, followed by monetary easing, followed by a recovery? If so, it is unusual in that we didn't actually have a recession. Furthermore, the speed at which it all happened was certainly different from previous eras. Perhaps the way to think about it is that central bank authorities worked hard to manufacture a cycle extension, one where 2018 will be thought of more as a mid- to late-cycle swoon rather than the absolute end of one.

- There are several current economic and market characteristics that remind us of the middle years of the last 10-year cycle:

  1. We are back into a period of a lower-for-longer interest rate environment.

  2. An across-the-board valuation re-rating has already occurred, and investors are now left wondering how stocks can go higher (particularly in fairly valued old-economy sectors such as industrials) if we are again stuck with 2% GDP growth globally.

3. Structural growth stories continue to deliver on expected earnings, and they continue to be rewarded for doing so.

Performance Summary

- Over the first quarter of 2019, Class F of Harbour Fund returned 7.2% and Class F of CI Canadian Investment Fund returned 7.1% (the "Funds"). The benchmark for both Funds, the S&P/TSX Composite Index, was up 13.3% over the same period. The main reason for the underperformance of each of the Funds relative to their benchmark during the quarter was the elevated level of cash in each of the Funds.

Contributors to and Detractors from Performance

- In terms of attribution, stock selection was generally good throughout the quarter, with no individual holdings of either of the Funds significantly detracting from their respective performance. On the positive side, the largest individual contributors to performance were holdings by each of the Funds in Brookfield Asset Management Inc., Thomson Reuters Corp. and Pembina Pipelines Corp. On the negative side of the ledger, holdings in Sony Corp. and Pfizer Inc. detracted from the performance of each of the Funds.

Portfolio Activity

- We made a number of changes to the portfolio of each of the Funds over the quarter. At the start of 2019, the Funds both had a defensive posture, expressed through high levels of cash as well as conservative sector and security selection. Thus, the Funds both underperformed their benchmark through the quarter, although the bulk of this underperformance occurred during the month of January. As it became more apparent that the quantitative-easing measures taken by central banks would likely lead to a stabilization in the global economy, in February we reoriented the portfolio of each of the Funds to be closer to a neutral stance versus the benchmark.

- Our favoured investment ideas are in those companies/sectors less sensitive to slowing growth. While these types of investments don't come at rock-bottom value, we believe we have still been able to acquire them at very reasonable prices. Therefore, we believe each of the Funds has a distinct GARP (growth at a reasonable price) orientation. Both Funds continue to hold yield-oriented securities, such as pipelines and utilities, although these have been pared back some as valuations have become to very high. We have shied away from cyclical value investment ideas, but we are currently allocating research efforts in these areas.

Outlook

- We suspect we might be in for another frustrating period for those investors chasing “cheap” old-economy value ideas. Both Funds are underweight in the energy sector relative to the benchmark as we have no clear conviction on whether oil prices will move higher or lower during the rest of 2019.

- Markets have run fast and hard, and valuations are again high, so we do not believe this is a time where an investor can indiscriminately “buy the market.”

Class F returns (in %) as at March 31, 2019	**Year-to-date**	**1 year**	**3 year**	**5 year**	**10 year**
Harbour Fund	7.2	3.5	3.1	1.3	6.1
CI Canadian Investment Fund	7.1	4.1	7.7	4.6	9.2

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