FRONT STREET

Hedge Fund

COMMENTARY Q4 2016

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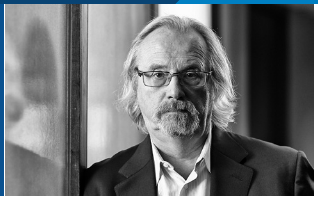

MARKET OVERVIEW

We leave 2016 with mixed emotions as we reflect on a year that had its challenges. Despite a positive year for returns, I am quite disappointed with the way I ran your money. Where I outperformed handily in 2015, it was just the inverse in 2016. Nevertheless, rather than belabour the past, let's focus on the year ahead.

Of all the shocking headlines in 2016, the U.S presidential election results may have the biggest impact going forward. Our view, as well as that of many others, has materially changed. Now that we're a month past the election and cabinet posts have been filled, it is increasingly clear that we are about to experience a profound, president-led ideological shift that will have a significant impact on both the U.S. and the world. This will not just be a shift in government policy, but also a shift in how government policy is pursued. Mr. Trump is a deal maker, a bully, who negotiates hard and doesn't mind getting banged around or banging others around. Similarly, when we look at his cabinet candidates, we see people who are successful, bold and hell-bent on playing hard ball to make big changes happen in economics, education, health care, environment, regulation and foreign policy.

Regarding economics, the new U.S. administration seems to distains weak, unproductive socialist people and policies, and it admires the strong "can do" profit makers – and brings to mind Thatcher, Reagan and Kohl's administration. This shift, however, may be bigger than one would calculate on the basis of changes in tax and spending policies alone.

Regarding tax cuts; the U.S. has a marginal corporate tax rate of 38.9% making it by far the highest in the industrialized world. While the actual rate some companies pay is less, the playing field is by no means level. There is a good case for lowering the marginal rate and simplifying the system. Repatriation of foreign holdings also closes loopholes that may have been used to optimize taxes paid.

With regard to regulation; regulatory burdens have increased dramatically in the U.S. The Obama administration added more than $100 billion annually to costs for business and individuals. Regulatory changes are coming in health care, finance, energy and the environment. While some areas will see dramatic changes, other areas, such as the banking group, will see an easing of regulation, but not back to the pre-crisis level of 2008.

With respect to trade and foreign policy, we should expect the new administration to be comparably aggressive. The question is whether it will be (a) aggressive and thoughtful or (b) aggressive and reckless. The key here will be the interaction between Mr. Trump and his advisors, who to date, have been pragmatic while Trump continues to bluster. We are sure it won't take long to find out which way the wind blows.

On the topic of fiscal spending, after decades of weak fiscal spending the new administration has promised a public-private initiative to aggressively get projects going. While there are very few shovel-ready projects on the table, the combination of deregulation and tax cuts could be the tonic needed to get the projects off the ground. Nevertheless, look to 2018 before any impact will be felt.

CONCLUSION & STRATEGIES

Inflation and bond yields in the U.S. have passed a cyclical point, but this does not mean that a sustained major uptrend is imminent. Trump's policy views are squarely bearish for bonds, mixed for stocks. For now, rising wages and prices are welcome news given that inflation will be higher as a result of tightening labour markets, but not to alarming levels.

As the world continues to politically move to the right, we need to recognize these changes and their results. Consistent with the new administration's view, we believe there will be four major changes; domestic agenda over global ones, deregulation over reregulation, fiscals stimulus over monetary and a broadening of volatility from currency markets to global interest rate markets.

Over the previous several years we had a restrained but slightly optimistic view of equities, fueled by a belief that general earnings growth had hit a wall, but due to low inflation and lower interest rates, that price-earnings ratios would expand. This has certainly been the case as P/E ratios have moved from 12.5 times to 19 times. As long as rates moved lower, P/Es moved higher. With the Trump victory, we now believe we will see material earnings growth for the next few years. However, conversely with inflation and a rise in interest rates, we will see some contraction of P/Es. With a more hawkish U.S. Federal Reserve, bonds and bond proxies will underperform. This obviously creates a divergence within the stock market. Held back by this divergence, the overall S&P will be increasingly outperformed by sectors and countries (including Canada) that are more sensitive to late cycle drives. We believe active management will outperform passive management.

In conclusion, here a quick checklist for 2017:

1. Shorter duration (interest rate sensitivity) for bond portfolios
2. Underweight allocation to sectors that are bond proxies, such as utilities
3. In the U.S., a favouring of domestic over international
4. Investment in companies with high effective tax rates
5. Investment in companies that will benefit from regulatory change
6. Invest in companies with strong balance sheets that can withstand higher interest rates in Canada, while we believe our domestic economy will continue to disappoint. The key areas of our focus will be on the financials, materials and energy, as per our details below:

- *Financials* – A rising interest rate environment and steepening of the yield curve is good for financials. Concerns continue to revolve around the Canadian housing market. At what point do rising rates kill the housing market and create risk to the Canadian banks?
- *Materials* – Prior to the U.S. election global growth was already seeing a turnaround. Seasonally, metals appear to have some legs. While rising inflation will be good for gold, rising interest rates and a cheaper U.S. dollar will not. Expect another year of volatility.
- *Energy* – This sector's performance will be a determining factor in whether Canada will outperform. If the recent OPEC cuts are enacted and enforced, and we get a stable environment, we could see oil trade between $50 and $60 per barrel. We anticipate that the environment will be similar to the 1990s, and thus, security selection will be paramount.

It remains our view that, with the administration changes south of the border, we have given ourselves a few more years without a recession. We expect we have a better than ever odds for the continuation of the bull markets.

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