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Global Investment Letter

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INTRODUCTION

A basic premise at the Global Investment Letter is that global investment returns are a product of the intersection of economic, political and historic influences. The relative importance of the respective inputs will, of course, change over time. It is our view that all three influences will assert themselves over the next 10-15 years, producing significant economic and geopolitical change. It will be a challenging environment for all, but also one of opportunity for the alert investor. The geopolitical events of the past month have only served to confirm our premise. We are spoiled for choice on where to start.

Of the month's developments, the announcement in late February that term limits restricting the tenure of Chinese leader Xi Jinping were to be removed in March has perhaps the greatest long-term global consequences. The news, while dramatic, is not entirely surprising. Xi Jinping's efforts to oust political rivals as part of his "anti-corruption" policy and recent insertion of his "thoughts" into the Chinese constitution suggest a growing cult of personality and consolidation of power. The imposition of Xi Jinping as leader for life will affect both Chinese domestic affairs and the larger geopolitical scene.

The remarkable pace of Chinese economic growth over the past 35 years, and therefore its geopolitical influence, has produced a certain admiration for the effectiveness of the one-party state in China, and even in some quarters of the West. A single party government can indeed act more decisively than a democracy. However, there is a fatal flaw to the one-party system and that is the difficulty of removing incompetent or corrupt leadership. China has been fortunate in having a series of relatively effective leaders since Deng Xiaoping initiated, in the late 1970s, the reforms that have produced today's China. Xi Jinping may continue the tradition, but what if he does not? What will prevent a leader for life from implementing destructive policies, as Mao Zedong did? Another issue presents itself: how will the successor to Xi Jinping be chosen? Will it be by Xi Jinping? One party systems with leaders for life create the possibility of monarchical style rule. Historically, real or quasi monarchies have not worked well when the ruler has had the power imbued in the current Chinese leader. It has long been our view that the greatest threat to China's long-term economic development is an adverse political development within the country itself. The abolition of term limits may well fall within this category. While they may not become apparent for some years, the domestic consequences for China may be far reaching.

The installation of Xi Jinping as long-term leader also serves to cement China's foreign policy in place as articulated by Xi Jinping at the 19th party Congress last fall. China is intent on occupying a much more dominant role in global affairs in the next two decades. It is extending its influence through its One Belt One Road Policy and in reinforcing economic ties with developing nations, most notably in Africa. China also continues to enhance its military strength. The Chinese desire to play a central role in global affairs is not surprising as it is in keeping with China's self-image throughout history. China has been the world's largest economy for most of the past 3000 years and has dominated Asian affairs. North Americans often do not appreciate how history and its perception can drive a nation's foreign policy. North Americans

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tend to have short memories because our nations are still young; the rest of the world does not. The friendships, rivalries and antipathies of European, Asian and African nations often have ancient roots. The fact that China has publicly stated an intention to take a more muscular position in world affairs coincident with the United States retreating from its traditional leadership role is going to serve to further destabilize the balance of nations. Any move from the status quo puts stress on the geopolitical order……stress that can have unintended consequences. There is no doubt that a China that is ambitious for power and influence will put stresses on the East/West balance of power in the next 10-15 years, with both intended and unintended consequences. These consequences will, of course, affect capital markets.

Donald Trump announced at the end of the month his intention to impose a 25% tariff on imported steel and a 10% tariff on incoming aluminum. The statement surprised almost everybody including, apparently, most of his Whitehouse staff. Once again, we cannot be completely surprised because Trump repeatedly referred to the use of tariffs during his election campaign. It is a popular measure with the roughly one-third of voters that constitute his electoral base. It is, however, a deeply flawed idea that will be negative for 100% of the U.S. population, not to mention allied countries. The history of tariffs is unambiguous. They lead to trade wars that inflict damage on all economies involved, either directly or indirectly. Tariffs have creditably been blamed as a factor that exacerbated the Great Depression of the 1930s. Once established, the escalation of trade wars through the adoption of counter tariffs is very difficult to halt. As well, a trade policy that relies on tariffs is susceptible to corruption as parties lobby for the installation of tariffs to serve vested interests. It is axiomatic that human civilization has prospered over thousands of years because of unencumbered trade. It remains to be seen whether the tariffs are implemented, and in what form. If the tariffs are indeed applied, all U.S. consumers will pay a price through higher prices for goods. Moreover, the likelihood of reprisals by trading partners makes the prospect of a trade war very real. A trade war may, in and of itself, be a sufficient catalyst to initiate the next recession. It is hoped that this intended policy is reconsidered.

The challenges for the European Union continue. On March 4th, it was announced that Angela Merkel had formed a coalition government with the SPD. Merkel had to cede a good deal of influence to the SPD to strike a deal. It remains to be seen how durable this arrangement will be. Germans may be going back to the polls sooner than they think. The Italians held their general election on March 4th as well. Predictably with Italian elections, no clear winner emerged, and a coalition must be cobbled together. Pre-election polls that suggested that populist/nationalist parties were gaining support were vindicated by the election results. The growing populist, anti-euro sentiment in the EU's third largest and most problematic economy is disquieting. Euro-skeptic feeling is growing in Italy, along with former Warsaw Pact countries in the EU. Meanwhile, Brexit continues to move to an uncertain end. The geopolitical stresses on the EU continue to build and may reach a point where they prove intolerable. Europe is likely to look like a very different place from a political standpoint in the next 10-15 years.

The geopolitical equivalent of tectonic plates are shifting. The consequences will have significant effects on both everyday lives and global capital markets.

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EQUITIES COMMENT

S&P 500(MONTHLY)

The long-term chart of the S&P 500 above provides ample evidence of the bull market that began in early 2009. The chart is notable for the duration and relative absence of significant pullbacks and volatility associated with this market move.

Volatility has returned to markets in 2018. The U.S. economy and equity markets are late in the current cycle. The Fed is raising interest rates. The unemployment level rests at very low levels and seemingly has only one direction in which to go. Donald Trump has proven to be a highly unusual President. The announcement by Trump that he plans to impose trade tariffs will not be good for anybody.

Yet, although volatility has returned and U.S. equities have stumbled recently, the bull market cannot be said to have turned into a bear market as yet. The S&P rebounded smartly after touching its 200-day moving average in February. The market has demonstrated surprising resilience despite a host of obstacles, which is a bullish indicator. Market prospects are also bolstered by the relative strength of the Nasdaq 100, which has been a useful leading indicator to market direction.

Thus, the equity bull market remains intact. There remains the possibility of a final sharp upleg, although a more subdued continuation higher seems more likely. A decline below the 200-day moving average would suggest the trend had changed. Investors must be attentive; we are late in the current cycle with no shortage of potential catalysts that could end the bull market. The next recession and bear market will

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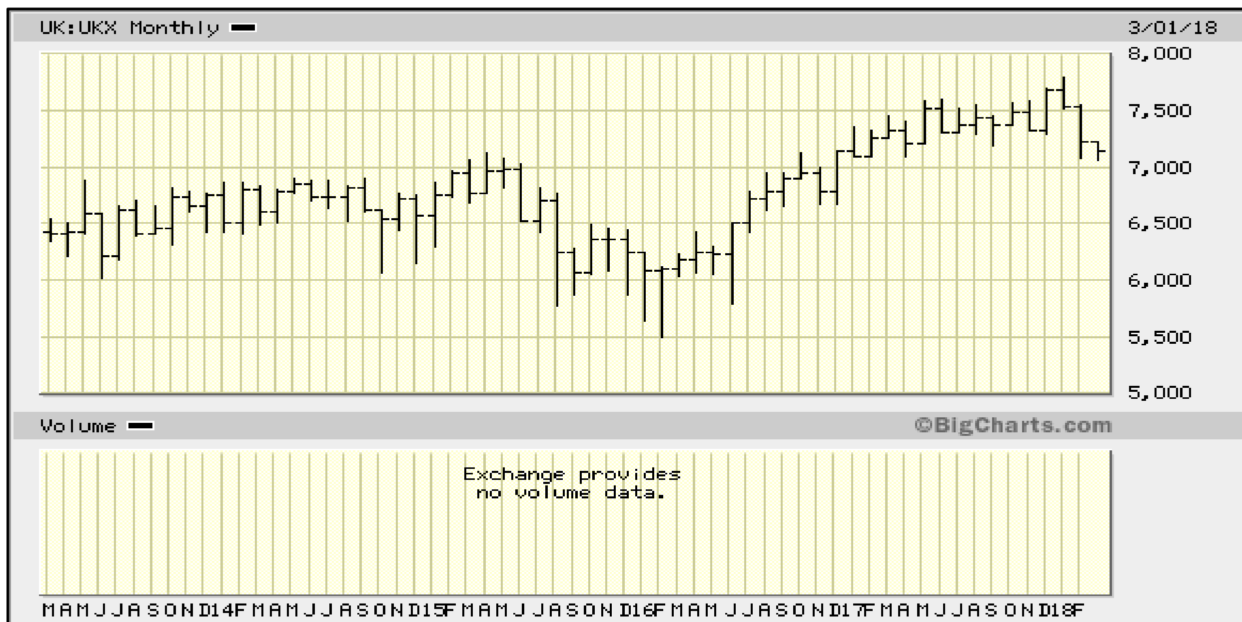
be at least as severe as that of 2008, which will provide its own set of opportunities to the prepared investor.

FTSE 100(MONTHLY)



My view on the UK's FTSE Index is unchanged. A cogent view of the prospects of the British economy and its capital markets cannot be formulated until the terms of Brexit are finalized. The FTSE appears to be retesting its breakout of early 2017. A move back below the 7000 level would be suggestive of a trend change.

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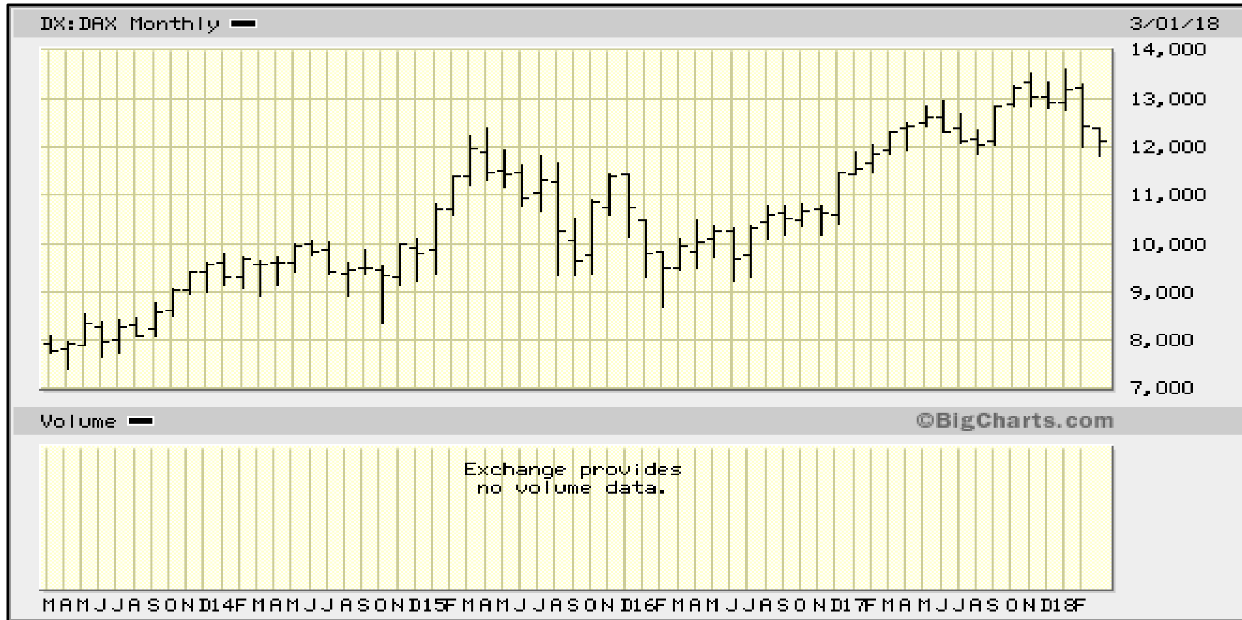
DAX INDEX (MONTHLY)



The Dax continued to trade in a distinctly bearish manner this past month, with the close below 12,000 being, in my opinion, a notably bearish development. A strong euro and weakness in other major equity markets are the primary reasons. The announcement in January by the European Central Bank that it will attempt to return to a more traditional monetary policy over the next year may have played a secondary role. The ECB has yet to implement significant changes to its intervention policies.

The DAX should be treated with caution. A rebound to new 52-week highs would be the most convincing evidence that the trend had become bullish.

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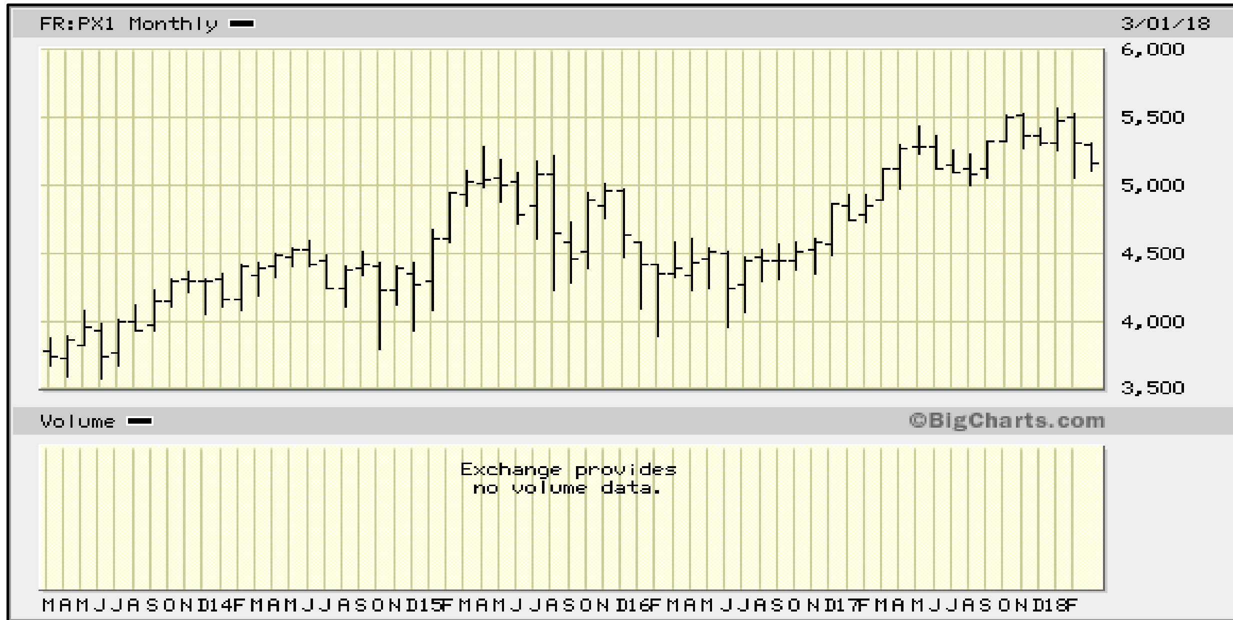
CAC 40 (WEEKLY)



The CAC 40 has been trading in a range between 5000 and 5500 for some time, with the tone becoming more bearish since year end. A break below 5000 would be a bearish development for many of the same reasons that have impeded the rise in the DAX.

The CAC 40, like other European bourses, does not appear to be a compelling purchase at present. A move above the 5500 level would be worthy of attention as a bullish development.

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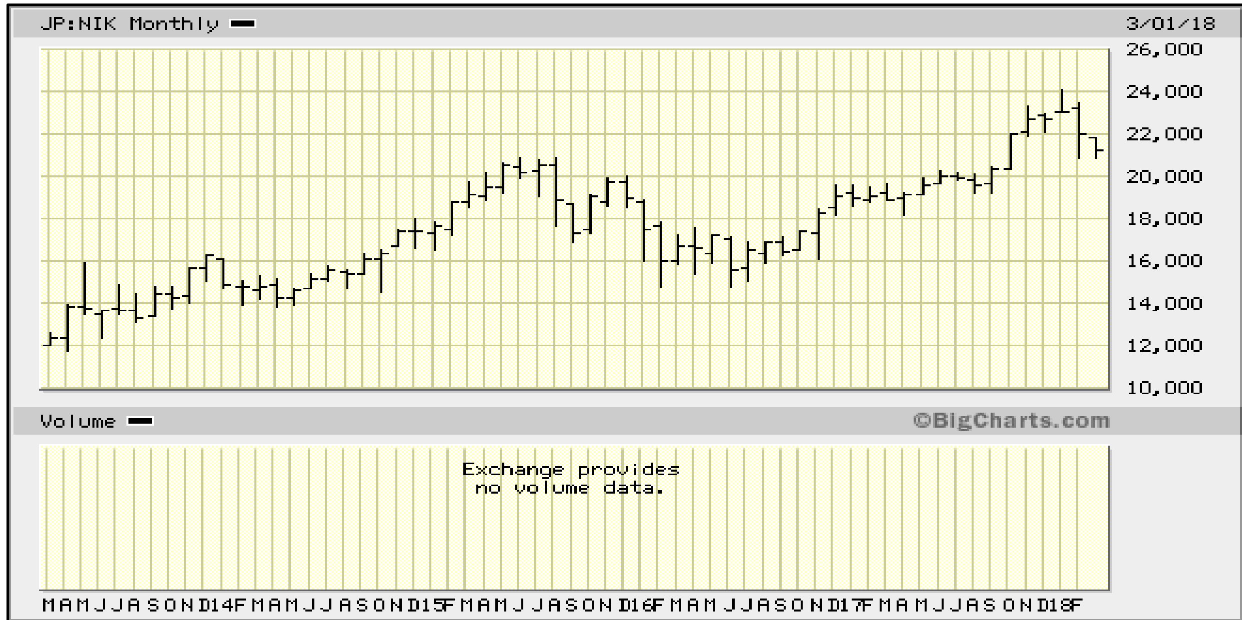
NIKKEI INDEX (MONTHLY)



The Nikkei has stumbled thus far in 2018 due to general weakness in equity markets and a rising yen. The inverse relationship between the yen and the Nikkei has a long history. Like other markets, the Nikkei should be treated cautiously until solid evidence of a bottom is presented. A decline below the circa 21,000 level could produce a sharper pullback.

The Nikkei remains more attractive than most equity markets, but one should be wary of all stock markets this late in the cycle until a buying opportunity is presented in the form of solid evidence of a market bottom.

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SHANGHAI COMPOSITE(MONTHLY)

The early March announcement by Donald Trump that he intends to implement tariffs on steel and aluminum pushes other considerations affecting the Shanghai aside. If the tariffs are implemented, China will be affected immediately as it is one of the larger steel exporters to the U.S. However, the real potential damage to this market lies in the prospect that these tariffs will be a catalyst to an escalating trade war. China is the major target for American trade protectionists because of America's large negative balance of trade with it. As will be the case with most nations, China can be expected to take retaliatory action. This is how most trade wars commence.

It is hoped that a trade war can be averted. Until more clarity is available on this topic, it is best to defer commitments to markets such as China. Tariffs and/or a trade war would also likely encourage the Chinese to weaken the yuan, which must be a consideration for non-yuan investors.

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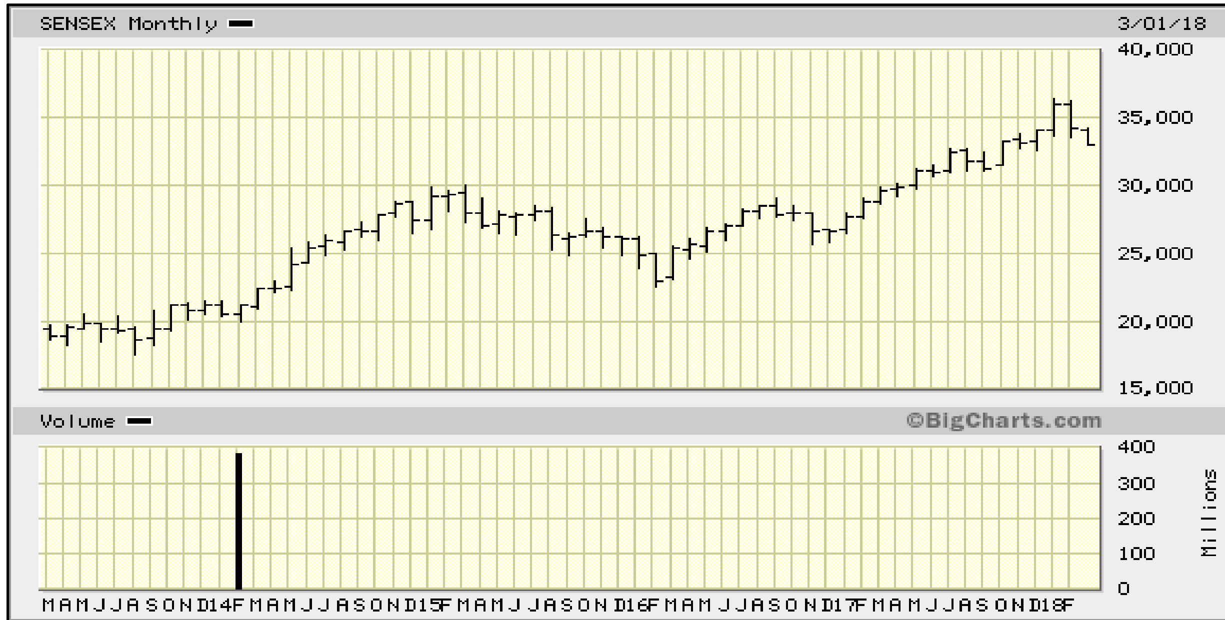
SENSEX (MONTHLY)



The Sensex posted a loss in February, following a more substantial decline in January. The Sensex has been impacted by the same factors that have negatively impacted the markets of developed nations thus far this year. As well, there have been stories alluding to bank fraud, corruption and disappointment in the accomplishments of Prime Minister Modi.

While India remains the favourite emerging market for long-term investors, it not without its challenges. In contrast to China, which is a largely homogenous society dominated by Han Chinese, India has 22 official languages, with many more spoken by sizable numbers. There is likewise a multitude of different cultural traditions that must co-exist. India is also much poorer than China and almost half the population is illiterate. Access to proper toilet facilities and electricity remain a challenge for many. However, it is these very considerable problems that present a great opportunity for investors in India. Progress is being made, albeit more slowly than many would like. There will be enormous intellectual capital infused in India, and the world, as literacy improves. The inherent leverage in India in almost all respects is enormous. It will not be an easy social, economic or political path, but the first steps have been taken.

As I have commented in prior issues, investment in India should be made within the expectation of considerable volatility. The bull market remains intact despite the recent pullback. A move back below the 30,000 level would be bearish and suggest that the bull trend has turned bearish.

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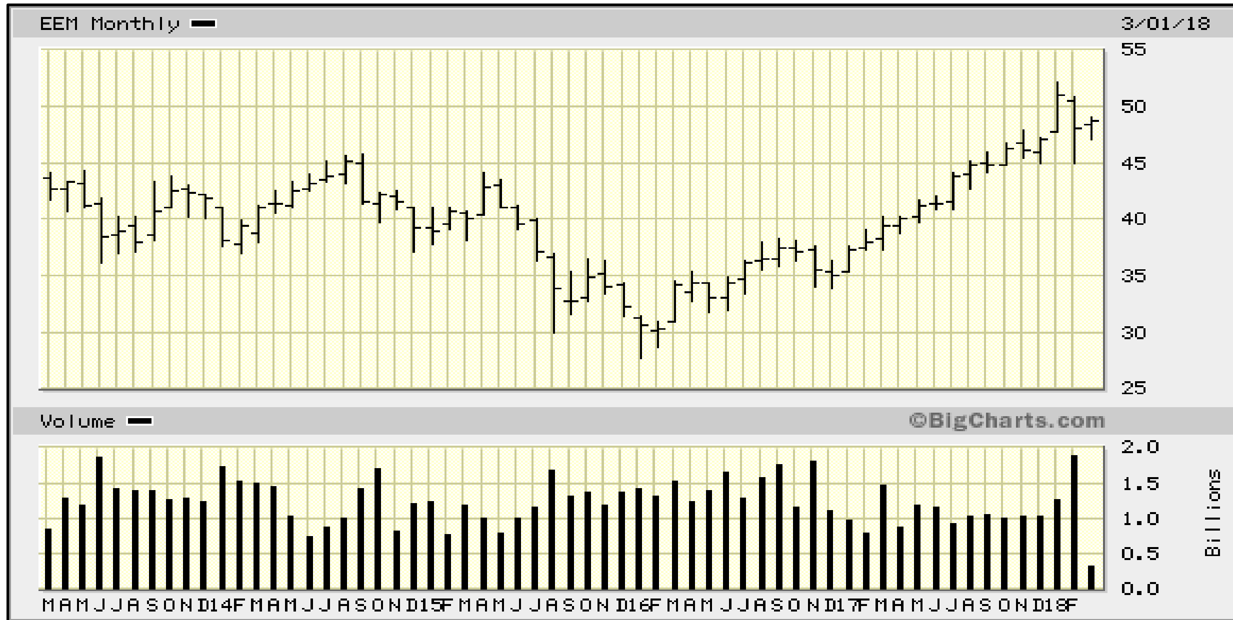
EMERGING MARKETS ETF (EEM) (MONTHLY)



The EEM chart above illustrates the remarkable performance of emerging markets in the past two years, and the notable breakout achieved in late 2017. EEM still trades comfortably above the $45 breakout point despite a sharp drop in January. The gains in emerging markets have attracted large capital flows which, in turn, have helped perpetuate the bullish trend. The appeal of emerging markets rests with their relatively more attractive valuation measures and growth prospects. Offsetting these attributes is greater economic and geopolitical risk, although global geopolitical risks seems to be getting more generally distributed.

The EEM ETF has performed relatively well thus far in 2018, notably stopping and reversing at the $45 level in January. The prospects for this ETF remain bullish. A move back below the $45 breakout point would, however, be a bearish development.

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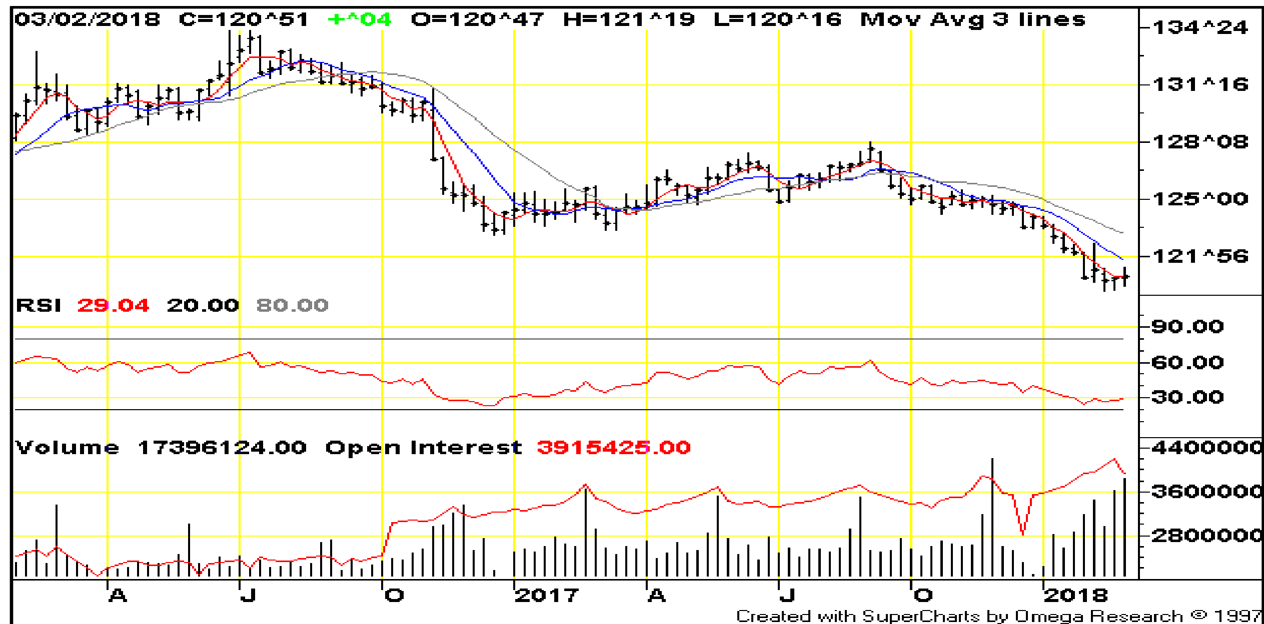
FIXED INCOME COMMENT

10-YEAR US TREASURY NOTE (WEEKLY)



The decline in the U.S. bond market stabilized last month, with the tone remaining decidedly bearish. A host of factors are weighing on the bond market: Fed rate increases, rising deficits because of the recent tax cuts and concerns about inflationary pressures. A new factor has emerged in the form of the Trump administration's announcement that the U.S. will impose punitive tariffs on all imports of steel and aluminum. If the tariffs are implemented, they will certainly produce inflationary pressures through the increase in steel and aluminum prices in the United States.

The trend of the U.S. bond market remains bearish. The next buying opportunity may appear when evidence of the next recession, which will presumably lessen upward pressures on interest rates, becomes apparent. We have yet to reach that point.

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CURRENCY COMMENT

US DOLLAR INDEX (DXY)

The US dollar index attempted to retrace some of the sharp decline experienced in recent months. The chart above suggests another leg down may be expected. A move back above the 92 level is required to change the tone of the DXY from bearish to bullish.

I continue to foresee a stronger dollar in the longer term based, in part, on my view that it remains the best of a decidedly-flawed group of major currencies. However, until the US dollar index demonstrates bullish behaviour, this index must be treated with caution.

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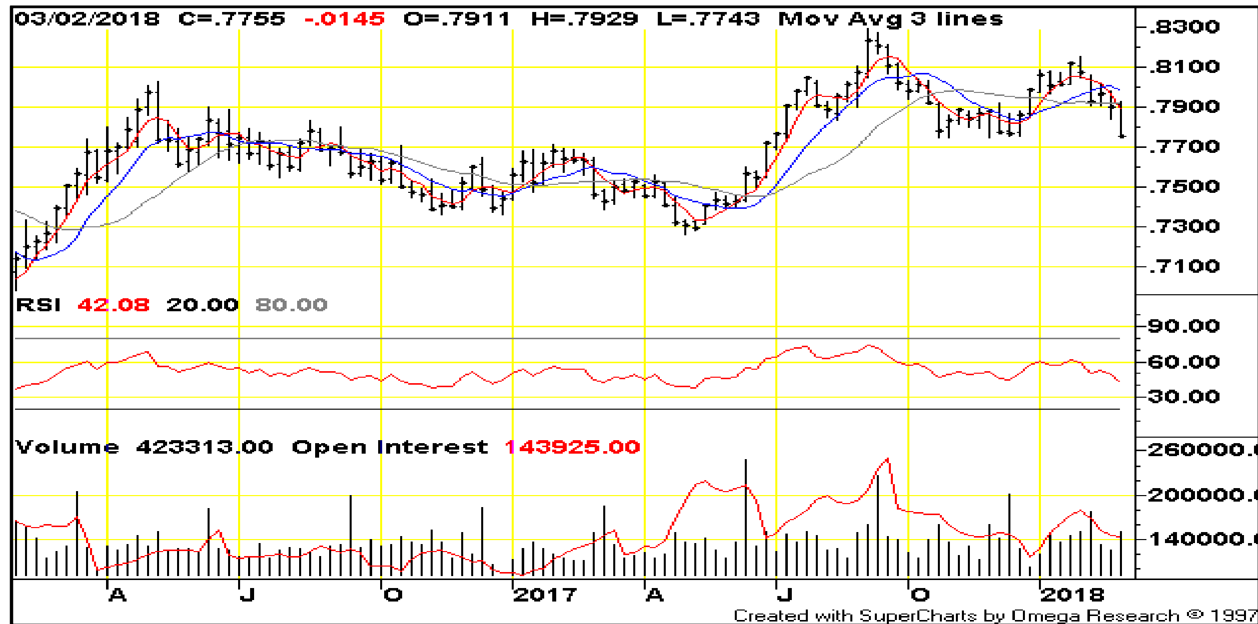
CAD/USD (WEEKLY)



The Canadian dollar declined sharply in February as NAFTA negotiations continue to bear little fruit, with the Trump administration suggesting publicly that they anticipate withdrawing from the accord. It is uncertain whether this is a negotiating tactic. Donald Trump stated repeatedly during his presidential campaign that he wished to end NAFTA. The decline in the Canadian dollar accelerated when Donald Trump announced his plans to impose tariffs.

The Canadian dollar will likely continue its decline if a trade war ensues for two reasons. Firstly, there will be an adverse impact on the Canadian economy. Secondly, the Bank of Canada can be expected to pursue a policy of a weaker dollar. One of the common consequences of trade wars is competitive currency devaluation as nations attempt to compensate for the effects of tariffs with lower currencies.

The prospects for the Canadian dollar versus its American cousin remain bearish.

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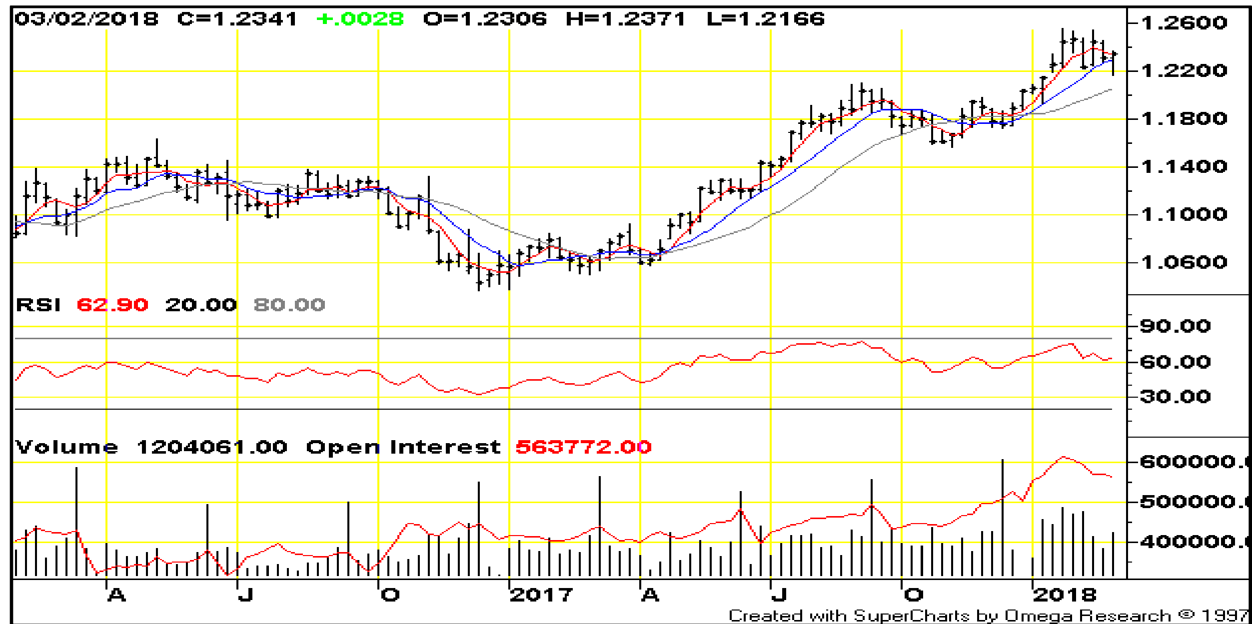
EUR/USD (WEEKLY)



The euro consolidated its recent advance versus the US dollar last month in a manner that suggests further upside potential for the euro. As stated previously, I attribute the strength of the euro more to weakness in the dollar than its own merits. The interest rate differential and mounting geopolitical stresses in the EU certainly suggests a lower euro over time.

However, until evidence of a change in the trend becomes apparent, it should be viewed as bullish. A move back below the 1.20 level would be a bearish development, with a move down to the circa 1.14 level indicating a definite change of trend.

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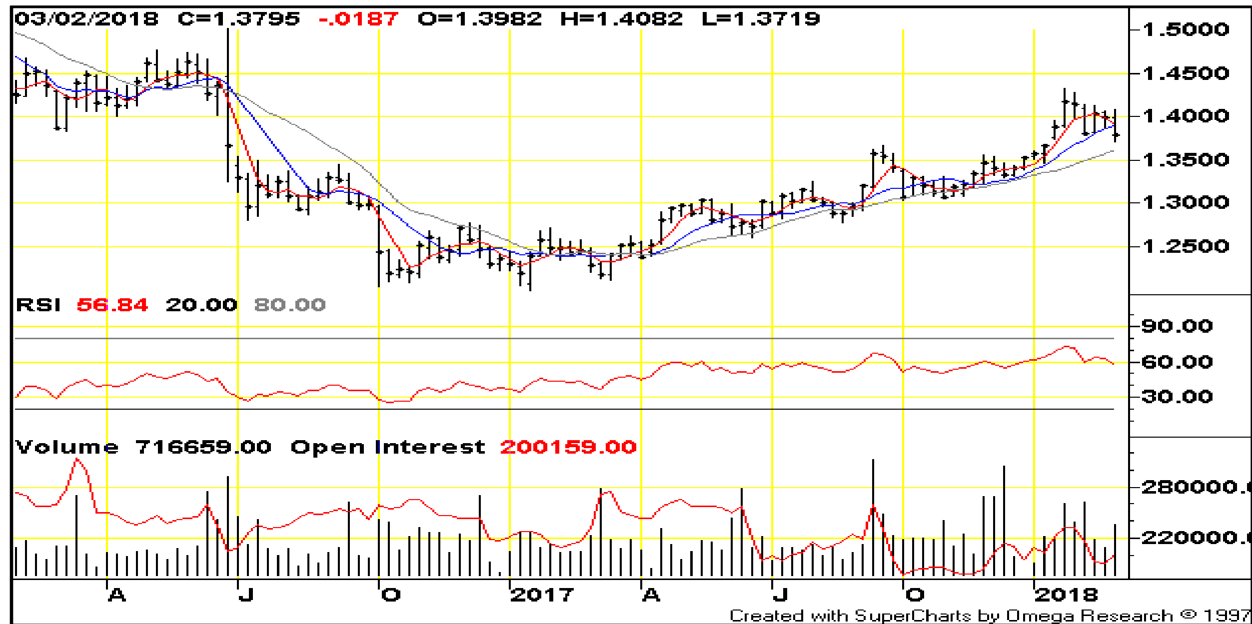
POUND/USD



The pound weakened in response to the strengthening in the US dollar. It would require a break above the 1.45 level for me to view the current strength in the pound as being more than a counter-trend rally in a long-term bear market. The ongoing debacle that is Brexit and the mediocre performance of the British economy argue for a lower pound.

I continue to believe the long-term future of the pound is par with the US dollar. However, the recent strength must be respected until signs of a trend change become apparent. A break below the rising trading channel begun in late 2016 would be a bearish development for the pound.

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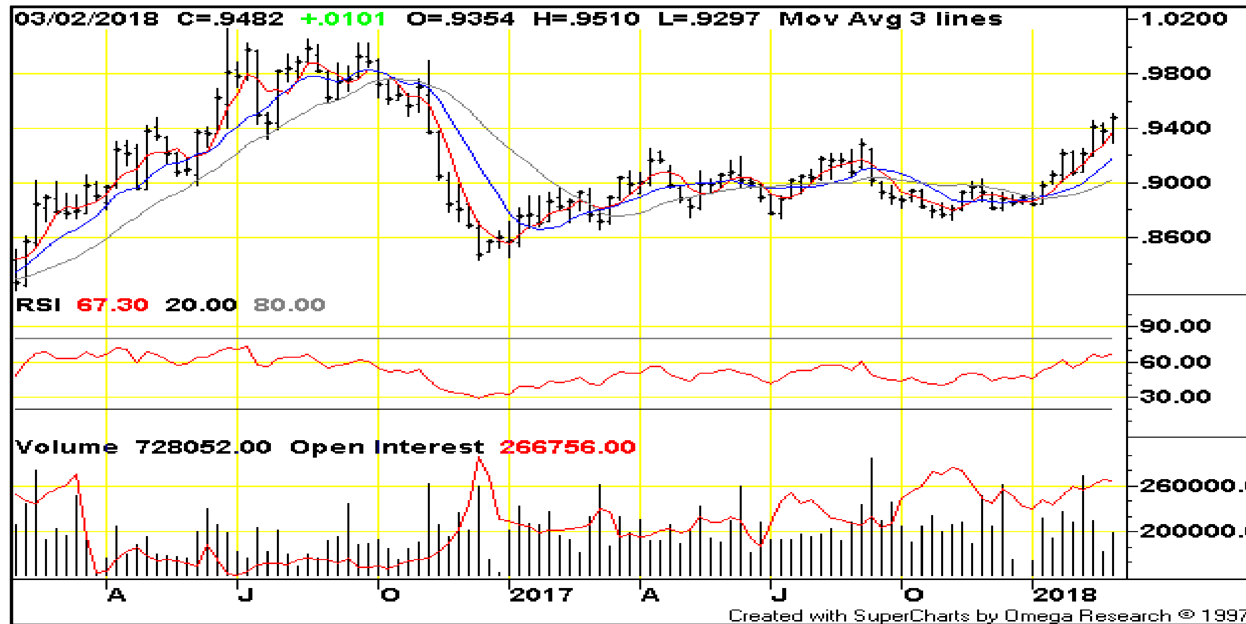
YEN/USD (WEEKLY)



The yen has demonstrated conspicuous strength in 2018, breaking out of a trading range that endured throughout 2017. The rise in the yen is noteworthy given the interest rate and monetary policy of the Bank of Japan, which is not designed to produce a stronger yen. The recent ascent of the yen is primarily a comment on the relative merits of competing currencies.

The yen will meet formidable resistance at the .98 level, which I do not expect to be breached. The risk/reward balance of the yen suggests adopting a neutral stance.

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USD/YUAN (MONTHLY)

The continued strength of the yuan has been somewhat surprising to me in that I believe the Chinese would prefer a weaker yuan. The maintenance of a stronger yuan may have been seen to serve a role in mitigating trade tensions with the protectionist-minded Trump administration.

However, the recent announcement of American tariffs on imported steel will be viewed as provocative in Beijing. The tariffs may serve as a catalyst for a weaker yuan if a trade war develops.

A strengthening of the yuan below the 6.2 level would be most surprising, with the odds appearing to favour renewed weakness in the yuan versus the US dollar rather than continued yuan strength.

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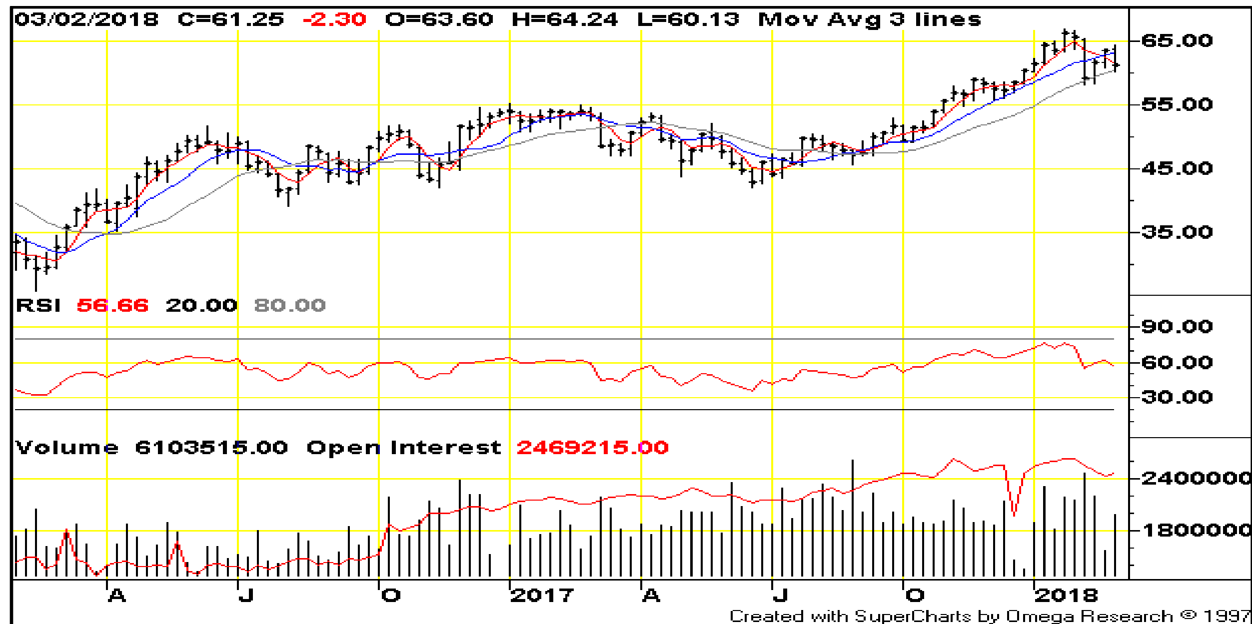
OIL COMMENT

CRUDE OIL (WTI)



While continuing to trade above its breakout level of circa $55, oil dropped sharply in early February before recovering some of its losses later in the month. The oil story continues to be one of OPEC production restraint and falling global inventory levels in the face of the steamroller that is rising U.S. production. The continued gains from shale production will likely make the United States the number one world producer of oil by year end 2018. This prospect would have been in the realm of science fiction less than a decade ago.

Tensions in the Middle East have risen sharply, increasing the likelihood of an adverse geopolitical event. The recent strength in oil is due, at least in part, to the restoration of a geopolitical risk premium in the price. Geopolitics can produce dramatic moves in the price of oil, but the effect is seldom long-lasting as markets are quick to adapt. This is particularly true today with the sharp increase in U.S. production.

The longer-term fundamental picture for oil points to lower prices. Technology will continue to lower the cost of production, bringing new supply to market. Technology will also serve to make oil consumption more efficient and work to lower the cost of competing sources of energy. Lastly, the current level of demand for oil is the product of an extended global economic expansion based on coordinated central bank intervention. By any measure, we are late in the expansion cycle. The next recession is likely to be sharp and significantly impact demand.

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Barring the effects of geopolitics, the prospects for oil are bearish. A move back below the $55 level would suggest a change of trend from bullish to bearish.

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DEFENCE SECTOR COMMENT

US AEROSPACE & DEFENCE ETF (ITA) (MONTHLY)

The defence sector, as represented by the US Aerospace & Defence ETF above, has weathered the recent general market weakness relatively well. The ongoing deterioration of global geopolitics will be positive for defence contractors.

I continue to believe the best opportunities lie with companies whose products possess the highest technology, such as aerospace, missile and anti-missile technology and armour and anti-tank systems. The U.S. ETF is used as a proxy, but non-U.S. defence contractors also warrant consideration. A diversified exposure to this sector would provide the best risk/reward.

At this stage, only a decline below 180 would warrant cause for concern. While defence sector stocks will trade within the context of the general market, I anticipate that this group will demonstrate superior relative strength for some time.

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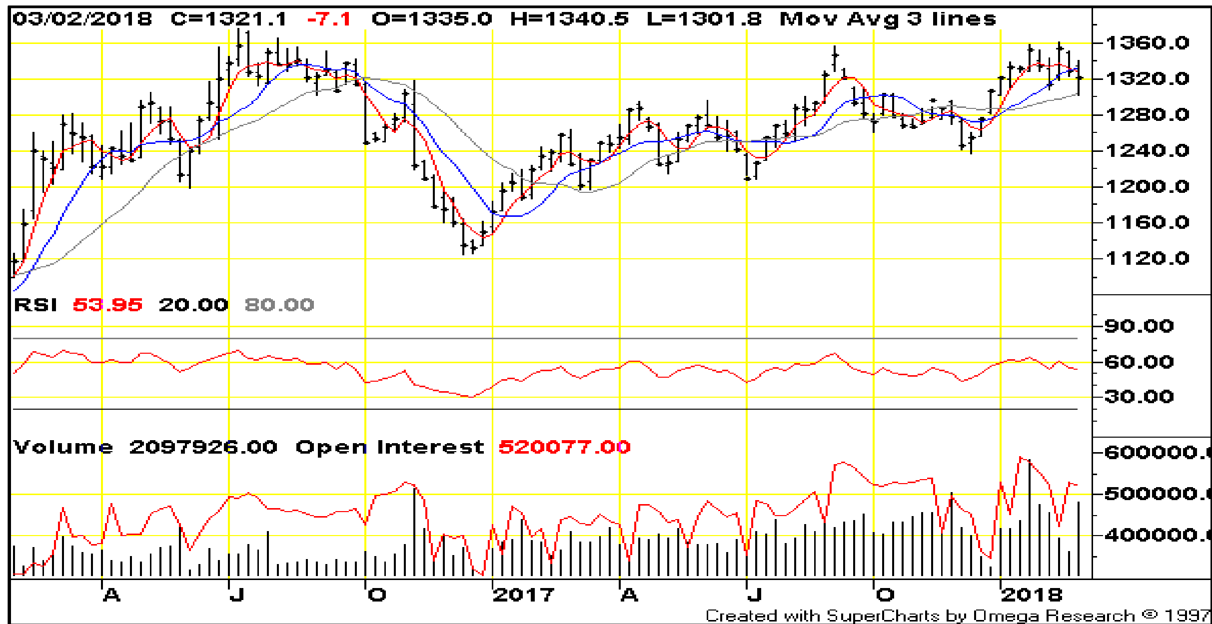
GOLD COMMENTARY



Gold once again flirted with breaking above the important $1360 level before falling back. The $1360 level is becoming an ever more formidable obstacle and thus it would be a very bullish development if gold were to make a concerted move higher. It is noteworthy that gold has failed to do so as the current environment would seem conducive to higher gold prices. A weakening US dollar, a tax bill that will balloon the budget deficit and concerns about the emergence of inflation would seem to be the stuff of gold buyers' dreams. That it has failed to break above 2016 levels must be viewed as bearish.

There is currently no compelling reason to own gold. A move above $1360 would be a bullish development and worthy of note.

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ABOUT THE EDITOR

The Editor and Publisher of the Global Investment Letter is Jonathan Baird CFA. Prior to founding the Global Investment Letter, Jonathan spent more than 25 years as an award winning money manager in Canada, most recently winning a Lipper Award in 2010 for managing the #1 Global Equity Fund in Canada. Jonathan managed several #1 ranked funds over the course of his career as a money manager, investing in all major industries, asset classes and markets. Along with his interest in the world of investment, Jonathan has been a lifelong student of history and uses the lessons of history to help interpret and provide context to current events. Jonathan no longer invests money for others, managing only his own account. The Global Investment Letter represents his personal thoughts and opinions.

Jonathan well understands the difficulty of the investment process, and the essential role that quality information and opinion play in successful investing. Each monthly issue will contain comments on major markets, economics, geopolitics as well as investment ideas. There may also be discussion of investment philosophy or practices and reviews of books deemed of potential interest to readers.

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