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INTRODUCTION

Over the past 25 years, there has been an explosion of financial products, most notably all manner of ETFs covering almost every conceivable country and asset class. As well, there has been an enormous amount of attention directed at the dramatic growth of China and other emerging markets as well as other developments that have illustrated the opportunities available to global investors. Yet when I travel internationally and/or speak with friends in the investment business, I am surprised at the narrowness of most people's investment focus. The majority of investors still devote the bulk of their assets and attention to their domestic markets, or to a particular industry with which they are comfortable.

I believe the era of having the luxury of being a narrowly focused investor is long past. It was perhaps true back in the 1980s, when I started my career, that one could just concentrate on being a "stock picker" or "bond bull". The times were very different back then. An historic bull market in equities was in its early days, interest rates were declining from very high levels and the available choice of large international markets was much smaller. Today much of the world is living with negative interest rates, central banks continue to practice massive intervention 9 years after the Crisis of 2008, government and household debt is at uncomfortably high levels and the global geopolitical environment is the most tenuous since the Second World War. Today's investor must cultivate a much broader view, recognizing that the investment landscape has grown unusually complex. The investment selection process must not only consider an investment candidate on its own merits, but also broader market conditions, economic and geopolitical influences and historical context. It has become essential to recognize that geopolitical and economic factors influence each other, and that all markets are interconnected.

There is danger in an observer, recounting the challenges facing the world, appearing alarmist. That is not my intent. The long arc of human history is one of progress. Human life is enormously safer and more comfortable for the vast majority of people than at any other time in history. I expect the arc of progress to continue. However, human history, like markets, is subject to volatility and temporary setbacks. The current set of economic and geopolitical challenges will surely produce volatile and dramatic times which, in turn, will produce unusual risks and opportunities. I would suggest that moving forward, success in minimizing risk and seizing the opportunities ahead will require the adoption of a global view of markets and a good understanding of the interplay between economics, geopolitics and history. Whatever it will be, the decade ahead will not be boring.

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EQUITIES COMMENT

It has been my view for the past couple of years that U.S. dollar denominated assets, especially equities, will be the best performing asset class for some time. In 2015, I wrote an article (available in the complimentary content area of the website) suggesting that U.S. dollar denominated assets will outperform over the next five years. This notion is based on two premises (1) that the U.S.A. will retain its relative economic strength and (2) that the U.S. dollar will maintain its role as a reserve currency as more international capital flows into U.S. dollar denominated assets in response to a tenuous and deteriorating global geopolitical environment. I see no reason to change that view as yet.

Both the S&P 500 and the U.S. dollar have exhibited relative strength over the past 18 months and received a conspicuous boost after the surprise victory by Donald Trump on November 8. Stocks rallied in response to the Trump promises of massive tax cuts and infrastructure spending, deregulation, etc., which should be positive for corporate earnings. I still believe U.S. equities will outperform competing asset classes over time, but the sharp run up in equity prices has seemingly plateaued in January and at least a short term pullback appears probable. A couple of developments suggest caution is warranted.

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The chart above illustrates the Volatility Index (VIX) over the past year. The VIX is used as a gauge of fear in the U.S. equity markets and is currently trading down to levels that suggest a good deal of complacency. Complacency, like pride, goeth before a fall. Market pullbacks are much more likely to occur during times of complacency and, conversely, the best market entry points tend to be when the VIX is elevated, suggesting widespread concern by market participants. As well, on a more anecdotal level, complacency seems widespread both among people I speak with and in the financial press.

The case for U.S. equities versus other asset classes remains bullish long term, but the odds do seem to suggest that a pullback will present itself, offering a more attractive entry point for new capital.

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U.S. BOND COMMENT

The long-term (monthly) chart of the U.S. long term bond index conveys a lot of information. It is fair to say that the bull market in U.S. bonds most likely ended in 2016, after an enormous 35-year run. The bull market first appeared to end in the summer of 2012, but deflationary forces and foreign capital flows into U.S. long bonds propelled prices to new highs in 2016. The election of Donald Trump spurred a very sharp selloff in bonds, with prices at January month-end trading below the 2012 high, which is technically significant. The decline in bond prices was not surprising. Donald Trump's stated policies of tax cuts, trillion dollar expenditures on infrastructure, increased defence spending and a wall along the Mexican border will significantly increase budget deficits.

The election of Donald Trump certainly exacerbated the decline in long bonds, but the change in trend was coming regardless of who was elected President. The resilience of the American economy has made additional Fed rate increases much more likely in 2017, with yields being pushed higher as investors sell long bonds to move down the yield curve. As well, investors seeking income have found attractive alternatives in dividend paying equities such as utilities.

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U.S. long bonds are likely to be under pressure for some time, with only the prospect of recession offering an opportunity to rebound. A good part of the developed world is labouring under a cloud of negative interest rates, so the positive yield of U.S. treasuries looks attractive in comparison. They are surely being purchased by foreign buyers as a result. However, they still offer negative real returns when adjusted for inflation, and the growing likelihood of further rate increases by the Fed mitigates any reasons to buy treasuries at this time.

The next buying opportunity for longer-term bonds will coincide with evidence of the next recession.

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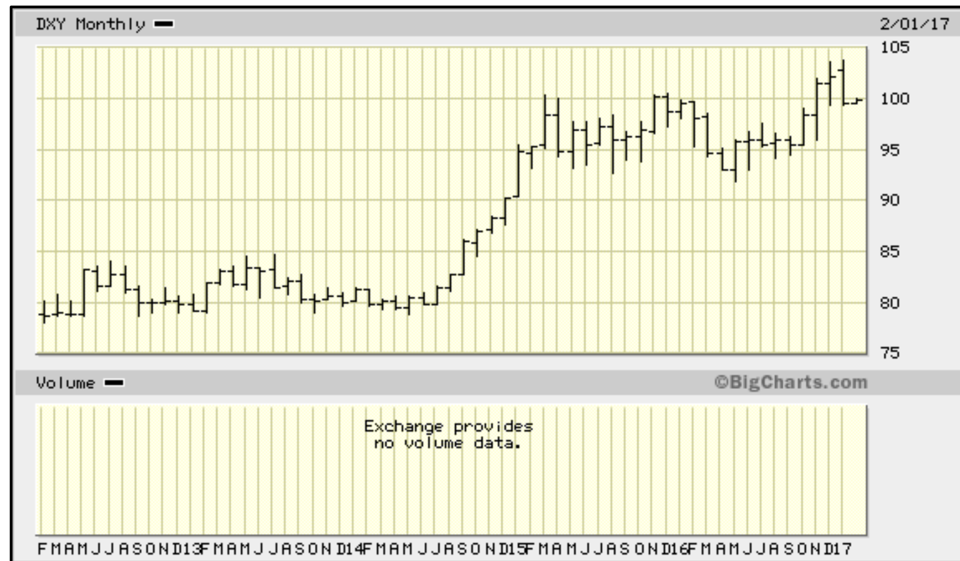
U.S. DOLLAR COMMENT



I have been bullish of the U.S. dollar for some time (see articles in complimentary section of the website) primarily because it was the "least bad" currency available in this era of tacit competitive devaluations. All major competing currencies have major flaws: the euro may not exist a decade from now given the existential troubles of the European Union; the yen has economic and demographic issues; the Chinese likely wish to see the yuan much lower rather than higher and the British demolished the pound with Brexit.

The United States faces difficulties, as any nation does, but its size, economic and military strength and depth of market will make the U.S. dollar the world's ultimate reserve currency and safe harbour for the foreseeable future.

The long-term chart of the Dollar Index (DXY) illustrates that the dollar broke out above a major resistance point at circa 100 before recently pulling back to retest the breakout. I remain of the view that the U.S. dollar is likely to exhibit conspicuous strength going forward. The lack of viable alternatives, combined with the prospect of Fed interest rate increases and an unsettled global geopolitical environment, will drive substantial capital into the U.S. dollar.

The U.S. dollar remains the currency of choice, with adverse political developments in the United States posing the only serious threat to its ongoing strength.

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CANADIAN DOLLAR COMMENT

The Canadian dollar appears likely to weaken against the U.S. dollar for a number of reasons. First, the anticipated Fed interest rate increase in March will likely not be matched by the Bank of Canada, putting pressure on the Canadian currency. Second, downward pressure may build on the Canadian dollar in anticipation of the expected NAFTA renegotiation talks. Third, and most important, is the price of oil. The Canadian dollar is something of a "petro-currency", bearing a high correlation to the price of oil. I believe the price of oil is likely to weaken, putting pressure on the Canadian dollar versus its American counterpart. My view on oil follows.

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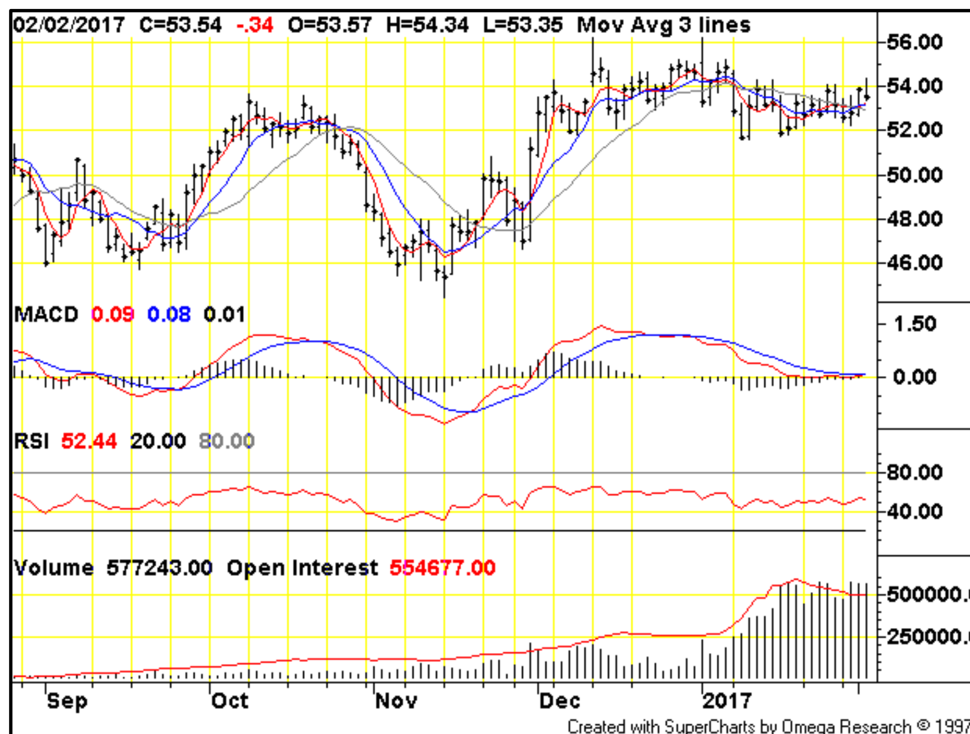
OIL COMMENT



Oil is a market where I have to battle my own psychology to remain unbiased in my analysis. I had particularly good success with oil, especially junior oil stocks, during my career as a money manager, and I tend to like oil company presidents. I therefore have a natural tendency to be bullish on oil. Our own human psychology is our greatest obstacle to clear thinking, and I'm at least aware of my biases in this regard.

The chart of WTI on the previous page illustrates the sharp rally from mid November through early December. This rally was almost wholly a result of an agreement by OPEC to curtail oil production. The apparent cohesiveness among OPEC members and the fact that Saudi Arabia was prepared to make significant concessions impressed the market. The oil market has more recently moved in a sideways fashion with muted volatility. I suggest that the complacency indicated by the lack of volatility in oil is not warranted given the underlying fundamentals of oil. Moreover, while the high number of speculative long positions in the oil futures market further suggests there is little belief that oil will decline, I believe that oil prices will settle lower.

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The history of OPEC is strewn with agreements that collapse because of cheating on production quotas by its members. OPEC is a collection of disparate countries, most notable currently Sunni Saudi Arabia and Shiite Iran. Many observers, myself included, believe it is but a matter of time before the apparent discipline exercised by OPEC members is compromised and production begins to rise. However, I further believe that the price of oil faces substantial obstacles to further appreciation even without OPEC cheating

The greatest threat to oil prices is a rebound in American shale oil production, which is already becoming apparent through a steady rebound in drilling activity. The breakeven point for U.S. shale oil has dropped considerably to the low $40s through developments in technology. Moreover, the collapse of drilling activity from the fevered pace of a few years ago has caused drilling costs to decline significantly as oil service firms scramble to utilize idle capacity. U.S. oil production may rebound as much as 1 million barrels per day in 2017, effectively offsetting any OPEC production cuts. There is the potential for even more shale production from the United States in the years ahead.

As well, China had been an active buyer of oil to build its strategic reserve in 2016. Recent reports suggest that China may have finished buying, or at least finished building its stockpile at current prices. Given that world oil inventory levels remain historically high, demand will soften should a large buyer like China experience economic weakness.

The next significant move in oil is more likely to be lower rather than higher. Of course, there is always a geopolitical element to the price of oil, so an adverse development in the Middle East, etc., could always cause a spike in prices. However, on balance, the odds suggest lower prices.

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GEOPOLITICAL PROSPECTS 2017

A new year and a new administration in Washington would seem a good time to assess the geopolitical landscape. We live in an era that is more "macro" driven than at any time since the Second World War.

The most obvious likelihood is that the new administration in Washington will be tested early in its tenure by one of America's ongoing adversaries or rivals, whether a terrorist group, Iran, Russia or China. This test of American reaction, readiness and resolve is not the result of Donald Trump being President, but could be expected with any new incoming administration.

It may serve Russian interests to engage in "sabre rattling" and perhaps more overt actions with its neighbours as a means of testing the limits of its relationship with Washington while generating goodwill with the Russian populace. A resurgence of violence in eastern Ukraine is a possibility; if Russia is feeling especially confident in outcomes, it could seek to expand its area of influence in the Ukraine. Ukraine is a sensitivity for Russia. That sensitivity is understandable even if we in the West disagree with Russian actions. Ukraine is an historic invasion route to Russia, with its flat topography being particularly amenable to tanks, as the Germans demonstrated in the Second World War. Russia will almost certainly step up military exercises such as "war games" much to the discomfort of the Baltic countries and other former Soviet Bloc nations. It is difficult to conceive, however, that Russia would be too provocative with a NATO member nation.

Perhaps the most potentially disquieting developments could come from Europe. There will be elections this year in France, the Netherlands, Germany and possibly Italy. The election of far right "populist" parties in Europe could threaten the future of the European Union as we know it. As well, the election of a "populist " party in a large economy such as France could well be a blow to the world economy through the adoption of an isolationist and trade protectionist stance such as took place in the early 1930s. Indeed, isolationist and protectionist policies are the greatest threats to the global economy in the coming years as they would provide the catalyst to initiate a cascade of negative economic consequences on an already fragile world economy. Even without this threat, however, the European Union has major problems such as massive economic disparities between members, negative interest rates, social issues related to immigration, etc. These problems will continue to put stresses on the future of the euro and of the European Union as we know it.

China, being China, always has the potential to impact geopolitics in a large way. I believe any major development in 2017 is most likely to be economic, either concerning the state of the Chinese economy or the value of the yuan. There has been considerable downward pressure on the yuan for some time, which has produced a weaker yuan despite defense from the People's Bank of China. The biggest political event on the Chinese calendar is the 19th National Congress this Fall. Xi Jinping needs to appear strong

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entering the 19th National Congress and thus can be expected to take a hard line in response to actions deemed provocative by foreign powers.

Turkey can be expected to capture headlines in 2017 as President Erdogan continues to consolidate power. Toward that end, Erdogan has invested substantial political capital in an April 16 referendum that seeks to change Turkey from a parliamentary system to an executive presidency. Turkey remains important because of its geographic position and its potential influence in the Middle East.

The Middle East will continue to be a political and human rights disaster. The situation is so fragmented with so many players pursuing competing interests that it is impossible to see a resolution.

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POTENTIAL OPPORTUNITIES IN DEFENCE SECTOR

War has always been a feature of human existence, with the 20th century being notable in terms of the amount of blood shed. However, there has been a prolonged period of relative calm since the Second World War, rivaled only by the decades prior to the First World War. There has obviously been an ongoing series of wars over the years, but none involving two or more major powers over the past 70 years. Several factors have contributed to limiting conflict during this period. The first is probably nuclear weapons and the prospect of "mutually assured destruction". Secondly, the bipolar world that emerged following WWII limited potential antagonists to the Unites States and its allies versus the Soviet Union and its allies. The collapse of the Soviet Union in the early 90s and the rise of China has restored the world to a more traditional multi-polar global order. As well, there is the presence of provocative "rogue" states such as Iran and North Korea. An increased number of nations pursuing competing interests significantly raises the risk of armed conflict.

The collapse of the Soviet Union produced a substantial “peace dividend” for NATO members in the form of decreased defence spending, which is perhaps best exemplified by the sharp drop in active aircraft and tanks etc., over the past 25 years. It is difficult for many today to remember the high state of ongoing readiness maintained in Europe to counter potential Soviet aggression. I recall taking an afternoon Rhine river cruise in 1989 and seeing a steady stream of military aircraft on patrol. NATO has substantial reserves to bolster today’s reduced level of active forces, but this equipment will, on average, be older than that used in active roles.

This slowdown in defence spending has coincided with rapid advances in technology, accelerating the rate of obsolescence of equipment. This situation increases the probability of conflict in that it creates the opportunity for a nation to achieve significant technological superiority through a program of concerted spending. This threat of a technological imbalance between military forces should provide a catalyst for increased spending.

There are other catalysts as well. The Trump administration has complained, quite justifiably, that most NATO members have not been honouring their commitment to spend at least 2% of GDP on defence. The United States currently spends 3.6% of GDP on defence and Mr. Trump has suggested he wants this to increase. The threat by the United States to "moderate" its contribution to NATO could prove to be an effective catalyst for others to increase their spending. The actions of Russia in Crimea and Ukraine and its efforts to influence elections in the West would seem to be a spur to increased European defence spending.

There are obviously many defence oriented companies for an investor to consider. My own preference is for companies that are technologically based, such as aircraft manufacturers, as they offer the most scope

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for revenue and margin growth. Military actions (at least among major participants) will be more and more a struggle of technology.

Boeing (U.S:BA) and Airbus (FR:AIRBUS) are two companies that are primarily producers of commercial aircraft, but have substantial defence operations. The commercial aircraft business is likely to do very well long term, with air travel continuing to increase and substantial barriers to new entrants in the large capital costs involved.

Lockhead Martin (U.S:LMT), Northrop Grumman (U.S:NOC) and BAE Systems (UK:BAE) are three more aerospace companies I believe will stand to benefit from an upturn in defence spending. Raytheon (U.S:RTN) should also do well given its strength in missile systems.

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GOLD COMMENTARY

Gold deserves consideration, if not ownership, in the current environment of negative interest rates, competitive currency devaluations and increased geopolitical risk. Gold's historical role has been as a store of value, which tends to assert itself in times of loss of confidence in government and alternative asset classes.

Gold rallied in late 2016 and has increased 7-8% since then. The prospect of a resumption of Fed rate increases in March will likely reduce the chances of further advances and may prompt a pullback. As there does not appear to be any compelling bullish catalyst for gold at present, purchases are best made during pullbacks.

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BOOK RECOMMENDATION

THE ROOKIE: BY STEPHEN MOSS BLOOMSBURY PUBLISHING 2016

Stephen Moss is a good, but not great chess player with a great love for the ancient game. This book recounts his three-year effort to improve his chess and examine the current state of the game he loves. Moss enters weekend tournaments in his native England, and travels to such places as the Netherlands, Russia and the United States to play and speak with chess enthusiasts, masters and grandmasters in his quest for chess enlightenment. He tells his story with humour and respect for the game, while providing observations valuable to those with just a passing interest in chess.

Moss's experiences at the chess table, and his conversations with other players, reveal the pressures and demands on a competitive chess player. Of particular value to those interested in investing, is the discussion of the importance of adaptability to changing circumstances, the role of psychology in practicing patience and managing risk through the avoidance of unnecessary risk. The reflections on how to cope with inevitable loss are useful for everyone, not least investors.

Everyone can become better investors by reading widely and incorporating lessons from other aspects of life. *The Rookie* is well written, provides interesting insights into chess and provides lessons useful to us all.

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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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