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INTRODUCTION

Most major world equity indices have posted strong advances thus far in 2017. Volatility has been unusually muted in most developed markets as investors have apparently adopted a "glass half full" approach to interpreting the investment landscape. An optimistic viewpoint is undoubtedly useful in life, but investors must cultivate a dispassionate, realistic view of the environment. Thus, a periodic review of some of the key macro factors affecting investors is useful.

The dominant issue on the geopolitical front is North Korea. I wrote in the February issue that I expected one or more challenges to test the new American administration. The most obvious challenger to date is North Korea, which has stepped up missile tests and missile launches in general. These tests have obviously alarmed its neighbours. Most concerning to the United States is growing evidence that it is nearing the ability to deliver a nuclear payload to North America. The United States clearly does not want North Korea to obtain the ability to strike its homeland. To that end, the Trump administration has cultivated the Chinese as an intermediary to broker an understanding. As well, there are currently two, and perhaps three, carrier task forces within striking distance of North Korea. It is hoped that military action can be averted, but the potential for the use of force is very real if an accommodation with the North Koreans proves impossible. History has proven how military action can escalate. Though North Korea may not be in the headlines daily, it remains a major global concern.

Syria remains a tragedy from a human perspective and a cauldron of competing interests. The United States, Russia, Iran, Turkey, et al each have their own agenda in Syria. It has often been the case in history that smaller nations become the theatres in which larger powers pursue their interests. The proximity of military forces increases the risk of accidental or intentional conflict, which can quickly escalate. As well, the Middle East remains a spawning ground for terrorist groups that appear to be inclined to launch attacks in Western nations. No quick solution is likely.

The rocky start by the Trump administration will become problematic if it cannot find its footing in the next few months. The issues are well documented and don't need elaboration here. There is a danger, in terms of markets, of the post-election rally eventually waning as expectations regarding the administration's ability to achieve its policy pledges on healthcare, tax cuts, etc., fade. Any new administration deserves a grace period, but that period cannot be indefinite.

The robust performance of stocks is not in and of itself a surprise to me; I have contended for some time that equities will be the best performing asset class for the next 5-10 years. What has come as a bit of a surprise is the duration of the run and the lack of volatility, and hence, the lack of a substantive buying opportunity. More on equities later in this issue.

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Yield curves bear watching. The curves in the United States and China are flattening. Flat, and especially inverted, yield curves often precede recessions. As well, the near zero or negative interest rates we now have in some large economies are a reminder that this is far from a "normal" state.

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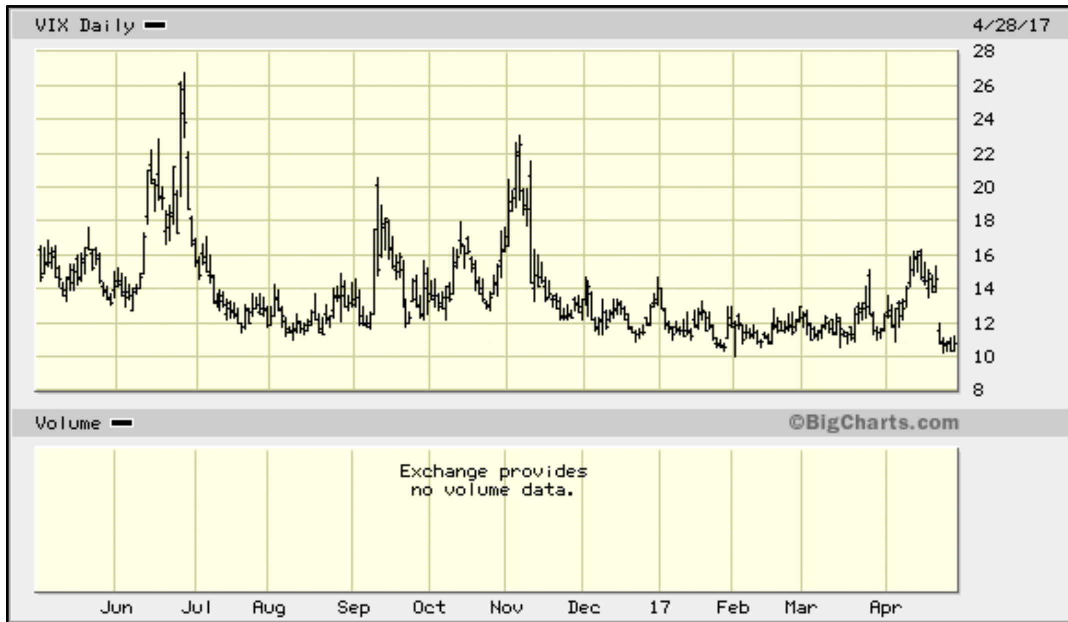
EQUITY COMMENT



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The S&P 500 rose in April but has yet to break above the high set in February. Although the chart continues to look bullish, the post-election rally appears to have stalled.

There are several ongoing market concerns that suggest caution. The VIX remains at very low levels, suggesting a good deal of investor complacency. It is not just the absolute level of the VIX that is problematic, but rather the rarity of daily moves exceeding 1% for an extended period of time. I have written previously about the mean reverting characteristic of volatility. The muted volatility we are currently experiencing will ultimately be offset by a period of high volatility. The longer the VIX remains low, the sharper the rebound in volatility is likely to be.

The leadership in U.S. equities is growing narrower, with large capitalization technology shares such as the so-called 'FANG" stocks (Facebook, Apple, etc.) making significant contributions to index returns. This phenomenon is reminiscent of the "Nifty Fifty" market of the early 1970s. It is reasonable for fast growing technology companies to lead a market advance, but trouble ensues when that advance is due to the appreciation of a dwindling number of issues.

There are also other sources of concern, i.e., the extended duration of the current economic expansion, the Fed raising rates recently, the less than bargain price of equities, etc. There are always reasons to be concerned, and it is true a bull market climbs a wall of worry. However, the risk/reward for committing fresh capital to the equity markets appears unfavourable at this time.

It would be unusual not to see a correction in 2017. Investors should exercise caution and be alert to a change of trend.

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The United States is not the only country to experience strength in its equity markets; strength in equity markets has been widespread of late. The German DAX Index has performed strongly since late 2016, as depicted in the chart above. The negative interest policy of the ECB has certainly played a role in moving capital into German equities. As well, the relative weakness of the euro versus the U.S. dollar is a benefit for the strongly export dependent German economy. A more positive view of the political dynamics in Europe, especially the preliminary election results in France, may also be contributing to a more positive view of equities.

The DAX has reached the level of the previous high set in early 2015. A clear break above that level, at circa 12,000, must be construed as bullish. However, a move higher followed by a sustained break below 12,000 could indicate a meaningful change of trend.

The CAC 40, the most widely-used indicator of the Paris market, has also performed strongly, with the positive interpretation of the first round of the election result near month end conspicuous on the chart above. I believe the reasons for the strength in French shares are much the same as those affecting the Germany market, with local politics playing a larger role of late. It is expected that Mr. Macron will defeat Ms. LePen in May. If that unfolds, the CAC may experience a further relief rally. After that, the prospects for French equities become more tenuous.

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INDIA: A LONG-TERM GROWTH OPPORTUNITY

The major economic success story of the past 30 years has been the rise of China from a deeply impoverished nation to the second largest economy in the world. The speed at which China grew was astounding and an example for other emerging economies. China is still poor by Western standards, but its long-term prospects remain bright, though the law of diminishing returns suggests China's future rate of growth will not approach that experienced over the past 30 years. However, there is another large Asian nation that has the potential to replicate the Chinese economic experience of the past quarter century.

The similarity of India to the China of 30 years ago is its huge population (approx. 15% of the world) and extreme poverty. There are, of course, significant differences between the two countries. India is a democracy and much more heterogeneous in terms of population and culture. India faces a number of impediments to growth but also possesses a dynamism in its people that needs only the correct catalyst to set it on a path of sustained growth. The catalyst is typically a political figure. In China, it was Deng Xiaoping. In India, I believe the catalyst will be the current Prime Minister, Mr. Modi. Narendra Modi was the Chief Minister of Gujarat for 13 years prior to becoming Prime Minister of India in 2014. Gujarat State grew at a double-digit rate during his tenure. His reputation of integrity and pro-business policies have

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made him very popular in India, which allowed him to win election as Prime Minister and has provided him with the political capital to introduce much needed change to the country.

Mr. Modi has taken steps to address the enormous Indian bureaucracy, tackling corruption and reducing redundant layers of administration that have impeded the economy. The Indian tax system was reformed with the adoption of a national goods and services tax that replaced all indirect taxes levied by the central and state governments. Mr. Modi has also begun to address India's deficient infrastructure. There is much more that needs to be done, but these are tangible steps in the right direction.

The investment appeal of India lies in the inherent leverage of starting from such a low base. The per capita GDP of India is just under USD $1600. Given its huge population, there is substantial domestic demand available to generate economic growth. Of course, exports have historically played a role in the development of economies such as India and I would expect ongoing efforts to stimulate that aspect of the economy as well. In addition, the fast-growing technology sector is well represented on India's stock exchanges, which should help the market going forward.

Indian equities have performed strongly thus far in 2017, as evidenced by the above chart of an ETF devoted to investment in India. The price/earnings ratio of Indian equities still remains at a discount to the price/earnings ratio of the S&P 500, which represents relative value given the political reforms and far greater growth prospects of India.

Given the very attractive risk/return, an exposure to Indian equities in long-term portfolios seems warranted. There will inevitably be volatility along the way, however, making Indian equities suitable only for long-term investors. The major risk is an adverse political development. If the policies of Mr. Modi and his associates are reversed or somehow abrogated, the premise of this investment concept would no longer be valid. However, there appears no threat of this, at this time. The anticipated economic benefits of these policies are expected to ensure their perpetuation going forward, much as Deng Xiaoping's were in China.

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FIXED INCOME COMMENT

U.S. long bonds performed reasonably strongly in April, which has served to further flatten the U.S. yield curve following the Fed rate increase in March. The likelihood of at least two further Fed rate increases in 2017 raises the spectre of an inverted yield curve, which almost always portends a recession. The long end of the U.S. yield curve would seem to be the best place to allocate capital for those who wish exposure to this asset class. The absence of meaningful signs of inflationary pressures combined with less than stellar GDP growth make it difficult to foresee much upward pressure on long-term rates for the time being.

I remain less than enthused by fixed income securities at these levels until evidence of a recession presents itself and/or equity markets suggest that a meaningful correction is likely.

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The chart above depicts the bullish price action of emerging market debt. A considerable amount of capital has been directed at this asset class of late as the pursuit for yield continues unabated. The mania for investment income has driven yields on quite risky vehicles to surprisingly low levels. Investors in these issues seem unconcerned about risk. Almost half of the debt in a typical emerging market portfolio is rated BB or below, and some is not rated at all.

This phenomenon is a product of the warping effects of the current ultra-low or negative interest rate policies of central banks. Investment in emerging market debt at these levels, given the economic and geopolitical risks that must be assumed, is not recommended.

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U.S. DOLLAR COMMENT

The U.S dollar index has broken the important 100 level as the dollar has weakened against major currencies such as the euro and pound. The conspicuous strength of the euro can likely be attributed to relatively robust economic reports from the EU and political optimism that Europe can avoid the election of a right-wing populist leader in 2017, though the result of the French election contest between Ms. LePen and Mr. Macron remains to be seen. Polls suggest that Mr. Macron enjoys a sizable lead, but election polls have been less than reliable of late. Theresa May also enjoys a decided advantage in the polls versus the widely unpopular Mr. Corbyn, but again, the predictive value of polls must be questioned in the current political climate.

I have been long-term bullish on the prospects for the dollar, but the price behaviour of the DXY should be respected. The sustained trading on the part of the DXY below 100 must be considered bearish and responded to accordingly. The weakness of the dollar, given the positive interest rate differentials against other major currencies and the prospect of further Fed rate increases, should be viewed bearishly. It may be that the controversial decisions of the Trump administration are exacting a toll on foreign confidence. My bullish view would be reinstated with the DXY again trading above 100.

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I have been bearish of the Chinese yuan for quite some time, but the weight of evidence suggests it is time to adopt a bullish stance and anticipate strength in the yuan versus the dollar over the short to medium term. The Chinese appear committed to defending the yuan in order to stem the flight of capital and provide stability, and perhaps for short term political expediency as they assess the new Trump administration. China has spent a considerable portion of its foreign reserves to that end. As well, short-term interest rates have been raised several times recently and the general weakness of the U.S. dollar has lessened pressure on the yuan/dollar exchange rate. Lastly, the behaviour of the yuan illustrated in the chart above suggests a stronger yuan. The yuan rallied in late 2016 and has since retraced part of that rise with gradually decreasing volatility. This constriction of volatility is likely to resolve itself by producing renewed strength in the yuan.

Though I continue to believe the long-term trend favours a lower yuan, the current environment suggests adopting a bullish view over the shorter term.

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CANADIAN DOLLAR COMMENT

The Canadian dollar has continued to drift lower versus its American cousin. Weakness in the price of oil, an unattractive interest rate differential and uncertainty about future trade policies by the United States have all played a role in keeping the Canadian dollar under pressure.

The Canadian economy has performed relatively well, aided in part by a weakening currency. The strength of the domestic economy is unlikely to be sufficient to alleviate the downward pressures on the currency, particularly given the price of oil. The prospects for the loonie remain bearish until the price of oil is able to demonstrate concerted strength.

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OIL COMMENT

My view on oil remains bearish for reasons outlined in previous issues. The fact that the price has failed to rally despite the machinations of OPEC and friends is decidedly bearish. Oil is nearing important support levels in the mid-forties. Penetration of support would suggest much lower prices, which could ultimately provide the next buying opportunity.

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DEFENCE SECTOR UPDATE

The defence sector continues to perform well as the chart of the Aerospace and Defence ETF above illustrates. Our bullish long-term view, as detailed in previous issues, remains. The companies discussed previously, producing high technology products such as aircraft, remain the preferred investment vehicles.

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GOLD COMMENTARY

The weakness of the U.S. dollar produced higher gold prices in April. My stance on gold remains unchanged; a basic position appears warranted but a more meaningful position seems premature.

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DEVELOPING AN INVESTMENT STYLE

I was reading an article on investing recently that got me thinking about my own development as an investor. I was initially attracted to the investment business after reading an article on Ben Graham, the father of value investing. I entered the business in the 1980s as a diehard value investor. While value remains an important aspect of my style (I like a bargain!) my investment style evolved over the years as I gained experience investing in a wide variety of markets and asset classes. I would describe my style now as pragmatic; I seek to apply my knowledge and experience to respond to the current demands of the markets. My current approach is heavily weighted to global macro as central bank and geopolitical factors are the key drivers of today's markets. I thought it might be helpful to others to recount the process I went through in the development of my own investment style.

The journey in learning about any skill that requires abstract thought, such as investing, usually begins with the printed page. An initial spark of interest in investing often occurs, as in my case, from a magazine article or book. Reading is the most valuable tool in learning about the process of investing and the development of style. A student of investing, or of any topic, must read widely about the subject. It is important to not restrict oneself to just reading about stocks or bonds, but to extend that reading to other markets, such as commodities. It is also important to read about topics such as economics and market history to provide context in interpreting events.

It is equally important during that initial period of reading to remember to discern what is evidence-supported fact and what constitutes the opinion of the author. There is a tendency in the early and mid-stages of learning to accept what one reads uncritically. This is a natural consequence of not yet having a sufficient trove of knowledge to provide context. An important milestone in my own education as an investor was when I found myself disagreeing with "expert opinions" because my own experience and base of knowledge provided the context to allow me to think independently.

The road to independent thinking is a long one, and our own human psychology works against us in this. Constantly reading to gather information on which to base our opinions is at least a partial solution to "group-think." We tend to have more confidence in our views when we have command of the facts. It is worthwhile to remember that our style of investing, or playing the guitar, etc., is a function of both what we know, and sometimes more importantly, what we don't yet know. It is why our attitudes can change over time and why it is important to guard against complacency in learning.

A major, and very personal, aspect of developing an investment style is formulating an approach that is complementary to our individual psychology. It is my view that human psychology is the most important driver of world events and that a good understanding of psychology, not least our own, is essential for success. We each have an individual comfort level with risk and volatility, which will determine appropriate investment vehicles, time periods, position sizes, etc. As well, ego can have a profound effect

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on investment style and success. For example, someone who will not accept being wrong will have a short and bumpy ride as an investor!

Self-awareness plays a key role in assessing our own psychological makeup, but it is the actual experience of trading/investing that teaches the sharpest lessens. No amount of hypothetical or paper trading can replace the experience of risking real money, even in just token amounts. In fact, it is best to invest insignificant amounts at first, risking gradually increasing amounts as knowledge, comfort and experience grow. It is important to remember that risk is a constant companion of the investor/trader and that risk increases with reduced knowledge and experience.

There is more than one way to be successful in investing, and many ways to go wrong. There is no replacement for doing the necessary reading and assessment of our own psychology. The effort required demands a considerable initial and ongoing commitment of time and effort. The compensations can be considerable, with the most important rewards being non-monetary. A capable investor will acquire knowledge about themselves and the world in which they live that will enrich all aspects of their lives.

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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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