MARRET ASSET MANAGEMENT INC.

Uncertainty!

January 2017

Our overriding theme for 2017 is uncertainty. Perhaps we could say this every year, but 2017 appears exceptionally uncertain to us. It is very difficult to ascertain where we are in the business/economic/ credit cycle due to the extraordinary policies of the world's Central Banks. The fact that the Central Bank policies are now diverging with the U.S Fed raising rates while at the same time maintaining the size of its balance sheet – offsetting activities – while the European Central Bank and Bank of Japan are still actively pursuing Quantitative Easing. This phenomenon itself creates or perhaps increases uncertainty. China continues to transition its economy from fixed investment and manufacturing, to a services based model – how this process evolves is uncertain and has large implications in the foreign exchange market, as well as global capital flows. Europe is struggling with recapitalizing its banking system but is still seeing some signs that growth is improving. The banking system is critical to long term growth and the messy process of bailing out Italian banks creates significant uncertainty. Perhaps the least uncertainty lies in Japan, where signs of breaking out of a multi-decade deflationary depression don't appear anywhere on the horizon. Oil prices and OPEC production cuts are another large source of uncertainty. Will they overproduce and reverse the gains in crude oil prices, which are very important to many emerging market economies and our own here in Canada? Uncertainty about the trade policies with the new U.S President is large and important especially as it relates to China and Asia. Is the 25 year globalization trend over or is it in a consolidation phase? The outlook for inflation, another big uncertainty, is currently dependent on how new trade policies evolve.

These are just a few factors in how uncertain the financial world is today. We do have plans and strategies that we believe will allow investors to earn reasonable returns without elevated risk. We will outline these later on. For now, we will review 2016 to see what worked, what didn't, and what we can take away from the past year.

As we and many others predicted, 2016 had several periods of high volatility. What very few predicted however, was how strong investment returns turned out to be. The four indices we regularly follow had the following returns in 2016:

S&P 500	11.96%
TSX	21.08%
HY Bonds	17.49%
Intermediate Term U.S. Treasuries	1.23%

While these returns are impressive, if you break them down from Jan. 1 – Feb. 11 and Feb. 12 – Dec. 31, the rally is even more surprising:

	Jan. 1 – Feb. 11	**Feb. 12 – Dec. 31**
S&P 500	- 10.27%	22.38%
TSX	- 6.79%	26.81%
HY Bonds	- 5.14%	23.17%
Intermediate Term U.S. Treasuries	4.59%	- 2.57%

Financial markets were very weak in January and early February as oil prices fell to $26/bbl. As oil recovered and the economic data improved, markets recovered strongly and rallied hard in the last seven weeks after the U.S election.

One curious event was that High Yield Bonds outperformed the S&P 500. This is not unusual, but usually only occurs early in economic cycles coming out of recessions. It is very rare for High Yield to outperform equities later in the cycle. The reason for this is related to the energy and mining sectors. In 2015, High Yield lost nearly 5%, whereas the S&P 500 gained 1.4%. Given that High Yield is roughly 60% as risky as equities, in down years High Yield is supposed to fall less than stocks and in up years, stocks are supposed to rise more than High Yield.

	2015	**2016**
S&P 500	1.40%	11.96%
High Yield Bonds	-4.64%	17.49%

Because energy was the largest industry sector in High Yield, when oil fell below $30/bbl, High Yield underperformed equities and when it recovered, High Yield outperformed the S&P 500. Assuming oil stays in a relatively tight trading range, High Yield and the S&P 500 should revert to their historical volatilities with High Yield outperforming in a down year, and the S&P 500 rising more in an up year.

If we analyze historical High Yield returns to see if a strong year is followed by negative returns, we are happy to report this isn't the case. In the 30 years where we have index data, 9 years produced gains greater than 15%.

2016	17.49%
2012	15.58%
2010	15.19%
2009	57.51%
2003	28.15%
1995	20.46%
1993	16.96%
1992	17.44%
1991	39.17%

Of these 9 years, only one had a year following (1994) where returns were negative and it was very small -1.03%. Six of these years were the first 3 years following recession; 1991, 1992, 1993, 2003, 2009, 2010. 1995 followed the 1994 U.S rate hike cycle, 2012 was after further Quantitative

Easing and 2016 was energy. History, at least suggests 2017 is unlikely to be negative, but also suggests another 15+% year is probably not in the cards either.

2016 was a volatile year, but only in short spurts. The VIX (S&P 500 Volatility Index) averaged just under 16% which is a little higher than the last couple of years, but in-line with longer term averages. The highest level was recorded, not surprisingly on Feb. 11 as oil and stocks bottomed, at 28.14%. The levels around Brexit and the U.S election were 17.25% and 18.74% respectively. These are pretty subdued levels for such unanticipated events. We suspect the reason why the market sell-offs were so brief and subsequent rallies so strong, was more related to market positioning than to fundamentals. Prior to the U.S election, risk markets, from equities to high yield were positioned very defensively with the so-called safe sectors priced very richly and the more cyclical areas being avoided. This would explain why markets would rally so quickly after seemingly negative or unanticipated events. Everybody was waiting for any sell-off and so they could buy and return positioning to neutral.

For all of the discussion in 2016 around bond yields, inflation and yield curve shifts, the data suggests stability. U.S Treasury yields were essentially unchanged in 2016 and with a small exception in the 30 year bond, the yield curve didn't shift:

	2016 Open	**2016 Close**	▲
2 year	1.06%	1.19	0.13
5 year	1.78%	1.93	0.15
10 year	2.29%	2.44	0.15
30 year	3.03%	3.07	0.04

This of course masked significant volatility. The 10 year yield traded in a range of 1.36% on July 8 to 2.60% on December 15. The yield curve had several bouts of flattening and steepening throughout the year. We would suggest that bond market volatility will remain high until rates are normalized - which is unlikely in the near term – and nontraditional Central Bank policies end.

To summarize 2016, it was a volatile year with some big unexpected events but in the end, markets exceeded even the most optimistic forecasts and did so for reasons totally unexpected. Economic forecasts were generally correct – the U.S economy muddled through, inflation gains were modest, bond yields didn't rise, the Fed only raised rates once (vs their own 4-5 prediction), and earnings didn't grow much if at all. This doesn't seem like a recipe for double digit returns but again markets were positioned defensively and when events occurred to change this view, capital flowed and prices rose.

Turning to 2017, markets are entering the new year with considerable optimism which is not unusual, probably more the norm than 2016 where sellers came in from day one. We see the consensus outlook currently as:

1. Stronger U.S. growth, perhaps as high as 4% real GDP
2. Higher interest rates, the Fed is predicting 3 rate hikes
3. A stronger U.S Dollar as interest rates rise relative to other countries
4. Higher inflation as higher wages and rebounding oil prices feed through to CPI

All of this should add up to higher prices for risk assets. As usual, we ask what could go wrong. Let's look at each component of this view:

1. Stronger growth – this is predicated generally on infrastructure spending, fiscal stimulus, tax reform, high wages and pent up demand.

   We do expect somewhat higher U.S growth in 2017 but the real question is how much and what is already priced into markets. Infrastructure and fiscal spending usually take longer to arrive than markets are currently discounting and tax reform usually isn't achieved quickly or easily. Higher wages are a definite and pent up demand seems probable. Our view is that growth will be stronger but will struggle to achieve anywhere near 3.5-4% the markets seem to be anticipating.

2. Higher interest rates – the Fed predicted/promised 4-5 hikes in 2016 and managed just one at the last meeting of the year. They are now predicting 3 hikes in 2017. We believe 3 hikes are much more likely in 2017 than 4-5 were in 2016 and suggest this is a reasonable expectation. While inflation did not rise in 2016, it is highly likely that it will in 2017 and growth should be somewhat higher.

3. Stronger USD – It is difficult to argue with a stronger USD as the U.S economy is improving relative to Europe and Asia, and the Fed is hiking while the European Central Bank, Bank of Japan, and People's Bank of China are all still in heavy stimulus mode. The real question is, how strong can it get without causing U.S inflation and growth to retreat?

4. Inflation – definitely going higher due to wages, oil and housing (although this is starting to show signs of leveling off). Inflation is however a lagging indicator and often continues to rise after the causes have started to retreat. The issue for inflation is how the Federal Reserve interprets the long term trend and adjusts rates accordingly.

There is solid fundamental support for these four consensus views but timing is very important and it must be recognized that they are actually contradictory in the long term. If you have stronger economic growth, absolutely and relatively, it is likely you will have higher inflation. Higher inflation will likely lead to higher interest rates (especially if you also have higher deficits) and higher rates will lead to a stronger currency.

These four factors can co-exist in the short term, but higher interest rates and a stronger U.S Dollar will eventually lead to weaker economic growth, lower inflation and as we have seen in the past two years, lower corporate earnings. So we see this as a question of not what the economy does but what is currently discounted and what are the time lags for these factors to play out.

As we enter 2017, stock markets are at record highs, High Yield markets are near 6%, the U.S Dollar is rising as are bond yields and inflation – the Fed is predicting 3 rate hikes for 2017. Our inclination is that markets are currently too optimistic, especially on earnings (given increasing rates and USD strength). Having said this and recognizing that markets outperformed expectations in 2016 by a wide margin, we don't see the probability of negative returns for 2017 as being particularly high. 2016 was a volatile year in short spurts and we expect the same in 2017, but perhaps even more so. More frequent sell-offs and rallies are likely, and continued strength in the first quarter, unlike 2016, makes sense to us. The sell-offs could very well be deeper this year as valuations are richer. Nevertheless, we expect that buying into the sell-offs in 2017 will be rewarded as they were in 2016.

Could we get a double digit return in equities and a 6-8% gain in High Yield for 2017? Yes, this is possible and perhaps probable. The real issue for us is how much risk you must incur to achieve these results. Consensus views are logical, but rarely correct. Given the macro outlook, we see volatility and risk rising and this encourages us to promote a more tactical approach to investing rather than building a diversified portfolio that reduces risk in the long term. The big risk is that rates rise too much and cause stocks to fall. This means stock and bond prices go down together and diversification didn't work. We prefer a tactical approach of staying broadly in cash substitutes, earning 4-5% return and waiting for market sell-offs to add risk. This strategy may or may not outperform a diversified approach but it will provide a significantly lower risk profile. We developed a highly liquid vehicle, Marret Enhanced Tactical Fixed Income Fund, two years ago and have produced nearly 5% returns with less than 2% volatility and lower than 1 year duration.

Our two big risk thresholds are 3% on the 10 year U.S Treasury note (versus 2.4% at the writing) and 108-110 on the DXY (U.S Dollar trade weighted index – 102 currently). Should we breach these levels, we expect the probability of a material risk sell-off to move to very high levels.

Finally, while we see many more risks than rewards for 2017 and uncertainty at unprecedented levels, we are not building recessionary portfolios. We are closely watching U.S rates and the USD and we see expectations as uncomfortably high. Nevertheless, we believe good risk adjusted returns are possible this year by maintaining a core portfolio of cash substitutes and taking advantage of periods when valuations become attractive.

Happy New Year and we wish all the best to all of our readers and clients,

Barry Allan
January 2017

Marret Enhanced Tactical Fixed Income Fund
Gross returns in Canadian dollars
December 31, 2016

	Current Month	3 Months	1 Year	2 Year	Since Inception *
Total Portfolio (fixed income & cash)	**0.52%**	**0.66%**	**4.89%**	**4.93%**	**4.88%**

**Inception Date: November 28, 2014*
*** Returns are calculated net of all fees*

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