GROWTH + INCOME

2017 2nd Quarter Review

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Technology, Then Everything Else

Executive Summary

- At home, all sectors of the S&P/TSX Composite index fell, producing a negative total return of -1.6% for this quarter, and of 0.7% for the year so far. However, we have been very cautious about the domestic market for quite some time already.
- In the United States, the S&P500 Total Return was a lacklustre 0.4% for the quarter, but a more convincing 5.4% for the year, as expressed in Canadian Dollars. It remains to be seen whether the market has any more room to grow, but investors in technology stocks certainly seem to believe so. Buyer beware…
- The main story is taking place in the Old World. Europe is the strongest market with a return on the D.J. Stoxx 50 of 3.2% for the quarter, and 8.6% for the year, as expressed in our currency.
- Our Loonie surprised most observers by increasing in value against the greenback. The U.S. Dollar lost 2.6% during the second quarter of 2017, and 3.6% so far in 2017 relative to the Canadian Dollar. The newfound strength of our currency, combined with the American administration's protectionist measures, could have a very cooling effect on cross-border economic exchanges. However, a stronger dollar allows to makes some stock purchases at a lower cost. Snowbirds may want to consider taking advantage of these favourable conditions to buy at least part of their U.S. dollars now, rather than wait for autumn to do it.

Exhibit 1

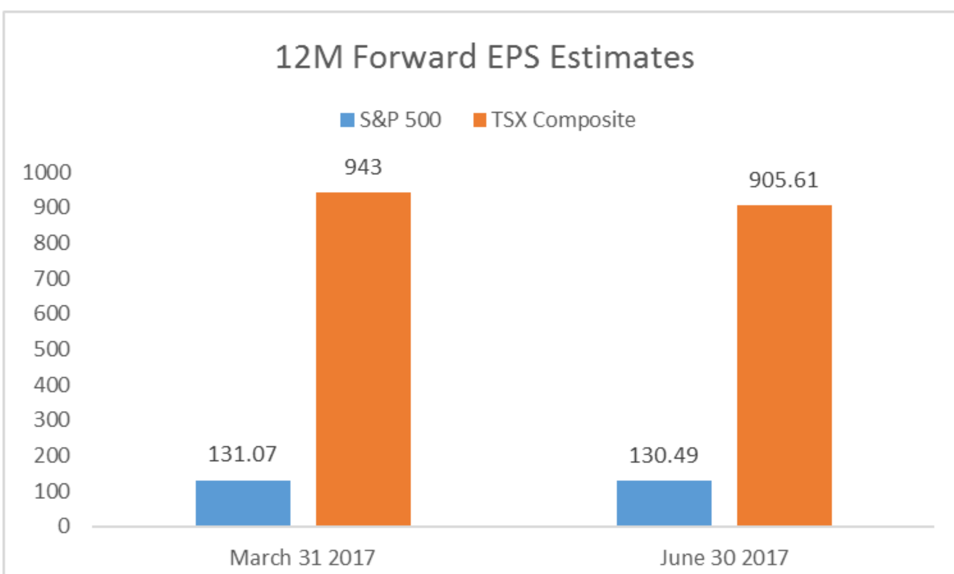
Second Quarter Returns on Various World Markets

Benchmark	2Q 2017	YTD 2017	12-Months Trailing
S&P/TSX Composite Total Return Index	-1.6%	0.7%	11%
S&P 500 Total Return (C$)	0.4%	5.4%	18.2%
Dow Jones Stoxx 50	3.2%	8.6%	14.5%
RBC DS Broad Composite Bond Index	1.1%	2.4%	0.0%
CAD per USD	-2.6%	-3.6%	0.3%
Oil (West Texas Intermediate)	-4.7%	-9.0%	-1.56%

Exhibit 2

Slight Decrease in Earnings Expectations for the S&P 500 and TSX Composite Indices

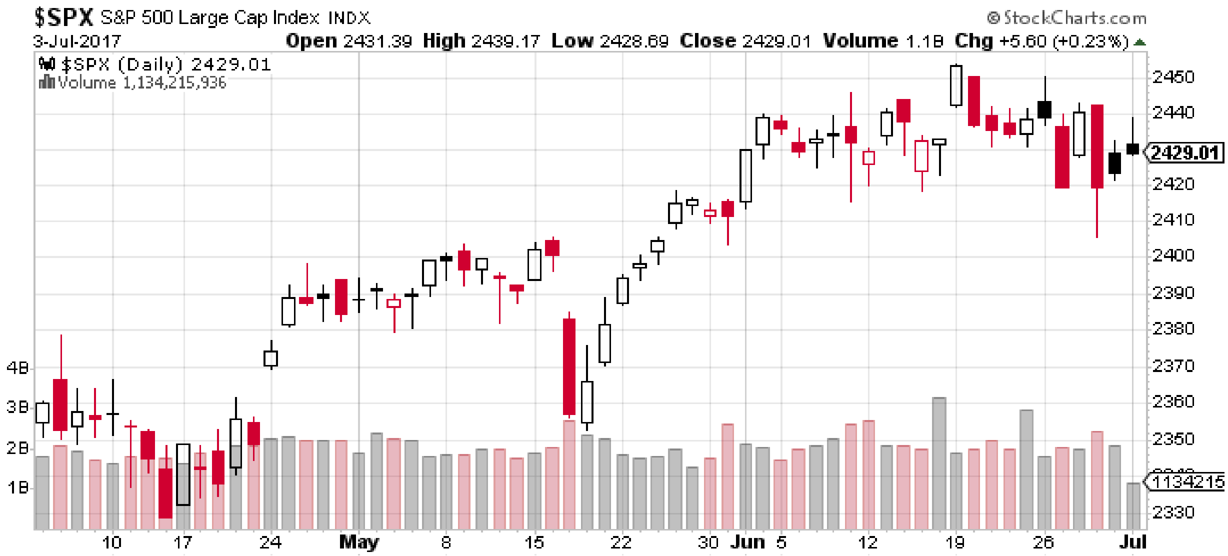
As shown on the chart below, the earnings expectations for both North American markets are falling. This is happening by small increments in both cases, but does not bode well for index investors on these markets. We currently have exposure to these markets, but are extremely selective and apply ruthless criteria to uncover value.



2ND QUARTER 2017 MARKET DRIVERS

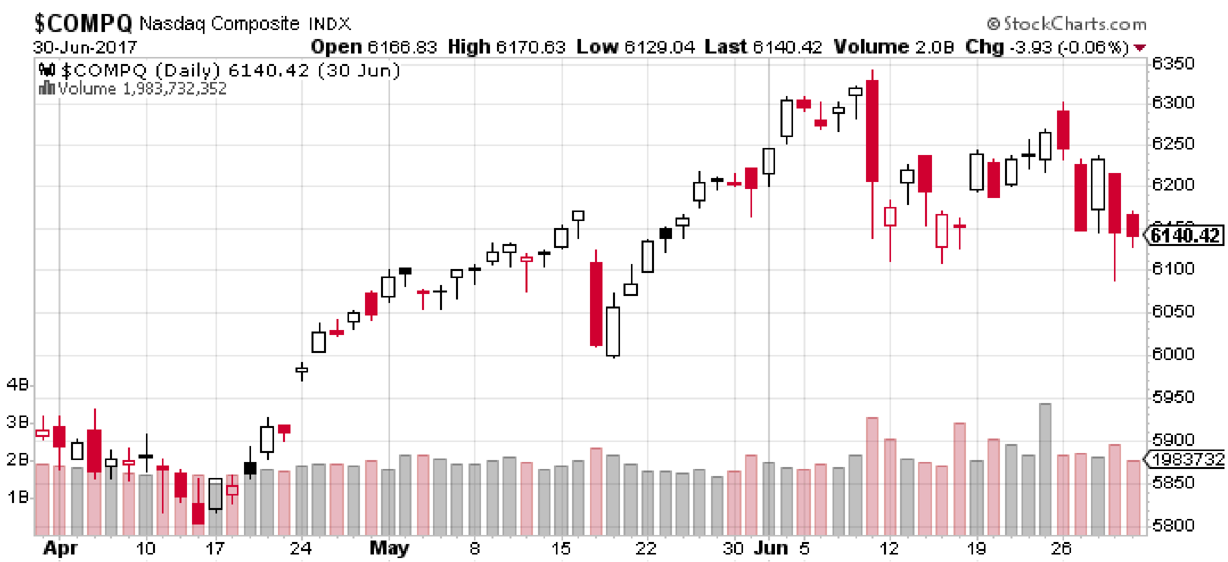
1 U.S. MARKETS

Chart for the U.S. Market Proxy, the S&P 500 Index

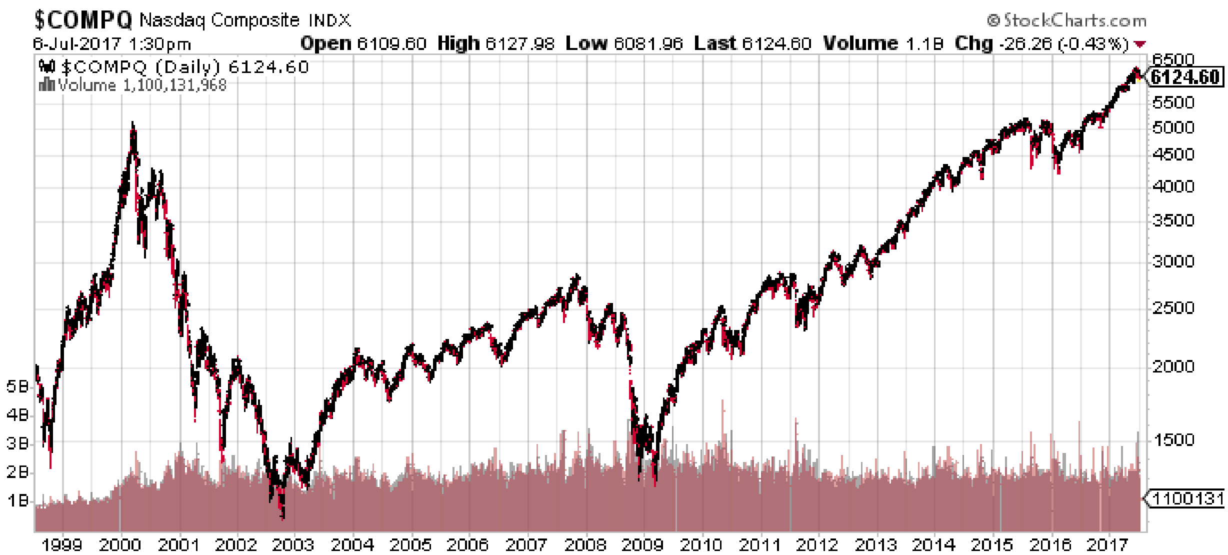


The U.S. market's path for the quarter shows little volatility. It has produced a 9.3% annual return, and 3.1% for the quarter (all expressed in USD). Once again this quarter, the technology sector has acted as the market engine.

Here is a look at the NASDAQ index, which is comprised largely of technology companies.



The NASDAQ is up by 14.1% for the year, and 3.9% for the quarter (in USD). Driven by what is commonly referred to as "FOMO", or *fear of missing out,* some investors might be tempted, at this late moment in the game, to rush into technology. This, however, would be a misguided reflex. Some stocks appear a tad overvalued, to say the least. (One has only to think of Amazon, which sells at about 190 times the expected profits! Or the fact that the mighty Apple and Uber, one of the new darlings, have both been in trouble over the past few weeks.) One simple rule of logic is that the higher the market goes, the more painful the fall is. The decline might be slow or quick, and we are not saying that this is a bubble that will burst suddenly. The scenario could be one of slow erosion of value. Be that as it may, recent history provides a good cautionary tale for technology investors. The 19-year chart of the NASDAQ Composite Index (below) shows how it took 15 long years for this index to regain its high after the technology bubble burst in 2000. Investors should consider themselves forewarned…



The heat map, which we introduced a few issues ago, lets us identify what is driving the U.S. market by showing the index's components and their performance.

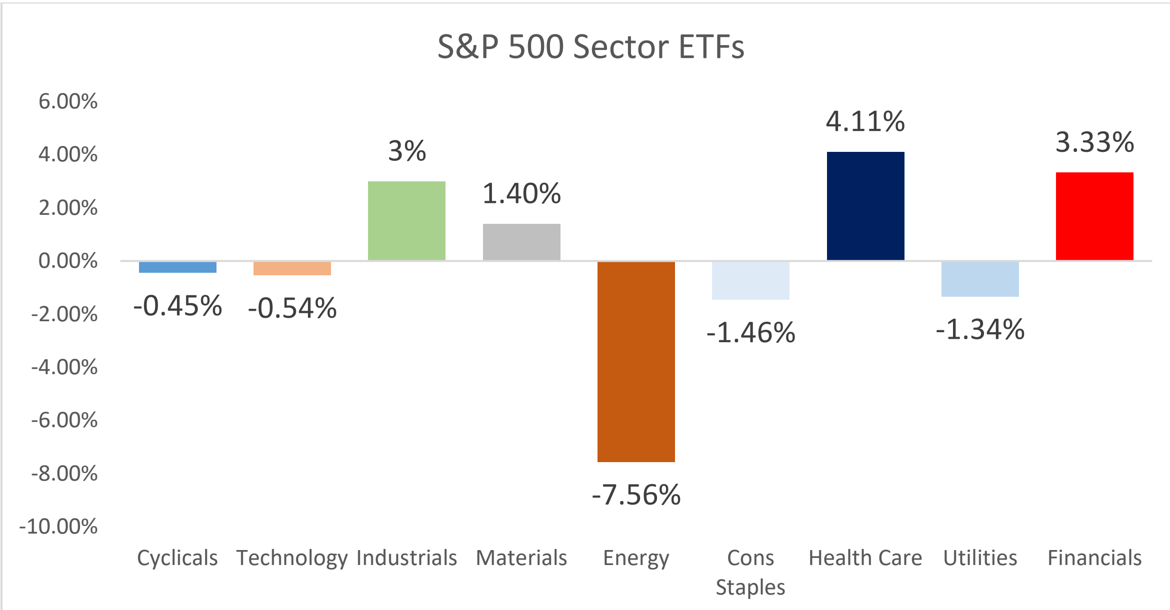
U.S. Market Heat Map (Past 3 Months, as of July 4, 2017)

About this map: Heat maps such as this one are an interactive tool we use to visually identify trends within a given market. The S&P 500 index, the proxy for the entire U.S. market, is divided into Technology, Financials, Services, Consumer Goods, Basic Materials, Healthcare, Industrial Goods, and Utilities. Companies' capitalization and weighting within the index are represented through area size. Finally, colours indicate performance: green means positive, red negative. The brighter the colour, the more pronounced the movement up or down.

Three observations are obvious from looking at the above chart:

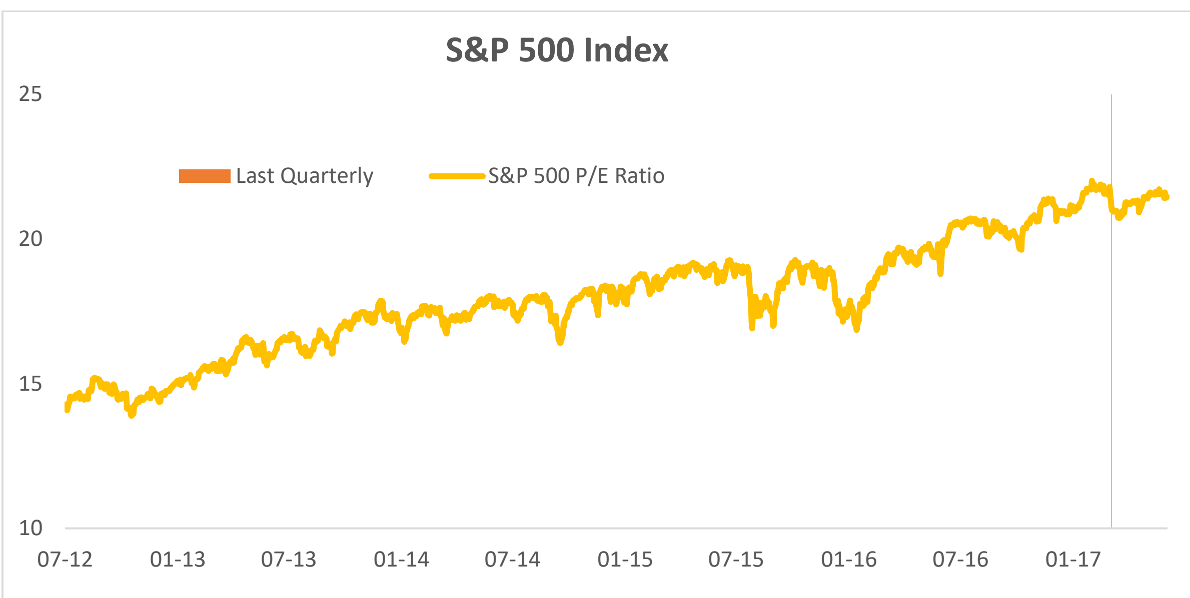
- The largest squares, representing large-cap companies, have had a good quarter. They were responsible for carrying the index.
- Google, Amazon, Facebook, Microsoft, and Oracle in particular, have had stellar quarters.
- Industrials were doing well, as were Financials, but Energy and Telecoms lagged.

Below is a view of the U.S. market by sectors. While Energy was down significantly over the quarter, Healthcare, Financials and Industrials more than made up the difference.



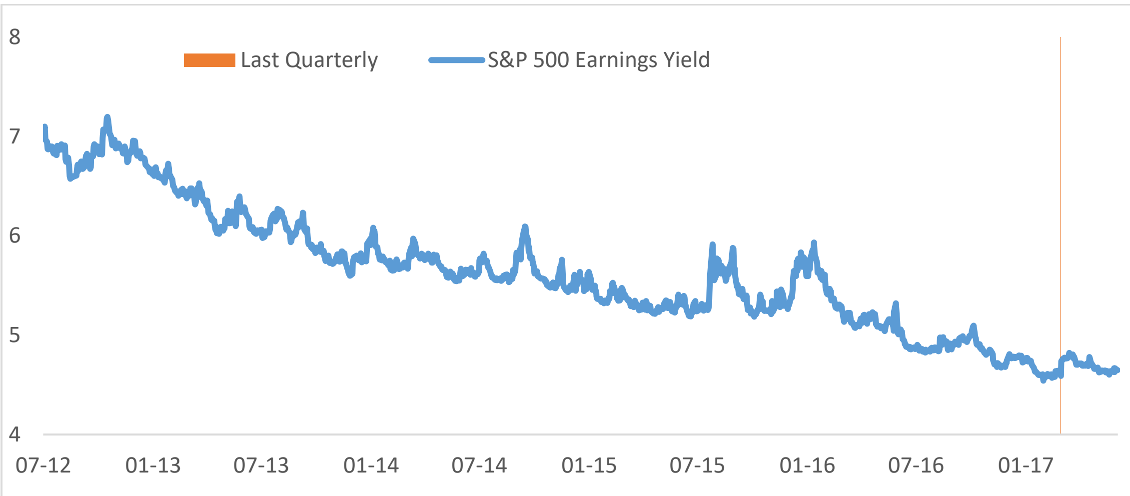
1.1 Valuations

S&P 500 Price-to-Earnings Ratio (Past Five Years)



The price-to-earnings (P/E) ratio is a measure of how expensive stocks are, relative to corporate earnings. In this chart, the upward trend is unmistakable, which is normal during a bull market such as the one we find ourselves in. While the index is expensive, as illustrated by the chart above, we are nonetheless able to find pockets of value. It is the largest names (concentrated in the technology sector), mentioned above, that are skewing the index's valuation.

S&P 500 Earnings Yield (Past Five Years)

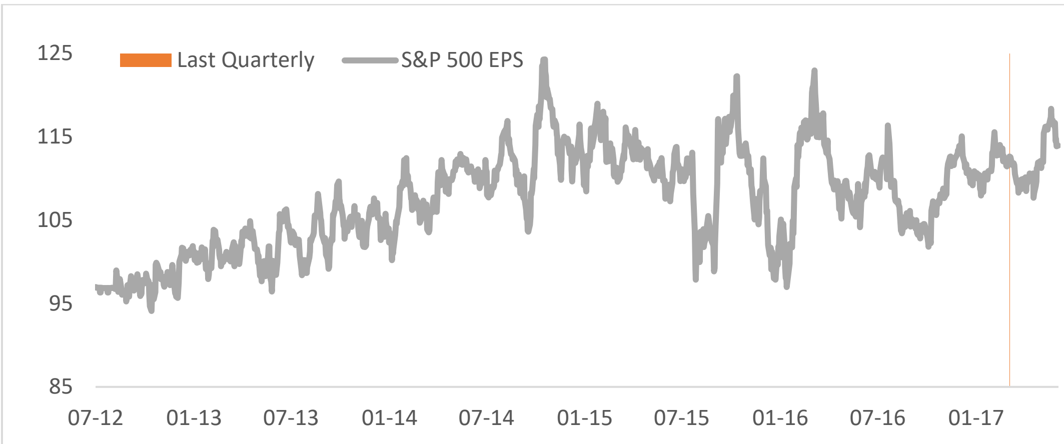


The earnings yield (which is the inverse of the P/E ratio discussed above) allows us to compare investors' return on an investment in stocks, which carry more risk, as compared to an equivalent investment in low-risk bonds, such as the 10-year U.S. Treasury bond. Currently, the interest rate on the 10-year U.S. Treasury bond is 2.30%, while the earnings yield of the S&P 500 is below 5%, closing the quarter at 4.6%. Typically, the "risk premium" (*i.e.,* the extra yield that stocks should pay above the prevailing interest rate) historically has been around 2 or 3%. This is why we are of the view that, while stocks might still be able to provide a slightly higher earnings yield, it will remain a relatively low one.

However, this is in a context of expensive bonds. In other words, the yield on bonds is lower than it would be if bonds were cheaper. As soon as interest rates increase, bond prices will drop, and bond yields will increase. Normally, this means that earnings yields should also increase, and stock prices decrease.

1.2 Earnings

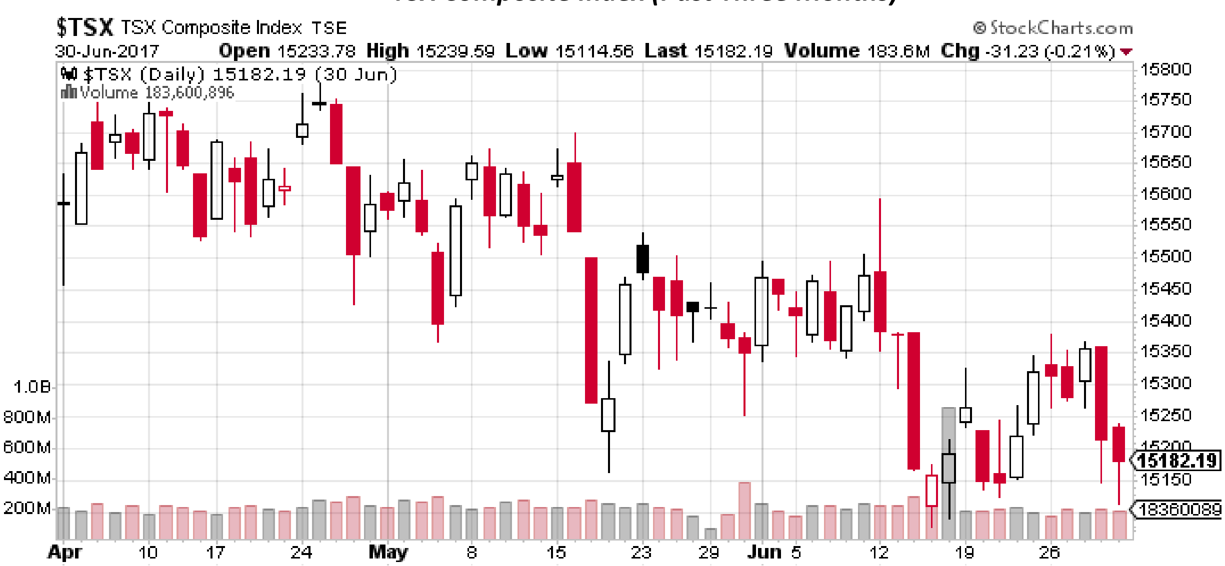
S&P 500 Index Earnings per Share (Past Five Years)



The second quarter brought on some much-anticipated growth in actual earnings per share. Part of why stocks advanced in 2017 is directly attributable to this earnings growth.

2 Canadian Markets

TSX Composite Index (Past Three Months)



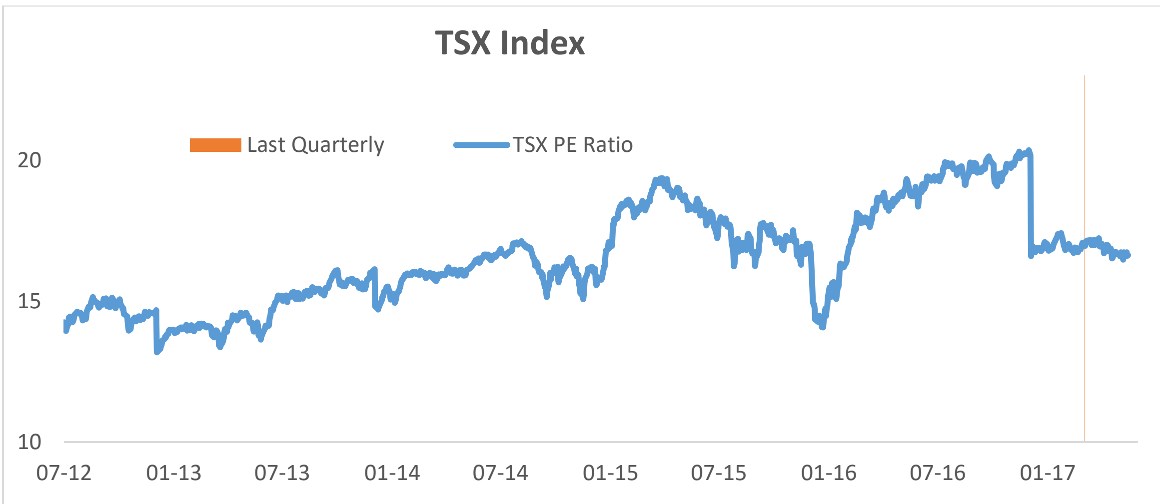
The Canadian markets were in a negative channel. Looking at the factors composing this negative return for the quarter, Energy (representing 20% of index) fell 8.3%, Materials (12%), which includes Mining

(8%), fell 6.4%; Financials (34%) fell 0.9%, while the Banking sub-index (23.5%) fell 1.9%. In short, it was a tough quarter in Canada for equity investors. The fact that all three pillars of our market were down is unusual. Of course, one poor quarter does not make a trend.

Nevertheless, we continue to be very cautious on the Canadian stock market. We are seeing pockets of attractive opportunities that may take some time to prove themselves by way of significantly higher prices. We did buy a few select names which pay dividends that made them a compelling investment decision even in the context of a difficult market.

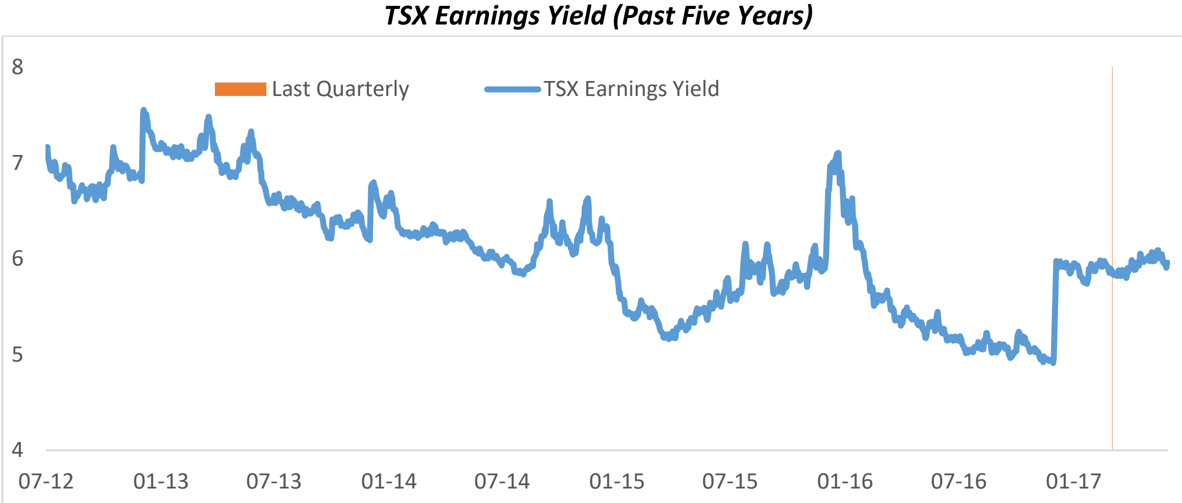
2.1 Valuations

TSX Price-to-Earnings Ratio (Past Five Years)



Valuations stabilized this quarter, but remain elevated. Until the energy sector recovers, the overall index earnings will remain depressed.

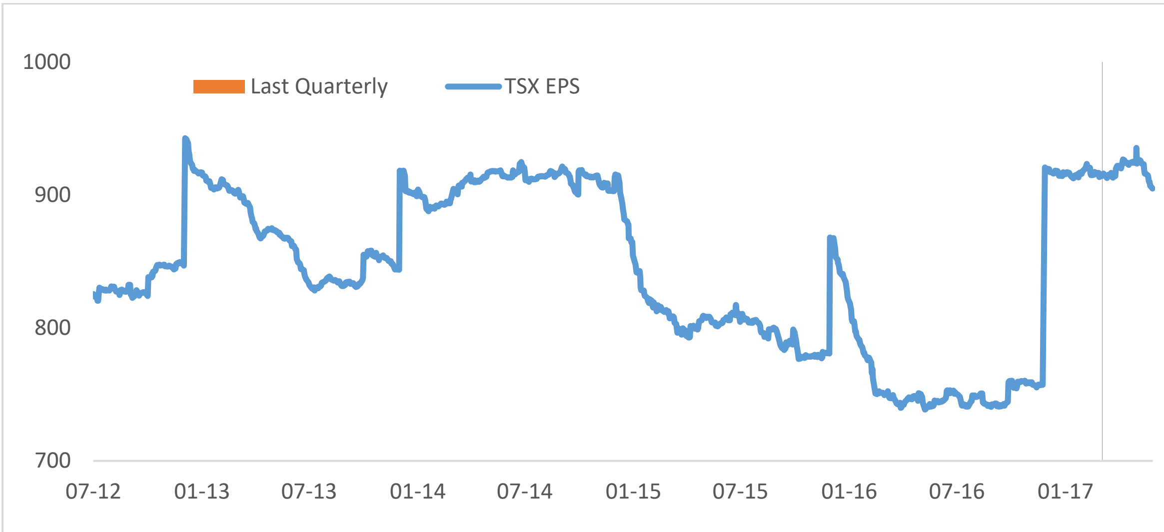
TSX Earnings Yield (Past Five Years)



The index valuation as illustrated by the earnings yield is approaching its five-year average. At this point, it is neither cheap, nor pricey. However, should the expected interest rate hikes materialize, bonds could become a competitive asset class.

2.2 Earnings

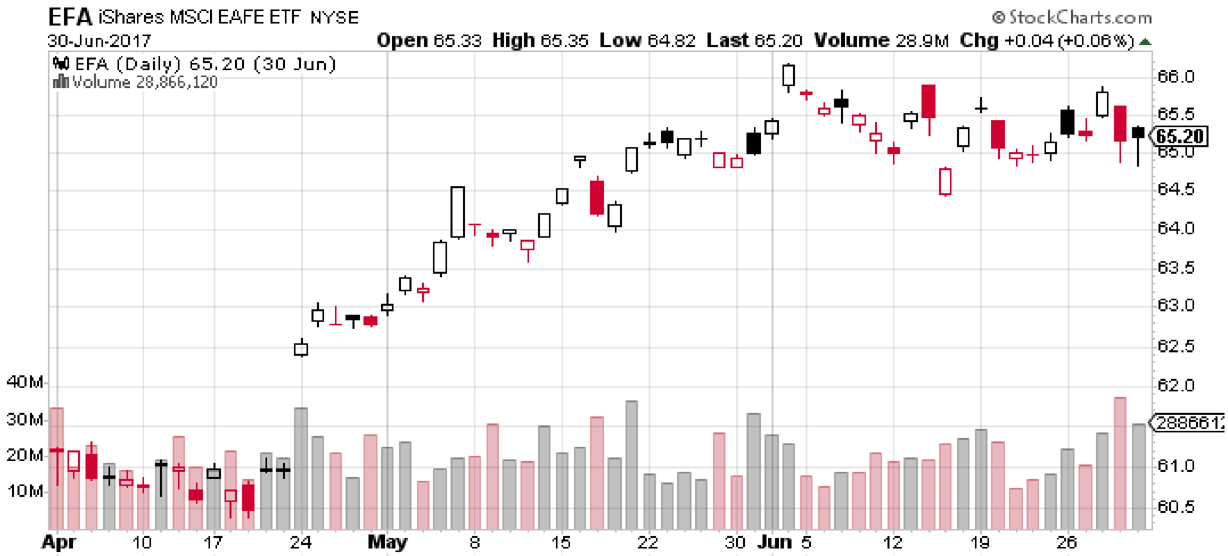
TSX Earnings per Share (Past Five Years)



The bounce in earnings we experienced last quarter did not repeat itself. We did witness a slight uptick in earnings, but nothing to get excited about.

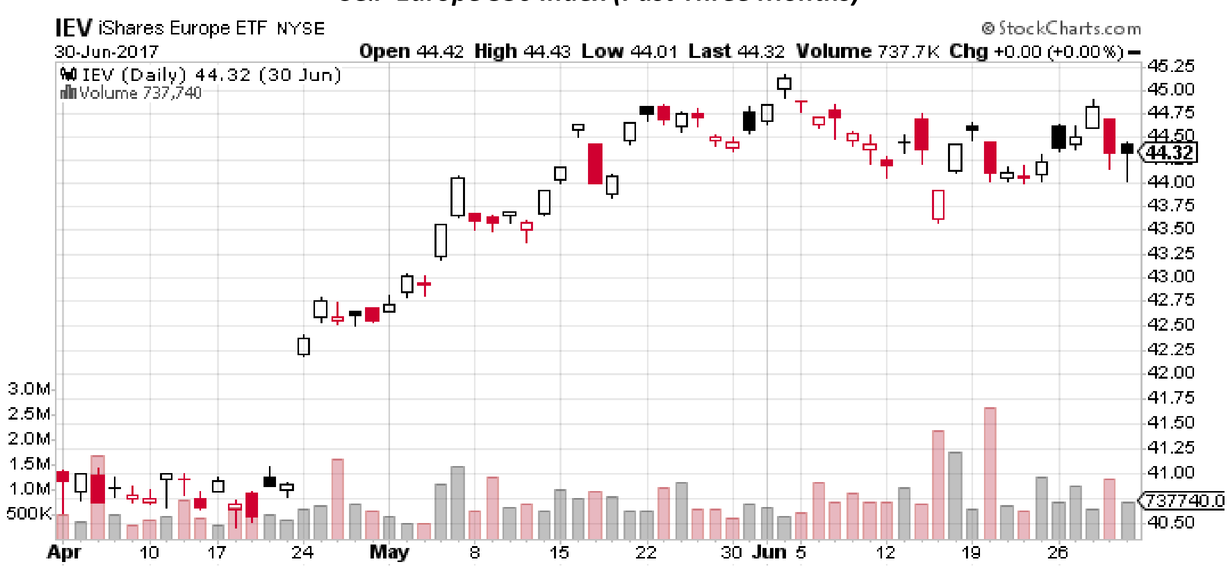
3 Foreign Markets

Morgan Stanley Index (Europe, Australasia and the Far East) (Past Three Months)



The global indices saw some positive momentum from several sources. Firstly, the weakening U.S. Dollar helped goose up the returns when converted from their native currencies. Secondly, European markets accelerated their advance on the back of the election of Emmanuel Macron as France's president. In Asia, the Chinese and Japanese stock indices showed a solid performance as well.

S&P Europe 350 Index (Past Three Months)



The Macron presidential win allayed fears of a short and abrupt end to the European Union. At Exponent, we continue to benefit from our decision to boldly move into European equities. While it may have been unprofitable at first, this decision is currently proving very rewarding financially. As a matter of fact, we are now being joined by some very aggressive investors: U.S. investment and hedge funds that now take a keen interest in Old World stocks. This is unusual on their part—and, in our memory, unprecedented.

Indeed, European stocks are now being touted in American investment circles. So much so that, recently, behemoths such as Unilever (a British conglomerate) and Nestle (a Swiss one) have been in the crosshairs of very vocal activist investors who are looking to unlock even more value from their rising investments.

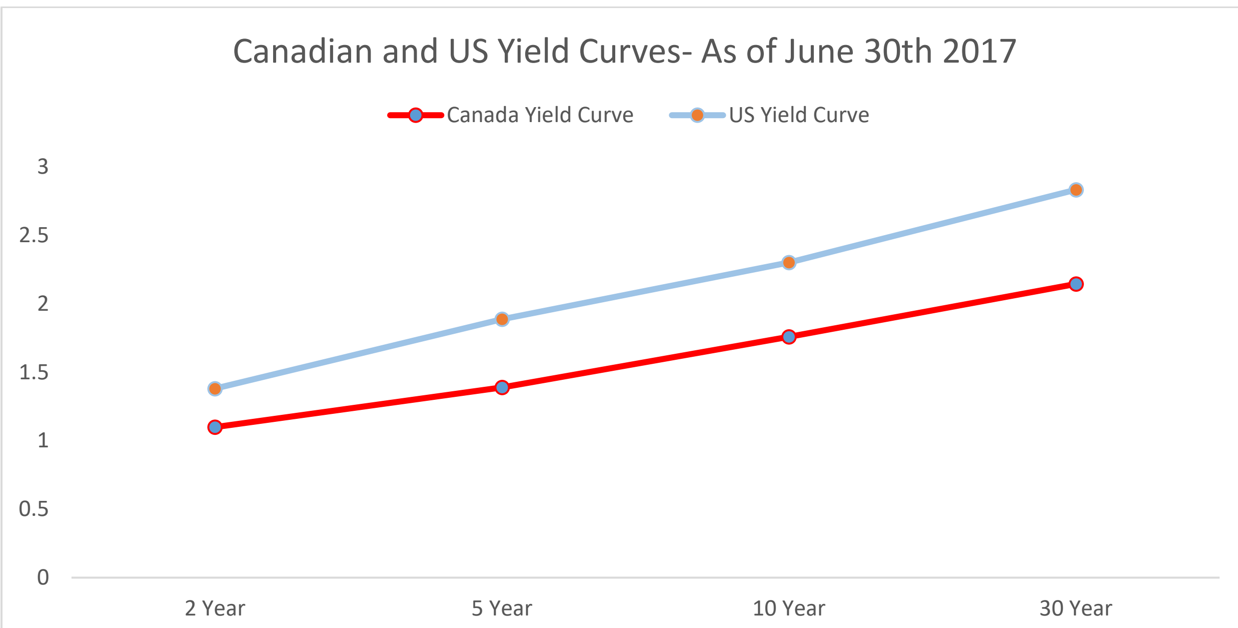
In general, European stocks continue to offer lower valuations and higher dividends than their U.S. and Canadian counterparts. However, this gap has narrowed and we foresee that their rise will continue, thereby adding even more value to our portfolios.

4 BONDS AND INTEREST RATES

The yield curve (see chart below) is the plot of the yield (Y axis) of maturing government bonds over their maturity (X axis). The shape of the curve is meaningful. Right now, it is ascending, which is perfectly normal. This means that rates for short-term bonds are lower than for longer-term bonds, as they should be.

Below is the shape of the yield curve both in Canada and the United States. The Canadian central bank, which has now raised its interest rates, had already been signalling its intention to do. This, by the way, can explain the rise in our currency. The price of bonds with shorter maturities has also begun to reflect this expectation of progressively higher rates.

In the United States, rate hikes are expected at least once, if not twice. Since investors consider this a *fait accompli*, the reaction in the currency and bond markets is much more muted.



5 Options

CBOE Volatility Index (Past Three Months)

An important indication of investor sentiment, the CBOE Volatility Index (VIX) chart (above) measures the volatility of the S&P 500 index on 30-day rolling periods. As has been the case during the past few quarters, this chart continues to show ever lower-than-usual volatility levels. This indicates that investors have settled into complacency. The “volatility bear market” continues as the index remains firmly around the 10 levels. This is very much a market that seems to have forsaken stomach-churning ups and downs. This lulls many investors into apparently forgetting the very concept of big price swings. However, such low volatility is not a normal occurrence.

Our conservative options strategy is designed to harvest volatility in normal or high volatility markets. Obviously, the current environment is less than ideal for this approach. However, we expect that normal volatility will be upon us as markets normalize. This seems almost inevitable as central banks around the world adopt a stance to raise interest rates over the coming months and years. Also, the United States are facing another budget debt ceiling negotiation in the near future, which should cause a bit of trepidation. We stand ready to exploit any market gyrations.

6 To Conclude

We continue our careful valuation work to ensure that we are not caught by surprise. We do not hesitate to sell when reaching our valuation targets. Conversely, we rely on patience in our buying process to ensure purchases at attractive prices. This explains our currently larger-than-usual cash balances.

We have deployed some capital as well as sold some holdings. The buys and sells have essentially offset one another.

We remain ever cautiously optimistic. Despite the current uncharted, historically anomalous market environment, our year-to-date return is slightly above our mid-year goals. One needs to look hard enough and ignore the ominous headlines associated with the weak short-term stock performance. This is what we do, and will continue doing for you.