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TOUCHSTONE STRATEGY

Richmond | Goodman Wealth Management

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Dear Clients and Friends,

Before writing this letter, we read our memo to you from last March. Much of what we wrote about is even more pronounced of late. Certainly, the wild day-to-day swings in the market haven't receded.

Back then the market had, within the prior 6 months, undergone two major moves: a sharp rise from Nov '17 to late Jan '18 on the back of tax cuts south of the border, and then a swift decline in February. Our memo outlined our rationale for having been cautious and what we would need to see going forward to be more confident in a sustained rise. Our process, and 25 years of experience, always leads us to be defensive and unemotional when others clamour for typical late cycle speculative returns (e.g. bitcoin, cannabis). Most end up in tears (some in "smoke").

That was our promise to our first clients in the mid 90's - and will continue to be going forward.

- Since our last letter, the same pattern has repeated itself: a market rally in late spring, followed by, as we all know, another very sharp decline mirroring the Nov'17 - Feb'18 period.
- The factors that led the rally a year ago were also involved in the late spring rally: namely US tax cuts, increased Government spending, and a rise in exports ahead of the trade wars. All of these are transitory but were given a sense of permanency through reams of White House tweets.
- The aforementioned led to a feeling that the economy was stronger than it might be, and the stock market rallied on the results. However, such stimuli are usually unsustainable.

Fast forward to September and what has changed?

- Valuations for companies even higher than they were.
- US Central Bank (the "Fed") firmly stating that they will continue to raise interest rates; Trade War with China ramping up; US Midterm elections looming; global political tensions higher (Saudi, Iranian, Turkey, Russia etc.). Emerging Markets struggling with higher US rates and dollar; and very much on the front burner now is a high level of corporate debt.
- Speaking of debt - at this stage of the economic cycle, Government debt should be in decline. Instead debt is rising, leaving little wiggle room to support a recessionary environment, should it emerge.

What does this all mean?

- Rising interest rates = less cash in the consumer/corporate pockets for spending = lower sales and profits for companies. Company stocks were priced for higher sales and profits…so any lowering of outlooks leads to lower stock prices until expectations = reality.
- Trade wars = less economic activity and higher prices for buyers. Which leads to the same end game as higher interest rates (i.e. lower sales and profits).
- Corporations are more debt laden at this point in the economic cycle…so higher rates can cause them pain via higher interest payments…which lead to lower profits.

Bottom line: In the interest of brevity and saving you from having to read a million newsletters/commentaries, the above is merely a fraction of the influences out there - but they all have one thing in common: the current economic expansion is closer to the end than even the middle. Consumers and corporations no longer have the wind in their sails to support the valuations that **were** in place. The market decline underway now is an attempt to rebalance valuations and expectations. Although painful, it is perfectly common, very necessary, and hopefully short-lived. In fact, this is the 7th time since 2009 that the market has corrected at least this much before continuing higher.

What are we doing about it?

- The first part of 2018 was very good for our clients both on a relative and absolute basis, while the TSX was essentially flat to slightly negative. We had nicely positive returns and did so despite our very conservative stance. With summer came a rally in the indices, and while we didn't continue to widen our positive gap, we held our own.
- "Then came now". Our process is designed for these market shocks. However, we will not sugar coat this - our clients have taken part in the decline the past 5 weeks, effectively removing the positive returns this year. Meanwhile (and as expected) the indices have suffered much worse. It has been a sharp and hard decline…not unlike the one last winter that saw the markets down approximately 11% in a matter of weeks.
- What have been our actions leading up to and during the decline? Well, through the late summer we continued to raise cash levels by selling any investment that broke our criteria. This did not insulate us fully though and have sold even more in the recent weeks/days.
- The net effect of this is that over the past several months, our cash levels have risen because of the jettisoning of weak positions. We are "playing defense" with your capital. It hasn't been the perfect defense, but it's been consistent with our rolling 12-month goal of protecting capital.
- The opportunity that you have over others (because of our approach), is that when the markets start a new trend higher, you have the cash to deploy, whereas investors who remain fully invested will look longingly at old statements wondering…wondering.

What do we want to see?

- Trade Wars receding
- More comfort from officials and politicians (!) that policy decisions will be gradual and steady
- Corporations prudently managing their own debt levels

Our stance is that clarity on these things may allow the economy to go through the last few "innings" of this cycle in a smooth manner.

Conclusion: We continue to follow our process as always. Despite short term periods that may see a decline from the highs for clients, we are well positioned from both a defensive standpoint and/or for deploying the cash to new opportunities. We are constantly looking for the latter, while keeping an eye on the former.

Best Wishes,
Doug, Phil, and Tina

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