

VIS A VIS

INVESTMENT COUNSEL INC.

DATE: July 15, 2019.

FROM: John Evdokias

RE: **Client Communiqué** 7/15/2019

Below, are some of the topics and points I think should be considered and discussed. In this communicate however, I will attempt only some of these, and not risk overwhelming the reader with too much information at this time. The other issues enumerated are also important and I hope to expand on them on another occasion [or discuss them with you, vis-à-vis, whenever you wish]. Even if most of our clients and readers are rather well informed already, we have noted recently that clarity and reliability of information has been muddled, in many cases, from the unavoidable bombardment of prevalent, unreliable electronic media and the likes. Unfortunately, needed 'noise filters' and 'integrity filters' are lacking in our environment of fake-news, information overload, deceit and treachery. More importantly, what is also in short supply is good judgment and this is where we also strive to contribute. Keeping things simple, often adds to clarity, perspective and better understanding. Perhaps, 'simple & realistic' is better? [Such issues are always more complex; if not now, expect they will be in the future.]

In our effort to be succinct, we hope that we still provide enough helpful insights and substance for the reader, to reach a better understanding of the current anomalous capital markets environment we all face.

- **Capital Market Volatility & Risk** – how best to navigate uncertainty? Diversification.
- **Geopolitics and effects on your portfolio**; Disruptive, Socio-economic changes?
- Nationalism, rise of Populism; "I hate solutions without problems" Macron; Climate change; Global Food Security; Migration; Digital revolution.
- Food prices are a fair proxy of inflation? Maybe. VV report Apr 2014 (-2% X 10 years = -20%) So, is inflation low & is low inflation a 'menace?') Alternative Assets; Cryptos; Gold.
- Is it confusing that Stock Markets are registering new highs, during an 'inhospitable' environment?
- How much should conservative investors expect to earn annually from their portfolio? Risk of losing savings? Opportunity loss? Ideal, Asset Allocation?
- Expectations are high? Probably; Risk is low? Only, if you're not paying attention. How not to react impulsively with your portfolio, to improper influences. **'Four trick-questions'** that almost no one gets correct. ⁱ
- Impact of 'Millennials who are not accumulating stuff and their parents who have [own] too much stuff?'

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Background:

Without belabouring the point, we thankfully avoided a global, economic depression during the last 11 years since the 2008 markets crash. How was this accomplished when asset-value losses at the time were estimated at about USD 100 Trillion worldwide? Simple answer is that governments everywhere 'printed their way' out of the default hole. There was no alternative, as many debtors had to reschedule or refinance the gargantuan debt and their creditors had to accept the promises that 'new paper' carried. [Recall some of the casualties, the humbled Banks, Nations, Institutions, Corporations, People...?]

Are we on the mend yet? I don't think we have fixed the profound damage but have indeed worked out hopeful methods to avoid that type of future systemic event. Legacy-losses are still lurking, cleverly tabulated within the 're-Balanced-Sheets.' Much of the monumental losses in those asset-values and the destroyed wealth, are still on accounting ledgers of banks and Nations. For those who are unaware of such precisions, Non-Performing-Loans [NPL] are an unsettling distraction to the financial community; Shadow banking opaqueness is another warranted distraction ["U.S. shadow banking assets total \$15 trillion or a third of total global shadow banking assets"- DBRS]; Securitized [Repackaged] Consumer and Corporate loans of dubious quality are also new stress points in our financial system. Previous Sovereign bond excesses in Europe, i.e. Italy, are possibly set to again capture debt-rescheduling headlines. Greece, needed to go through a merciless, economic Depression [drop of 26% in GDP], before a notable improvement materialized. I don't know any other nation, that could have mustered the fortitude, resolve, courage, and sacrifices made by the people of Greece. [From a 'technical default' in June 2015, when Greece refused to pay the IMF, Greece has now morphed into a nation that can again borrow internationally and at historic low EURO interest rates]

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Observations:

Capital markets, Volatility & Risk

December 2018, the world saw first-hand what occurred when the FED abruptly introduced and increased their interest-rate bias; Stock markets fell about 20% that month, as the then expected increases of interest rates, contributed to a negative sentiment on economic growth. A complete stock-markets reversal occurred 1Q & 2Q 2019, when the S&P rebounded by about 17%. This rebound resulted when new indications took hold, that official interest [administered by FED] rates would be reduced again. Recently, the US stock market has again registered incremental, new highs. I think such remarkable volatility is explainable: short investment horizons of hedge funds; algorithms designed for opportunistic, short-term trading, executed by the fastest of traders, the computer; AI; blitz of equity ETF creations; Institutional asset allocation changes, which favour higher proportion in Equities; disquieting investment environments in other geographies, 'advocated' USA as a more appealing investment environment.

It seems that we are set to also test a newer form of financial-repressionⁱⁱ in the West; the limits and 'power of negative interest rates/yields.' I think the result to savers, could be close to partial government 'confiscation of savings' [metaphor]. Pretty alarming observation, and perhaps exaggerated a little to make a point, that Governments don't have a solution but rather have a short-term method to postpone an undesirable outcome. Currently, negative yields, reflect a prevalent economic malaise.

Last ten years, the world economy has been growing, not evenly but steadily. [means in aggregate, world GDP has been positive but not enjoyed equally in every jurisdiction as would have been expected from a healthy, global economic expansion.] This year, IMF expects World GDP to grow about 3.3%; Eurozone to still expand modestly, even the UK; China GDP has slowed down to about 6.2%; Canada GDP has also slowed to about 1.3%.

Trillion\$ in government money [your money] has been put to work to keep the economic engines running; it's working for now. Is this growth *artificially* induced? Oh yes, through QE (quantitative easing & fiscal stimulus.)

"Our expectations are that this discernable improvement and future improvements, will affect the capital markets in a much more desirable fashion. Basically, we think that "global equities will likely be the best performing asset class"; interest rates and inflation will increase; bond markets will be a drag to investment portfolio valuations, pressures on underfunded pension plans to abate, somewhat." *Visavis 12/12/12*

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Result of Government easing? USA Stock markets [& elsewhere] have made new highs. Interest rates are still historically very low, real estate asset prices [including infrastructure] have not only recovered but have also experienced one of the biggest price advances of the past fifty years [my impression]. Unemployment in North America and Europe is lowest we have experienced during the last few decades. CAN 5.4%, USA 3.6%; Eurozone 7.5%.

So, who is to complain about this incredible economic recovery? No one, yet, except Mr. Trump and those on the receiving end of his relentless and impatient 'attention?'

“As the economic healing process the world is experiencing is still fragile and disjointed, Government policy-mistakes can adversely damage your portfolios (as can a disproportionate concentration). The cost of being 100% wrong, must **not** be irrecoverable.” VV 6June2011

Asset values which have improved notably beyond pre-crash highs, have done so helped materially by Governments' seemingly endless, '**charmed**' liquidities and fiscal accommodation. Europe, Japan, China, and USA have been relentless in their monetary easing, all trying to stimulate the world economy, to a point where massive QE will not be required and that the world would gyrate economically on its own dynamic. We are not there yet, for reasons last December's market drop demonstrated; just the bias for higher rates unraveled most of the unrealistic assumptions, that massive stimuli and resulting growth will not be interrupted. Plunging bond yields, are “usually a sign that investors are bracing for an abrupt slowdown.” “If a calamity is in the making, the U.S. high yield market seems blissfully unaware.”-cb/

Many professionals, policy makers, academics, and the public too often base their expectations and forecasts on *untenable* assumptions: that all-things-remain-equal. However, 'things mostly don't remain equal.' So, when rates increase, and we all know they will, valuations of all asset classes will be negatively affected. Magnitude of ensuing wealth destruction will depend in part on the speed of rate increases; on the riskiness of asset allocations; on the absence [or not] of undesirable systemic effects.

An extreme example: In 2017 Austria issued a **100-year Bond** yielding 2.1%. Since its launch two years ago, the price of this bond has increased over 50% and this bond's yield fell to about 1%. [it's suggested that this “madness” may be also copied by other EU sovereigns; *duration risks or credit exposure*, seem are the two prevailing choices facing the investing '*OPM*' institutions [other-peoples'-money]?

<https://www.bloomberg.com/news/articles/2019-06-25/austria-weighs-another-century-bond-for-yield-starved-investors>

When Financial markets bid up the yield curve, and they will irrespective of the FED's administered rates, this bond (and other ultra-long bonds) will suffer massive paper-losses. Wonder what inflation assumptions the purchaser ascribed, to this 'Austrian bond' investment decision process?

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Geopolitics and effects on your portfolio; Disruptive, Socio-economic changes?

Is it still valid, that government policy-mistakes at this juncture can cause havoc to the world economy? Who is not aware of recent megaphone tantrums & outbursts by leaders who wish to unilaterally impose changes to international trade? Some complaints seem defensible; others lack a clear causal effect and seem to self-inflict further economic malaise. Lately, international trade participants have become somewhat polarised, along very loosely drawn and more fragile trade links. That 'Trade' has not yet been materially disrupted is remarkable, given the loud, provocative threats and counter-threats echoing throughout the media [& backroom negotiations?]. Everyone in government and in business is designing and developing contingency plans.

World Trade is about \$82 Trillion [Merchandise & Commercial exports Trade: \$22Trillion]ⁱⁱⁱ. If tariffs announced to date by the USA and elsewhere, where fully implemented [& they are not yet] they may amount to about \$300 Billion per year, or 1.4% of World Trade. It is damaging but not immobilizing. Seems the current Trade environment is likely a casualty of Geopolitics and fired-Ambassadors.

“Section 232 [Tariff Modifications] allows the president to impose trade barriers if the Department of Commerce finds that imports threaten U.S. national security.”

The Additional Cost burden to Americans, of President Trump's 'Imposed' Tariffs to date, amount to about \$70 Billion as tabulated by Jacqueline Varas, Director of Trade Policy at the American Action Forum [<https://www.americanactionforum.org/research/the-total-cost-of-trumps-new-tariffs/>] June 11, 2019

These additional tariff cost burden to Americans don't seem that material when compared to the USA's \$22 Trillion GDP. [<https://www.weforum.org/agenda/2018/04/the-worlds-biggest-economies-in-2018/>]

Maybe we are at that *megaphone's* confluence I mentioned earlier, where the expression “*All the World is a Stage*” takes on new meaning, especially for President Trump and his audience. What is feared by all, is that if a resolution to the trade-conflict\$ is not imminent and orderly in its application, it could be economically and politically destabilizing and bring about a nasty recession. However, that China and USA are still seeking a palatable resolution to their current trade conflict is constructive. Even if China's economy “*slowed to the weakest pace since 27 years, it still expanded 6.2% last year.*” We agree with Jenny Leonard of Bloomberg that differing interpretations of what was agreed when two leaders met in Osaka earlier this year may require a fresh start to negotiations.

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Tariff amounts announced to date, if/when fully implemented, are not yet of magnitude to derail the world economy; far from it. However, an *unlikely* escalating and extended trade-conflict [still only a squabble] can destabilize trade routes, business expansion plans and current economic and political alliances. Biggest Creditor nation and biggest Debtor nation [China/USA?] need and are set to make many more future bilateral-deals, while they also propagate ongoing trade-harmony.

Earning a decent return on your portfolio versus earning an in-decent return:

An 'indecent-return' on your portfolio can be very positive or very negative [At such extremes, typically a very high return or a very low return.] In isolation, these qualifiers are not that meaningful. High or Low return compared to what? Expectation of investor? Expectation of PM [portfolio manager]? Compared to an index benchmark? Compared with your nephew's portfolio? Context is important, when one measures relative performance. Most 'successful' investors do not diversify; means they take bigger risk with their savings by maintaining disproportionate concentrations within their asset selections. In this fashion, these 'successful investors' need to also be correct. Otherwise, when wrong, the return is still indecent, and usually very much negative.

"For performance-oriented accounts, meaning those who seek higher returns and are willing to accept higher risks, the portfolio management approach is materially different. (i.e. Diversification, for deemed 'aggressive' investors, is less critical to portfolio structure and by design, is not sought by investors in these cases.) However, I have found that even deemed *aggressive investors*, those who are more conscious of risk, are still **ill**-prepared to lose money." V.V. 4/2/2014

A 'decent-return' on your portfolio, should be one that: meets your medium and long-term goals (& realistic expectations); provides measurable, positive growth to your savings; manages some risk exposure through diversification; manages your expectations in context of 'fluid' capital market dynamics and incorporates your changing life-style needs to the investment-decision-process.

Striving not to be 100% wrong in our asset-allocations decisions [diversification], maintains the integrity of your savings. The cost of attempting to be 100% correct in investment decisions, over time, often destroys most investment portfolios. That is why maintaining a balance within your investment portfolio is so important. Because the future is unknowable, there is a risk and a cost of being 100% wrong which is irrecoverable in most cases. [unless you are a bank, insurance company, pension fund or a country].

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In search of higher portfolio returns: A constructive client discussion with their Portfolio Manager [PM]:

- Investor: "I need to make more money"
- PM: "You mean you are willing to take more risk with your savings?"
- Investor: "No, I don't want to take more risks at my age; just to get higher returns."
- PM: "What is a good or acceptable return for you?"
- Investor: "Well, how about 12% per year?" That is what others are getting.
- PM: "Me too, I would like this return. But you realize you cannot easily earn this return on low-risk, Fixed Income, right, not in this environment?"
- Investor: But my cousin's portfolio at Dragon-Bank has enjoyed a 12% return per year for the past 5 years. And he was pretty well diversified.
- PM: Very nicely done. What investment instructions did your cousin Joe give his PM? How and where was Joe's money invested?
- Investor: "Make me money" were Joe's instructions. Joe is actually very well diversified, in 4 ETF'S & three stocks.
- PM: Any Fixed Income in the account? ETFs are invested in what? Which stocks?
- Investor: I am not sure, but Joe has most of his money in the market. One ETF is in American stocks, in Social-Media I think and the others are in Bank and Financial industry ETFs. Oh, yeah, he owns JPM, a Cannabis company & Amex. Well diversified, don't you find?
- PM: Do you realized that your, portfolio returns, on your stock component, have been higher that Joe's!
- Investor: What do you mean? But my portfolio only averaged 9% per year.
- PM: Let's look how the 9% was generated. You had 50% in fixed income that earned, granted, a modest 3.5% [riskless] and your **Stocks earned 14.5%** per year. = **9%**
- Investor: Oh. So why did you invest only half of the portfolio in stocks?
- PM: Very good question. Preservation of capital is the fast answer. However, to best answer this, please let's sit down and review your sought investment profile and goals, deemed risk parameters, your instructions and expectations, liquidity needs and how you prefer to monitor the rate-of-return metrics of your savings. If you wish, **please also invite your cousin Joe to attend**, as I think he could benefit materially from our discussion and from our portfolio management expertise.
- Investor: Ok, how about Thursday, next week.

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So, how to get a healthy, balanced growth in an investment portfolio?^{iv} You will need to own some Equities, preferably of companies and industries which have a future. Avoiding big allocation mistakes in ‘misadventure-blow-ups’ [i.e. disproportionate ownership in DOT.COM four-letter words at the beginning of the millennium] is also helpful. Other notable and undesirable contributors to erosion^v in every individual’s portfolio, are inflation and taxes.

Does managing pension money and that of individuals require a different skill set from their PM (portfolio manager)? When managing an individual’s portfolio, the PM should be even more mindful of investment risks and allocation choices. Typically, an individual’s savings are more limited than say, a pension fund, where contributions and inflow of funds are more frequent and often ‘limitless’ in their continuity? It is more difficult to ‘smooth-out’ mistakes in an individual’s portfolio as their savings are typically, limited in amount and scope.

Portfolio allocation decisions ultimately determine the financial wellbeing of any savings-pool. Being correct also helps.

Risk management is another ‘subjective’ consideration I find. There is much ‘fancy’ math that tries to objectively define risk, but once the unrealistic assumptions in such models are dropped, the exercise and result often become moot. Few financial professionals, CIOs, analysts, bankers, informed-journalists or PM’s you meet or listen to in the media will admit openly that ‘they do not know.’ On the contrary, some of the biggest Banks and money-managers ‘seem to know the future’ or purport to do so. More responsible affirmations from some of these professionals, at least have disclosed assumptions. Being aware of the disclosed (and the undisclosed) assumptions is particularly helpful to better understand why the current financial markets exhibit a “*contrived calm*.”^{vi} and how to arrive at better investment/divestment decisions.

Qualifiers like “*history suggests; cannot rule out; ascribe low probability; historical valuations; does not signal; we believe*” are terms often used to fill up space. [I admit to also be culpable of this sometimes] Recently, I read a disturbing public comment and investment conclusion from a notable and successful money manager; to paraphrase:

‘Because the current investment environment is most uncertain, because of the destruction of purchasing power of holding cash, and because of the higher risks of owning bonds, we believe we should hold mostly Equities.’ Selecting this, majority Equity allocation stance [i.e. All-in metaphor], you **need** to be correct through the next recession cycle, to avoid permanently impairing your savings and being forced to change your lifestyle. If the investor is correct in holding a mostly Equity portfolio, the resulting portfolio returns would be notably higher in comparison to a portfolio which is better balanced. Investment risks taken, are regrettably an afterthought, to most individual investors & some PMs.

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Institutions and Pension Funds have more flexible dynamics, as their allocation and investment errors are often funded & rebalanced through virtually 'unlimited future capital contributions' from their *vested-conduits*. Individual investors need to be much more careful with hard earned savings.

This IMF's recent observation and explanation, is also a riveting 'afterthought' that exemplifies an institutional effect of being wrong.

"The IMF had no fall-back plan for a systemic EMU crisis because it had ruled out any chance that one could happen. "The possibility of a balance of payments crisis in a monetary union was thought to be all but non-existent," it said.

At root was a failure to grasp an elemental point: that currency unions with no joint treasury are inherently vulnerable to debt crises. States facing a shock no longer have sovereign tools to defend themselves.
Devaluation risk is switched into bankruptcy risk." vii

Bottom line, Governments' current effort at propagating global economic sustenance, seems to be working, for now. Or is it? An important question to raise and answer is "why, after ten years of this *sustenance*, is the global economy unable to run under its own steam and dynamic?" Why is massive monetary and fiscal easing still required? Are we pushing-on-a-string?'

We think Conservative investors should seek to maintain a Balanced Investment Portfolio, with moderate-to-Low risk attributes; this should satisfy most clients' short and medium-term financial goals and conservative 'portfolio performance expectations.'

A portfolio makeup of Fixed Income 45% and an Equity component allocation of 55% Equities may provide the sought financial flexibility. Long term, inflation's erosion of cash and 'unsupportable' high bond price values may require a more frequent review and perhaps portfolio rebalancing.

Please let me know if you require or wish further clarification of the thoughts shared with you in this communiqué. As always, it will be my pleasure to discuss these matters further or any other financial considerations you may have.

Sincerely,

John Evdokias

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ⁱ This Questionnaire with 4 “trick questions” is readily available to you when you wish. We think it helpful to the investor.

ⁱⁱ <https://www.investopedia.com/terms/f/financial-repression.asp>

ⁱⁱⁱ https://www.wto.org/english/res_e/statis_e/wts2018_e/wts2018chapter03_e.pdf p2&3

^{iv} Other Asset classes are Real Estate, Private Equity, Gold, Collectables...

^v [steady confiscation of savings]

^{vi} BNP-Creg Boutle.

^{vii} https://www.telegraph.co.uk/business/2019/07/17/another-imf...es/amp/?WT.mc_id=tmg_share_tw&__twitter_impression=true 2019-07-18

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