The Sandler Quarterly

Wealth Management Dominion Securities

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The first quarter of 2018 was challenging for investors. After a number of years of relative calm, volatility returned with a vengeance at the end of January. Markets grappled with a fast and furious stream of headlines and global indices gyrated in reaction. President Trump added fuel to the fire as the world tried desperately to make sense of his impetuous U-turns and daily tweets.

For some time we have been wary of the market's valuation and have positioned your portfolio accordingly. This defensive stance, in addition to the unwavering stream of income that we collect from our investments, has served to lessen the impact of weak equity markets. Generating investment returns in this environment is difficult, to say the least. Risk management becomes the primary focus and the importance of a prudent asset allocation strategy is suddenly obvious.

As mentioned in prior communications, your portfolio has ample cash as well as safe, liquid bonds. Conversely, our exposure to the stock market is underweight by design. Recent weakness in equities (see *figure 1* below) and continued market volatility may present an opportunity to make some timely investments in world class companies. Lower prices, along with improving corporate profits, have brought valuations to more reasonable levels (see *figure 2*). We maintain a wish-list of best-in-class companies that we would love to own at the right price. So far this year patience has been rewarded; we will continue to vigilantly monitor the market for attractive entry points.

There are a number of major headlines in focus at the moment. We could write at length on tax reform, trade wars, NAFTA negotiations and Facebook. That, however, has already been done to exhaustion and we would struggle to add new commentary. Instead we would like to dedicate some time to two lesser reported issues that are of more importance to us as investors. Both rising interest rates and the risk of increased inflation are influential factors that we are focusing our attention on at the moment.

For many years the market has been anticipating higher interest rates. Starting from zero, it wasn't difficult to forecast that at some point rates would rise. Going back a number of years, the general consensus was that the increase would be slow and gradual. In the past two

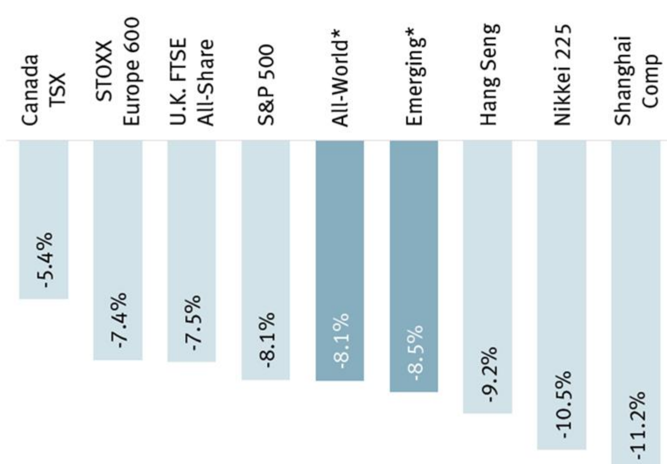

Table 1: *Market Performance since Jan. 26, 2018*

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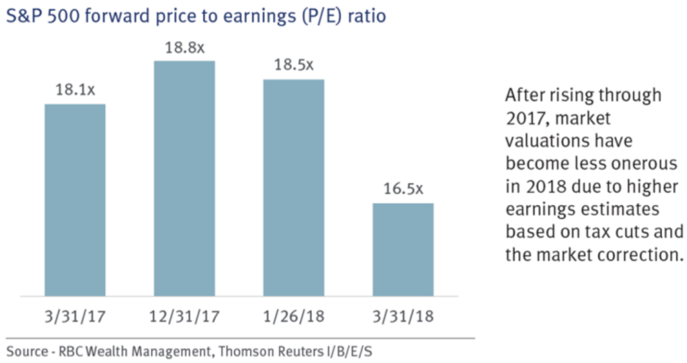

Figure 2: *S&P 500 forward P/E at select dates*

years, Canada and the US began raising rates. The market was not taken by surprise; central banks had done a good job of telegraphing their intentions and managing expectations. If anything, the movements flew under the radar. Whether rates were a quarter or half of one percent, money was still remarkably cheap. Fast forward to today and the central bank target rates are 1.5% to 1.75% in Canada and the US. The expectation is for two or three further increases this year and potentially three or four next year. Suddenly, the reality of meaningfully higher rates seems like a distinct possibility. The US Fed's 2020 forecast is 3.4%.

Higher interest rates send ripples across every single aspect of the economy and markets. Increasing interest rates should temper economic growth and this can cause market jitters. That said, data shows that markets have typically continued higher as rates increased to approximately 5%. Anything above 5% and markets have suffered historically. With that in mind, equities may yet have room to run. Importantly, we will benefit from better yields on our fixed income investments. As we have explained in the past, we have purposely focused on shorter term bonds so that we could take advantage of higher rates as we reinvest proceeds from maturities. Additionally, our preferred shares have terms that allow for dividends to be reset higher as rates rise.

Directly related to interest rates, the other area of focus for us is inflation. Like rates, inflation's effect is felt across all facets of the economy. Central banks aim to maintain inflation at a long term target of 2%. This level is healthy for sustainable economic growth. For the first time in many years the risk of increased inflation is present. Many factors are at play; two that we watch closely are wage growth and the output gap. With unemployment at a multi-year low (4.1% in the US) almost everyone who wants a job has one, and employers compete to hire new employees and keep existing ones by paying more. At its simplest, inflation is described as “too much money chasing too few goods”. An employee earning more money becomes a consumer spending more money. The output gap tracks economic capacity. In several countries, including the US (see *Figure 3*), excess capacity is turning into not enough capacity. As this happens, more money competes to buy a reduced supply of goods and the result is higher prices.

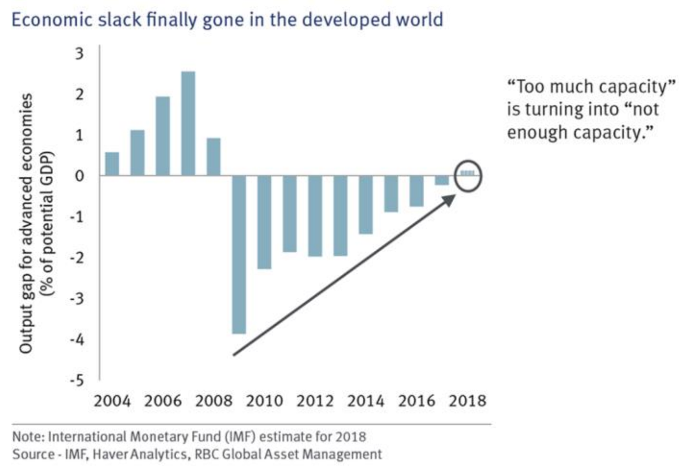

Figure 3: *Output Gap for advanced economies, 2004- 2018*

As investors, inflation is a primary concern. It can erode our future purchasing power and by extension our lifestyle in retirement. It is important to factor inflation into investment decisions. Investments such as the real estate companies that we own offer protection; the underlying building values increase as inflation occurs. We predict this topic will become a recurring theme in the coming months. Rest assured that we are carefully monitoring the situation and will weigh this critical factor as we manage the investments in your portfolio.

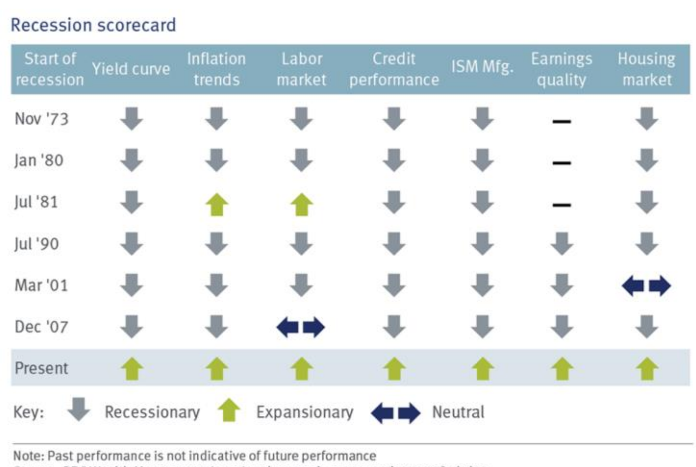

Figure 4: *Recessionary Scorecard as of March 1st, 2018*

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Additional Services

We have recently helped a number of clients with both insurance and mortgage needs. While these services are not our primary focus, we wanted to bring them to your attention. Working with RBC professionals, we can provide you with access to sensible insurance and lending solutions when needed. Insurance in particular can be complex and confusing; we align with you to oversee the entire process and ensure that you are presented with the optimal solution and best pricing.

Turbulent markets can be unsettling for many investors. We are here to prudently manage and care for your investments. We are always happy to discuss the market, inflation, interest rates and how these and other factors affect your investments and financial future. Please reach out to us should you want to speak in more detail on these topics.

Sincerely,

Scott Sandler
Vice President & Portfolio Manager

Ronan Clohissey, CIM
Vice President & Portfolio Manager

	Q1 2018	1 Year**
Indices		
S&P/TSX	-5.19%	-1.16%
Dow Jones	-2.49%	16.65%
S&P 500	-1.22%	11.77%
Nasdaq	2.32%	19.48%
Euro Stoxx	-4.07%	-3.98%
Japan Nikkei	-7.05%	11.90%
India Sensex	-3.20%	11.30%
VIX Volatility	107.16%	84.88%
Commodities		
Gold	1.70%	6.07%
Silver	-3.78%	-10.78%
Copper	14.06%	-7.96%
Oil	6.55%	27.23%
Natural Gas	-32.54%	-4.51%
Currency		
CAD	-2.73%	-0.26%
EUR	2.52%	5.68%
JPY	5.47%	6.35%
AUD	-1.88%	0.08%
GBP	4.17%	5.98%

**1Year as of March 31st, 2017

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