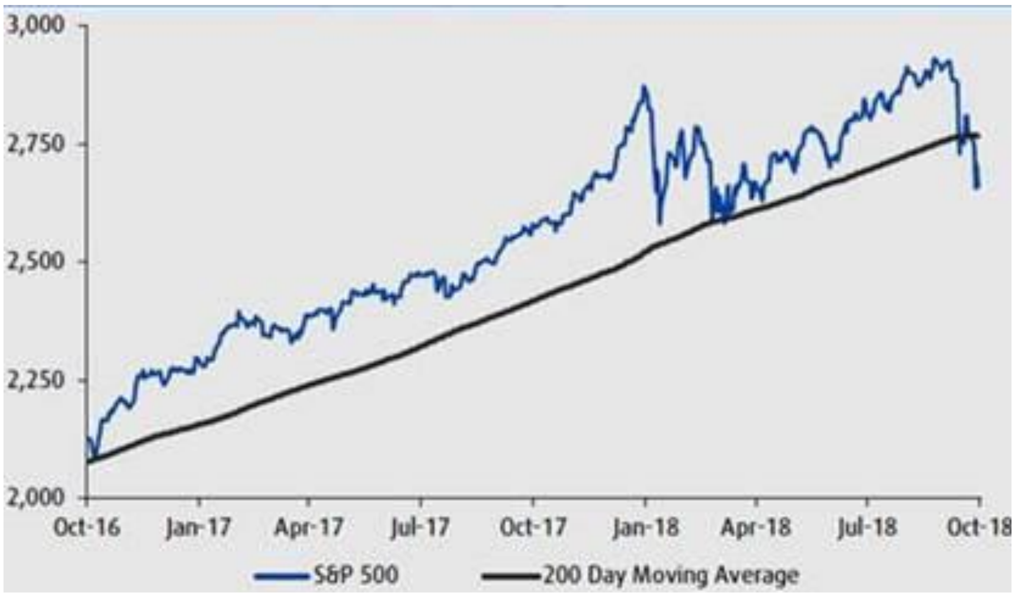
Portfolio Management
Monthly update

October 2018

Highlights

- **US Federal reserve clouding economic picture**
- **US economy & earnings still good, but slowing**
- **US consumer very strong**
- **Expect market bounce soon**

October revives its nasty reputation with the S&P 500 & TSX down about 8.7% and 7.5% respectively.



Source: FactSet, BMO Nesbitt Burns, BMO Capital Markets

Q3 earnings growth has been strong, up about 20% year over year. The worry is that we may have seen the highs and the growth has begun to fade. The market is always looking 6-12 months down the road, and the overall share of S&P 500 companies beating revenue expectations has slumped to about 45% over the past 30 days, vs nearly 70% several months ago.

This realization would not be so bad, if the US Federal Reserve talked down interest rate increases, as past regimes likely would have. Unfortunately, they have not backed off their stance of ¼ % increases every 3 months. Many of the economists and portfolio managers we speak to feel some slowing of rate increases is likely, given stock market weakness, tame inflation and lower global growth estimates.

US Real GDP increased at a 3.5% quarter over quarter rate in Q3, down from 4.2% in Q2, but better than the 3.3% consensus. Consumption was a bright spot, increasing 4.0%, the best since 2014. However, economists also highlighted some disappointment with the sharp and broad-based slowdown in business investment growth. They also flagged a third straight decline in housing investment which has crushed housing related stocks. A strong US consumer does give us optimism however, given that that consumption comprises about 70% of the economy. *(Early Edition; Markets This Morning; Portfolio Advisory Team; October 30, 2018)*

US personal spending rose 0.4% in September, on track for a 2.7% annual rate in Q4, after 4.0% in Q3 and 3.8% in Q2. This supports our call for some moderation in GDP growth to 2.6% in Q4, as the impact of tax cuts begins to ebb. Core consumer prices rose 0.2% after a flat August, keeping the 3-month annual rate calm at 1.4% versus May's high of 2.2%. The yearly pace stayed at 2.0% for a 5th straight month, bang on the Fed's target. ***Recent stability in core inflation will discourage the Fed from hiking rates next week, but the still above-potential rate of economic growth will likely spur a move in December*, as the Fed continues to normalize rates.** *(Early Edition; Markets This Morning; Portfolio Advisory Team; October 30, 2018)*

The Technical Picture

"The TSX Index closed below its early 2018 low yesterday, ending the day very near to a 2-year low. There are minor support levels along the way, but the next major support zone from here is in the 14,000-14,100 zone (roughly 4.75% below yesterday's closing level), which would represent a 50% retracement of the entire rally since the beginning of 2016. On a more positive note, short-term momentum gauges for the TSX are now oversold enough to support a decent relief rally soon. First resistance is at 15,325, followed by the 50 and 200-day moving averages near 15,900. Use any rally as an opportunity to continue scaling back risk since, as we noted in yesterday's report, there is no evidence of the sort of irrational behavior/panic selling that usually accompanies a major trading low, i.e. more downside is likely following any relief rally that develops in the weeks ahead." *(Early Edition; Markets This Morning; Portfolio Advisory Team; October 30, 2018)*

Sector Comments

The most extreme drops have been in the cyclical housing, industrial, materials and energy stocks. We do envision a bounce back in these sectors from very oversold conditions. We have done some selling in these areas, especially where tax losses are useful. On a bounce we would sell more in the cyclical area, given slowing growth and the possibility of a Fed policy mistake. Defensive stocks such as McDonalds and Coke don't offer great value at current prices, but some longer term growth companies are coming down to reasonable valuations such as Costco, Estee Lauder, Home Depot, Microsoft, Visa, Agrium, Brookfield and Onex. Health Care is displaying its defensive characteristics, but some values surface on bad days as well.

Financials, especially US banks which everyone thought would be great this year, haven't been. We do see value in this area, but would wait for a base. Amazon, Alphabet and Facebook still have great sales and now earnings growth, but global regulators are targeting them relentlessly with increasing taxes and regulations. At some point, likely soon, their falling valuations will take these negatives into account.

There are some catalysts to an up move: Getting past US mid-term elections, some thawing in the US-China trade war with the end of November meeting, some acknowledgement by the Federal Reserve that growth has slowed and further interest rate hikes simmering down.

Bonds and Asset Mix

With interest rates, even on 1-2 year bonds near 3%, more conservative investors should be slowly increasing the percentage of bond and other income investments. Some reset preferred shares are yielding 4 ½-5% with resets coming up to get them to 5 ½-6%. Some income trusts and REITS have fallen in price to provide yields of 5-7%. Since we don't expect rates to go materially higher, some selective buying can be done here.

If you have any questions about the above information and would like to discuss with us, please feel free to call our office.

Regards,

Scott Barnum, CFA
V.P. and Portfolio Manager

Don Behan, CFA
V.P. and Portfolio Manager

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