OUR FAMILY PERSPECTIVES

INSIGHTS FROM CANADA'S LEADING FAMILY OFFICE

A Look at the Year Ahead for Investors

Fourth Quarter, 2018 - January 1, 2019

With 2018 officially in the books and the holiday season drawn to a close, investors enter 2019 reminiscing about the good old days of quantitative easing and geopolitical tranquility. Coming off the worst year for most equity markets since the 2008 downturn, perhaps the ceremonial New Year's Eve champagne-popping festivities will prove to be a celebratory cap-off to nearly a decade of double-digit annualized returns. Or will a bruising fourth quarter set the stage for an encore performance driven by moderating but still positive global growth trends supported by a recalibration of market valuations? Without a crystal ball, this is a difficult question for anyone to answer with a high degree of certainty. There are, however, road signs along the investor highway that can provide a sense of guidance for what's to come. Observable through both the windshield and rearview mirror, a mix of warning signs, speed bumps, and maybe even a rest stop or two can help investors understand how the road traveled thus far may differ from the journey ahead.

WHERE WE'VE BEEN

With the benefit of hindsight, year-end is a good time to take a step back and unpack some market developments that may offer up useful insights into how to position for the future. At the risk of stating the obvious, analyzing what has already transpired is a much easier exercise than predicting what may come down the pike. Nonetheless, the past, present, and future, are inextricably connected – it's up to investors to separate what's relevant from what's not. This is a tall order in today's world of "always on" technology and an ever-increasing barrage of financial media clickbait. Though at times it can be easy to fall victim to the onslaught of macroeconomic or company-specific news feeds, staying "focused on the game and not the score" has always been the mantra at Our Family Office. Starting 2018 on the back of a 14-month stretch of positive performance for global equities, investors entered the year accustomed to record low levels of market volatility. The so-called "Trump Bump" helped support a post-election rally which seemed virtually unshakeable up until late January. A relatively swift upward move in interest rates accompanied by strengthening employment data during the first few months of the year introduced renewed concerns over the direct and indirect implications of living in a world with higher borrowing costs. Escalating trade war tensions between the US and China further fueled investor worries, sending major equity indices into correction territory with declines in the 10% range. By the end of the first quarter, surging corporate earnings growth began to take centre stage, outweighing investor anxieties and re-starting a market rally which drove US stocks to new highs by the fall.

Spurred by late 2017's US tax cuts and record corporate profit margins, market participants welcomed mid-20% year-over-year earnings growth with open arms. Though the summertime rally energized market sentiment and helped make weekend trips to the cottage a bit more enjoyable, mounting geopolitical worries, tightening monetary policy, and a recognition that double-digit earnings growth can't last forever were increasingly starting to creep in to investor psyche. Fast-forward to the end of the year and equity markets are down low to high teens from 2018 peaks, depending on geography and market capitalization. What has been particularly disconcerting for many investors is not only the magnitude, but the speed at which 2018's two market

corrections (defined as a decline of 10% or more) have occurred. Using the S&P 500 Index as a measuring stick, Q4's unraveling marks the sixth official correction since the post-crisis bull market began in the spring of 2009. Late January's approximate 10% sell-off transpired over a speedy 14 days, while the most recent market decline of just under 20% (which would officially constitute a bear market) unfolded over the course of a 96-day period. The last time markets contracted anywhere close to what we've seen in the most recent quarter was in the spring of 2011 when the S&P 500 dropped almost 20% – but this took a full 158 days to play out. To put it simply, the last six market corrections have averaged about a 15% price decline, but the two we experienced in 2018 have materialized, on average, about twice as fast.

WHERE WE'RE GOING IN 2019

So, what does this all mean for 2019 and beyond? Although there are countless variables to consider, what seems to be taking shape today is an overall re-pricing of risk and what investors are willing to pay for future earnings. Cost of capital is among the most, if not the most important of factors governing all dimensions of how risk assets will perform going forward. Even after nine rate hikes beginning in December 2015, the current Fed Funds rate of 2.5% is well below the longer-term pre-crisis average of 5.7%, and about half of what it was back in 2007. Artificially low interest rates for the greater part of the last decade have pushed individual investors, corporations, and institutions alike further and further out on the risk curve to pursue return opportunities that were otherwise unattainable within the realm of safer asset types. Though central bank policy around the world is not executed in lockstep, a strong case can be made that the shape of the US yield curve influences global interest rate movements to a significant degree. As risk-free rates tumbled in the post-crisis era, every Dollar, Loonie, Pound, and Euro (emerging markets typically follow a more fragmented central bank policy narrative) of future cash flow was precipitously worth more in present value terms. In today's environment of heightened uncertainty surrounding global trade policy, waning corporate tax cuts, and a protracted economic cycle, it seems intuitive that higher current and expected interest rates would lead to a recalibration of asset prices.

As it stands today, we don't see a doomsday scenario on the horizon for risk assets. Softening global growth and higher, albeit still historically reasonable interest rate levels indeed support the case for tempered return prospects going forward. That said, the combined effects of a tax policy-driven surge in corporate profits and the Q4 market sell-off has had a noteworthy impact on US equity valuations. Coming into 2018 with a forward P/E of over 18x, the S&P 500 Index had repriced to 16x by the summer – at the time of writing, we're just a touch above 14x. Against a 25-year average of about 16x and the build-up of proximate (observable) risk factors, today's valuation levels don't seem entirely unreasonable. Investors should, nevertheless, proceed with caution, as elevated volatility is likely to persist for the foreseeable future.

Multiple compression may very well be an innate byproduct of tighter monetary policy, but that doesn't mean positive returns are unachievable. Looking back at the pre-crisis bull market as one comparison, the Fed raised rates from a 1% starting point in the summer of 2003 up to a high of 5.25% in the summer of 2006. During this period, the S&P 500 delivered an 11% annualized return and forward P/E's gradually declined from about 18x to about 14x. Though core inflation was discernibly running 1% to 2% hotter than the current environment, today's Fed Funds rate is still less than half of where we ended up by the time the prior hiking cycle concluded. With two predicted rate hikes for 2019 based on current projections, it's important for Powell not to lose sight of how $50B a month of Fed balance sheet shrinkage, or "quantitative tightening" as some would call it, may affect economic conditions from an ancillary perspective. As long as the data supports it and the execution is methodical, it's important for the Fed to continue to raise rates. Inflation aside, going back to the 1960's there's never been a period where a recession began without the Fed Funds rate being at least at the 4% level. Point being, there needs to be enough room to cut rates during a downturn to help stimulate an economic kick-start. If we cling to low interest rates indefinitely, we run the risk of not only an economic overheating, but also severe constraints to administering effective monetary policy in future times of need.

THINKING ABOUT GEOGRAPHY

Built upon a foundation of global accessibility, Our Family Office's investment program is designed to pursue attractive opportunities around the world within asset classes that offer the best long-term risk-adjusted return potential. Although US economic activity has a strong influence on broader world-wide trends, it's important to recognize the value that geographic and asset-class diversification can provide within a total portfolio context. Though nearly every equity market ended last year in the red, it's worth taking a closer look at how

Emerging Markets (EM) currently stack up to other parts of the world. Valuation-wise, EM almost always trades at a discount to developed markets. As such, coming into 2018 at approximately 13x forward P/E doesn't necessarily signal a screaming buy. That said, to borrow a quote from legendary investor Howard Marks: "It's not what you buy, it's what you pay for it that determines whether something is a good investment". At just over 10x forward P/E today, Emerging Markets equity valuations are back down to levels seen in the 2012-2013 period. With emerging economies on the whole projected to outpace developed market GDP by at least 2 percentage points, annually, for the next 5 years, we take a constructive view on the asset class and aim to position for what appears to be an attractive entry point. To the extent the US Dollar depreciates going forward, which we believe is quite possible, EM investors will be poised to benefit from an added performance tailwind.

DEFENSE WINS CHAMPIONSHIPS

Although 2018 was a challenging year for many investors, a focus on defensively-oriented strategies and sourcing return from investments with little to no correlation to tradeable assets has helped protect our clients from some of the more recent market headwinds. Appropriately sized allocations to directional market exposures and a strong emphasis on actively managed strategies across the private markets' spectrum embodies the foundational principles of our investment program. Through the lens of a strategic asset allocation blueprint customized to each family's unique risk and return objectives, we aim to extract the illiquidity premium that exists within a broad array of private equity, real assets, and private debt markets. By striking long-term partnerships with high quality investors only when projected risk-adjusted returns meet our uncompromising standards, we strive to grow capital in a thoughtful and responsible manner. As always, our focus on capital preservation remains paramount. We thank you for your trust and confidence, and appreciate the continued support.

Neil Nisker - Executive Chairman & CIO
Our Family Office, Inc.

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