



THORNMARK ASSET MANAGEMENT INC.

PERSPECTIVE

MARCH 31, 2018

GOLDILOCKS ECONOMY IS NOT TOO HOT, NOR TOO COLD. IT'S JUST RIGHT....



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A Goldilocks economy means global expansion is synchronized and coordinated. It also means strong employment, low interest rates, low inflation, neutral monetary and fiscal policy, and improving geopolitical rhetoric. These conditions led the International Monetary Fund (IMF) to project the highest global GDP growth for 2018 in seven years. When combined with improving earnings, reasonable valuation, deregulation and an aggressive infrastruc-

ture spending program, almost all investment indicators are flashing green for North American equity markets. Goldilocks is knocking at the door.

FIRST QUARTER 2018

Despite solid underlying economic fundamentals, daily diatribes from Trump's Twitter pulpit sent domestic and international markets on a roll-coaster ride in the first quarter. As we discussed in the December *Perspective*, directional volatility was expected. It played out quickly! Volatility, as measured by the Chicago Board Options Exchange SPX Volatility Index (VIX), spiked over 450% between January and February. The spike was so dramatic, it wiped out some volatility Exchange Traded Funds that were expecting a more moderate environment. Those funds have since closed.

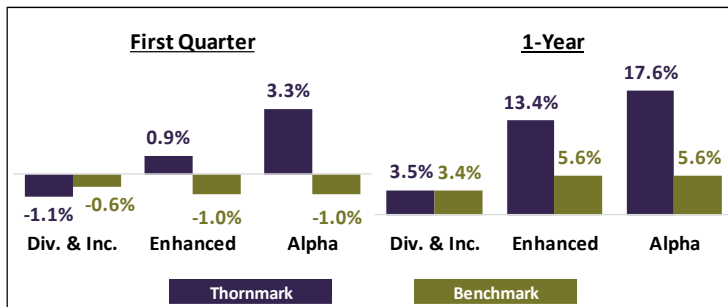
Investment updates previously discussed along the way described Thornmark's tactical strategy, including reducing portfolio risk in late January before tactically reinvesting after the bulk of the declines. During the quarter the Canadian bond market (FTSE TMX Canada Universe Bond Index) was up a meagre 0.1%. In local dollars, the TSX and S&P 500 total return indices were down 4.5% and 0.7% respectively. Despite the lousy markets, as shown in the table on this page, the Thornmark investment funds performed well. For the past year ending March 31, 2018, all the Funds exceeded their benchmarks. The Alpha fund was more than 200% better than its benchmark, and the Enhanced Equity Fund was 139% better than it's benchmark*. The past year rewarded disciplined investors handsomely. As we discuss below, we project more of the same in the year ahead.

GLOBAL OUTLOOK

The global economic upswing that began in 2016 is gaining momentum. The IMF expects global GDP growth to be 3.9% in both 2018 and 2019. This rate is the highest level since 2011 and up from 3.2% in 2016 and 3.8% in 2017. Regional economic momentum as translated into a global surge as sentiment has improved, financial conditions remain favourable (but not improving), and U.S. expansionary fiscal policy gains traction and seeps overseas. Despite the positive outlook, there are some risks. After all, when Goldilocks is knocking, the bears can't be too far away. Tighter financial conditions will lead to higher borrowing costs. Since rates are rising from such low levels, the critical risk is the pace of change. Expectations

are for an orderly process that does not undermine confidence and momentum. As trade rhetoric continues, there is risk of a trade war. However, Trump's bark is usually worse than his bite. Indeed, Trump is famous for, shall we say, exaggeration. His negotiation style starts with an arrogant attack before yielding to a more moderate outcome. Trump has repeated his negotiating strategy over and over. We expect this will be the case with trade, whether it be NAFTA, China, TPP or otherwise, when cooler heads prevail.

Thornmark Investment Funds - Consolidated Performance



"C" class net of all fees and expenses for the period ending Mar. 31, 2018.

NORTH AMERICA OUTLOOK

In North America, the first quarter selloff was a buying opportunity since solid underlying fundamentals remained intact. Trump tweets will continue to be unpredictable and incendiary. Therefore, discipline is critical to avoid getting whipsawed in the volatility.

While equity markets prices declined, earnings continued to improve. Consensus estimates are for earnings to grow in 2018 by 17% in the U.S. and by 9% in Canada. As first-quarter earnings season gets underway, we expect earnings and sales to continue the strong momentum. The strength is the result of continued accommodative monetary and fiscal policy both North and South of the border, strong employment and sentiment, and low interest rates. These are characteristics of the late expansionary phase of an economic cycle with no imminent

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signs of a slowdown. As expected, inflation is nudging higher and central banks are taking their feet off the gas pedals. In this environment we expect cyclicals to perform best, including energy, materials, healthcare and financials (specifically banks, which benefit from an increasing spread between the rate they charge clients and the rate they pay to borrow money). Therefore, tactical asset allocation strategy remains overweight stocks and underweight bonds and cash.

Since economic and financial momentum is stronger south of the border, interest rates should rise faster there. As a result, we expect the U.S. dollar to strengthen against the Loonie and U.S. dollar exposure is tactically unhedged.

SECURITY COMMENTARY

Alibaba (BABA) is the leading e-commerce player in China. Its websites have more than 600mn active monthly users which gives it the scale to offer the lowest prices and fastest deliver times – and provides a platform to test new products such as cloud storage, video content and financial products. Alibaba is like Amazon although differentiated by sharing more sales information and site customization for its listing partners and is coveted by international brands trying to reach Chinese customers. Sales in China will continue to expand rapidly as the economy grows (GDP per capita is \$8k in China vs \$56k in US), e-commerce penetration increases, its footprint expands into rural cities, it adds data and analytic services and it incorporates more North American brands. Margins should also expand driven by lower losses in its video and cloud business which are losing \$2bn a year or 23% of total profits as scale will offset the high fixed costs of these businesses. Its EBITDA is growing by 30% a year mean-

while it is only trading at 20x EV/EBITDA (2019). Our target of \$230 is based on a 25x multiple comparable to where Amazon traded before the Trump tweets. There is upside to this target should they penetrate the U.S. market, but that is unlikely given strained China/US trade relations. However, there is demand BABA in the U.S. from companies looking to diversify away from Amazon and Walmart.

Canadian Pacific Railway (CP) was added to portfolios during the quarter. Rail has a dominant market share of transport due to its massive infrastructure network (not easily replicated) and low costs which should continue to improve with rising truck driver wages and road congestion. It's volumes generally perform well in the late stage economic cycle and will also benefit from high grain harvests as well as a shortage of oil pipeline capacity. CP is the preferred operator and earnings should grow at a faster pace than the street expects, due to these trends and market share wins over CN. CN has run into congestion issues stemming from lack of locomotives and its customer dissatisfaction scores are at multi-year lows which coincides with a few multi-year contracts expiring. CP will also see better pricing and longer-term contracts – which bodes well for 2019 growth as well. Its valuation is in line with its peers at P/E of 15x (2019) and a discount to the S&P 500 at 16x but deserves to trade at a premium due to its higher growth outlook (EPS growing 12% vs peers at 10% and market 8%) and low risk (rail is not going away in our lifetimes). Our target of \$260 is based on its historical valuation of 17x and represents a 17% potential return over the next year.



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* Unless stated otherwise, all performance and benchmark data are total return, in Canadian dollars and net of all fees and expenses. Thornmark offers three funds, namely Thornmark Dividend & Income Fund, Thornmark Enhanced Equity Fund and Thornmark Alpha Fund (the "Investment Funds"). Thornmark provides the consolidated returns of the Investment Funds ("Consolidated Performance") to demonstrate the aggregated returns generated by the Investments Funds, or their predecessors, between 05/01/93 and the present. Units of each fund included in the Consolidated Performance are or were available for purchase by qualified investors. The returns provided for the Investment Funds are for O-class units. The Consolidated Performance is calculated by including an equal weighting of the Thornmark Investment Funds, or their predecessors, as follows: 100% Enhanced Equity Fund from 05/01/93 to 07/31/98; 50% Enhanced Equity Fund and 50% US Equity Fund to 12/31/98; 33.3% Enhanced Equity Fund, 33.3% US Equity Fund and 33.3% Dividend & Income Fund to 08/31/00; 25% Enhanced Equity Fund, 25% US Equity Fund, 25% Dividend & Income Fund and 25% Alpha Fund to 12/31/02; 50% Enhanced Equity Fund and 50% Dividend & Income Fund to 01/31/06; 33.3% Enhanced Equity Fund, 33.3% Dividend & Income Fund and 33.3% Alpha Fund to 12/31/06; 25% Enhanced Equity Fund, 25% Dividend & Income Fund, 25% Alpha Fund and 25% Fixed Income Fund from 12/31/06 to 07/31/2013; 16.67% Enhanced Equity Fund, 16.67% Dividend & Income Fund, 16.67% Alpha Fund, 16.67% Fixed Income Fund, 16.67% Canadian Equity Fund and 16.67% U.S. Equity Fund from 07/31/13 to 01/31/2017; 33.3% Enhanced Equity Fund, 33.3% Dividend & Income Fund, and 33.3% Alpha Fund from 01/31/2017 to present. Results prior to July 7, 1998 for the Thornmark Enhanced Equity Fund are for the Thornmark Canadian Equity Composite. The Composite was an account managed by Thornmark Holdings Inc., whose portfolio was used create the Thornmark Enhanced Equity Fund. Deloitte LLP, Chartered Accountants, have performed Level I and II verification on the composite, in accordance with the CFA Institute's Performance Presentation Standards, for the period from inception ending December 31, 1998. Investment performance benchmarks provide readers with a tool to assess the Consolidated Performance of the Investment Funds against an index of securities reasonably reflective of the composition of the investment portfolio of the Investment Funds. Since we present Consolidated Performance, we also provide a consolidated benchmark (Consolidated Benchmark). The Consolidated Benchmark is a pro-rated weighting of the benchmarks for each individual Investment Funds for the performance period. The benchmarks of each of the individual Investment Funds, and which make up the Consolidated Benchmark are as follows: Dividend & Income Fund: a blended benchmark composed of 30% S&P/TSX, 30% S&P 500, 30% DEX Uni-Bond, 10% DEX 91-day T-bill. Enhanced Equity Fund: a blended benchmark composed of 60% S&P/TSX, 30% S&P 500, 10% DEX 91-day T-bill. Alpha Fund: a blended benchmark composed of 45% S&P/TSX, 45% S&P 500, 10% DEX 91-day T-bill. Canadian Equity Fund: 100% S&P/TSX. U.S. Equity Fund: 100% S&P 500. Fixed Income Fund: 100% DEX Uni-Bond. These benchmarks are used because they are relevant, meaning there is a significant degree of comparability and similarity between their strategy or composition and those of the relevant Investment Fund. This is not an offer to buy or sell any securities. The information contained herein has been obtained from sources believed to be reliable. Thornmark Asset Management Inc. and/or its employees and/or the Thornmark Investment Funds may at any time have an interest in any securities discussed herein. Important information about the Thornmark Investment Funds is contained in the Offering Memorandum, which is available upon request, and should be read before investing. Past performance may not be repeated, is not indicative of future returns, and does not guarantee future results. Unit values and investment returns will fluctuate. There are no assurances that the full amount of your investment in the fund will be returned to you.