THORNMARK ASSET MANAGEMENT INC.

Perspective

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Goldilocks Economy is Not too Hot, Nor too Cold. It's just Right….

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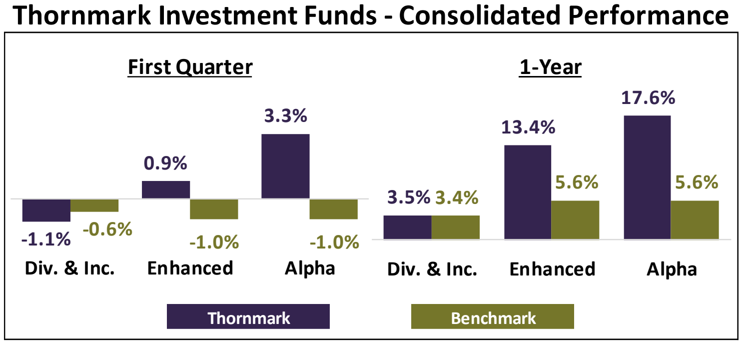
A Goldilocks economy means global expansion is synchronized and coordinated. It also means strong employment, low interest rates, low inflation, neutral monetary and fiscal policy, and improving geopolitical rhetoric. These conditions led the International Monetary Fund (IMF) to project the highest global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

Thornmark Investment Funds - Consolidated Performance



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

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.

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 meanwhile 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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