SECOND QUARTER 2019

Index	Q2 2019	YTD
S&P/TSX Composite (C$)	2.6%	16.2%
S&P 500 (US$)	4.3%	18.5%
S&P 500 (C$)	2.2%	13.7%
MSCI EAFE (US$)	3.7%	14.0%
MSCI EAFE (C$)	1.5%	9.4%
FTSE TMX Universe Bond Index (C$)	2.5%	6.5%
C$ / US$	1.3363 to 1.3087 (+2.1%)	1.3642 to 1.3087(+4.2%)

**** Index returns are total returns, including dividends.***

FALLING INTEREST RATES, AGAIN

Two years after long-term government bond yields began to rise from historic lows, rates have fallen again. The 10-year U.S. Treasury bond yield recently fell below 2% while the 10-year Government of Canada bond yield fell to 1.5%, levels not seen since 2016 during the height of the deflation scare. The flight to these low-yielding, long maturity and risk-free assets in large part reflects fear about economic growth which has been further fanned by an escalating trade fight between the world's two largest economies.

Economic uncertainties recently caused the U.S. Federal Reserve and the Bank of Canada to take a more cautionary stance given their sudden about-face on raising rates. The pivot was certainly a surprise – in a *Wall Street Journal* survey of more than 60 economists last year all predicted that the 10-year U.S. Treasury yield would be above 3% throughout 2019. The 10-year yield has not reached that level in a single day so far this year. Now, three-quarters of the same group are now predicting rate cuts by the Federal Reserve.

At the levels, returns offered on fixed income investments generally look very poor and even though prices for longer duration bonds have risen this year due to their higher sensitivity to interest rates, our preference for shorter duration bonds remains. We would much rather take less of a return in the short run than lock in a meager return in the long run. It seems absurd to have money trapped at the low returns currently available on fixed income investments over the next 10, 20 or 30 years. In fact, buyers of the 10-year Government of Canada bonds today are likely to see a decrease in their purchasing power with inflation currently running at 2% or higher.

In addition, the rate pivot this year has hurt the performance of many of our preferred shares that have variable dividends tied to an interest rate benchmark such as the bank prime rate. Expectations that the rate benchmarks will fall have driven down preferred prices so much that their current yields have increased. Many of our preferred shares now have current yields of 6%,

far higher than the 3% yields available in the corporate bond universe. In our view, this yield advantage more than compensates for the more junior position that preferred shares hold in a company's capital structure.

CONTINUED VALUATION DIVERGENCE IN EQUITIES

While stocks in general have almost universally risen this year, some sectors have far outpaced others. Year to date, the S&P 500 has returned 19% in U.S. dollar terms but prices for tech stocks have surged even higher, with the Information Technology sector returning 27%. This divergence has continued to enlarge the multi-year return gap between value and growth stocks (the latter is where many of the tech stocks are classified).

The Russell 3000 Value index has returned 16% in U.S. dollar terms compared to 21% for the Russell 3000 Growth index so far, adding to the lead since 2011. Over the last eight years, the Russell 3000 Growth index has returned a cumulative 208% compared to 139% for the Value index, equating to an annualized return advantage of 3.4%. This recent stretch has been a significant inverse of the longer-term trend. In the past 20 years, the Russell 3000 Value index has outperformed its respective Growth index by about 1% per annum.

The significant divergence in the performance between these two indices suggests that investors in this long-running bull market have been less focused on underlying business fundamentals and more on stock price momentum, buying with the anticipation that the shares can be sold for higher prices. This has added to the rapid price gains already experienced by popular stocks that have been in vogue. Meanwhile, companies in unloved and shunned sectors such as oil and gas and retail have experienced little gain in their stock prices, regardless of their recent business results.

IPO WACKINESS

Evidence of the herd-like behaviour of investors could be observed in this year's IPO market, where 25 technology companies have gone public raising US$19 billion. Uber Technologies, the largest of the newly public companies, raised an incredible US$8 billion in May, valuing it at US$75 billion, despite the company losing US$3.6 billion pre-tax last year. Pinterest, another hot tech company, went public at a US$10 billion valuation even though the company lost US$182 million last year. Perhaps most egregious is Beyond Meat, which currently boasts a US$9 billion market valuation despite generating less than US$90 million in revenues and a net loss of US$30 million last year.

Such valuation liberties would seem alien to many of the ho-hum value stocks that are available today. For example, Martinrea International Inc.[1], an auto parts manufacturer that we own and have profiled in past quarterly letters, is currently valued by the market at less than C$900 million. This market value is just five times the nearly C$200 million earnings the company generated last year. Moreover, under current management, the company has quietly but rapidly improved profitability over the last several years by increasing both capacity and operating efficiencies.

[1] *Some clients may not own Martinrea, FedEx or both due to timing.*

Another example is FedEx Corp.[1], the world's largest express delivery company and a stock that we have been buying for client accounts this year. Under Fred Smith, founder and current Chairman, FedEx has built an unrivalled global transportation and delivery network, and has grown its earnings per share 17-fold over the last 30 years. Nevertheless, sparked by fears that Amazon would soon replace the logistics infrastructure and expertise that took a half-century for FedEx to develop, the entire company is being valued by the market at just US$41 billion, despite earning US$4.1 billion last year and its tremendous long-term track record.

Though Martinrea and FedEx may lack the sexy stories of many newly minted public companies, we believe that a track record of profits and a proven business model to generate profits actually means something. In the end, it is not a story or narrative that ultimately determines the return that an investment will generate but the profits that it will earn over its lifetime and the price that is being paid by investors for that stream of earnings.

PROSPECTIVE RETURNS

Interest rates act like gravity on asset prices so it should come as no surprise that the recent sharp decline in rates coincided with a spike in both bond and stock prices. Even though recent returns have been strong, we continue to be cautious about prospective returns over the long term. In a world where long-term government yields are likely negative in real terms (after taking inflation into account) and high-teen earnings multiples for stocks are the norm, it is unlikely that future returns will resemble what we have seen in the last 10 years.

Faced with very low yields and pockets of high valuations, we continue to find attractive corners in the market to invest. We continue to strive to do what makes sense and not what appears to be most popular at present. By following this edict, we are likely to do worse than the broader market during times when prices are rising rapidly and investors are flooding into more popular names. Over time, we believe that our approach of carefully buying good businesses at reasonable prices will provide the best route to generate decent returns with acceptable risk.

Thank you for investing with us and for your continued confidence.

The Evans Team