

Investment Update for Q3 of 2019

After an eventful 2nd quarter, the third quarter of 2019 was even more eventful. The daily updates on the trade war seem to shift the sentiment of the market on a dime, even though they had no real impact on the underlying economy. In between stories about trade wars, there was also the consistent speculation of impending rate cuts by the Federal Reserve in the US, the ongoing mess that is Brexit, as well as increasing geopolitical tensions both in Hong Kong as a result of ongoing protests against the government, and in the Middle East caused by a drone attack on Saudi Arabia's oil refineries by Houthi fighters who may have been backed by Iran. Finally, to top it all off, there was impeachment proceedings initiated against Donald Trump as a result of a phone call with the Ukrainian President where he seems to have asked Ukraine to investigate his political opponent Joe Biden and his son Hunter.

The news cycle in 2019 has been overwhelming the better sense of the market in a lot of cases. The market goes up on positive trade rumours and down on negative trade rumours. Through it all there has been increasing tariffs which are starting to actually hurt economic growth in both China and the US. More recently there has also been talk of restricting access to capital markets for Chinese companies. This is something we take seriously as we do own some Chinese positions which have been negatively affected by this, and could be more negatively affected if these restrictions were introduced in the US. While a delisting or a threat to limit American investment in the two Chinese businesses we own, would not really affect their underlying businesses very much, it may temporarily cause a drop in their prices because of less access to investors. It is definitely not good for those investments.

However as Ben Graham famously said, in the short term the market is a voting machine, in the long term the market is a weighing machine. We believe that even if these Chinese companies were forced to delist their shares in the US, their underlying businesses will continue to be very strong. Over time that is the only thing that matters for our investment in those companies.

We also think that worst case scenario is unlikely for the following reasons:

1. It is not in the US's interest to restrict investment in all Chinese companies. The concerns seem to stem from less transparency from Chinese companies who are seeking to go public in the US. This is well documented and is something I would agree with. There are many Chinese companies who have not been very transparent with regulators prior to raising money in the US. In addition there have been a number of scandals involving Chinese companies and their accounting statements. However, I don't think this applies to huge multi-national companies like Alibaba and Tencent. We also believe that Alibaba and Tencent are run by honest management who are already complying with existing disclosure requirements in the US.

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2. While it is likely that the Chinese are using this threat for leverage in the ongoing trade talks, it is worth pointing out that if the Chinese chose to retaliate in the capital markets, they could also inflict serious damage on the US. China owns \$1.123 Trillion dollars of US government debt as of December 2018. Alan Ruskin, the chief international strategist for Deutsche Bank said that “the policy risks reciprocity from China, where China is of course a much bigger player in US portfolio markets than the US is in China.”
 3. Whether or not the trade war continues or it comes to some kind of a resolution, China is going to have more growth than the US in the next 10-20 years. That’s simply due to a much larger population and continued modernization and development of their economy which is starting from a much lower base. If the US restricts investment in Chinese companies, that will hurt US investors as they will not have as much access to this growth story.

The other major story which played out during the 2nd quarter was massive movements in the price of oil. The attack by Houthi drones was carried out on September 14th. When markets re-opened Oil jumped up over 10% and very briefly traded up above \$60 a barrel again. However this spike in prices was quickly erased as geopolitical fears seem to have subsided and were replaced by fears of the world economy going into a global recession.

The international oil market is quite complicated and has been really upended due to the dramatic rise in production in the US over the past 10 years. A lot of this increase has been fueled by historically low interest rates which have allowed US producers to borrow tremendous amounts of money instead of having to live off of the cashflow generated by their businesses. This can only continue for so long. In Canada there has been a similar story which has been compounded by the lack of access to international markets caused by a lack of pipelines. In addition there is increasing concern over climate change which is weighing on the long term viability of fossil fuels.

Despite all of these challenges, we do believe oil and gas still presents a good opportunity to invest in specific situations. We think that the debt fuelled production binge in the US is not sustainable long term and will have to taper off at some point. In addition, although electric cars and other renewable solutions are going to take away some demand, there are many activities such as Jet fuel which have no viable alternatives at present. Tack on fossil fuel use in agriculture, chemicals and plastics, amongst other uses and the demand for fossil fuels is not going away anytime soon. Some Canadian energy companies are trading at less than half of the value of their assets at the moment and we like those kinds of discounts.

The market has gotten more volatile in the past year as the economic expansion has gotten longer in the tooth and market valuations in certain sectors have gotten more stretched. The political environment is also very unstable, to put it mildly. Nevertheless, these are not unusual situations for markets and it doesn’t change the fundamentals of what we’re trying to do, which is buy good businesses at a price which builds in a large margin of safety. I fully expect the 4th quarter to be very volatile and the possibility of a global recession cannot be ignored, however I am as

confident as ever that our businesses that we own will continue to prosper, in spite of these potential headwinds.

Should you have any questions or concerns about your portfolio or about the topics discussed in this letter, please feel free to reach out to me.

- Craig White, BA, LL.B., CIM

Craig White is an Investment Advisor at Endeavour Wealth Management with Industrial Alliance Securities Inc, an award-winning office as recognized by the Carson Group. Together with his partners he provides comprehensive wealth management planning for business owners, professionals and individual families.

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