By Martin Lalonde, MBA, CFA and Jean Lamontagne, CFA, FICA

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Introduction

Hello everyone,

Working in investment has to be the best job in the world. The responsibility to decide when to buy or sell to maximize the return and enrichment of our customers keeps us sharp. Although it is not possible to guarantee superior performance every period, to succeed in doing so for more than 5 years is an undeniable sign of success. And it is important to put things into perspective in order to fully understand the tough opponent that is the stock market. On July 25, 2014, exactly three years ago, the main Canadian equity index, the S&P/TSX, was priced at 15,455. Today it is at 15,025, which represents a drop of 3% (excluding dividends). Anyone who says it is an easy job and does not have a proven strategy will only end up being the victim of the next storm to hit the markets, because a storm there will be. To paraphrase our friend Warren Buffet, "only when the tide goes out do you discover who's been swimming naked".

I would like to take a moment to thank the people who are part of our radio audience. We are now on summer break but in the fall, I will once again do a financial segment on 104.7 FM with colorful radio host Roch Cholette. If some of you would like to hear about specific topics, please feel free to email them to info@rivemont.ca.

We will begin this financial newsletter with a review of the last quarter and our performance since the beginning of the year. We will continue with a presentation of the current interest rate situation and our views on the matter. Finally, as usual, we will conclude by discussing our market outlook and presenting our most important positions.

Happy reading!

“Since the beginning of the year, the American market has performed much better than Canadian market.”

Portfolio Performance and Positioning

http://rivemont.ca/wp-content/uploads/2017/07/Rivemont-Growth-June-30-2017.pdf

The return on our core Growth Strategy was 0.8% in the last three months and 3.1% year-to-date compared to -1.0% and 1.1% respectively for its benchmark. Our exposure to the U.S. market was relatively profitable as the New York Stock Exchange performed much better than its Toronto counterpart. One of the stocks that performed particularly well is Micron Technologies.

The initial purchase price was under $18.00, and we pocketed our gain at about $29.00, a 60% profit in 6 months.

“The Bank of Canada surprised the market with an increase in the target rate.”

But over the past few weeks, an unexpected phenomenon has occurred: a steady and important decline in the U.S. dollar due to a surprise increase in interest rates by the Bank of Canada. Before May 2017, analysts agreed that no rate hike would occur before the fall, at the earliest. But it was on June 12th that events began to unfold. That day, at the Asper School of Business in Winnipeg, Carolyn A. Wilkins, Senior Deputy Governor of the Bank of Canada, spoke of the impressive growth of the Canadian economy, even implying in thinly-veiled terms that a rate hike was forthcoming. This was confirmed the very next day by the head honcho of the Bank of Canada, Stephen Poloz. From the time these comments were made until the July hike, Canadian employment figures remained solid, putting the final nails into the coffin of this very lengthy period without rate hike in Canada: 7 years in total.

As the above chart shows, the Canadian dollar has increased from $0.725 USD to more than $0.79 USD since the beginning of May, an increase of almost 10%. As a result, our U.S. securities lost the same percentage in total value, due solely to the foreign exchange effect. You can imagine how much higher our yield would have been being it not for the change in the exchange rate.

Two other stocks that have been doing particularly well for several months now are General Dynamics and CAE. These defense and aerospace-related companies benefit undeniably from the Trump Effect and the pressure on NATO countries to increase military spending.

"The acquisition of Whole Foods by Amazon had repercussions on the entire food sector."

Unfortunately for us, not all decisions are immediate winners. And some external events may have an unforeseen impact on our investments. Last April, we acquired shares in Loblaw, the Canadian leader in the food sector. The stock was on a strong upward trend and passed the $75.00 mark for the first time. A nice chart in a nice sector. But on June 16, an unprecedented earthquake shook the entire North American food sector. Amazon, online retail giant, bought Grocery Whole Foods Markets for $13.7 billion USD. Whole Foods specializes in natural and organic products. Knowing that Amazon has succeeded in gaining a significant market share in all the sectors covered by the company, it is easy to understand investors' fear in this particular sector. In a single day, Loblaw lost 4% of its market capitalization. South of the border, within 48 hours of the announcement, food giant Kroger's share price dropped from $30 to $21, a sudden loss of 30%. At the moment, we still hold Loblaw stock, as it has not broken its bullish trend over the longer term, unlike some of its competitors. But be assured that our patience has limits. Even if we believe we have chosen the best and most independent member of the flock, we will cut ties if it heads toward a cliff.

Finally, in the last few weeks, we traded the XIC exchange-traded fund that replicates the Canadian market for the XSP, which replicates the U.S. market but protects itself in terms of the exchange rate. The S&P500 and the NASDAQ reached a historic high on Bastille Day, unlike the S&P/TSX which is still lagging behind.

Rivemont Absolute Return Fund

"The absolute return strategy posts an annualized return of 8.9% since inception."

http://rivemont.ca/wp-content/uploads/2017/07/Rivemont-Absolute-Return-Fund-2017-06-30.pdf

We currently have a positive return of 8.9% annualized over the past 4 years for the fund, but the past few months have been challenging. We recorded a loss of 1.5% during the quarter. The month of June was very slightly positive, and we are convinced that a turnaround is in progress. It is mostly the short positions that are responsible for the current turmoil.

Are we worried? Not at all. As you know, the Rivemont Absolute Return Fund return is not correlated to the benchmark, which means that the status of the market does not affect its performance (which is its primary attraction). Currently, the loss from our highest point is about 15%. Is that a lot?

Warren Buffet is one of the greatest investors of our time. Here are some truths about his returns (calculated by Ben Carson, CFA). Since 1980, his investment vehicle (Berkshire Hathaway)'s returns have been 21% annualized, possibly the best on the planet. However, here are its biggest losses during the same period:

Berkshire Hathaway Largest Losses Since 1980	
1981-1982	-19%
1987	-37%
1989-1990	-37%
1998-2000	-49%
2007-2009	-51%

So, every six or seven years, an investor of Berkshire Hathaway can expect to lose 40% to 50% of the value of his portfolio. Without suggesting that Rivemont is in the same league as Mr. Buffet, I can say with confidence that few of my clients would be very comfortable losing 50% of their assets twice in 10 years. And it is for this reason that it is essential to take advantage of a product as interesting as the Rivemont Absolute Return Fund whose role is, among other things, to protect portfolios in a bear market. A 15% loss then becomes quite acceptable, and above all normal, compared to Berkshire Hathaway's figures.

Interest Rates

With the collaboration of Jean Lamontagne

This is not the first or the last time we will be talking about interest rates in this financial newsletter, but the rate hikes by U.S. and Canadian central banks in recent months, as well as those expected in the near future are forcing us to revisit this theme.

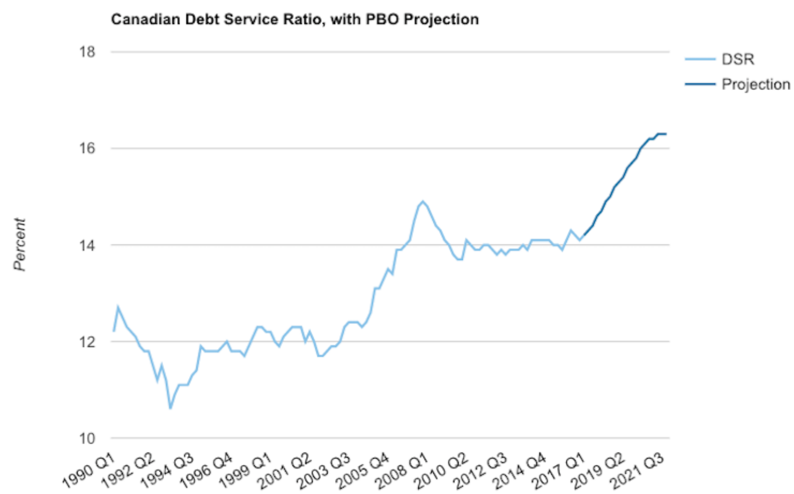
"An increase in interest rates translated into negative returns for the bonds."

First, let me tell you that these increases have already had a direct impact on your portfolio. Since bond yields run in the opposite direction of interest rates, the Canadian bond market has lost more than 2% since the beginning of June, and almost 5% since the beginning of 2015 (excluding coupons).

However, being aware of this rate risk, we positioned ourselves accordingly, to the great delight of our investors so far. First, we are underweight in bonds. Second, half of our bond position is comprised of 5 to 10 year corporate bonds, and the other half of high-yield bonds that perform similarly to equities because of the associated risk, despite their high interest rates. We therefore have no exposure to government bonds or long-term bonds, which are more likely to be impacted by higher rates.

"The debt service ratio of Canadians could exceed 16% in 2021. "

Do we really have to worry about a rise in rates from a macroeconomic perspective? Yes and no. First, I do not believe in a quick and significant rise in rates due to the low inflation of Western economies. Currently, Canadian and U.S. increases are anticipatory, which means that inflation could increase due to an exceptional labor market as opposed to dealing with inflationary pressures. On the other hand, a gradual and moderate increase is to be expected, and it could even have significant repercussions. The Parliamentary Budget Officer, who presents independent financial analysis in Parliament, recently indicated that the cost of servicing Canadians' debt will explode over the next few years. The following chart shows that the debt service ratio could exceed 16% in 2021, if the current target rate of 0.75% increases to 3%.



Source: Statistics Canada, PBO.

If these predictions come true, Canadians will pay over $16 in interest on their debt for every $100 of disposable income, a record for Canada. By devoting such a proportion of their disposable income to serving their debt, Canadians will be severely cut off from their consumption capacity. The Bank of Canada will therefore need to be cautious in normalizing its policy rate.

"An increase of 1% of the American debt service rate translates into an annual deficit increase of 30%."

The same is true for the Americans, although the issue is more serious south of the border because of government debts. With a federal debt approaching $20 trillion USD, each 1% rate increase represents an additional annual budgetary expenditure of $200 billion USD, or 5% of the total federal budget or 30% of the annual deficit. Without a corresponding increase in tax revenues to prevent the already large debt from inflating further, the U.S. government may decide to make substantial budget cuts, which would have a negative impact on the economy.

Central banks in Canada and the United States are thus faced with a major challenge: to slow inflationary pressures by stopping the very accommodative monetary policies of recent years while ensuring that the return to a more "normal" monetary policy is achieved without causing a significant contraction in the economy.

"The real estate sector would surely feel the impact of a rapid increase in mortgage rates."

An asset class that is likely to be adversely affected by a rate hike is the real estate sector. Many households purchased property at low interest rates before the federal government introduced new mortgage rules. Some of these households often have very little leeway to absorb a rate hike. For example, in the event that mortgage rates increase by 2% or 3%, some will unfortunately have to dispose of their residence, which could lead to a drop in real estate values. Again, not everything is static and several elements influence the value of real estate including the city, sector, type of property, immigration and economic strength of the region. Certainly, the real estate sector would feel the impact of an increase in mortgage rates.

But what does not change is that each type of market presents opportunities that should not be missed. One of the best performing sectors in a rate hike scenario is the commodities (raw materials) sector. We are already closely monitoring this sector, and our first signals target the copper sector. It is not yet in a bull market, but we will certainly be there if it confirms itself.

Market Prospects

Rivemont Investments			
Subject	Question	Recommendation	Comments
Allocation between equities and fixed income securities	Which are most interesting, stocks or bonds?	Underweight in bonds.	We recommend adding alternative investments to portfolios.
Distribution between Canadian, U.S. and international securities	Which securities are most interesting: Canadian, U.S. or international?	Neutral weighting between Canadian and U.S. markets.	The technology and health care sectors are particularly interesting.
Distribution between corporate and government bonds	Which are more interesting, corporate or government bonds?	We recommend corporate bonds and high-yield bonds.	We recommend short- and medium-term corporate bonds as well as high-yield corporate bonds.
Investments in Canadian dollars or in foreign currency	Do investments in other currencies increase or decrease the total yield?	American securities remain essential in portfolios.	We are awaiting the next signal from the Bank of Canada before taking a position on this.

Favorite Securities

You will find below a list of the individual securities with the largest weight in our "growth" portfolio. These stocks were selected based on their respective potential to outperform the stock market. You will find a short description of their activities, the annual dividend, if any, and the total return since their first inclusion in our portfolio.

As of July 18, 2017

1) Symbol: GD
Name: **General Dynamics**
Description: Production of military equipment.
Dividend Yield: 1.7%
Total Return: 31.5%

2) Symbol: DOX
Name: **Amdocs**
Description: Software and technology services.
Dividend Yield: 1.4%
Total Return: 5.4%

3) Symbol: CNR
Name: **Canadian National Railway**
Description: Railroads.
Dividend Yield: 1.6%
Total Return: 24.4%

4) Symbol: QSR
Name: **Restaurant Brands**
Description: Fast-food outlets.
Dividend Yield: 1.3%
Total Return: 15.8%

5) Symbol: CAE
Name: **CAE**
Description: Flight simulators.
Dividend Yield: 1.4%
Total Return: 13.1%

6) Symbol: SLF
Name: **Sun Life Financial**
Description: Insurance.
Dividend Yield: 3.7%
Total Return: 26.2%

7) Symbol: RY
Name: **Royal Bank of Canada**
Description: Financial services.
Dividend Yield: 3.7%
Total Return: 17.7%

8) Symbol: BAM.A
Name: **Brookfield Asset Management**
Description: Real estate and infrastructure investments.
Dividend Yield: 1.5%
Total Return: 0.1%

Conclusion

Our technical analysis and trend following method of investment is applied successfully all over the world and is based on important and, above all, successful principles. If you want to know more about it, I invite you to read the new edition of the book "Trend Following" by Michael Covel, that just hit bookstores. With this book in hand, all you need is a small reading corner in the shade, which is particularly easy to find these days!

Sincerely,

Martin Lalonde, MBA, CFA
President