MARKET VOLATILITY COMMENTS

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Markets tend to go "up the escalator" and "down the elevator", a scenario we are seeing now. We emphasize that we see no signs of a recession on the horizon. Instead, solid fundamentals, being a synchronized global economic expansion with stronger earnings growth resulting from tax reform in the U.S. continue to underpin the markets. We are not witnessing panic selling, rather profit taking after the recent melt-up in the S&P 500. Further contributing to market action this past couple of weeks is the unwinding of positions in short-volatility funds. The market needs to enter a period of digestion of recent volatility.

Rising long term interest rates and the threat of inflation, driven by recent wage gains, have upset the apple cart. As we now see it "good news is bad news" given investors were accustomed to low interest rates and low volatility and markets were priced for this. A secular reversal of the 30-year bull market in bonds may be underway. Fixed income, real estate, utilities and pipelines have been hurt the most as a result, and have been correcting for a couple of months. These areas of the market may continue to feel pressure if interest rates and inflation trends accelerate. In our balanced portfolios (Dynamic Strategic Yield Fund and Dynamic Dividend Income Fund) we have been significantly underweight fixed income with shorter duration as well as underweight interest rate sensitive equities. Profit taking has broadened out most recently into cyclical equities given they have run hard. As we have seen continued price pressure, we have been taking profits in cyclicals in order to preserve strong gains.

Dynamic Strategic Yield Fund has 26% fixed income and 11% in interest sensitive equities (real estate, infrastructure and telecommunications) and cash has been raised to 11%. We have reduced our total equity exposure to 63% (cyclicals 33%, secular growers 13%, defensives ex-interest sensitives 4%, alternatives 2%) from as high as 70% earlier in the year. In comparison, retail investors have recently increased their exposure to the equity market to such an extent that there is not a lot of cash on the sidelines, limiting incremental demand for stocks in the short term. If you do have cash, slowly enter the market when you see long term rates and stock prices stabilize, and the VIX declines.

In a recent research report Tobias Levkovich, Citi Chief Equity Strategist, stated "Most fund managers cannot remember an extended period of healthy GDP growth given two equity collapses since 2000 and a financial crisis, plus European periphery sovereign debt woes." and "...few can remember the nine-year expansions of the 1980s and 1990s." Assuming you start your career at the earliest age 23 you would have to be 48 years old today to have lived through an economic expansion and rising interest rate environment. In a 30 year bull market in bonds you could obtain a good return owning interest rate sensitives and fixed income. You did not need to take chances with cyclicals in that environment. Lately fixed income and interest rate sensitive sectors have been weak and cyclicals (industry, technology and financials) have been strong, but cyclicals have sold off as late due to profit taking. It may be difficult to recognize the change in conditions and adapt accordingly if you have not experienced them first hand.

Depending on the investor's cash position, it may be prudent to either a) buy back into the market on compelling valuations or b) take some profits from long-term winners and rebalance the portfolio to where the investor can sleep at night.

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