The past twelve months has seen huge swings in global equity and bond markets. A year ago, amid projections of strengthening economic growth touched off by the Trump tax cuts, equity markets moved up strongly and bond yields began to rise. Federal Reserve commentary became more aggressive, as Chairman Powell suggested that strong projected economic growth would be met with a larger and more rapid series of interest rates increases. Equity markets promptly began to fall, with major developed markets ultimately dropping close to 20%. This, naturally, touched off a series of new economic predictions, as forecasters began to warn of an imminent global recession. In the face of the rising tide of gloom, equity markets abruptly reversed course, leading to one of the strongest first quarters in history and a further mild advance in the second quarter. Bond yields, meanwhile, collapsed, with the US 10-year yield falling below 2%, and central bank rhetoric rapidly turned dovish, with central banks now envisioning rate cuts instead of hikes.

In our view, the interplay between market events and economic forecasts over the past year was very typical. Although it may seem rather cynical to suggest that economic predictions tell you far more about what has just happened rather than what is about to happen, there is an abundance of evidence suggesting that this is generally true. As a result, we do not place forecasting at the center of our investment process. If anything, we aim for the opposite. We target industries and companies where the need to rely on accurate forecasting is minimized. This is due to stable competitive environments, lower cyclicality, and no material structural changes underway. Despite our reluctance to rely on forecasting there are some extremely important areas where we feel we have no choice—where we need some guide posts to the future. We touch on two of them below.

The first area is the rate of inflation and its impact on discount rates and equity valuations. This seems a somewhat "academic" topic, until you realize that the market's assumptions here drive overall stock market levels and returns. The inflation environment of the past two decades has been extremely benign, with inflation generally stuck below 2% in developed countries. Since bonds are priced as a spread over the rate of inflation, bond yields have also come down to extremely low levels. If we assume that this environment will persist "forever", it is extremely important to think about what this generally implies for risk assets.

In our view, lower inflation rates and lower bond yields should ultimately lead to a repricing of risk assets to the point where they also offer lower future returns, this requires a run-up in current prices to achieve. For example, if the dividend yield on a stock is repriced from 4% to 3%, it causes the share price to go up by 33%. In a similar fashion, a small reduction in the discount rate used to value a company causes a large increase in the expected share price. A place where this process may have already played out is residential real estate globally. With mortgage rates declining to generational lows, residential real estate prices have increased around the world, with Canada proving no exception. Generally, within equity markets we have also seen a similar process at work, as companies viewed as consistent and sustainable have experienced notable increases in valuations. In a perpetually low inflation environment, these valuation increases may prove durable, and arguably valuations may continue to expand. So far, overall equity valuations do not appear to have fully priced in a "new normal" inflation rate and we have no way of knowing if they will. If they ultimately fully reprice, equity markets may continue to go up a surprisingly large amount from current levels, even in the absence of robust earnings growth.

The second area is the direction of the economic cycle, which has a very material impact on both the performance of the overall equity markets and the relative performance of individual sectors and stocks. Across an economic cycle, it is quite common to experience mini slow-downs, where earnings growth stalls and markets correct sharply before roaring back. Recessions, while initially looking very much like a mini slow-down, are much more impactful events, leading to an extended drop in corporate earnings and generally a major downdraft in equity markets.

Recession forecasting, unfortunately, is an area where economists have not met with a great deal of success. Although each recession is accurately forecasted by a subset of observers, we have noticed that many of them seem to be of the "stopped clock" variety. These are the market commentators that seem to forecast a recession each year, making them, at some point, inevitably correct. Clearly, this is not a particularly helpful guide for investing.

In our experience, there are certain hints that the economic cycle is maturing. We have written at length in the past that material declines in residential real estate have tended to lead economies into recession. Inverted yield curves and falling leading economic indicators have also provided early warnings in prior cycles. Finally, very low levels of unemployment have also tended to precede recessions, as the economy begins to push up against cyclical constraints to growth. All these indicators are currently hinting that we are getting later in the cycle.

From a practical investing standpoint, the main line of defense against a slowdown is to emphasise companies that are much less cyclical than average. Although we naturally target companies that grow consistently, over the past two years we have steadily reduced or eliminated companies that we believe have more sensitivity to the economic environment. At this point, we believe that our funds are positioned appropriately.

During the quarter, we initiated positions in Alcon and SAP.

Alcon is the world's leading eye care company. Although the business recently returned to the public markets, it was not new to us. Prior to being acquired by Swiss pharmaceutical giant Novartis in 2011, the company was listed in the United States.

In our view, Alcon has all the attributes that we look for in an investment. The business has existed for over 70 years, and during this time has created an enviable franchise, with a broad portfolio of products and a very well-respected brand. In addition, at this point we believe that there is considerable scope to improve the company because of Novartis's mismanagement.

Over the years we have watched several "blockbuster" acquisitions that were entered into with considerable fanfare, fall apart. In our view, the combination of Novartis and Alcon falls firmly into this category. Novartis is a pharmaceutical company, and although Alcon had a strong portfolio of drugs related to eye care, ultimately the company is a medical device business. These are enormously different types of companies, with pharma companies focused on creating home run drugs—individual products with revenues in the billions of dollars—and then defending their maturing portfolio against generic drug manufacturers. Well-managed device companies, on the other hand, are much more incremental. They aim to build a development pipeline that aims to consistently generate many small wins and operate in a competitive environment that rewards stability and reliability.

Under Novartis's management, Alcon began to underinvest in new product development and manufacturing capacity. This is not particularly surprising, as the senior executives at Novartis had the choice of investing capital into new exciting molecules that could yield massive company-changing results if successful, or into Alcon where they could add a new manufacturing line to expand contact lenses capacity. Fortunately, before too much damage was done, a management change at Novartis resulted in a reassessment of the firm's portfolio of businesses and a decision to spin-off Alcon's device business, while retaining the pharma component of the company.

Alcon began to re-invest in R&D and capacity expansion several years ago, with the new pipeline of products expected to gradually come to market over the next few years. This, combined with continued work on the underlying cost structure of the business, should result in rising organic growth and expanding margins over the next 3-5 years. All of this should occur against the backdrop of a very attractive industry. Eye care is a consolidated oligopoly with a handful of large players, the industry is not particularly economically sensitive, and aging populations and technological improvement provide a steady tailwind for growth.

SAP, headquartered in Germany, is a global software company with a dominant position in ERP (Enterprise Resource Planning) systems. A decade ago, we viewed the company as a mature software business that was downshifting from growth to maturity. In 2010, the company appointed its US leader, Bill McDermott, to the role of co-CEO and then sole CEO in 2014, with the goal of revitalising the business.

ERP systems are the core operating platforms of most major companies as they create an integrated backbone for sales, manufacturing, inventory management, finance and human resources. They are notoriously expensive and difficult to install, with installations commonly occurring over several years, and price tags running into the hundreds of millions of dollars. This has given SAP an enormous economic moat, since tearing out and replacing an ERP system would be a nightmare, with no possible economic justification.

The challenge SAP encountered was that most major companies have already deployed an ERP system, which makes for a wonderful annuity stream of income, but very limited growth. SAP's solution to this challenge was to move upstream, into the analytics and business intelligence areas, creating and acquiring new products that sit on top of their underlying ERP platform and allow businesses to analyze and understand the vast amount of data that is passing through their ERP system.

In addition, SAP invested heavily in updating their underlying platform, moving it from on-premise to a cloud-based version, called S4/HANA. Although the investment was necessary if SAP was to continue to grow, it pressured overall margins, during a period where sales were already slowing.

This combination of slowing growth, softer margins and, questionable capital deployment (some of the acquisitions, particularly the large acquisition of Qualtrics, appeared extremely expensive), resulted in somewhat lackluster stock market performance, ahead of the overall market, but weak relative to comparable large US based software companies.

In our view, the company has now finally turned the corner. The global roll-out of S4/HANA continues to pick-up pace, with cloud sales now over 20% of total revenue. The company anticipates cloud revenues will continue to grow at a CAGR of over 30%. The business has recently attracted the interest of activist investor, Elliott Management, who helped ensure that the management is focused on execution; moving from the investment stage to the growth and margin re-expansion stage. Finally, discussions with other companies, who operate in overlapping areas, has helped confirm that SAP has returned to growth and execution mode.

Outlook

In general, the global economy continues to expand while inflation remains muted. Global growth continued to slow, with most economic indicators continuing to weaken over the quarter. Interest rates globally declined materially over the past 9 months, with the US 10-year yield dropping from over 3% to below 2%. We are suspicious that high debt levels globally will continue to make the economy more interest rate sensitive than in the past, which may continue to lead to a lower growth rate of global GDP over a cycle. In addition, very low policy rates may make it more difficult to recover from a recession as the standard Central Bank stimulus lever of slashing interest rates by 5% or more during a downturn is not currently an option.

As always, we continue to own 30-35 companies that are leaders in their respective niches. We believe each investment will continue to outgrow their peers while showing superior profitability, generating strong free cash flow, and maintaining the balance sheet flexibility necessary to weather difficult economic environments. We have invested through many different cycles and environments in the past and continue to believe that companies with these characteristics, bought at sensible prices, will outperform over time.

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On November 10, 2006, the Mackenzie US Growth Class acquired the assets of another Mackenzie-sponsored fund in a merger that was considered a material change for the Fund. Therefore, the Fund's performance is provided from the date of the merger rather than its inception, as required under applicable securities laws.

Fund and Benchmark Performance as at: June 30, 2019	1 year	3 years	5 years	10 years
Mackenzie Canadian Growth Balanced Fund – Series F	7.8%	10.5%	10.7%	9.2%
65% S&P/TSX Composite TR and 35% FTSE TMX Canada Universe Bond Index ($CDN)	5.3%	6.5%	4.5%	6.8%
Mackenzie Canadian Growth Fund – Series F	8.3%	14.5%	14.3%	12.0%
Blended Benchmark* ($CDN)	5.4%	10.5%	8.1%	10.4%
Mackenzie Global Growth Class – Series F	11.0%	16.2%	12.1%	12.1%
MSCI World Index ($CDN)	5.6%	12.0%	11.1%	12.0%
Mackenzie US Growth Class – Series F	16.1%	17.3%	13.4%	12.3%
S&P 500 Index**	9.7%	14.4%	15.3%	16.1%

*The Mackenzie Canadian Growth Fund's benchmark was changed in March 2017 from the S&P/TSX Composite Index to a blended benchmark of 60% S&P/TSX Composite Index, 30% S&P 500 Index, and 10% MSCI EAFE (Net) Index, in order to better reflect the long-term average geographic composition of the Fund. **The Mackenzie US Growth Class benchmark was changed in March 2017 from the Russell 1000 Growth Index to the S&P 500 Index in order to better reflect the long-term average geographic composition of the fund.

The Bluewater Team assumed leadership of Mackenzie Global Growth Class and Mackenzie US Growth Class effective August 9, 2016.

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