Mackenzie Bluewater Team

Q3-2018 COMMENTARY

Global equity markets were highly volatile in the third quarter with a notable divergence. While the US markets continued to exhibit resiliency, the emerging markets fell sharply as global trade policies and rising rates continue to weigh in on global growth.

The Federal Reserve has been at the forefront of policy normalization, having raised interest rates eight times already since 2015. Healthy corporate earnings, which continue to grow rapidly, and leading economic indicators that continue to signal strength, suggest the economy no longer warrants extremely accommodative monetary policy. There continued to be very legitimate concerns that raising rates too quickly could potentially tip the economy into recession and derail global growth. Historically, Federal Reserve tightening cycles have often proven too aggressive, as the impact of tightening policy takes an extended time period to show up in the economy. At this point we are less concerned about valuations, which are within normal ranges relative to earnings and cashflows, and more concerned about the future trajectory for earnings.

From our perspective, the US economy remains robust, aided by US tax reform and the US Government's decision to run larger deficits. In this environment, businesses that are cyclical and highly leveraged tend to outperform, as they experience an outsized acceleration in bottom-line growth. As a result, you often have a shift in investor sentiment from stable businesses to more cyclical businesses – a rotation from growth towards value style investing. Historically, this rotation has tended to be fairly short lived, as the acceleration of economic growth is met by accelerated central bank tightening. This tightening ultimately creates a slowdown in growth; an environment where our style, and our companies, have tended to return to strong relative performance.

We continue to view the US as the most structurally sound economy. Canada has just dodged a big bullet on trade with the US and as a result our prospects have improved. Canada can now benefit from the US economy's strength which has been a long-term positive for this country. After 18 months of negotiation and demands for substantial changes to NAFTA, the drama ended with no material changes. The auto sector has been saved and there is plenty of flexibility to allow Canada to continue to grow in this area if the companies choose to proceed. There were some concessions in the dairy sector which allows some incremental access to the US, but Canada will maintain the managed supply regime. All in all, it was a non-event but good enough for President Trump to declare a victory.

In light of the trade dispute, we had avoided Canadian businesses in industries that could be negatively impacted from tariffs including automotive, lumber, steel, agriculture and dairy. As such, the new USMCA agreement had little direct impact on our portfolios.

Since President Trump was elected, we have viewed his anti-trade rhetoric against China as a potential risk to global growth. In President Trump's view, China should not expect the US to be an important customer while at the same time creating unequal trading rules that disadvantage the US. As the US looks to "modernize" its trade pacts globally, it appears that President Trump's strategy is to increasingly isolate China on global trade by effectively vetoing their partners' ability to forge ties with China. The pressure on trade, combined with rising US interest rates, are creating pockets of concern within the emerging markets. Some emerging markets like Turkey and Argentina have faced a "textbook style" crisis as these countries borrowed heavily in US dollars when rates were low and are now faced with higher borrowing costs and an enormous debt load. While we do not envision contagion risk, the pressures are certainly mounting.

During the quarter, we exited Home Depot, Waters Corp. and Dassault because valuations were at the upper end of what our models told us they were worth. We also sold our position in Metro due to increased concerns that growth without increased food inflation would be difficult to achieve.

We initiated a new position this quarter in Techtronic, a company whose stock price has been pressured by the US/China trade dispute. For historical reasons, Techtronic is a Hong Kong listed business, although the vast majority of the company's sales are in the United States. Techtronic is a dominant player in the tools business, with their Ryobi brand now the global #1 in mainstream tools (having displaced Black & Decker's decades long dominance) and the company is rapidly moving to the global #1 position in professional tools behind the strength of the Milwaukee brand. At the retail level, Techtronic sells purely through Home Depot in North America.

There is a very clear secular trend in the tools market to move from corded plug-in tools to cordless battery powered platforms. What is interesting about this shift from an investment perspective is that with corded tools, tool buyers could be brand agnostic--buying tools from multiple brands. For battery powered tools, the battery itself comes at a major cost and each tool brand's battery system is incompatible with those of competitors. This is forcing users to tie themselves into a single system, turning the tool market into a classic "razor-razorblade" model. Techtronic spotted this shift early and has capitalized on it remarkably well by investing in the software engineering capability to drive much better battery performance than their competitors, while simultaneously surrounding their core battery with a massive and highly innovative platform of different tools. We believe that Techtronic will continue to be a beneficiary of the continuous improvement in battery price and performance that sits beneath the shift towards electric vehicles. But unlike the EV market, which is becoming brutally competitive, the tool market is a narrow oligopoly, and may, if anything, be tending towards a duopoly. We believe that Techtronic is a high single to low double digit organic growth business, and with the recent pressure on tool company stocks from the US/China trade dispute (all tool companies source components from China) we have initiated a position at a discount to our estimate of fair value.

This quarter, Dollarama was a significant detractor from performance as the company reported same store sales that missed street expectations although their earnings growth was in line with our expectations. For many years we have discussed with management how they have been able to grow their earnings consistently through the business cycle. This has been a multifaceted approach: introduction of higher price point items every 3-4 years, consistent new store openings, refreshing 25-30% of the product assortment every year to maintain relevancy, introducing alternative payment methods such as credit cards and debit, and outright price markups. On the latter, Dollarama's strategy has been to reverse engineer the pricing based on cost, currency, and relative value proposition – All to achieve their desired margin goals. Although the company has experienced cost pressures from minimum wage increases, Canadian retaliatory tariffs on US goods and higher transportation costs, a big offset this quarter was the deflation they are experiencing in China, which we think is largely a function of the trade disputes between China and the US. As a result, management deemed appropriate to retract from pricing markups to further enhance their value proposition, all while maintaining their desired margin goals. While not explicitly discussed (ever), we surmise that price markups typically provides a tailwind of approximately 2% to same store sales growth, the inclusion of which would have brought the comparable sales growth comfortable within the 4-5% range versus the 2.5% they reported and what disappointed most investors. We are confident that the lower sales number is not an indication of lost market share, nor a broken business model. In fact, management has articulated that they "would be disappointed if they cannot achieve 4-5% comparable sales growth over the long term."

At the time of this writing, markets across the world sold off sharply. The initial sell-off appeared to be related to the spike in 10-year US Treasury yields, but in a similar fashion to the abrupt plunge in February of this year the follow-on declines seem to have been driven by selling from various quantitative strategies. With an estimated US$1.5 trillion in total assets, even relatively small adjustments by these strategies can rapidly swamp the cash equity markets, driving stocks down rapidly. A number of large strategies are trend following in nature, which means they buy assets that are going up and short sell assets that are going down. As equities fell below "trigger levels" these strategies pile on, creating further losses.

There is a tendency to try to create stories during a large market event, and we have seen a fair number over the past few days to explain the sell-off. They have included trade conflict, runaway inflation, imminent recession, excessive valuations, crushing global debt loads, and rampant speculation. In a world where short term trading volumes are dominated by computers, we aim to simply focus on company and economic fundamentals. The global economy continues to expand, with particular strength in the United States. Earning and cashflow oriented valuations remain within normal ranges. Leading indicators suggest further growth ahead. As always, we focus the bulk of our time on identifying what we believe are some of the greatest businesses in the world. Here is what you need to remember. We own a group of companies that are not deeply cyclical, businesses that are high free cash flow generators and that ultimately implies they are in a very strong financial position. We have specifically chosen these companies because they are unique, relatively resilient and are run by the best management teams in their industry. One of the reasons we consider these businesses as leaders in their respective industries is because we have studied their performance in periods of economic slowdown and they outperform their peers. We have been here many times before and hope you continue to share in our appreciation for the philosophy and process that has worked through more than three decades of investing.

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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: September 30, 2018 (%)	1 year	3 years	5 years	10 years
Mackenzie Canadian Growth Balanced Fund – Series F	9.9	10.0	12.7	8.2
65% S&P/TSX Composite TR and 35% FTSE TMX Canada Universe Bond Index ($CDN)	4.4	6.9	6.3	5.8
Mackenzie Canadian Growth Fund – Series F	13.5	14.0	17.0	10.3
Blended Benchmark* ($CDN)	10.7	11.6	11.4	8.9
Mackenzie Global Growth Class – Series F	18.2	11.8	12.6	11.1
MSCI World Index ($CDN)	15.0	12.2	14.4	10.7
Mackenzie US Growth Class – Series F	22.9	11.5	14.3	11.4
S&P 500 Index**	21.9	15.9	19.3	14.2

*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.

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