Leon Frazer & Associates
INVESTMENT COUNSEL

experience counts...
managing private clients' money for over 75 years

DECEMBER 2016

LEON FRAZER QUARTERLY REVIEW

# Equity Market Commentary: Looking Back on a Remarkable Year

2016 WAS A REMARKABLE YEAR WITH SEVERAL SIGNIFICANT SURPRISE EVENTS. While we could not have predicted OPEC co-operation with Russia, the UK vote to withdraw from the European Union and President Elect Donald Trump a year ago, we did correctly predict that our portfolios composed of quality dividend-paying Canadian equities would rebound significantly.

## US ELECTION TAKES THE MARKETS BY SURPRISE

The fourth quarter was defined by the surprise election of Donald Trump as the 45th President of the United States. The speed with which the financial markets digested the result and formed an opinion contrary to the nightmare scenario that most were predicting just a day earlier was truly breathtaking. Much ink has been spilled trying to predict what the election will mean to both financial markets and the world at large and we will not add to that; we are firmly in the wait-and-see camp. From a purely clinical perspective, our view is that no one person dictates the path of the stock market. Remaining invested in quality companies over time limits downside and produces sustainable returns. Donald Trump will be the 13th US president to take office since we opened our doors in 1939. If he does a good job there is nothing to worry about. If not, he'll be gone in 4 years and the companies we own will continue on regardless. One thing we will say is that the range of possible outcomes has expanded relative to what could have been expected with the status quo. This means there will likely be continued market volatility in 2017 and beyond. Considering the inflationary potential of fiscal stimulus with low interest rates and full employment, however, we are comfortable with the risk/reward tradeoff embedded in our current portfolios relative to other instruments like cash and longer duration bonds.

## SIGNIFICANT OUTPERFORMANCE FOR LEON FRAZER PORTFOLIOS

The S&P/TSX Composite Total Return Index gained 4.5% in the fourth quarter to end the year up 21.1%. By comparison the S&P 500 Total Return Index gained 3.8% in Q4 to end the year up 12.0% in US dollars, translating to an 8.8% annual return in Canadian Dollars. Canadian dividend-paying stocks had an even stronger year than the TSX, resulting in significant outperformance for Leon Frazer portfolios and all but erasing the negative effects of a nasty 2015. As expected, our favourite sectors rebounded significantly with Pipelines up 35%, Banks up 30%, Utilities up 18% and Telecom up 15%. It is important to note that while market values have fluctuated greatly over the last two years, overall dividend payments have been consistent. We have seen over 55% of our holdings increase dividends in each of the past two years, helping to maintain a stable income stream for clients while market values fluctuated. Portfolios without a spending requirement had the added benefit of reinvesting this income stream at advantageous prices during late 2015 and early 2016, adding to performance in some cases.

We expect another positive year for portfolios in 2017, although we are wary of potential volatility. We have seen elevated upside volatility

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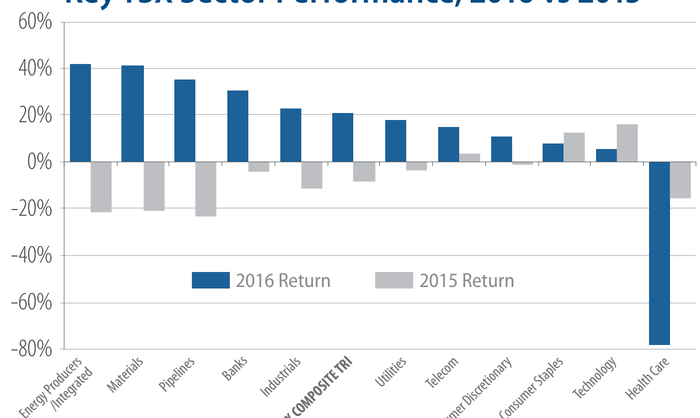
**Key TSX Sector Performance, 2016 vs 2015**




*Source: Thomson Reuters*

***"Remaining invested in quality companies over time limits downside and produces sustainable returns"***

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in markets following the election and we would not be surprised to see corresponding downside volatility (a correction) at some point in the next couple of quarters. The US economy is expanding at the fastest rate since the recession, consumer confidence has soared and the potential for real inflation with a short-term rise in bond yields is palpable. The Canadian economy is likely to get dragged along to some extent, especially if recent OPEC coordination proves credible and oil prices remain sustainably above $50. Longer-term we believe the headwinds to growth in both equity markets and the economy will begin to blow stronger and ultimately bring on the next recession, but we do not feel that will be a 2017 event.

### POSITIVE OUTLOOK FOR 2017

The Leon Frazer investment team was active last year, repositioning the portfolio to participate in the Canadian market recovery and increase the dividend income stream paid to clients. We remain positive on the Canadian equity market for 2017, but are also becoming wary of the length of the current economic expansion. We feel the portfolio has reached a maximum for economic sensitivity in the expansion that has lasted since 2009. Over the next several quarters we will be looking to reduce lower yielding cyclical holdings and add to defensive sectors like Utilities and Telecom with sustainable and attractive dividend yields, especially if their share prices continue to soften. Given the extent to which dividend yields remain above benchmark bond yields, there is considerable cushion for interest rates to rise before they compete with the higher after-tax yields offered by our portfolios. Additionally, given the size of the bond market is more than ten times the size of the equity market (let alone the dividend-payers), a sell-off in bonds could be positive for dividend stocks if even a portion of those proceeds seek income in the equity market. Leon Frazer portfolios have recovered within a hair of our 2014 all-time highs and we look forward to reaching new heights in the new year. All the best to our clients as we wish you a prosperous and healthy 2017! ●

## Fixed Income Commentary

*"For the first time in several years, North American government bonds of all maturities over 5-years experienced negative total returns"*

Fixed Income markets were set ablaze following the US election as inflation expectations changed markedly. For the first time in several years, North American government bonds of all maturities over 5-years experienced negative total returns in 2016 after a brutal fourth quarter where both Canadian and US 10-year government bonds were down 6% and 7% respectively. For the full year, 10-year interest rates went on a wild ride, dropping to new lows following the Brexit vote only to shoot upward following the US election. As interesting as the equity market was last year, what happened in the bond market could be far more meaningful. Stimulative policy has been in place globally for some time, but inflation has been noticeably absent outside of financial assets and real estate. The US has been the leading economy since the financial crisis and for the first time since 2008, bond markets are bracing for inflation. Our long-term view is that interest rates will not rise on a sustained basis, however given the incredibly low levels reached last year, even a small temporary increase could inflict significant pain on longer duration fixed income portfolios. Case in point, the 0.75% increase in US 30-year (long) Government bond yields during the 4th quarter resulted in a -13.8% total return. Canadian long bonds were down similarly in Q4 (-12.9%).

We expect fixed income markets will continue to be volatile in 2017, given participants' need to digest changes to inflation expectations and government policy. Longer term, however, we believe interest rates will be capped on the upside by sluggish global growth.

The JOV Leon Frazer Bond Fund was down 0.5% in the fourth quarter, significantly outperforming our benchmark (50% FTSE TMX Short-Term Bond Index and 50% FTSE TMX Mid-Term Bond Index) by 1.3%. For some time we have been stating that our conservatively short average term-to-maturity would help performance when interest rates started to rise. That is exactly what happened in 2016, where the Fund outperformed the benchmark by more than 50% (2.2% for the Fund vs 1.4% for the benchmark).

The JOV Leon Frazer Preferred Equity Fund had a very interesting year, posting an 8.4% total return in 2016, outperforming the S&P/TSX Preferred Share Total Return Index by 1.4%. The preferred equity market had a strong fourth quarter as the optionality in 5-year resettable issues caused share values to move higher in anticipation of higher interest rates at future reset dates. Considering that preferred shares yield significantly more than comparable Government of Canada bonds, we continue to see value for taxable investors given the beneficial tax treatment for preferred share dividends relative to interest income. ●

# Spotlight: Hunger in Canada

According to Food Banks Canada, thirteen percent of Canadians live in a state of food insecurity, without reliable access to safe, good-quality, nutritious food. Low income, the root cause of hunger in Canada, consistently affects more than four million people at any given time. Food banks offer an important venue for those in need. Each month, over 850,000 people turn to Canadian food banks for help, with more than one-third being children and youth. To put it in perspective, you could fill the Rogers Centre 17x with the number of people who use a food bank each month!

### HUNGER IS A MULTI-FACETED PROBLEM

Food bank recipients come from all backgrounds. They include families with children, employed people whose low wages do not cover basic living essentials, individuals on social assistance, and Canadians living on a fixed income, including seniors and people with disabilities.

> *"The scope of food bank use in Canada is shocking"*

In Toronto, a common issue faced by food bank recipients is the percentage of their income spent on rent. For many, a food bank is the only way to put food on the table while still managing housing costs. As real estate values escalate in the city, more people are retreating to the suburbs in an attempt to find affordable housing, putting more pressure on food banks in rural areas. Food Banks Canada estimates 156,000 Canadians in rural communities rely on a food bank.

### SCOPE OF FOOD BANK USE IN CANADA

The scope of food bank use in Canada is shocking. In Alberta, where workers have been affected by the low price of oil, the unemployment rate reached nine per cent in November, the highest it's been in more than two decades. The fall in the value of the loonie has affected the manufacturing sector in central Canada. In the east, unemployment continues to hover well above the Canadian average. And in the north, 1 in every 5 households skips meals because there isn't enough food in the house, or eats suboptimal food because they can't afford better.

> *"We are happy to say that in 2016, we increased our commitment to food bank recipients by over 25%"*

EACH MONTH, OVER

**850,000**

PEOPLE TURN TO CANADIAN FOOD BANKS FOR HELP

### COMMUNITY IS KEY

Since Leon Frazer opened its doors 77 years ago, being a part of our community has always been important to us. That's why when we were approached in 2015 by one of our long-term clients to help sponsor the annual City Carol Sing, in collaboration with CityTV and the W. Garfield Weston Foundation, we were happy to be involved. In its 8th year, the City Carol Sing features some of Toronto's top singers in a Christmas concert to raise funds for the Churches on the Hill, a local food bank. We were pleased to again continue our sponsorship in 2016.

### OUR COMMITMENT

Recognizing that food bank use in Canada continues to rise and wanting to do more, we decided to increase our commitment to this worthwhile cause. As our client, you may have noticed you didn't get a Christmas card in the mail from us this year. That's because we decided to donate the money we would normally direct to this activity and put it where it could be used more effectively. We are happy to say that in 2016, we increased our commitment to food banks by over 25%, not only in Toronto, but also in the communities where our clients live, such as the Greater Vancouver Food Bank, Brown Bagging for Calgary's Kids, Kawartha Lakes Food Source and the Kincardine Food Bank.

Going forward, we will continue to strengthen our commitment to this crucial cause. We hope you will consider donating as well. ●

# Leon Frazer Timeline: A History of Food Facts

**1939** Food stamps first issued in US
**1940** Civilian rationing implemented in Britain
**1942** US starts food rationing, beginning with sugar and coffee
**1943** Meals on Wheels originates in UK
**1945** Wartime food rationing ends
**1952** Topps Chewing Gum Company issues first large set of baseball cards in gum packages
**1953** Swanson and Sons introduces the TV dinner
**1955** Ray Kroc acquires the McDonald's chain of fast food restaurants
**1958** Rice-A-Roni becomes the San Francisco treat
**1961** The Pillsbury Dough Boy is introduced
**1963** Meals on Wheels starts in Canada
**1964** Tim Hortons coffee and donut franchise opens
**1965** Gatorade sport drink developed at University of Florida
**1967** World's first food bank is established
**1972** Dr. Atkins publishes his Diet Revolution, a restricted carbohydrate diet
**1974** The first UPC code is scanned in a supermarket
**1977** Generic food brands offered in grocery stores
**1982** Paul Newmann introduces a food company with 100% of profits directed to charities
**1984** McDonald's serves its 50th billion hamburger
**1985** Coca Cola changes the secret formula of Coke to negative reviews
**1990** More informative food labeling system introduced on packaging
**1994** Genetically engineered tomatoes available in grocery stores
**1999** First certified organic restaurant opens in US
**2001** Kraft Foods goes public on NY Stock Exchange
**2006** New York becomes the first city to ban trans fats at restaurants
**2007** UN food agency reports 18,000 children die every day because of hunger
**2012** Save the Children says 5 children around the world die every minute because of chronic malnutrition
**2016** FDA announces improved nutrition facts label for packaged foods

*Source: foodtimeline.org; timelines.ws*

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