First Quarter 2016

"Another Year, Another Round of Stimulus"

Central Banks Add to Monetary Stimulus Efforts as Economic Growth Stalls and Markets Tumble While Canada Looks to Fiscal Stimulus

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Stimulus to the Rescue Again but Canada Changes it up with the Fiscal Variety

- The S&P/TSX Composite Total Return Index gained 4.5% during the 1st quarter of 2016.
- The consumer staples, materials, telecom, utilities and energy sectors led the S&P/TSX Composite Index in the quarter while the consumer discretionary, financials, health care, industrials and information technology sectors trailed.
- Reversing some of the 8.4% underperformance in the fourth quarter, the S&P/TSX Composite outperformed the S&P 500 by 3.2% in the first quarter. Canadian equity markets benefitted from a major bounce in most commodity prices, particularly oil and gold, and investors flocking to commodity-linked currencies like the Canadian dollar. Canadian markets, specifically construction, utilities and consumer stocks, also benefitted from the federal Liberal government's commitment to infrastructure spending and its willingness to run deficits for the next four years.
- The WTI oil price was US$38 (WTI) at end of trading on March 31, up ~4% from the end of the fourth quarter and up ~46% from the 12-year low of ~$26 hit in mid-February. While Saudi Arabia and other OPEC members have discussed the possibility of an oil output freeze in concert with Russia, Iran has intentions to produce at least another one million barrels per day in the near future. Iran's oil production rose by almost 187,800 barrels in March alone, the largest gain in a single month since 1997. Oil prices are likely remain under pressure as Iran ramps up production, North American production remains resilient and demand growth remains sluggish.
- The Canadian dollar rose by ~7% during the quarter, from $0.72 to $0.77, versus the U.S dollar, making it the leading G7 currency in Q1. The major reason for gain in the Canadian dollar, as well as gains in the euro, yen, gold and most commodities, came from falling U.S. interest rate expectations throughout the quarter, with the U.S. Federal Reserve now guiding for one or two 0.25% interest rate hikes in 2016 versus expectations of two to four rate hikes at the start of the year. The key rationale for tempering interest rate expectations was most likely the additional interest rate cuts and other stimulative actions undertaken by central banks in Europe, Japan and China to fight the economic weakness, equity market weakness and deflationary pressures experienced in early 2016. Energy sector layoffs and bankruptcies, which picked up steam in January 2016 when oil prices fell to as low as US$26 (WTI), also have a materially negative effect on the near-term U.S. economic outlook, and makes the U.S. Fed cautious on rates.
- Further reason for the stellar Canadian dollar performance was due to a notable shift in Canadian interest rate expectations. Interest rate expectations rose materially as a result of improving economic and export growth in the non-energy producing provinces and an improved outlook for the Canadian economy as a result of higher commodity prices and the federal Liberal government's 2016 budget that includes plenty of infrastructure and social spending. The budget includes a 2016 deficit of $29.4 billion and expectations of nearly $100 billion in deficits over four years, allowing the Bank of Canada to stand pat on interest rates for the time being. The odds of an interest rate cut at the start of the first quarter was approximately 60% while the odds of an interest rate cut at the end of the quarter is immaterial and investors are now pondering when the Bank of Canada will raise interest rates.

PIMG Model Benchmarking Disclosures

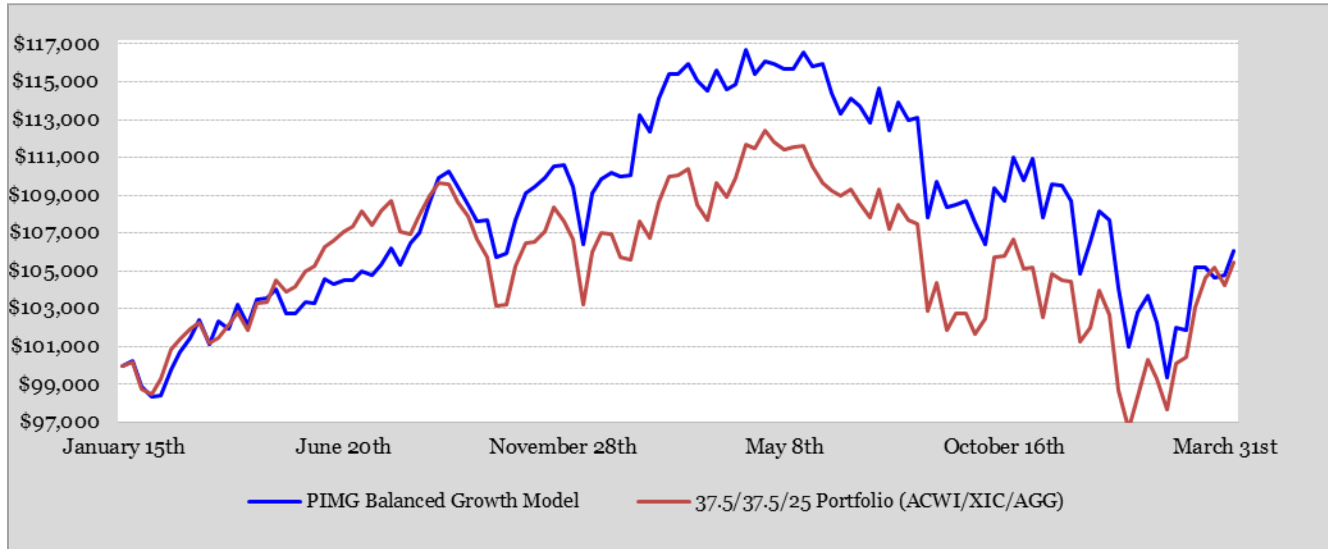
- The numbers presented on the following two pages reflect those of our two models, Balanced Growth and Balanced Income. As a client of Steele Wealth Management, you may or may not have your account linked to one or both of these models. In our discussions prior to signing your PIMG documentation, we outlined which model(s), if any, your accounts would be linked to. If you are unsure whether your account is linked to one or more of these models, please let us know and we can clarify this for you.
- Model returns presented are those of two individual accounts whose returns fully reflect that of the model's holdings and transactions and are not impacted by deposits or withdrawals that could impact return calculations. The accounts we use to reflect model performance incur a 1% annual investment management fee, charged monthly, which is also subject to 13% HST, charged monthly, for a total cost of 1.13% annually. Your individual account performance may deviate from the model account based on any differences in fees charged relative to the model account, differences in account holdings relative to the model account as well as any deposits or withdrawals made throughout the reporting periods outlined.
- On January 15, 2014, we materially changed the composition of our two model portfolios. We renamed our Tactical Taxable and Tactical Registered models to Balanced Growth and Balanced Income and made major changes to model allocations and exposures. The Tactical Taxable and Tactical Registered models were invested in 80%-85% common equity and 15%-20% preferred equity and our exposure was virtually 100% in Canadian dollars and Canadian companies. The Balanced Growth model has an asset allocation of ~75% common equity and ~25% fixed income, of which half is invested in preferred equity, and roughly 40% exposure to non-Canadian securities. The Balanced Income model has an asset allocation of ~50% common equity and ~50% fixed income, of which a third is invested in preferred equity, and roughly 30% exposure to non-Canadian securities. With these changes, our two models now reflect a more universally appropriate choice, in terms of asset allocation and risk, for the vast majority of our clients and investors in general. As a result, we expect these new models will remain in force for the foreseeable future.
- As a result of the model changes outlined above, we also changed our benchmarks to reflect the new asset allocations and exposures. Benchmark information is detailed in the disclosures at the bottom of the following two pages.

Benchmark of iShares XIC/ACWI/AGG (37.5%/37.5%/25%)

vs

The PIMG Balanced Growth (BG) Model

January 15, 2014 (Inception of BG Model) to March 31, 2016



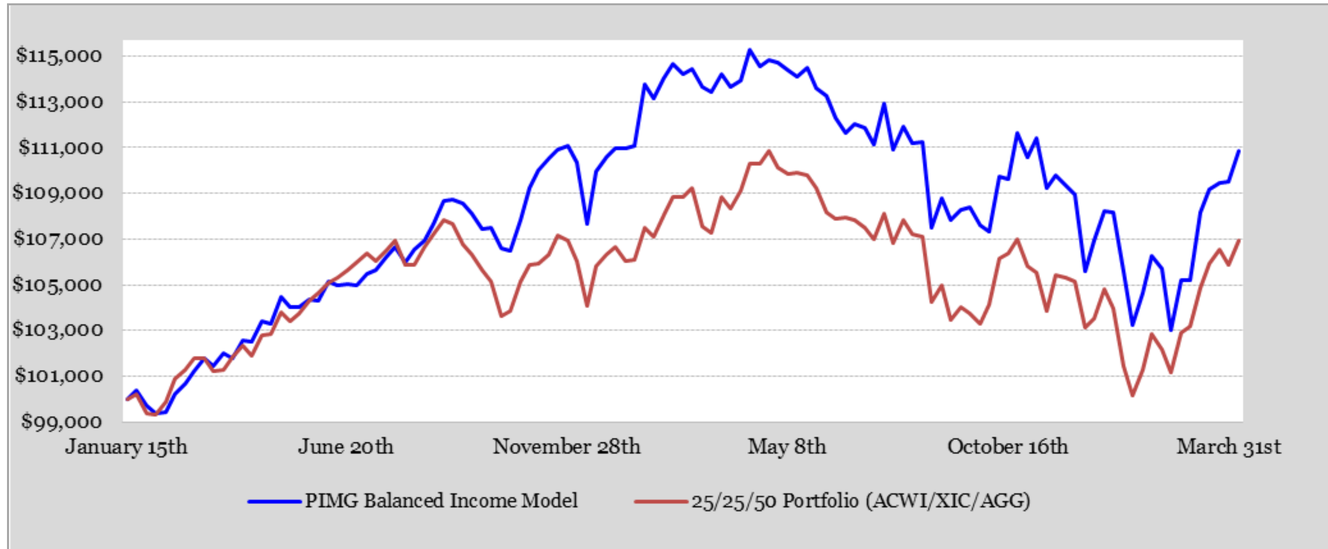
01/15/2014 – 03/31/2016	PIMG Balanced Growth Model	37.5% XIC / 37.5% ACWI / 25% AGG	iShares XIC	iShares ACWI	iShares AGG
Cumulative Return Since Inception	6.03%	5.42%	4.49%	2.32%	9.05%
Compound Annual Return	2.69%	2.42%	2.01%	1.04%	3.99%
Standard Deviation	9.69%	9.58%	13.69%	13.92%	3.21%
Sharpe Ratio	-0.03	-0.06	-0.07	-0.14	0.31
Largest Monthly Gain	4.16%	5.04%	5.45%	7.66%	2.22%
Largest Monthly Loss	-3.99%	-4.25%	-4.31%	-6.81%	-1.07%
Number of Up Months	15	14	13	13	15
Number of Down Months	12	13	14	14	12
Correlation with Balanced Growth	--	0.90	0.89	0.83	-0.36

PIMG Balanced Growth Model	3 month	6 month	9 month	12 month	3 year	5 year	10 year	Inception
	-1.56%	-0.58%	-6.14%	-7.81%	n/a	n/a	n/a	2.69%

We have assumed a 1% investment management fee plus 13% HST when calculating the returns for our PIMG models. To the best of our knowledge, the ETFs used as benchmarks track the indices they represent though material tracking error and misrepresentation can occur which is beyond our control. The 37.5% XIC / 37.5% ACWI / 25% AGG index is an index consisting of 37.5% iShares XIC (S&P/TSX Compositie Index ETF), 37.5% of iShares ACWI (All-Country World Index ETF) and 25% iShares AGG (Barclays Aggregate Bond Fund). Volatility and correlation data are calculated from weekly returns. For the purpose of calculating Sharpe ratios, a risk-free rate of 3% is assumed. All returns presented for the PIMG Models and the ETFs used for comparison are in Canadian dollars. Data used to calculate returns are derived from Market-Q (for ETFs) and Dataphile (for the Models). All returns presented are “total returns”, meaning they include all dividend payments & interest payments. All return numbers beyond 12 months are annualized numbers.

Benchmark of iShares XIC/ACWI/AGG (25%/25%/50%)
vs
The PIMG Balanced Income (BI) Model

January 15, 2014 (Inception of BI Model) to March 31, 2016



01/15/2014 – 03/31/2016	PIMG Balanced Income Model	25% XIC / 25% ACWI / 50% AGG	iShares XIC	iShares ACWI	iShares AGG
Cumulative Return Since Inception	10.84%	6.93%	4.49%	2.32%	9.05%
Compound Annual Return	4.77%	3.08%	2.01%	1.04%	3.99%
Standard Deviation	7.39%	6.20%	13.69%	13.92%	3.21%
Sharpe Ratio	0.24	0.01	-0.07	-0.14	0.31
Largest Monthly Gain	4.87%	3.65%	5.45%	7.66%	2.22%
Largest Monthly Loss	-3.06%	-2.95%	-4.31%	-6.81%	-1.07%
Number of Up Months	15	15	13	13	15
Number of Down Months	12	12	14	14	12
Correlation with Balanced Income	--	0.88	0.89	0.83	-0.36

PIMG Balanced Income Model	3 month	6 month	9 month	12 month	3 year	5 year	10 year	Inception
	2.48%	3.26%	0.41%	2.66%	n/a	n/a	n/a	4.77%

To the best of our knowledge, the ETFs used as benchmarks track the indices they represent though material tracking error and misrepresentation can occur which is beyond our control. The 25% XIC / 25% ACWI / 50% AGG index is an index consisting of 25% iShares XIC (S&P/TSX Compositie Index ETF), 25% of iShares ACWI (All-Country World Index ETF) and 50% iShares AGG (Barclays Aggregate Bond Fund). Volatility and correlation data are calculated from weekly returns. For the purpose of calculating Sharpe ratios, a risk-free rate of 3% is assumed. All returns presented for the PIMG Models and the ETFs used for comparison are in Canadian dollars. Data used to calculate returns are derived from Market-Q (for ETFs) and Dataphile (for the Models). All returns presented are "total returns", meaning they include all dividend payments & interest payments. All return numbers beyond 12 months are annualized numbers.

PIMG Balanced Growth Model

Lost 1.5% during the quarter (from January 1 to March 31)

The model's asset allocation as of March 31 was 1.8% cash, 17.0% bonds, 10.2% preferred equity, 3.2% alternatives and 67.8% common equity.

Top five outperformers in Q1 were:

- Russel Metals (Industrials/Metals Distribution) at +25.45%
- Progressive Waste Solutions (Industrials/Waste Management) at +24.39%
- Cara Operations (Consumer Discretionary/Restaurants) at +21.72%
- Dundee Corp Preferred C (Preferred Shares/Retractable) at +17.84%
- Bank of Nova Scotia (Banking/Diversified) at +14.65%

Top five underperformers in Q1 were:

- Performance Sports Group (Consumer Discretionary/Branded Sports Goods) at -68.89%
- Black Diamond Group (Industrials/Remote Workforce Accommodation) at -39.53%
- Sandvine Corp (Technology/Network Hardware) at -20.97%
- AMC Networks (Consumer Discretionary/Media) at -18.38%
- AIMIA Preferred C (Preferred Shares/Fixed Reset) at -15.30%

During Q1, we bought:

- Telus Corp (T): We purchased a full position in Telus. Telus had fallen 17% from its late 2015 high as a result of Shaw's acquisition in Wind Mobile. Though we believe this does add some competitive pressure on Telus, it is unlikely that this pressure will be exerted to any material degree in this upcoming decade. Shaw has to invest billions upon billions before it will be able to compete with Telus and other carriers in a way that is far more intimidating than what Wind has been doing to date. We believe Telus was a bargain at 16x trailing earnings considering its above average long-term growth rate, its high dividend of 4.7% and the recent trend of much better than expected mobile margins and revenues in Canada. Telus currently trades at an 11% discount to Rogers and BCE, the first time it has traded at a material discount for as long as we can remember. Telus should at least trade in line with its competitors due to its higher growth rate and more stable earnings track record.

- Nintendo Co (NTDOY): We purchased a half position in Nintendo. Nintendo had US$8.5 billion in net cash and an enterprise value of only US$10 billion. Compare this to the valuation of companies like King Digital, which was recently bought by Activision for US$5.9 billion and only has one successful mobile game (Candy Crush Saga), and Electronic Arts at US$19.8 billion. We believe Nintendo's foray into the mobile game industry could result in a significant boost to Nintendo's revenues and earnings and allow for its valuation to be partially reset to that of mobile game developer valuations rather than that of traditional electronics manufacturers. We believe Nintendo is attractive as it could see high double digit or even triple digit returns over the next couple of years whiles its ultimate downside is limited to 40%-50% as some value must be retained for its cash on hand and superior intellectual property.

- JP Morgan Chase (JPM): We purchased a full position in JP Morgan as we believe its outlook is solid despite market, and in turn capital market and trading, weakness. JPM should benefit from rising U.S. interest rates as this adds to JPM's loan net interest margins and the strong

U.S. employment data and 2%+ U.S. GDP growth outlook should ensure that mortgage originations remain strong despite rising interest rates. Within the banking sector, JPM provides a good balance housing market exposure and capital markets exposure and comes at an attractive valuation relative to the housing focused Wells Fargo.

- Apple Inc (AAPL): We purchased a full position in Apple. Apple traded at a major discount to its peers at 10.5x trailing earnings. Even when considering the potential for declining margins in its phone business over the long-term, we believe Apple will find new markets (e.g. TV, auto, wearables) that will offset this potential margin decline. Apple traded roughly in line with dinosaurs like HP and IBM which have no clear outlook and we think Apple should trade at a meaningful premium to these companies and at a valuation much closer to that of segment leading tech companies like Intel and Cisco which face similar margin pressures. Intel and Cisco traded at roughly 13.5x trailing earnings so this implies at least ~30% upside for Apple shares in our opinion.

- BMO Tactical Global Equity ETF Fund (GGF70217): We purchased an oversized position in BMO Tactical Global Equity ETF Fund. This fund is run by SIACharts, a momentum tracking website that recommends timely allocations to the hottest common equity sectors and segments. We believe this fund has the best chance of reaping above average gains from a momentum strategy both because of its specificity of investment choices, its timeliness and its low cost. The fund is one of the cheaper momentum strategies with an MER of only 0.7%. This fund also makes bold calls on equities in general and will go to all cash if it detects that equity momentum has faded sufficiently, potentially helping it evade major market downturns.

- Cara Operations (CAO): We purchased an oversized position in Cara. Cara traded at 10x 2-yr forward EV/EBITDA (based on RJ estimates) which is roughly in line with our benchmark of CAO's peers. We believe Cara should trade at a material premium to its peers as it has four opportunities that its peers do not. Firstly, Cara has plenty of opportunity to franchise its current suite of restaurants across the country, it has shown that it is a willing acquirer and it faces little competition for small to medium sized franchises in this regard. Secondly, due to Cara's unmatched list of restaurant brands which span the restaurant industry, Cara has an unmatched opportunity to drive sales and attain customer loyalty across brands through a single loyalty program. Thirdly, Cara has the opportunity to offer different versions of its restaurants (e.g. restaurant groupings or changes in restaurant service time). Lastly, due to the sheer number of brands under its control, Cara has the longest list of recipes in the country amongst restaurant operators and therefore has the most opportunity in the retail licensing segment.

<u>During Q1, we sold:</u>

- Sysco Corp (SYY): We sold our position in Sysco as it remained near its all-time high while the broad stock market was down over 10%. At the time, Sysco traded at 22x trailing normalized earnings. While we saw the potential for significant earnings growth as a result of Sysco's plans to lever up its balance sheet to buy back stock and make small tuck-in acquisitions, we expect organic growth in the food distribution sector to remain in the low single digits indefinitely and for Sysco to have little capacity to make material acqusitions following its failed acquisition of U.S. Foods. We also wished to reduce our U.S. dollar exposure as we saw the Canadian dollar as a little undervalued at the time.

- Open Text Corp (OTC): We sold half of our position in Open Text as its prior quarterly results were mediocre and didn't show full recovery from the low revenue and earnings levels hit in early- to mid-2015, yet the shares are close to fully recovering from the highs seen in 2015. If Open Text reports earnings that are still in line with the lower revenue and earnings level, we believe they could experience profound weakness. That said, as our worries are founded on incomplete information and Open Text could very well see full revenue/earnings recovery, we chose to sell half of our position.

- FedEx (FDX): We sold our position in FedEx to reduce our overweight industrials exposure. FedEx has posted mediocre earnings since we purchased it and there was little reason to think its poor performance will change, especially with the looming threat of Amazon entering the short-haul shipping business.

- AGF U.S. AlphaSector (AGF5030): We sold our position in AGF AlphaSector. We chose to our position in AGF5030 as the performance of the underlying securities and strategy has been poor yet the fund has retained much of its value due to U.S. dollar currency exposure

- Dundee Corp Preferred C (DC.PR.C): We sold our position in Dundee Preferred C as it had held up well despite the equity market and preferred market selloffs. Dundee Corp common shares traded below $4 for the first time since 2009 and the risk of the preferred share restructuring deal not going through as agreed rises as the common share declines. Selling our remaining position at just 6% below par looked attractive given market weakness and the risks facing the preferred share itself.

- Saputo Inc. (SAP): We sold our position in Saputo as it was near the top of its typical trading and valuation range and we saw further material upside as unlikely. Saputo traded at over 25x trailing normalized earnings at the time, compared to its average post-2008 valuation of ~23x and a previous high of 26x. While cheese prices are likely to rebound from their 2015 levels, we only expect ~10% earnings per share upside as a result which is not enough to justify its valuation.

PIMG Balanced Income Model

Gained 2.5% during the quarter (from January 1 to March 31)

The model's asset allocation as of March 31 was 2.2% cash, 24.5% bonds, 6.9% convertible debentures, 14.9% preferred equity, 3.3% alternatives and 48.2% common equity.

Top five outperformers in Q1 were:
- Progressive Waste Solutions (Industrials/Waste Management) at +24.39%
- Cara Operations (Consumer Discretionary/Restaurants) at +21.72%
- Dundee Corp Preferred C (Preferred Shares/Retractable) at +17.84%
- Telus Corp (Telecom/Diversified) at +14.57%
- Crescent Point Energy (Energy/Light Oil) at +13.40%

Top five underperformers in Q1 were:

- Black Diamond Group (Industrials/Remote Workforce Accommodation) at -39.53%
- AIMIA Preferred C (Preferred Shares/Fixed Reset) at -15.30%
- BMO Tactical Global Equity ETF Fund (Alternative Equity/Momentum) at -8.55%
- WSP Global (Industrials/Engineering) at -8.55%
- Enbridge Preferred E (Preferred Shares/Fixed Reset) at -5.65%

<u>During Q1, we bought:</u>

- Telus Corp (T): Same reasoning as the Balanced Growth Model.

- Sun Life Financial (SLF): We purchased a full position in Sun Life. Sun Life had fallen ~13% from its late 2015 high as a result of general market turmoil. We saw Sun Life as very attractive trading at 11x trailing earnings as this is well below the market's multiple and Sun Life's earnings and more stable than the broad market. Sun Life typically trades 20% above this level.

- BMO Tactical Global Equity ETF Fund (GGF70217): Same reasoning as the Balanced Growth Model.

- Cara Operations (CAO): Same reasoning as the Balanced Growth Model.

- Great-West Lifeco Preferred H (GWO.PR.H): We purchased a full position in Great-West Preferred H with the proceeds of sale from STB.DB.C. GWO.PR.H provides a high level of income, 5.65% at the time of purchase, and potential upside of 10-15% should credit conditions normalize in the preferred share market.

<u>During Q1, we sold:</u>

- Great-West Lifeco (GWO): We sold our position in Great-West as it appeared expensive relative to its Canadian life insurance peers, Sun Life and Manulife. For the first time since the 2008 financial crisis, Great-West was trading at a premium to both of its peers and its dividend was about equal to that of its peers. As we believe Sun Life and Manulife provide more upside potential. As they are both more levered to equity markets and interest rates, given that the equity was well off its highs and interest rate expectations were at rock bottom, we opted to switch out of Great-West in favour of Sun Life.

- BMO Covered Call Banks (ZWB): We sold half of our position in BMO ZWB as it had held up well during the market turmoil and we were concerned about potential financial contagion from the European banks which were in freefall early in the year primarily due to regulatory changes. As the U.S. banks had begun showing signs of contagion, we figured it was only a matter of time before Canadian banks fell ill as well.

- AGF U.S. AlphaSector Fund (AGF5030): Same reasoning as the Balanced Growth Model.

- Dundee Preferred C (DC.PR.C): Same reasoning as the Balanced Growth Model.

- Saputo Inc. (SAP): Same reasoning as the Balanced Growth Model.

- Student Transportation Debenture C (STB.DB.C): We sold our position in Student Transportation Debenture C as it had recovered from the market selloff far quicker than its high yield peers and it no longer offered an attractive yield relative to the available options in the market.

Going Forward:

The Balanced Growth model performed poorly relative to its benchmark as falling interest rate expectations resulted in outsized price gains for commodity producing companies, long-term government bonds and interest rate sensitive equities, of which the Balanced Growth has very little as well as opposite exposures. While we think the winding down of the commodity supercycle will resume and the models will perform much better on a relative basis in the coming months, it is certainly difficult to watch such powerful moves in the shares of these companies and not be participating. We remain highly underweight the materials and energy sectors and believe this is likely the right call for the next two years. Our preferred share holdings registered low single digit losses on average as preferred share spreads widened substantially and interest rate expectations were flat. We believe there is plenty of opportunity for upside in our preferred share holdings, not only from a normalization in interest rates, but also due to historically wide credit spreads that should heal naturally as capital flows back into the asset class.

The Balanced Income model did well relative to its benchmark due to its exposure to high yielding, value-oriented and interest rate sensitive securities.

In our last commentary, we wrote that we believe the Bank of Canada is done cutting interest rates. This view has since been reinforced by the 2016 federal budget and higher commodity prices. Improving economic data in Canada and elsewhere leads us to believe that upside surprises are much more likely than downside surprises with respect to Canadian interest rates and that Canadian interest rates will likely begin to rise sometime in 2017, contingent on higher oil prices, but that interest rates will remain below 2% for several years due to subdued inflation. We believe that we are currently in a sweet spot wherein most credit-sensitive securities should benefit from interest rate normalization. As a result, we are comfortable with both our fixed reset preferred share holdings that are positively correlated with interest rates and our perpetual preferred shares and high-yielding common shares that are negatively correlated with interest rates.

In our Balanced Growth model, the changes to our U.S. dollar denominated positions brought our U.S. dollar exposure down 1% to 12%,. These changes occurred early in the quarter when the CAD/USD exchange rate was about $0.71. Because we believe the oil price rally, and in turn the Canadian dollar rally, is overextended, trading at $0.77 at quarter end, we would be comfortable adding new U.S. dollar positions at this point. We can once again consider U.S. securities without having to worry about currency effects.

We are constructive on the equity markets but believe they could be range-bound for some time. We see the utilities and consumer staples sectors as particularly expensive and the technology and consumer discretionary sectors as particularly inexpensive. We made a few switches during the quarter which reflects this view and we will continue to look for opportunities along these lines.

As at the end of Q1, the models yield 3.3% (Balanced Growth) and 4.0% (Balanced Income) from 3.4% and 4.5% at the end of Q4. The decrease is due to the rotation from defensives to cyclicals.

Sincerely,

Steele Wealth Management

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