MARQUEST
ASSET MANAGEMENT INC.

Second Quarter 2016 Review

Market Commentary

The Canadian market continued its outperformance in the quarter. Momentum continues to pull the market higher. The strength has come from resource cyclicals as we have seen the stabilization of energy, and rebound in basic materials. With all the noise around the world, gold has once again become a safe haven. Certainly with over 20 trillion dollars trading at negative yields, gold becomes even more compelling.

Resource cycles typically contain three phases: U.S. dollar depreciation, economic progression and late-cycle inflation. We believe we are now seeing a transition from U.S. dollar weakness to economic reacceleration. Resource stock outperformance—despite U.S. dollar strength—confirms this transition. In fact, south of the border, we now see wage pressures starting to rise, which will set the stage for late-cycle inflation. Any stability in oil prices will only confirm this upward bias.

The third phase should occur later this year or early in 2017. Over the past 11 years, U.S. real rates have turned negative three times and each time they did, resource sectors had a sizable leg of outperformance. Assuming a $50 oil price, we believer CPI should surpass 2%. Investors should remember that relative resource rallies outperform the TSX by 43%. This rally is five months old and, to date, we are only half way to the 43% outperformance. Thus, the odds favour a continuation of the current rally until the end of this year and into early 2017. While gold equities have outperformed more than oil, we are reluctant to eliminate the group given the uncertainties of Brexit, presidential elections and China. As such, gold remains an insurance policy.

It is striking how closely oil prices, crude inventories, oil rig counts and energy stocks are tracing the 1998-1999 experience. It seems like we are taking the same 18-month duration it took for rig counts to bottom out in April 1999. The 2014-2015 oil bear market was never about demand, but rather, supply. The key going forward is the lagged impact of weak oil prices on supply.

Admittedly, Iran coming back delays the pinch point between a balance of supply verses demand. Nevertheless, the longer oil stays below $50, the more likely further supply constraints will persist. Thus, starting in the second half of 2016, global oil markets should begin the process of rebalancing, a process that should last at least a year. As such, energy stocks remain a core holding in our equity portfolios.

Regarding base metals, we have seen a sizable bounce from acutely oversold positions. While we are unlikely to see the same demand we saw during the 2001 to 2010 period, we recognize that global copper production growth will continue to subside given that nearly $85 billion in capital expenditure has been removed.

The rest of the market will likely underperform commodities over the next year. Financials will benefit from better oil prices, as the risk of large defaults abates. Nevertheless, low interest rates and the flattening of the yield curve does not help net interest margins for the financial industry. Strong capital market operations will offset some of the negatives, and meanwhile, hefty dividend yields relative to bond yields should limit valuation erosion.

Market outlook

Welcome to the summer of 2016. The violently flat paradigm that the U.S. and, to a lesser degree, global markets have been stuck in for the past two years, continues following the U.K.'s vote to exit the European Union ("Brexit"). Brexit perplexity, an enigmatic U.S. Federal Reserve Board and U.S. presidential theatrics are scaring investors away from the facts once again. Yet, with all this uncertainty, we are very close to new highs. To be sure, these are confusing times, with many negatives including Brexit, negative interest rates, Trump uncertainties, protectionism, immigration, U.K. recession risk, ISIS, employment rates, Middle East instability, central banks out of ammunition, high frequency trading, ETF's and China risks, etc.

While we do not disagree that this summer noise will unnerve markets, we do believe that a contrarian approach may be warranted. It seems a good time to invest when there are many negatives and investors are bearish. We believed prior to Brexit, that we would see some improvement in earnings in the second half of 2016 and that the U.S. economy would continue to improve. More importantly, with firming oil prices, many global risks have also improved, as defaults became less of a concern. Post-Brexit, many developments have occurred to explain why global markets have rebounded.

The response has been as follows.

1.. The Bank of England offered $345 billion in liquidity
2. Japan took foreign exchange steps
3. Italy offered a $44 billion injection to its banks
4. The European Central Bank may loosen the rules for bond purchases
5. Bank of England indicated that it will likely have to ease policy in the summer
6. A tsunami of mergers and acquisitions transactions
7. Brent crude oil has held close to $50
8. The U.S. dollar move has been moderate

The results of Brexit, while still not totally known, will likely bring further monetary easing in Europe. Coming into Brexit, the market was assigning a rate increase for July and September. That now appears to be off the table.

The bottom line is, Brexit is ultimately a political crisis and one that is not likely to be resolved in a hurry. There will be many twists and turns in the path to ultimate resolution. There may yet be circumstances that give rise to bigger systemically risky events. For now, we don't think we are quite there and we can now focus on stocks again.

Portfolio Commentary

For the second quarter of 2016, the fund was basically flat. While it underperformed the TSX, its mandate remains focused on income-producing assets. As such, during periods (as what we have experienced recently) when commodities are rebounding, it is not unusual for the fund to underperform. Why is this? Well, let's look at what has outperformed in the quarter and year-to-date: materials +26.4% and energy +8.5% for quarter, and materials +50.8% and energy +17.2% year-to-date. The question one must ask is, how many dividend payers are in these two groups? The answer is very few. Outside of utilities and telecommunication services, the TSX has underperformed. Financials returned -2.9%,

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consumer staples added +2.1%, consumer discretionary returned -1.1%, information technology was down -6.1% and health care returned -12.4%.

In a dividend/income fund, it is quite impossible to keep up with returns without sacrificing income and stability. Market volatility has been vicious, which is something this fund has always tried to avoid. So where do we go from here? While we believe it is likely that the bulk of the rebound in commodities has occurred, we do not believe a major correction is in the cards. A sideways pattern would be ideal, and we do believe there may be a broadening of the market. Thus, there may be a 'catch up' by some of the underperforming sectors. Longer term, we may see further upside in commodities as the world normalizes.

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