CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

July 17, 2018

Global Trade Relationships in Focus

Until now, we have not felt any need to discuss global trade relationships in our Newsletters. The general trend in recent decades has been towards trade liberalization. This trend has arguably been of net benefit to investors who own shares of multinational corporations, even as it has reduced the compensation and job security of some workers in developed countries. Goods can be manufactured cheaply in low wage countries and exported to developed countries with little friction. For example, a finished consumer good like a car may be sold to an American but may be assembled in Canada or Mexico and may contain parts made in several other countries. Low cost goods often benefit consumers, as measures of inflation and interest rates in developed countries remain low. Trade liberalization has also contributed to the emergence of a vast middle class in China, India and other developing countries. Countless people have been lifted out of poverty in the past few decades.

Global trade relationships are now at risk. The current U.S. administration has taken an aggressive "America first" stance in its dealings with other nations. Any significant restructuring of global trade relationships could impact global growth and our investment returns. We are therefore going to devote much of this second quarter of 2018 (Q2) edition of our Newsletter to the topic of global trade. In particular, we will focus on the crucial trade relationships between the U.S. and China and the U.S. and Canada. Finally, we will also discuss certain changes that we have made in our discretionary portfolios during Q2.

The U.S. – China Trade Relationship

The U.S. trade deficit with China is near record levels. On an annual basis, U.S. imports from China are expected to exceed U.S. exports to China by around US$340 billion.[1] This is of great concern to the current U.S. administration, so it has chosen to instigate a trade dispute. In early July, the U.S. and China imposed 25 percent tariffs on US$34 billion of certain categories of the other's imports.[2] (A tariff is simply a tax or duty to be paid on a certain class of imports or exports.) The dispute may escalate from here. In the most extreme scenario, the U.S. administration has suggested that it may be willing to impose tariffs on US$500 billion of Chinese goods, covering virtually all of the goods that China exports to the U.S.[3]

We do not know exactly what the U.S. wants China to do, but we have a general idea. Clearly the U.S. wants a reduction in the trade deficit. The U.S. likely wants more market access for U.S. exports and fewer restrictions on U.S. investors who wish to acquire Chinese assets. The other concern goes beyond economics and is really a matter of national security. If the Chinese economy continually grows faster than the U.S. economy in the coming decades, China will eventually have a larger military budget and may achieve military superiority. (China is currently second to the U.S. globally in military spending.[4]) With that in mind, the U.S. administration may be willing to suffer some economic pain now to slow the rise of China as a superpower. CIBC Economics recently offered some more detailed views on the U.S. bargaining position:

> There are legitimate grounds for questioning aspects of Chinese policy. The issue is not only a lack of reciprocity and market access, but also the absence of a level playing field in China for American investors and allegations of intellectual property rights violations. Some examples: China imposes a 25% tariff on new car imports from the U.S. while facing only a 2.5% tariff. A U.S. company offering cloud services to Chinese users must store the data in China and use a Chinese partner to operate the servers. And China's main sectors such as cars, telecoms, IT and healthcare are basically off limits to any U.S. company.[5]

We may not know exactly what the U.S. wants China to do, but it seems unlikely that the U.S. will back down from its position without extracting any concessions from China. One vulnerability of the U.S. administration is the possibility of democratic political change. China has already imposed tariffs on some U.S. goods produced in the States won by President Trump in the last election. The U.S. midterm elections on November 6, 2018 could alter U.S. trade policy if economic pain influences voting decisions.

China is even harder for us to analyze than the U.S. Will China end this dispute by offering the U.S. any concessions on trade? We cannot know. So far, China has decided to fight tariffs with tariffs. CIBC Economics believes that China is more vulnerable than the U.S. in a tariff war, in part because the U.S. accounts for 19% of China's exports and China accounts for only 8% of U.S. exports.[6] This means China could suffer more short-term economic pain from the dispute. But pain and the ability to suffer pain are different.

From a political perspective, China's leadership is now entrenched and less subject to internal pressure to change course than the U.S. administration. Due to recent developments in the Chinese political system, President Xi Jinping has gained incredible power. China has eliminated the two-term limit on presidents, allowing him to rule indefinitely. The Chinese Communist Party has also added President Xi's name and key objectives to the Party's constitution. According to some commentators, this elevates his status considerably, as the Party's constitution is seen as "the leading guidebook for Chinese development."[7] For example, Mao Zedong and Deng Xiaoping are the only other Chinese leaders who have had their names added to the Party's constitution. Xi's predecessors Jiang Zemin and Hu Jintao were not given that status.

Based on our minimal understanding of China's politics, it seems like China has the capacity to bear economic pain for long enough to see whether the U.S. midterm elections affect U.S. trade policy. This means there may be no immediate resolution to the trade dispute between the U.S. and China.

The Canada – U.S. Trade Relationship

As Canadians, we are biased, but we believe that the trade relationship between Canada and the U.S. is generally fair and benefits both countries. Canada has a goods trade surplus with the U.S. and the U.S. has a services trade surplus with Canada.[8] On a net basis, it is unclear whether the U.S. has any significant trade deficit with Canada. If there is a trade deficit, it certainly does not appear to be large enough to warrant a dispute that could damage the countries' long-term relationship.

We must remember that the U.S. buys a lot of oil from Canada, much of it at a discount. In that area of trade, the U.S. is arguably taking advantage of Canada's lack of access to alternative buyers. If you subtract oil from the equation, the U.S. runs a trade surplus with Canada. Canada is also the largest customer globally

for U.S. goods, buying US$282.5 billion of goods from the U.S. in 2017.[9] Canada is not a national security threat to the U.S. Overall, it is unfair to accuse Canada of exploiting its U.S. trade relationship.

It would be best for Canada and the U.S. if the current trade dispute ends immediately. Mexico elected a new President on July 1, and it is possible that new talks on a revised version of the North American Free Trade Agreement (NAFTA) could commence soon.

If the trade dispute continues, Canada likely has more to lose than the U.S., but the U.S. will also suffer significant pain. An estimated 7 percent of U.S. jobs are tied to trade with Canada.[10] There are many powerful voices in the U.S. that support free trade with Canada. If the dispute expands, for example, through the imposition of a 25 percent tariff on vehicles manufactured in Canada, the dispute could cause a Canadian recession.

Closing Thoughts on Trade

Our assessment is that the U.S. has many legitimate concerns about its trade relationship with China, and it is likely that the trade dispute between those countries will continue in the short-term. Negative headlines could easily weigh on financial markets. We do not think that the U.S. has many legitimate concerns about its trade relationship with Canada. We do not believe that the U.S. will act to radically restrict trade with Canada in the coming years.

The Chief Investment Strategist of CIBC Asset Management recently commented on the potential consequences of a global trade war:

> An all-out trade war that reverses globalization would set off an inflationary supply shock that would lower growth, bring higher inflation and negatively impact the pricing of most financial assets. Bond yields would rise, equity market multiples would decline and real estate prices would collapse. What probability do we assign to this kind of risk scenario? Our best guesstimate with what we currently know… is low, but not zero, over the next 1-2 years.[11]

We agree that the probability of an all-out trade war is low because of the potential harm to all parties. That said, we are committed to managing risk in client portfolios. We will stay informed about risks to trade, and we will be ready to make adjustments if necessary. To date, we have made no changes to client portfolios in response to these risks. Trade is still only one factor we are considering, along with company-specific developments and other macroeconomic factors. It has to be weighted appropriately in our decision-making. Finally, we will note that if the multi-decade trend of greater trade liberalization does change, it will bring new potential opportunities along with the risks, and it is our responsibility to find those opportunities.

Selected Portfolio Changes

In recent weeks, the financial markets have largely shrugged off the negative headlines about trade, and returns have picked up in some areas of our portfolios. We found some attractive opportunities to deploy cash during Q2, and we describe some of them below.

Balanced Portfolio

In the Balanced Portfolio, we added a 2.0% weighting in TransCanada Corp. (TSX:TRP)[12] in mid-May at a price of $56.09 per share. TransCanada is an energy infrastructure company involved in natural gas pipelines, oil pipelines and power generation. TransCanada shares are down year-to-date, despite the company's decent growth prospects and annual dividend of close to 5%. TransCanada is one of many high-quality dividend equities that have experienced some downward pressure on their valuations due to the trend of rising interest rates. We view current prices as a buying opportunity. In addition to our new position in the Balanced Portfolio, we also hold TransCanada shares in the Total Return and High Yield Portfolios.

High Yield Portfolio

We were active in the High Yield Portfolio in late May, making several purchases of high-quality companies. For example, we added more shares of PepsiCo, Inc. (NASDAQ:PEP) at US$100. PepsiCo now has a 4.8% weighting in the portfolio. The company has a long track record of success and above-average profitability. Its business is easily understandable, and its brands are meaningful to customers. 2018 is the 46th consecutive year that it has raised its dividend.[13]

We purchased a 2.0% weighting in Vermilion Energy Inc. (TSX:VET)[14] at a price of $45.01 per share. Vermilion is a Canadian energy producer with good growth prospects and a variety of oil and natural gas assets in North America, Europe and Australia. Vermilion's current dividend rate gives it a payout of $2.76 annually, or a yield of just over 6% at our purchase price.

We purchased a 2.0% weighting in Iron Mountain Inc. (NYSE:IRM) at a price of US$33.35 per share. Iron Mountain is a leading provider of records and information-management services. The company services customers who need to store documents offsite and recall them occasionally. It is also moving into related businesses such as data centers and art storage. At our purchase price, Iron Mountain's yield was around 7% annually.

Finally, we added a 3.4% weighting in BCE Inc. (TSX:BCE)[15] at a price of $54.17 per share. BCE is Canada's largest telecommunications company. It offers a dividend of over 5% at current prices as well as moderate growth prospects. Like PepsiCo, Vermilion and Iron Mountain, it fits the objectives of the High Yield Portfolio, which are to generate an average yield of around 4% plus provide the potential for 2-3% annual capital growth.

Total Return Portfolio

In the Total Return Portfolio, we were active in early June. We added more shares of global food and beverage producer Kraft Heinz Co. (NASDAQ:KHC) at US$57.94 per share, bringing its weighting to 2.6%. We view Kraft Heinz as a high-quality, well-managed company that has extensive expertise in making good acquisitions. The company offers a dividend of close to 4% annually.

We also added to the Canadian real estate investment trust H&R REIT (TSX:HR.un) at a price of $20.45 per unit, bringing its weighting in the High Yield Portfolio up to 3.3%. H&R pays an attractive cash distribution of

around 6.8% annually and trades at a reasonable valuation. H&R is also one of Canada's largest REITs, with a diversified asset base that includes high quality office, retail, industrial and residential properties across Canada and the United States.

Finally, we added more shares of Walt Disney Co. (NYSE:DIS) in the Total Return Portfolio, bringing its weighting to around 2.6%. We paid US$100.25 per share. Disney is a high-quality entertainment company with a long track record of success. We believe that it offers decent growth potential over the next 3-5 years. The company also pays a dividend of around 1.5% annually.

Conclusion

Threats of a global trade war are different than an actual global trade war. With a high probability that many of the trade disputes making headlines will be resolved through negotiation, we are watching closely for new developments. Our discretionary portfolios are already positioned somewhat cautiously, given our concerns that we may be late in the economic cycle. Discretionary management gives us the ability to rapidly take advantage of any corrections that may occur in financial markets. We will do our best to manage the risks that we believe the markets are facing as well as look for new opportunities to profit.

Thank you for reading our Q2 Newsletter. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for your business.

David W. Papau *BA, CIM, FCSI*
First Vice-President, Portfolio Manager
T: 604 641-4358
david.papau@cibc.ca

Michael H.F. Armstrong *BA, CIM, FCSI*
Vice-President, Portfolio Manager
T: 604 608-5223
michael.armstrong@cibc.ca

Andrey Schmidt *BA, LLB, CIM*
Investment Advisor
T: 604 608-5224
andrey.schmidt@cibc.ca

APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

---

[1] https://www.bloomberg.com/news/articles/2018-07-13/china-s-exports-hold-up-though-imports-slow-more-than-forecast

[2] https://www.bloomberg.com/news/articles/2018-07-13/china-s-exports-hold-up-though-imports-slow-more-than-forecast

[3] CIBC Economics. *Storm Over The Pacific – US-China Trade*. July 10, 2018.

[4] https://en.wikipedia.org/wiki/List_of_countries_by_military_expenditures

[5] CIBC Economics. *Storm Over The Pacific – US-China Trade*. July 10, 2018.

[6] CIBC Economics. *Storm Over The Pacific – US-China Trade*. July 10, 2018.

[7] https://www.theglobeandmail.com/news/world/chinas-xi-gains-mao-status-adding-to-power-with-name-in-constitution/article36700515/

[8] https://business.financialpost.com/news/economy/debating-trade-deficits-a-dangerous-business-cibc-economist-warns

[9] https://www.theglobeandmail.com/business/briefing/article-what-if-trumps-not-bluffing-trade-is-crippled-canada-sinks-into/

[10] https://business.financialpost.com/news/economy/debating-trade-deficits-a-dangerous-business-cibc-economist-warns

[11] CIBC Asset Management. *Trade War Views.* July 2018.

[12] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.

[13] PepsiCo News Release dated May 1, 2018.

[14] CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.

[15] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this

company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company. An executive committee member or director of Canadian Imperial Bank of Commerce ("CIBC"), the parent company to CIBC World Markets Inc. and CIBC World Markets Corp., or a member of his/her household is an officer, director or advisory board member of this company or one of its subsidiaries.

CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2018. David Papau, Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. They and their clients may own securities mentioned in this column. Their views do not necessarily reflect those of CIBC World Markets Inc. If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor.