Welcome to the deflating bubbles of 2019

December was quite a month! Investors found out the market doesn't always go up. The S&P 500 Index was down almost 20% at its worst point, with many stocks down 30, 40 and 50% from their highs earlier in the year. The JFT Strategies Fund (the "Fund") was down 0.4% in December. In comparison, the S&P/TSX Composite Index was down 5.4%, and the S&P 500 Index was down 9.0% (all on a total return basis) for the month. The Fund's short positions paid handsomely but, like everyone else, we lost with our long positions.

For the year, the Fund finished up 0.3% compared to -8.9% for the S&P/TSX Composite Index, -4.4% for the S&P 500 Index and -2.8% for the NASDAQ (total return). Again, the short portfolio was a positive contributor for the year. Measured as the return on capital deployed on shorts, our short investments gained 18% versus the 8.9% decline in the S&P/TSX Composite Index, for the year. Overall, we are happy with this performance as, on average, our short positions went down more than the market. Unfortunately, our long positions underperformed the market this year. Our longs were down 10% (return on capital deployed in long names). Certain detractors on the long side included a few positions in Energy (Parex Resources, Freehold Royalties, Baytex Energy) and Diversified Royalty Corp. Positive contributors in the long book included Great Canadian Gaming, Cannabis Strategies Acquisition, Green Growth Brands, 5N Plus, CGI Group, Pattern Energy and Five Below.

Also, we would like to mention that our two-year total return of -0.04% did better than the S&P/TSX Composite Index at -0.3%. Although we are not thrilled to have made no money in two years, we are happ y to see the markets returning to something more of normality with some volatility and a correction. That should give us more opportunities going forward.

From the low point in early 2016, the market took off with record after record of new highs, record low volatility and record flows into passive strategies, until it started to break down early 2018. We wrote multiple times that the low volatility and record markets were not sustainable. We mentioned many times that the odds of deploying capital (on the long side) were not attractive based on our view of risk and reward (remember our analogy to playing blackjack and counting the cards from our February 2018 monthly comment). **Let's not forget that some of the excesses of the last crisis (2007-2009) have not even been dealt with. As we wrote in our monthly pieces in November 2017 and December 2018, debt levels have continued to rise in many countries around the world (please read our previous comments to get more details).**

We have never got so much pressure from our investors and some have decided to exit. The pressure from the FOMO (fear of missing out) crowd was tremendous. The most I've seen in my whole 25-year career. Many people were asking, "How are you going to make money?" and were talking about all the great investments being made all over the place. **It seemed easy. Too easy.** Unlike most other years in my career, not one sole person asked, "How are you going to protect capital in this very risky and dangerous market?" Our goal is obviously to both protect capital and make money. This is definitely our goal for 2019. As the well-known and successful investor Howard Marks says, "…have more risk exposure when markets rise and less when they fall." In our terms, we would say, "Have more money at work (on the long side) when the risk/reward ratio is attractive and have less money when it's unattractive." After 10 years of a bull market, low and negative interest rates and massive amounts of money printing, we are no longer in the attractive risk/reward zone but rather on the other side of this equation. Remember, as of this writing, the S&P 500 Index is down only about 6% from January 1, 2018. If the economy hits a recession in the next two years, stocks could be down 30 to 50% on average.

We believe the markets will remain volatile and provide less attractive returns in the next year or two. Selling the strength/shorting might turn out to be key for 2019 followed by buying once stocks have corrected. On the long side, we have a list of companies that we believe are very promising. Some of them have the potential to return more than 100%. On the short side, behind selling/shorting rallies, we see upcoming problems in corporate debt, high yield and leverage loans and some emerging markets (we are short JNK-HYG-EEM). We see potential problems in Australia (see our prediction below) therefore we are short Australia. We continue to see the Canadian dollar depreciating, partially because of bad economic policies by our governments (read our predictions below) therefore we are long the U.S. dollar. We believe there remains tremendous excesses in the market, WeWork (now "The We Company") being one great example, in our opinion. Just this week, SoftBank said they would invest $2 billion in the company, with $1 billion going toward buying out existing investors at $54 per share and the other $1 billion going to the company for newly issued equity at $110 per share[1]. Have you noticed the huge difference? Is the company worth $54 per share ($21B) or $110 per share ($42B)? This new year should be interesting indeed.

LET'S ALL HAVE A GREAT 2019.

Predictions for 2019

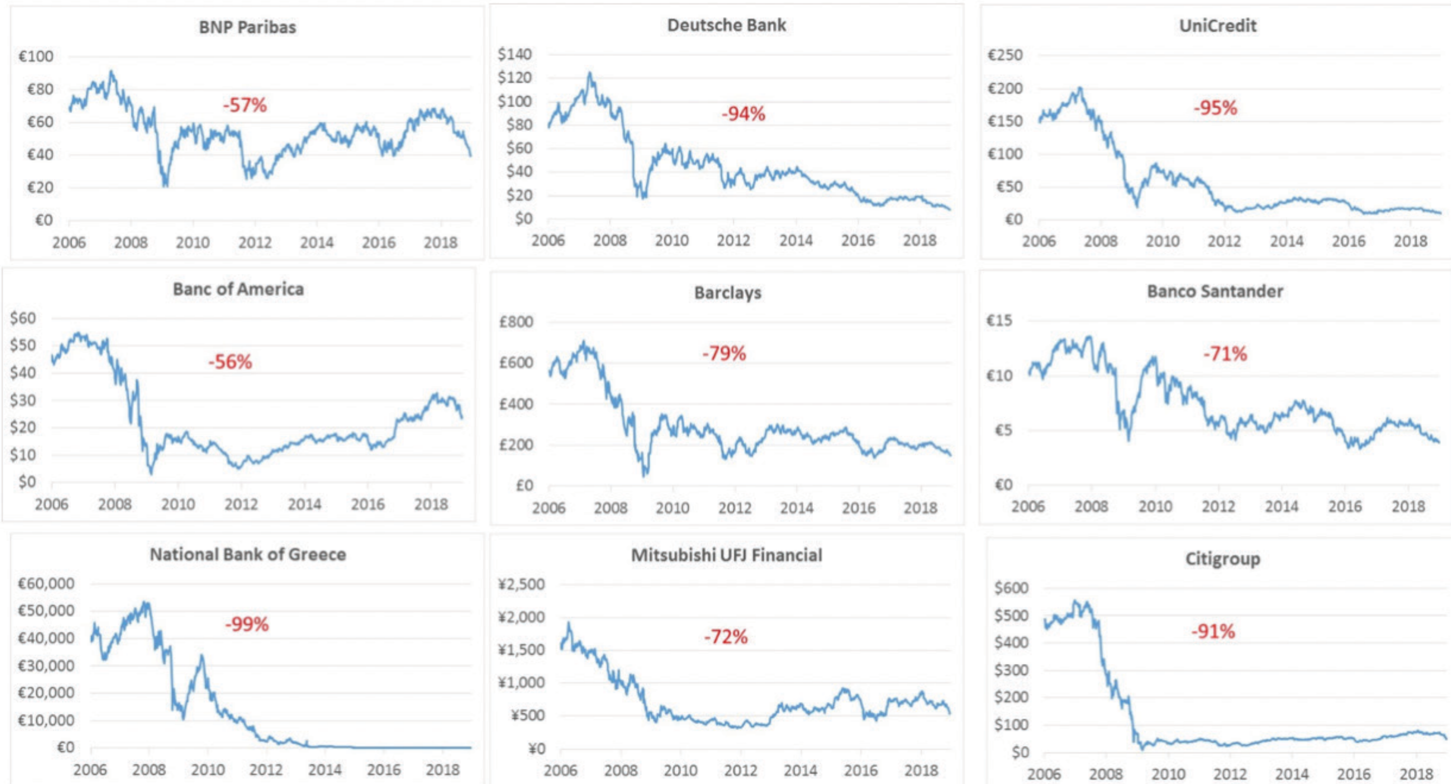
Banking crisis in Australia could be on the horizon: Canadian bank stocks have been a tremendous investment. Over the past 35 years, the "big five" Canadian bank stocks have had annual total returns of 12-14%. While this strong performance has led many investors to always "buy the dips" in Canadian bank stocks, we note that the sector has also had very big drawdowns. In our career we've witnessed three of these big events, as shown in the chart below.

Source: Bloomberg as at December 31, 2018

Sources:

1. WeWork executives pitch next act after SoftBank deal. Financial Times, Jan 9, 2018 - https://www.ft.com/content/81ff92f6-1423-11e9-a581-4ff78404524e

Canadian banks have historically always recovered from market crashes, leading investors to believe that there is safety in buying bank dips. However, this is not the norm as banks are not always safe. Most of the time, when a banking crisis happens it leads to a big negative impact to bank stock prices, and these banks have not recovered back to the highs. This can be explained by the fact that banks are typically levered 20-30x, so any negative impact to the loan book leads to a much bigger impact on shareholders' equity. The below charts show how major banks in the U.S., Japan, and Europe never recovered from the last financial crisis.



Source: Bloomberg as at December 31, 2018.

While we do not expect a banking crisis in Canada, we do believe that a crisis in Australia could happen in 2019 or 2020. The sector has been under pressure lately as the government launched a Royal Commission inquiry that found banks made inappropriate loans, over-charged customers, had lax compliance standards and lied to regulators. As a result of the investigation, Commonwealth Bank of Australia has already been fined US$530 million[2]. Markets have been worried that increased scrutiny and regulation on these banks could result in a deterioration in lending growth and profitability.

We believe Australian banks are risky for several reasons. First, the Australian economy has benefitted from China's growth. Because we think China is in a recession (or at the very least growth is slowing considerably), we think this is a risk for Australia (see below for more thoughts on China).

Second, Australian banks are very exposed to the housing market, as banks have US$3.5 trillion in total assets (more than 3x GDP) and 2/3 of these assets are in mortgages[3]. The Australian housing market has started correcting, with national prices falling 1.3% in the month of December and 6.1% for the year. December's decline was the biggest monthly fall since 1983[4]. The decline is from a very high peak as Australian housing is among the most expensive in the world, with house prices nearly 13x higher than average household income[5]. Given the banks' exposure to such an expensive housing market, it's easy to see how even a modest correction could have a big impact on banks. In fact, Morgan Stanley has stated, "We think the steep downturn in house prices exposes Australia to the risk of recession."[6] If this happens, it would mark Australia's first recession in 27 years.

Sources:

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Lastly, we think another potential risk for Australian banks could be funding. Banks get funding three ways: 1) customer deposits, 2) equity and 3) wholesale funding. Wholesale funding is considered the most risky source of funds as it is the least sticky. According to the Reserve Bank of Australia, wholesale funding accounts for roughly 30% of all funding in the Australian banking sector[7]. This creates a big risk for the sector because if this capital decides to go elsewhere (either because they can get better rates or have concerns about safety), Australian banks would be forced to find new capital or quickly de-lever their balance sheets.

In addition to Australia, we believe Italy is also at risk of having a banking crisis. In Italy, regional banks hold nearly 10% of their assets (or €387 billion) in Italian government debt and, because of banking regulations, these bonds are assigned a risk-weighting of zero (meaning they don't count as risky assets and have no capital requirements against them). As the Wall Street Journal explains, this has not been a problem in the past as "€365 billion in European Central Bank ("ECB") purchases of Italian sovereign debt since 2015 can explain how, in recent years, a country whose debt has ballooned to 130% of GDP, nearly the same interest rate as Germany, which has a 60% debt-to-GDP ratio."[8] Given that the ECB's quantitative easing purchases ended in December 2018, we believe Italian bonds could fall when Italy hits the next recession, which would put stress on Italian bank balance sheets.

Federal policies will likely lead to a recession in Alberta, cause problems for Liberals in upcoming provincial and federal elections: Low oil prices have hurt Alberta badly, but Federal government policies are hurting them even more. It is no surprise, since Prime Minister Justin Trudeau is against the energy sector. In a January 2017 speech, Trudeau said, "We can't shut down the oilsands tomorrow. **We need to phase them out.** We need to manage the transition off of our dependence on fossil fuels." So far, Trudeau is getting his wish, as his inaction on getting the Trans Mountain or Energy East pipelines built have caused Alberta to force producers to shut-in 325kboe/d of production, equivalent to ~9% of the province's total production. They are doing this because the lack of pipelines means that Alberta oil is essentially landlocked, and with nowhere to go (sell to), Alberta oil prices have traded at record lows relative to West Texas Intermediate (WTI). This low energy price on lower production is already impacting the local economy as certain towns have reported revenue shortfalls because of the lack of taxes being paid[9]. Congratulations Trudeau, you've been successful so far in your promise to "phase them out."

Compounding Albertans' anger towards the Federal government is the fact that in mid-2018, the Trudeau government decided to keep the equalization payments formula unchanged until 2024. What this means is that even during the crisis caused by the downturn in oil prices, Albertan's tax revenue will continue to subsidize other provinces. In the last decade alone, Alberta has sent $220 billion to the Federal government[10] and since equalization payments began in 1958, Alberta has only received a total of $92 million. Meanwhile, Quebec has received over $220 billion, or roughly 51%, of all government payments[11] and the Premier recently said "there's no social license for a pipeline that would carry 'dirty energy' through the province."[12]

Given the fact that some provinces and the Federal government are happy to take Alberta's money while also playing a part in destroying its economy, it's not surprising to hear Jack Mintz, the President's fellow of the University of Calgary School of Public Policy, talk about separation in a recent Financial Post op-ed. Mr. Mintz is only one of the several prominent Albertans that have brought up the idea of separation in recent weeks, a list which includes the likes of Brett Wilson (FirstEnergy co-founder, Dragons' Den star, investor). In our view, this rhetoric will only increase as both Alberta and the Federal government are set for elections this year and we would not be surprised if Albertans started to make a case for suing the Federal government to recoup past transfer payments considering the lack of help they are getting from Ottawa and harmful actions from other provinces.

Sources:

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The last thing we want to highlight relating to Canada's energy policy is the hypocrisy of the argument against new pipelines. Because of a lack of pipelines, Canadian refiners on the coast import oil from abroad. What this means is that Canada currently imports 100kboe/d of oil from Saudi Arabia. By blocking new pipelines from being built not only is the Trudeau government costing Canada thousands of jobs and millions of dollars a day in GDP, but they are also directly funding a government that has a carbon footprint that is nearly 30% higher per capita relative to Canada[13].

China is in a recession or major slowdown. We do not believe the economic data coming out of China and we see indicators giving off warning signs. We saw the Chinese manufacturing Purchasing Managers Index (PMI) contract[14] in December with both domestic and foreign new order demand weighing on the index. Consumer spending is slowing in China with automobile sales falling 3% in 2018[15] indicating decreased consumer appetite for big ticket purchases. Additionally, Apple's recent guidance revision highlights a weakening consumer. Chinese housing is another sector which poses a risk with housing sales being down in October 2018 and S&P forecasting a 5% pricing decline for home prices in 2019[16]. As we have written about before, we believe the U.S. trade war has negatively impacted China, and will continue to do so, with expectations the U.S. will remain resolved in its approach until a far better trade deal is achieved. Lastly, we would highlight that China continuously cutting banks' required reserve ratio[17] throughout 2018 and into the start of 2019 is indicative of a weak economy. **It is important to highlight that as the world's second largest economy and a major global growth driver, any recession or major slowdown in China will impact the world economy in a wide variety of ways.**

We anticipate Canadian real estate prices will decline; with prices down sharply in British Columbia we believe there will be a compounding effect of government policies and economic conditions which result in real estate prices declining in Canada, with B.C. being the most impacted. First, the tightening of mortgage regulation across the country is reducing the maximum theoretical borrowing capacity of households and impacting ability to purchase homes. In B.C., multiple taxes, including a 20% foreign buyers tax, the speculation tax and the increased school tax on properties above $3 million, have all made B.C. real estate investments less attractive for foreign capital. Lastly, on the economic front, as discussed above, a recession in China will have a negative effect for overseas spending and asset accumulation, and we predict Alberta will go into a recession in 2019 driven by lower oil prices and pipeline challenges.

We have seen this starting to play out in different parts of Canada. Vancouver housing sales were down 32% in 2018, with greater Vancouver overall prices down 6% from the peak[18]. A similar situation is happening in Toronto, with number of housing sales down 16% in 2018 vs. 2017 and overall prices down 4.3%[19]. Calgary has already seen condo prices decline 16% from the October 2014 peak as employment in the oil sector has declined[20]. **For the Canadian economy, where housing goes - the economy follows, and we believe B.C. and Toronto housing prices could drag on the Canadian economy in 2019.**

The popularity of unprofitable businesses will decline. In recent years, markets rewarded high-growth, money losing companies by giving them expensive valuations and lots of capital. This was very similar to 2000. Examples include Uber, WeWork, Spotify, and Wayfair. This allowed them to continue to sell products/services at uneconomic prices in order to gain market share at the detriment of profitable, competing businesses. Valuations focused solely on revenue growth, with little concern for future profitability. Another good example is Carvana, an online used car retailer that sells cars an average of $1,000 (or 5%) lower than competitors such as Carmax[21]. Carvana has more than doubled its sales in the past 12 months yet it is still losing money. In 2019, we believe investors could become impatient with these money-losing businesses, which could negatively impact valuations. Patience has already worn thin with Carvana's stock price, which has declined 57% from its peak in September. Lower investor demand may also prove difficult for potential 2019 initial public offerings (Uber, Lyft, AirBnB); and if we are right we wouldn't be surprised to see material losses in some venture capital and private equity funds that invest heavily in those types of companies.

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	Uber (3Q18 results)	WeWork (YTD18 results)	Spotify (TTM)	Wayfair (TTM)	Caravana (TTM)
Valuation	$76B (Aug 2018)	$42B (Jan 2019)	$19.42B	$7.64B	$4.35B
Revenue	$2.95B	$1.5B	€4.9B	$6.2B	$1.64B
GA AP Loss	$939M	$1.2B	€1.1B	$0.4B	$216M

Source: Company reports, EDGAR, Wall Street Journal, Recode, Techcrunch, Reuters, Financial Times

Last prediction – investors will have to unlearn "buying the dip." The recent pullback in stocks marked the end to the longest bull market in history. The fact is, many investors have never even seen a bear market. All they've known is that markets always go up and to "buy the dips." We think 2019 will mark the year that investors will have to unlearn this trait (along with many others like buying unprofitable companies just because they always go higher). In our view, stock picking on both the long and short side will be much more important in 2019.

	1 month	3 month	6 month	YTD	1 year	1 year	3 year	4 year	5 year	Since Inception*
JFT Strategies Fund (JFS.UN)	-0.43%	1.38%	0.37%	0.31%	0.31%	-0.04%	1.79%	3.65%	4.91%	6.87%
S&P/TSX Composite Index TR	-5.40%	-10.11%	-10.62%	-8.89%	-8.89%	-0.30%	6.37%	2.49%	4.06%	6.85%
S&P 500 Index TR USD	-9.03%	-13.52%	-6.85%	-4.38%	-4.39%	7.94%	9.26%	7.23%	8.50%	12.82%
NASDAQ Composite Index TR	-9.40%	-17.29%	-11.16%	-2.84%	-2.84%	12.24%	11.10%	10.05%	10.97%	15.43%

*Since Inception May 18, 2012

Source: Morningstar and First Asset. As at December 31, 2018.

The S&P/TSX Composite Index is a capitalization-weighted index designed to measure market activity of stocks listed on the Toronto Stock Exchange. The NASDAQ Composite Index is a broad-based capitalization-weighted index designed to measure market activity of stocks listed on the NASDAQ. The S&P 500 Index tracks 500 large-cap U.S. stocks representing all major industries. These indices are used as a benchmark to help you understand the Fund`s performance relative to the general performance of broader Canadian equity, Technology and U.S. equity markets.

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