Pendragon: Monthly Memo

March 2017

Wilbur Ross, the Secretary of Commerce, finally stated what many have known for some time, since World War II, trade has not been fair and balanced. The devaluation of currencies and the inability of the World Trade Organization to police global participants has meant that we have actually been in a trade war for decades. It has just been implicit. Now Team Trump has brought this dirty little secret into the light. We've seen this narrative many times in the economic history of the world. Economic nationalism is upon us. To be sure, those forces (the status quo), who benefit from globalization will not allow change without a fight. As was the case in the early years of American history, when the agricultural sector fought hard against policies that supported an infant manufacturing sector. But true to Darwinism, we hypothesize that the global economy needs to evolve because it has no choice. The rise of populism, the chronic economic growth in the western world and the view that policy makers are out of touch is not about the left or the right but about that fact that the so called "Party of Davos" has left the middle class behind. This leads us to think that we are now living through one of those critical periods of history equivalent to the American Revolution, the U.S. Civil War, and the 30 years of war between 1915 and 1945. Secretary Ross speaks the truth. There has been a global trade war and currency war going on for decades. The rise of populism in North America and Europe have now made this dirty little secret a public crusade.

Our major thesis is that Team Trump is the agent of change. Its simple goal is to generate jobs for those that are feeling abandoned by the Party of Davos. In order to "Make America Great Again!" a major and bold policy shift is needed, but they may or may not be successful. The global economy is experiencing a significant regime change; it needs to rebalance. The global imbalances built up in 1945 need to be dealt with. John Maynard Keynes warned the Americans, and specifically, Harry Dexter White at Bretton Woods that using the U.S. dollar as the medium of exchange for the global economy, and not having a fixed process whereby those countries who manufacture too much and consume too little are not penalized, will by definition mean that the global economy will be doomed to repeat the mistakes of the past. Robert Triffin in the early 1960's again warned of the inevitability of the coming crisis. Just as Governor Howard Dean was the first politician to harness the power of the internet in a Presidential campaign and lost, Team Trump may not be successful in its goal. While many are concerned about Russia, we are not. As the media puts forth the thesis that the Trump agenda is dead, we focus on fundamentals. It's interesting to note that the National Association of Manufactures' Outlook Survey for the first quarter of 2017 recorded the highest level of optimism at 93.3% in over 20 years. Fundamentals do matter. Trump experienced a set back with health care reform, but he was elected on a platform of tax cuts, deregulation, trade, and infrastructure. We will use that fear and doubt that Trump created to position our portfolio.

As Charlie Brown said to Violet in A Charlie Brown Christmas (1965), "Don't you know a sarcasm when you hear it?"

Those fighting for the status quo are hoping that Elon Musk or Jeff Bezos will find life on another planet, so that the globally economy finally no longer remains as a closed economy. As President Clinton stated in his seminal speech nominating president Obama, "It's arithmetic!" This era of globalization is drawing to an end, let's just hope those in the official sector can solve this problem without any bloodshed. The last time the global economy reached this tipping point, the result was 30 years of war. As in the Bible, when Noah's warnings were not heeded, Keynes' warnings were also not heeded, and now the rains have started and we don't have an Ark. To be clear, we are politically agonistic, we build our portfolios to capture inefficiencies in the global market. We believe a major regime change is upon us and investors need to heed the voices coming from the populist movements around the world.

Investors in the first quarter ignored the clouds on the horizon, voted with their feet and made a major proclamation that the status quo will rue the day. Those issues that benefit from a successful implementation of Trump's strategy were sold. Those issues that benefited from the forces for the status quo winning, attracted significant capital. For example, 50% of the performance of the S&P 500 was generated by technology. In addition, 30% was generated by the FANG stocks, Facebook, Amazon, Alphabet, Apple, and Netflix. Having such a narrow rally is a cause for concern. The result is that on a Cyclically Adjusted Price Earnings basis, (CAPE) the S&P 500 now trades at a valuation of 31. That's very expensive. Yet, financials, energy and materials stocks, which were all significantly sold in the quarter are still attractively valued. Growth stocks have outperformed value stocks since 2008. If Team Trump fails at implementing its agenda, investors should expect a significant market correction. Ignoring the noise will allow us to see the light at the end of the tunnel. The status quo can no longer be maintained and too few investors have yet to understand this critical point.

We focus on undervalued areas of the global economy for investment ideas. In general, opportunity is created by the natural evolution of a cycle. Opportunity in investing always exists in the context of fear and doubt. The fear existing in the market may be based on logical concerns that may or may not continue. Our goal is to find investment opportunities where investors' fears have reached a level of irrationality. We accept the fact that the short-term markets are driven by emotion. However, over the medium to long-term, emotions will give way to fundamentals. It's these emotions, along with the natural evolution of the global economy, which we try to exploit. We buy fear, and sell greed.

Normalizing an economy, or a company's valuation over a market cycle allows us to build a narrative based on the normal market cycle. To this point, there are some expensive areas of the market, specifically, the broad index of stocks in the United States. The S&P 500 has a cyclically adjusted price earnings ratio of 30, yet, financials and cyclical stocks are trading close to a price-earnings ratio of 10. During the first quarter of 2017, technology, utilities and consumer staples stocks outperformed each valuation level outside of their historical norms. We did not chase this momentum driven trade, fear of Mr. Trump, and the so called Trump trade, which have provided nice entry points into stocks that our research suggests will outperform within the coming years. For example, Morgan Stanley has rallied nicely since the November 2016 election. However, it has corrected and consolidated in the first quarter of 2017. If we extended our time horizon back a few years we see that it is trading at a level back to the summer of 2015. Today Morgan Stanley's return of equity is now greater than its cost of capital. The retirement of Daniel Truillio, the head of Financial Supervision at the Federal Reserve Board, suggests a new era of "credit creation friendly" has been introduced. Dodd Frank does not have to be repealed for the financial environment to be more susceptible to credit and value creation for U.S. financial stocks. Furthermore, a rising interest rate environment and the possibility of the Federal Reserve finally contracting its big balance sheets, points to a future environment were U.S. financials will create value and share price appreciation for their shareholders.

Our fundamental research on geographic areas, industries, and asset classes attempts to identify the asset that has the highest probability of strong future returns in equities. We have an eye on Europe, and would expect extreme fear from the French elections this summer to possibly provide an entry point into European equities. Surprisingly, since the New Year, markets and stocks are not directly linked to the "Trump Agenda" and have rallied hard, while stocks in Canada and the United States consolidated. None of these markets are seeing the pro-growth policies that are taking place in the United States. Eventually, the anti-Trump trade will run its course and yes, the markets can be irrational.

As investors realize that the pro-growth policies are being implemented, capital will flow back to those areas that will benefit the most. To be clear, most of the deregulation within Trump's plan can be accomplished without Congress or the Senate. The desire to cut taxes and make North America the dominant economic zone in the world, suggests that focus is on this area while the mainstream media generates fear, is our optimal investment strategy. As long as Canada realizes that being part of the solution to Trump's desire to "Make America Great Again" is our optimal strategy, investors should take advantage of the opportunity that fear provides. Investors should expect a slow rise in interest rates in the U.S. and the possibility of the Federal Reserve slowly contracting its balance sheet, providing a favorable environment for financial stocks and stocks that pay high dividends. Investors should also consider cyclical stocks to take advantage of the synchronized global growth occurring in the world.

Dr. James E. Thorne
Chief Capital Market Strategist
& Senior Portfolio Manager

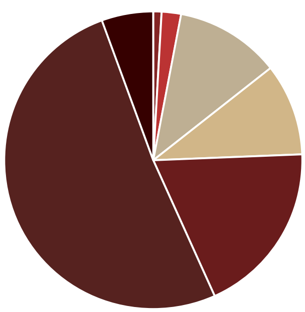
Pendragon Fund

Top Ten Holdings

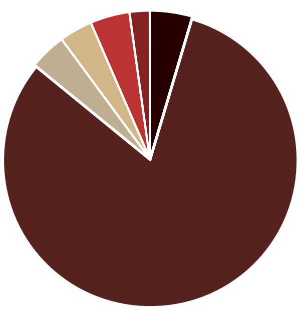
BANK OF AMERICA CORP NEW	4.60%	RICE ENERGY INC	4.10%
PIONEER NTRL RES CO	4.50%	BANCO SANTANDER	4.00%
RANGE RES CORP	4.40%	GOLDMAN SACHS GROUP INC	4.00%
DEUTSCHE BK AG	4.30%	JP MORGAN CHASE & CO	3.70%
CITIGROUP INC	4.10%	US CONCRETE INC	3.60%

As at March 31, 2017

Sector Weights



Geographic Weights



Pendragon FundServ Codes: CWF1400 | CWF1401

Inception Date	September 15, 2016
Subscriptions	Monthly
Liquidity	Monthly Redemption (5 business days notice)
Currency	CAD
Minimum Investment	$10,000 (Builders Class) $25,000 (Investors Class)

Manager	Caldwell Investment Management Ltd.
Eligibility	RRSP, RRIF, DPSP, DSP, RESP, TFSA
Auditors	Deloitte LLP
Custodian	Caldwell Securities Ltd.
Legal	McCarthy Tetrault LLP
Administrator	SGGG Financial Services Inc.

Accredited Investors Only

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Caldwell Investment Management

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