Manitou
Investment Management Ltd.

Quarterly Commentary
September 30, 2018

"What Inning Are We In?"

October inevitably brings with it the baseball post season, and this year it also brings the question, "where are the global economies and markets on the relevant time scale"? While economic growth is robust in North America, global growth is slowing. With the erratic and sometimes conflicting rhetoric surrounding world trade issues with the United States, it is difficult to determine the direction and trajectory of global growth in the short term. China and the countries of South-East Asia are beginning to feel the effects of Donald Trump's trade tactics. However, successful negotiations between the US and China could normalize resulting in more normal trade flows. This situation bears close attention as multi-national companies are beginning to cite trade tensions as a concern for their businesses going forward.

Bull markets do not generally die of old age. In virtually all cases, it is a recession that causes their death. In turn, recessions are often the result of tightening monetary and/or fiscal policies. History is quite conclusive on the impact that interest rates have on the economy and stock price valuations. It stands to reason that when rates are low, especially when they reach near zero as has been the case for nearly a decade, stocks and real estate have little competition from bonds in terms of attracting savings. Accordingly, their prices are bid up, sometimes to unsustainable levels. As rates rise, competition from 'guaranteed' type savings vehicles like government bonds and bank GICs becomes quite real. In classic supply-demand terms, this competition draws money away from less certain assets to more certain ones.

For over a year the Federal Reserve Board has been transparent in its resolve to return rates to 'normal' levels as the economy has recovered. Evidence of the recovery is clear when measured by record low unemployment levels, strong consumer confidence, robust corporate profits, strong GDP growth, low tax rates, etc. In contrast to the obvious economic headwinds of the Financial Crisis, the backdrop for investors today is quite benign. However, with the Federal Reserve's efforts to restore interest rates to more 'normal' levels, investors are beginning to reconsider the merits of continuing to hold assets that have appreciated. By statistical measures, these assets may look expensive in a more normal rate environment. While we do not profess to know what may become a new normal given a decade of historically low rates, we believe 'higher than today' is extremely plausible.

Transitioning from a low to a higher rate environment takes time and often results in an inversion of the 'normal' shape of the yield curve, in which short (1-2 year) rates move above long (5-10+ year) rates. Today the yield spread between Treasury Bills and 10-year Treasury Bonds has narrowed considerably, as shown in Chart 1. This has caused angst amongst market pundits trying to predict the moment of "inversion", thus adding to the volatility caused by uncertain geo-political events. Chart 1 provides a long-term perspective, demonstrating fairly conclusively that a flat yield curve has preceded each of the last five recessions.

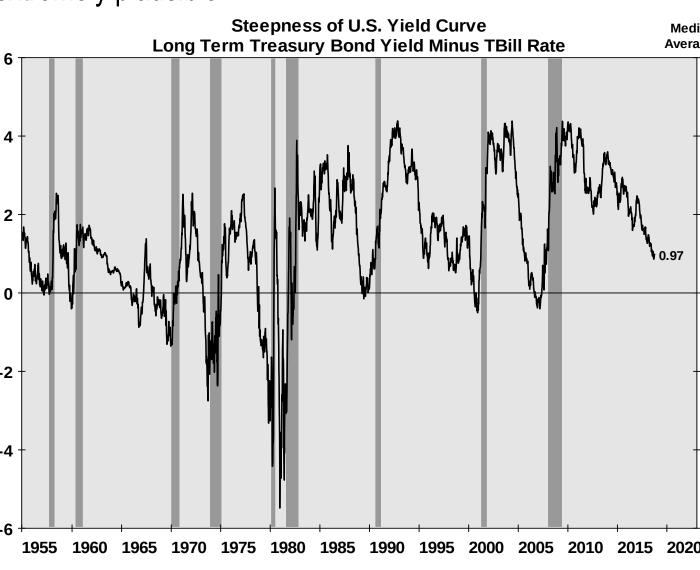

Chart 1 Courtesy of TD Securities – Sept. 2018

Drawing on baseball parlance, we may well be at the 7th inning stretch; meaning higher highs are in store, or we may well be nearing the end of one of Wall Street's greatest Bull Markets of all time. While we are followers of many noteworthy economists such as Levy, Smithers, Yardeni, Grant and Barnes, we recognize that they are no more expert at predicting when rates will invert or when the economy will rollover than the National Weather Service is at predicting the precise timing of a hurricane making its way onshore.

Market tops are only identifiable in hindsight. Subsequent corrections are uneven across industry groups and global geographies. Calling the precise market top and cause of the reversal is often unknowable, and beyond our control. It is however, entirely within our control to ensure that we do not overpay for investments beyond what we believe to be achievable over a 3-5 year time period. Therefore, we allocate capital to businesses we believe have a sustainable competitive advantage due to their strong financial position in absolute and relative terms, and most importantly to their shareholder-focused management teams.

Not only are we sitting on liberal quantities of cash, many of our investee companies are as well. It cannot be stressed enough that we do not consciously build cash reserves in anticipation of a downturn or a readjustment of valuations due to rising rates. Our cash positions are a function of disciplined capital allocation, based on rational and conservative analysis/assumptions. We always try hard not to overpay. In this regard, we subscribe to Benjamin Graham's view: "Investment is most intelligent when it is most businesslike….For the enterprising investor this means that his operations for profit should be based not on optimism but on arithmetic"[1].

As previously described in our Q2/18 Commentary, the primary driver of the major US indices attaining their recent highs is due in large part to the impact of a select number of mega-cap technology stocks. As a result, flows of money into index funds have been indiscriminately allocated to the largest and generally highest priced stocks. This has meant that a number of high quality businesses have been overlooked or under-appreciated. As interest rates creep up, investors' appetite for paying premium valuations naturally comes down. Seemingly, the current level of stock market volatility is a sign that investors are struggling with the price they are prepared to pay for high-valued assets. In Wall Street terms, this is referred to as rotating from *growth* to v*alue*. If so, companies such as those dominating your portfolio should fair well in both absolute and relative terms.

Conclusion:

1. The Federal Reserve will continue to move administered rates higher over the next few quarters.
2. For holders of fixed-income securities maintaining short duration will likely be prudent.
3. The economic cycle is mature and North American growth is expected to slow in 2019. Uncertainties around trade issues and other domestic and foreign geo-political issues will create noise but should not detract from good results from many companies.
4. There will be some rotation in the equity markets, and with broader breadth, good returns will accrue to a wider spectrum of companies.
5. In our estimation, volatility will remain high as the market struggles to determine where interest rates will ultimately "normalize"'. With volatility comes uncertainty. Uncertainty breeds fear, and fear breeds opportunity. Accordingly, we end with Ben Graham's advice: "be fearful when others are greedy and be greedy when others are fearful".

Manitou Mandates

For Q3 2018, all Manitou Mandates, with the exception of Focus 5+, achieved satisfactory results in spite of extremely volatile markets. This was principally due to stock selection. Global Equity returned +2.24%, Equity North America +3.37%, Canadian Equity +0.84%, US Equity +3.49%, Focus 5+ -0.63%, International Equity +0.20% and Income Fund +2.3%.

The principal contributors to this quarter's returns in Manitou Global Equity were Apple (+20.24%), Walgreen's Boots Alliance (+20.03%), Microsoft (+14.39%), Alimentation Couche-Tard (+13.49%) and Berkshire Hathaway (+12.77%).

Apple reported strong earnings, largely due to stronger pricing on its newest iPhone.

Walgreen's solid stock performance reflects the company's continued success in executing its global strategy.

Microsoft also reported strong results led by its Azure cloud division that grew 23% compared to the same period last year.

Couche-Tard outperformed analysts' expectation with its latest quarter results. The company achieved both organic and acquisition-led growth in sales leading to an adjusted eps that increased 31% year-on-year.

Berkshire outperformed due to timely stock buy backs. It had not made a significant share repurchase since 2012.

The detractors affecting this mandate were Whirlpool (-19.42%), Dentsply-Sirona (-15.60%) and Canadian Natural Resources (-10.34%).

Whirlpool's share price declined as a result of the negative impact of US Tariffs that led to increased steel and resin prices.

Dentsply had no firm-specific news associated with the share price decline.

CNQ declined as a result of pipeline constraints, which are hindering the company's ability to participate in the recent uptick in global oil prices.

Manitou Equity (North America) achieved similar results to Manitou Global. In addition to Apple, Walgreens, Microsoft and Couche-Tard, Union Pacific was also a top performer.

Union Pacific outperformed in part due to the announcement of a new operating system, which will increase efficiency through improved scheduling.

The detractors that differ from the Manitou Global mandate were Constellation Software and Wells Fargo. There was no new firm-specific news on either stock.

Contributors to Canadian Equity included Toromont Industries (+18.01%), Equitable Group (+16.02%), Alimentation Couche-Tard (+13.43%), GDI Integrated Facility Services and Brookfield Asset Management (+8.11%). All companies posted strong quarterly results, which led to their share price strength.

Canadian Equity detractors included Canadian Natural Resources (-10.45%), Constellation Software (-6.96%), Stella-Jones (-9.50%), Tucows (-9.50%), and Prairie Sky Royalty (-11.95%). There was no firm-specific news on any of the companies that have not been previously mentioned.

All of the US Equity Mandate's top performers and detractors are mentioned above.

The Income Fund significantly outperformed its relative benchmark (+2.3% versus +0.24%). We continued to favour short duration bonds in a rising interest rate environment. The fund also benefitted from the contribution of high yielding securities contained within its basket clause.

We will not be publishing the performance data for the Total Return Yield Fund (TRY) until after the first full year of operation. This said we are pleased with the returns obtained from the individual investments year-to-date. The fund has committed funds totaling approximately $20 million across a broad spectrum of investments including private debt, real estate and mortgages as well as publicly traded high yield instruments.

The International Fund returned +0.20% during Q3, 2018 and beat its relative benchmark at -2.30%. We continue to slowly populate the mandate using a bottom-up quality approach. The sole addition to the fund during the Quarter was the UK industrial company, Spectris plc.

Established in 1915, Spectris is a leading supplier of highly specialized, productivity enhancing measurement and control instruments used in a wide range of production and manufacturing industries. Its products, applications and services help customers streamline processes, save time, increase yield and improve quality, while enabling customers to earn rapid payback on their initial investment. The company employs over 8,900 people globally, most of which are highly trained engineers and technicians. Spectris' innovative products, direct sales method and asset-light business model have led to high profitability and customer retention. The stock was purchased at a reasonable valuation.

1 [footnote The Intelligent Investor, p. 523, First Collins Essentials edition 2006].