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CAPSTONE
ASSET MANAGEMENT™

ECONOMIC UPDATE

The first quarter of 2017 has been a busy one in terms of defining policy. The G20 Finance Ministers and Central Bank Governors convened to discuss usual policy agendas. There was a focus on creating resilient economies that could brace against potential economic shocks through stronger policy frameworks. When it came to trade talk, however, the tone was somewhat muted. Instead of the usual pledge to reject protectionism, the rhetoric was such that it only fleetingly referenced a strengthening of trade. As might be expected, this is largely due to the US' current stance on protectionism.

In March, we saw the release of the 2017 Canadian Budget which is considered by most to be an update of the 2016 budget, rather than unveiling something new entirely. Within the new budget, there is an emphasis on policies that help the middle class, including health-care funding, more flexibility on parental/family leave, as well as community infrastructure. The consensus among analysts is that this budget is very cautious, which is in part due to our strong ties to the US. It is still unclear how the US will approach trade, tax reform (which could take months to enact), infrastructure spending and deregulation. With these big upcoming decisions, Canada is in a "wait and see" period. These US policy changes could greatly impact the competitive landscape between the two countries.

Also in the US, the Federal Reserve (Fed) increased interest rates at their March meeting and it is anticipated that further rate hikes will likely occur at a quicker pace. Having said that, the Fed raised the rates of the Federal Funds only in response to the strength of the US economy. Without the latter, we won't see the former.

The question that often comes next is when do these rate increases hit the marketplace? The March rate increase was already priced into the market, as it was largely expected. That is to say that bond markets reacted ahead of the game; sometimes they price it in correctly, as was the case here. Keep in mind, however, that the Fed ultimately controls only short-term rates while the marketplace controls longer-term interest rates.

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So if you have not been trustworthy in handling worldly wealth,
who will trust you with true riches? ~ Luke 16:11 (NIV)

ECONOMIC UPDATE

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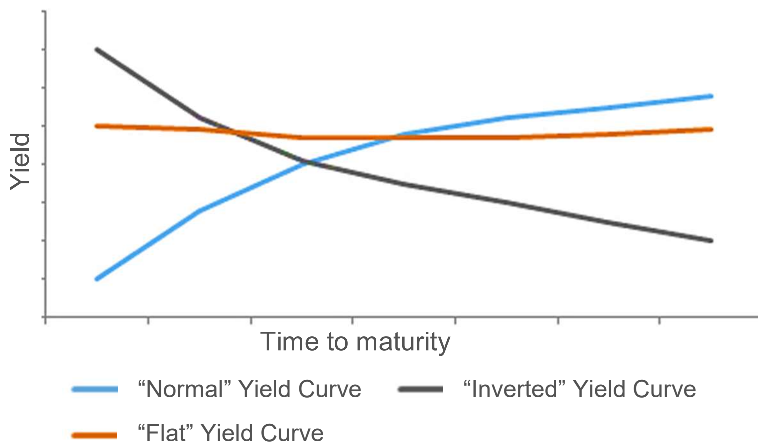
If longer-term rates don't move up in tandem with short-term rates it has the effect of punishing savers who are putting in money for a longer period of time, but are not being rewarded with a higher yield. This can be seen by the orange line in the graph below, while the blue line represents a normal yield curve. There can even be situations when short term rates become higher than long term rates, but this is usually indicative of a very doom and gloom scenario and typically precedes recessions (shown as the black line).



Source: helpingadvisors.com

How do bond prices affect the economy? Well for starters, the global bond market is higher than the capitalization of all equity markets combined. As additional backdrop, we have seen investors increasingly flock to bonds that pay next to nothing without realizing the large risks attached. As interest rates begin to rise, the prices of bonds fall. This happens when people try to sell off their bonds in the hopes of getting bonds that pay higher rates. In fact, this is exactly what we have been witnessing as of late: a sell-off in the bond space which has led to an oversupply and drop in price which is punitive to current bondholders.

So, how are the equity markets fairing? We continue to see lofty valuations that have some people questioning whether a correction is looming. In order to prompt a massive correction, however, there would need to be an additional, separate trigger; high valuations alone are not enough to cause a massive correction. What could some potential triggers be? Well, the biggest threat would be an economic downturn in Canada, but could also entail scenarios abroad. These potential triggers include the increasing impact of protectionism on global economic growth, and as per usual, uncertainty around China's growth trajectory.

In Europe, a tense geopolitical scene wages on. The Netherlands just finished their election. Although the Dutch protectionist party didn't win, they are now the official opposition. We're only at the start of election season across the Eurozone, with upcoming elections to take place in Germany and France. A notable rise in populism and continued political disruption have given rise to an economy of uncertainty. Still, there are other wild cards that could send the market into a tailspin without warning. The takeaway here is that while we cannot predict if and when a correction will occur, there is clearly a lot of downside risk to valuations being as high as they are at present.

As we have explored the theme of uncertainty in the markets for a while now, it is important to note that we are by no means against the traditional markets. In fact, we have exposure in all of our Funds to that space, including real estate. To be sure, we believe that value still exists and can be found with a careful, disciplined approach. However, the key here is one that we have been practicing since our inception: one of proper diversification and specifically, ensuring that the different types of assets held in one's portfolio have low correlation to each other. By limiting exposure through proper diversification, we can ensure clients' portfolios are well protected to the down side while still achieving a competitive rate of return.

Suppose one of you wants to build a tower. Won't you first sit down and estimate the cost to see if you have enough money to complete it? ~ Luke 14:28 (NIV)

MORTGAGE INVESTMENT CORPORATIONS

Reasons To Be Cautious

There was recently an extensive article published in national media about Mortgage Investment Corporations (known as MICs). The piece echoed many of the concerns we have had for some time regarding these investments; concerns that have caused us to consistently reject including such structures in any of our investment funds.

It is important for investors in Capstone's mortgage funds to understand that our funds bear no resemblance to MICs. Our funds are structured as either Mutual Fund Trusts or Canadian Limited Partnerships. The key difference being that in most MICs, the people raising capital are the same people that loan it out; a clear conflict of interest forcing the MIC operator to constantly choose between serving the best interests of the borrower, or those of the lender. This is never the case in Capstone's mortgage funds where mortgage sourcing, arrangement and administration is done by a specialist team at MarshallZehr Group with project approval and the allocation of investors' money being done by the Investment Management Team at Capstone.

This effective avoidance of conflicts provides Capstone investors with enhanced security. Direct-to homeowner MICs have no such system in place. In recent years, MICs have diversified into commercial arenas – raising money perhaps for a landlord struggling to make repairs on his deteriorating rental stock, or a developer using a MIC of their own design to raise capital for their own purposes! We see these scenarios as lacking reasonable accountability and therefore being excessively risky for investors.

There are other important differences; typically, MIC's are a 'lender of last resort'. In other words, the homeowner or business owner has been declined financing through conventional channels – the bank has said 'no', so they must seek an alternative. In development financing, most deals are collaborative – the bank or other conventional source has said 'yes' to providing the bulk of the financing. They like the project, the business plan, the amount of equity the developer is providing and the credit worthiness of the borrower. They are simply not willing to provide all of the capital – creating the opportunity for private capital to fill the gap between the developer's equity and the bank.

Other differences include:

Loan to Value Ratio

Many MIC borrowers have already used up most of the equity in the property used for security – this is a common reason for being declined for conventional lending. We take a dynamic approach to Loan to Value, carefully evaluating each project on its merits. But across the whole portfolio, LTV in our funds is typically around 60 - 65%.

Liquidity

MICs often contain a limited number of projects. This means that investors may have to wait for an indefinite time for a mortgage to be paid out before they can redeem their investment. Capstone's mortgage funds hold a large number of mortgages, written over relatively short terms. This enables us to offer either monthly or twice yearly opportunities to redeem (depending on the fund chosen) while still providing monthly distributions that can be used to acquire more units, or received as cash.

Regulatory Approval

Many MIC operators have been shut down by regulators because of the conflicts of interest and other matters. Whereas structures that effectively separate mortgage administration and portfolio management have passed examination and have been allowed to continue.

Do you have questions about your investments at Capstone? We would be happy to answer your call and explain our funds in more detail. We can be reached at 604 546 1500.

CAPSTONE'S POOLED FUNDS SUMMARY

Performance figures are those of Class I units as of March 31st, 2017

Capstone Mortgage Pool
Diversified pool of construction and development mortgages (Launched April 30, 2012)

3 Month:	2.17%
1 Year:	9.27%
Inception:	9.59%

Capstone Fixed Income Pool
Conservative, traditional and non-traditional income (Launched November 1, 2013)

3 Month:	1.46%
1 Year:	5.98%
Inception:	4.27%

MarshallZehr Mortgage Opportunities Fund
Diversified pool of construction and development mortgages (Launched July 31, 2014)

3 Month:	2.12%
1 Year:	9.50%
Inception:	9.51%

Capstone Non-Traditional Equity Pool
Diversified portfolio of non-traditional equity investment opportunities (Launched May 2, 2014)

3 Month:	1.90%
1 Year:	6.61%
Inception:	6.63%

Capstone Traditional Equity Pool
Value-based approach to investing in traditional markets (Launched November 14, 2014)

3 Month:	-0.26%
1 Year:	15.37%
Inception:	5.03%

MarshallZehr First Mortgage Fund
Diversified pool of construction and development mortgages (Launched August 31, 2016)

3 Month:	1.24%
1 Year:	N/A
Inception:	2.95%

Class I Funds are only available to Capstone's managed account clients and certain institutional investors.
Performance is annualized for periods longer than one year.

HOW FAR WE'VE COME

As you will have undoubtedly heard by now, our name has officially changed to Capstone Asset Management. What you may not be aware of is the progress we have made since our inception 13 years ago. Back in April 2012, we launched our first Pooled Fund. To date, we now have six Pooled Funds including two Limited Partnership Funds. In the past three years alone, our assets under management have almost tripled while the number of staff has grown from 9 to 14. We have gone from being the manager only to clients of Covenant Family Wealth Advisors to now serving a number of foundations and larger institutions alongside our growing private client base.

We are pleased to welcome a new team member this month, Heather Chua. Heather joins us as Stephen Smith's new Executive Assistant, while Jennifer takes maternity leave. To all of our clients, we look forward to continuing on this journey with you and hope that you do too!