CALDWELL

U.S. Dividend Advantage Fund

August 2016 Management Update
TMX: UDA.UN

North American markets changed slightly in the month of August. The U.S. (S&P 500) closed down -0.1% and Canada (S&P/TSX Composite Index) finished up 0.1%. Europe (Euro Stoxx 50) was up 1.1%, and Japan (Nikkie 225) was up 1.9%. Crude oil ("WTI") rebounded up 7.5% as robust demand helped raise prices from its July sell-off.

August was a rocky month in North American markets as investors became increasingly nervous at the prospect of tightening interest rates. New highs in the S&P 500 retreated after the Jackson Hole speeches of Federal Reserve Chairman Janet Yellen and Vice-Chairman Stanley Fischer. They both emphasized that the Federal Reserve ("The Fed") is data dependant and the case for raising interest rates has strengthened. This contradicts previous Fed rhetoric that highlights the asymmetric risks that come with tightening too fast; the costs to the economy of greater-than-expected inflation are likely to be less than those associated with unexpected economic weakness. Inflation expectations of market participants are still below the Fed target of 2%. Raising rates now would further hinder what inflation does exist and increase the probability of recession and deflation going forward. This is why the market rallied back to near all-time highs as the August payrolls fell far short of their consensus expectations: Bad news is good news. While the unemployment rate continues to move down, the civilian labour force participation rate is still far below its pre-2008 levels. If the economy were nearing full employment, the Phillips Curve – which describes the inverse relationship between rates of unemployment and corresponding rates of inflation – should be steepening and thus showing higher inflation expectations in the market. This is far from the case. Five and 10 year inflation expectations of market participants are below the 2% target of the Fed. The participation rate and hourly wages most likely need to increase before inflationary forces become pervasive in the economy and warrant the need to increase interest rates.

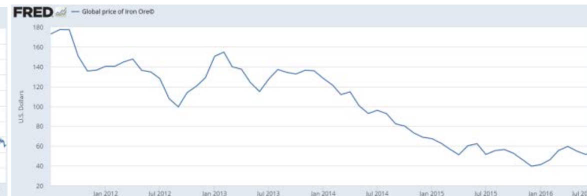
We wrote last month that the 300% debt-to-GDP of the world would act as an economic anchor if deflationary pressures are allowed to persist. Prolonged low interest rates lead to increased inflation expectations which provide a path out of this global debt burden. The Fed is supposed to be a symbol of stability and promoting inflation rather than taming it seems to be counterintuitive. However, the asymmetry of risk lies in the Fed raising interest rates too fast, not too slowly. The Fed faces the dilemma that the later innings of the current business cycle is happening at the end of a generational debt cycle. Trying to be proactive in the former could be absolutely detrimental to the latter. The Fed will most likely continue to convey the responsible tone that when inflationary

forces do emerge, they have the tools to fight them. Until inflation begins to increase, it is unlikely that anything more than talk will take place at the Fed and low interest rates will continue.

Oil and commodity prices are stabilizing. Oil prices gained 7.5% in the month of August as it appears that gasoline and crude inventories have peaked. Capital spending cuts have reduced 2016 U.S. shale production by 800,000 barrels a day and total crude production in the U.S. is down 1.1 million barrels a day. Current crude forecasts suggest that this number could be 1 million barrels a day higher in 2017 as capital expenditures ("capex") have fallen off a cliff in this low price environment. Despite market share wars between the Iranians and Saudis, it appears that OPEC is also nearing its production limit. OPEC's collective production will also significantly decline in 2017 if serious reinvestment is not made into exploration and production. Most OPEC nations have been faced with the difficult decision of directing oil revenues back into capex reinvestment or putting what oil money they do have into the social programs of their populace. By choosing the latter, OPEC has drastically underfunded its assets and risks a high degree of well depletion by the end of 2016. Capex in the mining space is down 65% below its peak in 2011 and is running at a level far below required maintenance for mines to stay operational. It appears that global iron ore prices, a harbinger of global economic health, have found a bottom. High cost operations are shutting down and capacity is contracting. As zero and negative interest rates persist, the attraction of real assets, such as mines and stockpiles, increases. The industrial sector of the economy should benefit from this new wave of global capex as mining companies put long needed reinvestment into their operations.

Crude Oil (WTI) Price

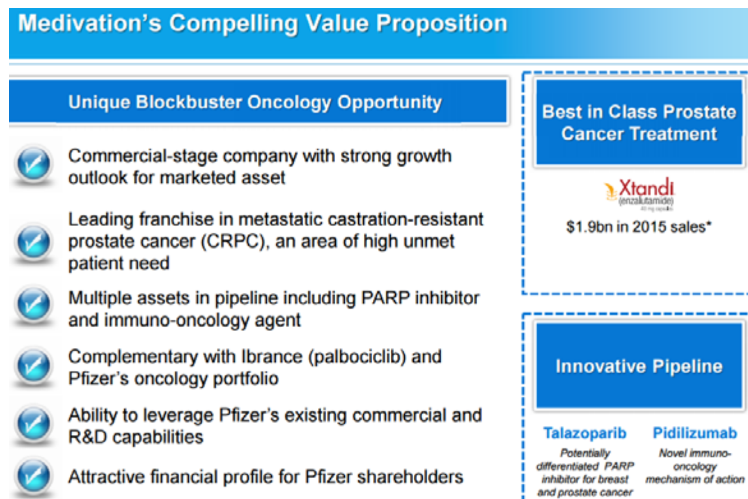
Global Iron Ore Price



Source: St. Louis Federal Reserve

Canada's economic landscape is improving. GDP numbers were down 1.6% in July but the cause of the sharp pullback in production was from transitory maintenance shut downs and disruptions tied to wildfires in Alberta. Overall, it appears that the economy is starting to adapt to a weaker dollar and low oil prices. The trade deficit in July improved by $1.5 billion Canadian Dollars ("CAD") and exports improved 3.4% while imports declined 0.1%. Economies take some time to adapt to a new currency regime and Canada is no different. The lower Canadian dollar is starting to materially impact exporters and tourism throughout the country.

The Fund has used recent events as a chance to rotate back into the health sector. One such company that the fund finds attractively valued is Pfizer Inc (NYSE:PFE). PFE is a biopharmaceutical company that discovers, develops, manufactures and sells healthcare products worldwide. PFE operates through Global Innovative Pharmaceutical (GIP); Global Established Pharmaceutical (GEP) segments; and Global Vaccines, Oncology and Consumer Healthcare (VOC). The GIP segment develops and commercializes medicines for inflammation, immunology, cardiovascular, neuroscience and rare diseases, where as the GEP segment offers products such as branded generics and generic sterile injectable products. The VOC segment develops consumer healthcare products such as Centrium, Advil, ThermaCare brands and Robitussin, to name a few. Pfizer's main focus is leadership in the oncology segment by providing cures and accessible breakthrough medicines to patients, helping redefine life with cancer. This strong Immuno-oncology platform, coupled with increasing revenues, drove margin expansion for PFE that translated into significant growth in earnings per share. Recently, PFE acquired Medivation, one of the most desired independent biotechs because it sells a leading prostate-cancer drug and possesses an innovative pipeline. The deal was financed entirely through cash and provides bolt-on drugs that will immediately flow through to the bottom line of the company.



Source: Pfizer Investor Relations

PFE has maintained a consistent strategy, to improve their revenue growth and advance their pipelines, which has led to exceptional performance across their innovative and established products businesses. PFE has successfully re-launched lagging brands, providing them with renewed branding and marketing, while still growing their established businesses. In doing so they have created financial flexibility that creates options for both short and long-term value creation. This was exhibited in PFE's sixth consecutive quarter of standalone operational revenue growth.

The Fund believes that PFE will continue to be a strong performer in 2016, as strong revenues and increased earnings per share reflect strong performance to date. In addition,

fundamentals continue to support biotechnology as a source of growth in the U.S. economy. We believe U.S. dividend-paying equity securities that possess a combination of low volatility and high profitability will significantly and disproportionately benefit from the continued U.S. economic expansion.

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