BIM Barrantagh Review

Volume 24 | Edition 4 | December 2019

ECONOMIC & GEO-POLITICAL BACKDROP | EASING TRADE TENSIONS MAY BOLSTER GROWTH

The December announcement of a phase one U.S.-China trade deal in principal represented a significant breakthrough in negotiations between the world's two largest economies. Greater clarity regarding the detail of the agreement is likely to follow the signing ceremony planned for mid-January, though there remain contentious issues to be tackled in future discussions. More importantly, it demonstrates that both protagonists can behave in a pragmatic manner at a critical juncture, implying there may be limits to the level of brinkmanship each is willing to breach. **The amount of trade uncertainty throughout 2019 was unprecedented (Figure 1), though began to moderate into year-end. This should increase confidence of many companies to resume capital investments, a positive for economies globally.**

Financial markets echoed the improvements in trade, with global equity, Canadian equity and fixed income benchmarks posting strong total returns for the year. In fact, the referenced equity benchmarks produced positive total returns in every quarter, a feat that would have been repeated for fixed income absent the sequential increase of interest rates in the fourth quarter.

As the new year begins, the U.S. drone strike on a top Iranian military commander has increased fears of a broader Middle East conflict and represents a risk to corporate confidence should it further escalate. The situation and continued exchange of threats warrants close attention though for the time being we take the view that further escalation of tensions is not in anyone's interest. European leaders are calling for restraint and are most likely to play a leading role in mediation efforts.

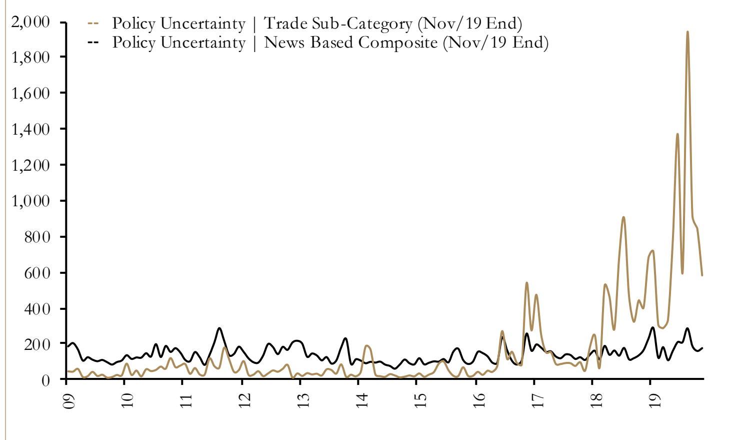
While the markets are not offering as many bargains as a year ago, our outlook for 2020 remains positively disposed towards equities given improved prospects for global growth reacceleration and still reasonable valuations, especially in the context of low bond yields.

ECONOMIC SYNOPSIS

The U.S. consumer remains a bright spot and continued to support the economy in 2019. The employment picture has been very good as shown by the record low unemployment rate, strong wage growth and higher labour force participation. Inflation remains well contained for the time being, which allowed the Fed to reduce interest rates several times last year. In contrast, business investment has been weakening partly due to the trade dispute, however, the service economy remains resilient given its more domestic focus. We expect corporate sentiment to improve this year with a better trade environment. The U.S. election in November could introduce additional volatility to financial markets should the Democrats choose a left-leaning presidential candidate, but we expect this to be more sector specific.

Housing activity and prices in Canada have picked-up again and helped the economy to grow. Montreal is Canada's hottest major market, and Toronto remains strong, while resource dependant provinces are comparatively weaker. Delinquencies on interest rate sensitive consumer debt have been rising, indicating a potentially stretched consumer that in part may be feeling the impacts from the Bank of Canada (BOC) rate hikes announced from mid-2017 through 2018. This is a trend that we are watching carefully, but since rate increases are on hold, we expect the strong job market and rising wages to help consumers manage debt loads. Fortunately, the job market remains robust with very low unemployment and good wage growth. Business investment will be key to monitor in the coming year given the expected approval of the recently updated USMCA (United States-Mexico-Canada Agreement), which should provide some clarity for Canadian businesses who can feel more confident in making spending plans.

FIGURE 1: U.S. ECONOMIC POLICY UNCERTAINTY



Source: www.PolicyUncertainty.com

Western European economies have been among the more impacted by reduced global trade given strong ties to emerging markets. This has been particularly acute in Germany due to its large automotive exports, but we are starting to see signs of stabilization. Sentiment has also started to improve in the rest of the region with the recent progress in the U.S.-China trade dispute. In the U.K., a strong conservative majority election victory provides the government with a mandate to "Get Brexit Done" and withdraw from the European Union in an orderly fashion by the end of January. However, the road ahead for the U.K. will be a difficult one as it must agree to a new trade deal with the European Union, with a tight deadline of 2020 year-end.

Emerging market economies have also suffered due to the escalation in the Sino-U.S. trade dispute. China's export sector has felt this pressure, softening economic growth to 6% as a result. To help mitigate this headwind, China has turned to a more aggressive monetary policy and tax cuts, which is supporting the consumer. GDP growth currently looks to be bottoming in China and should start to show some improvement later this year with a better trade environment.

Despite a variety of political issues facing a number of regions ahead of 2020, economic growth is expected to remain positive this year, which should be supportive of a healthy employment environment. Last year was marked by an escalation in trade wars that resulted in a deceleration of global economies. It is possible that this year we could see the reverse.

EQUITY MARKETS | SOLID PROSPECTS FOR EQUITIES IN 2020 DESPITE STELLAR 2019

The positive gains continued for equites in the fourth quarter with Canadian (+3.2%) and Global (net of +6.3% or +8.5% in USD terms) benchmarks posting solid returns. Full-year results were exceptional for Canadian (+22.9%) and Global (net of +21.2%, or +27.2% in USD) indices.

In 2019, global equity fundamentals were characterized by decelerating growth in the face of escalating trade tensions, which resulted in downward earnings revisions for companies with cyclical exposure and underperformance in those that were most exposed to global trade. In general, the quality structural growth and defensive stocks outperformed throughout most of the year, while cyclicals benefited towards the end of the year as trade tensions de-escalated. Within cyclicals, energy in particular had a strong final quarter benefiting from rising oil prices as OPEC committed to a further supply cut through Q1/2020.

We enter the new year with more optimistic signs regarding trade discussions and with that, better prospects for global growth reacceleration. With this backdrop, we are looking more closely for value in laggards that have seen earnings revised down over the course of the past year and a half, while also remaining balanced in stock selection in light of the continuing uncertainty around trade, politics, and other issues that fester. As such, retaining exposure to structural growers, quality cyclicals, and dependable defensives with reasonable valuations remains the focus. Although the backdrop for earnings acceleration looks more favourable heading into 2020, strong share price gains in 2019 have made it more challenging to find attractive valuations across a larger group of companies. However, we continue to find pockets of value. Careful stock selection remains particularly important in this fluid economic and political environment.

GLOBAL MARKETS

From a geographical perspective, European equities continue to trade at a substantial valuation discount to the U.S., yet generally have higher dividend yields and stronger balance sheets (Figure 2). This discrepancy is mainly due to greater uncertainty in earnings growth since European companies are more exposed to international trade and therefore at greater risk of downward earnings revisions. As such, we have been finding some interesting opportunities in the region and hope to capitalize further on this valuation discrepancy as earnings and trade risks recede. Encouragingly, German business confidence appears to be recovering following a low in mid-2019.

At the sector level, we continue to view Health Care as offering attractive investment opportunities given continued benefits from an aging population and growing medical requirements in both developed and emerging markets. With greater scrutiny in the U.S. on healthcare costs last year, politicians became more vocal about introducing new regulations. This has resulted in a divergence of performance within the sector whereby Health Care stocks with regulatory risk have underperformed. Although our preference within healthcare is to remain invested in structural growers that are less exposed to regulatory risk, we find valuations have become more attractive in managed care and pharma, particularly with companies that help to deliver better health care outcomes at reduced cost. Although the fourth quarter witnessed a strong rebound in these lagging health care stocks, valuations remain compelling and we continue to maintain our positions.

FIGURE 2: EUROPEAN VALUATION DISCOUNT

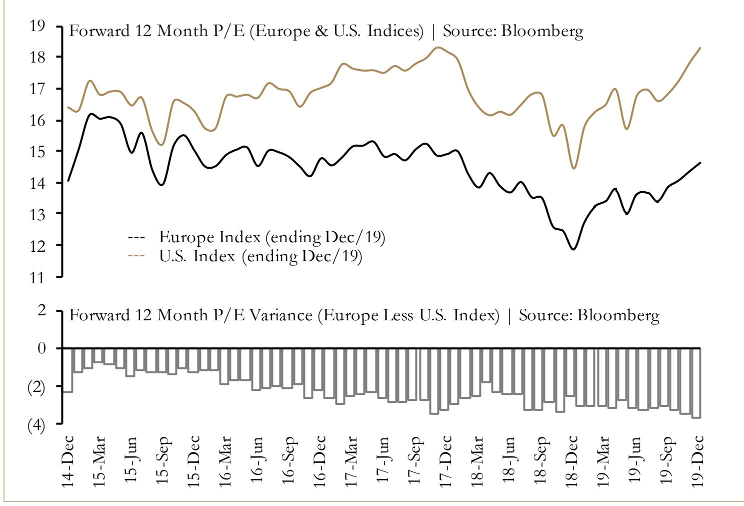
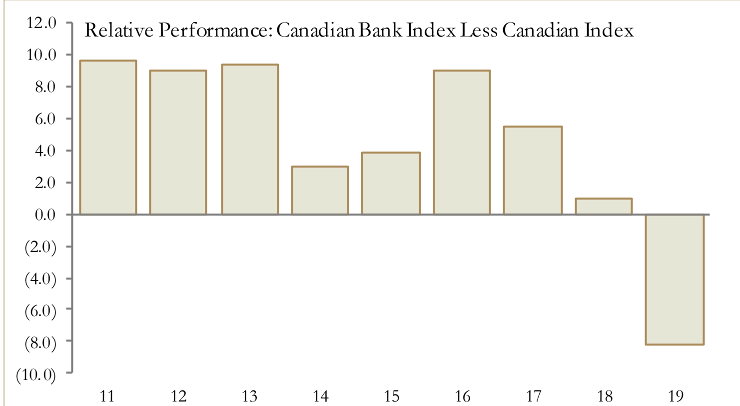


FIGURE 3: CDN BANK WINNING STREAK ENDS



Source: Bloomberg | Performance Calculated On Total Return Basis

CANADIAN MARKET

While the Canadian banks posted strong absolute total returns in 2019, the groups' eight year winning streak versus the index came to an end (Figure 3) as earnings growth disappointed and growth is expected to remain subdued in 2020 per the most recent management commentary. Three broad tailwinds during the long period of relative outperformance included strong loan growth with solid interest margins, positive operating leverage (revenues growing at faster rates than operating expenses) and improving credit conditions (absent an oil price weakness related wobble in 2016). However, a quicker-than-expected normalization of credit conditions in 2019 (whereby provisions for losses as a percentage of the loan book crept higher throughout the year), and weaker interest margins, contributed to both reductions in future earnings growth expectations and lukewarm investor sentiment. This led to below average valuations awarded to the group.

Looking to 2020, the onus is on the banks to prove the resilience of their earnings to restore faith in medium-term growth targets and regain more favourable valuations. The disappointments of 2019 and muted outlooks provide a lower bar to hurdle and the pro-cyclical nature of the banks would also benefit from an improving economic environment. So while the banks may have a few less levers to pull for growth in the near-term and investors will have to see some stronger numbers in print for concerns to alleviate, the long-term track record and construct of the industry point to banks continuing to be a good investment over time.

COMPANY SPOTLIGHT

We continue to own TSX-listed WSP Global (WSP), one of world's leading pure-play engineering consulting firms with a substantial presence in Canada, the U.S., the U.K., the Nordics, New Zealand and Australia. This structural grower has roughly 50,000 employees around the globe and has amassed significant technical expertise and pedigree within the transportation, infrastructure, buildings and environmental sectors. Importantly, WSP does not take on financial risks related to the underlying construction projects, which has been a key differentiator over the past few years.

WSP's diversified global platform delivered impressive organic revenue growth and margins in 2019, despite an uneven global economic backdrop, which helped the stock to outperform. We expect solid organic growth in the years ahead in part due to many governments needing to address aging infrastructure, growing urban populations, and demands for sustainable transportation and ecosystems.

Also, the global engineering and environmental services consulting sectors remain highly fragmented and we expect the company to continue to execute on its successful M&A playbook to further strengthen its network and drive shareholder value. WSP has a strong balance sheet and boasts solid free cash flow conversion, providing significant capacity for the company to self-fund its acquisitions.

FIXED INCOME MARKETS | A TOUGHER END TO A STRONG 2019

The Canadian fixed income benchmark produced strong returns of 6.9% for the full year. Overall, the stars aligned for the fixed income market this year as interest rates declined and credit spreads tightened significantly. For calendar year 2019, long corporate bonds outperformed with returns in the mid-teens.

A small index decline of 0.9% in the fourth quarter occurred as the positive economic backdrop led to rising rates (Figure 4), not entirely offset by tighter credit spreads and interest income. Short corporate bonds were the top performers for the quarter and produced positive returns. We begin 2020 with low yields, which we are monitoring carefully.

As trade relations between U.S. and China improved this quarter, the market became less concerned about a global recession. This is supported by sentiment indicators showing that business confidence is starting to trough, or in some cases improve off of the bottom. Some manufacturing indicators are in contraction territory, but this weakness does not appear to be spilling over into the larger service economy. This is likely a result of the job market remaining strong as employers are reluctant to let go of qualified employees.

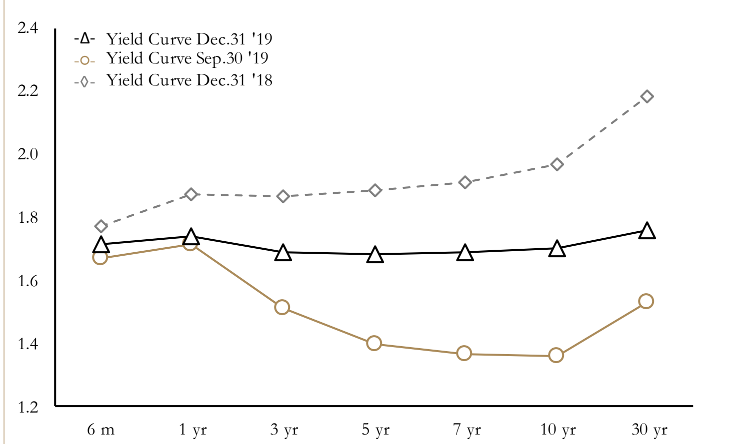
The improving environment resulted in interest rates increasing this quarter by an average of ~20 bps along the curve led by the 10-year term (Figure 4).

The Bank of Canada administered rate remains unchanged since October 2018 at 1.75%. At 2019 year-end, the 2-year rate is 5 bps lower than the administered rate, reflecting a chance that the Canadian economy could deteriorate over that time.

The lowest point for Canadian interest rates this year occurred in August, after President Trump's surprising announcement of additional tariffs. Canadian 30-year interest rates set a historic record low of 1.30%, and the 10-year rate reached 1.10%. At year-end the yield curve was essentially flat, with the 30-year rate at 1.76% and the 10-year at 1.70% (Figure 4).

The Bank of Canada (BoC) is firmly on hold and can chalk up a victory for not raising its rate too high in 2018, and as a result, not needing to cut in 2019. In the near-term, the BoC will remain on hold observing the indebted consumer and modest economic growth. Reported inflation in Canada is slightly above the 2% target and is often the highest in the developed world. For the most part achieving the 2% inflation goal is a good thing and going forward the BoC likely has an appetite to let it rise further without feeling pressure to raise interest rates, again particularly while economic growth is below potential. Globally, Central Banks would like to see inflation rise near or above 2% to achieve their objectives, including price stability and full employment.

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

PORTFOLIO INSIGHTS

Fixed income portfolio duration is about 8 years, a touch lower than the benchmark at 8.1, and portfolios remain underweight long maturity Provincial credit.

There were two additions to fixed income portfolios this quarter, both in early-December.

Province of Newfoundland and Labrador 2029 bonds were bought, which offer the highest interest yield of all the provinces, and even more than the municipal City of Toronto issues. Newfoundland is Canada's most energy sensitive province and has endured struggles. However, we believe that recent Federal Government support from the updated Atlantic Accord, the near completion of Muskrat Falls large-scale hydro electric dam, additional corporate capital spending and the ability to deliver energy products on the Atlantic Ocean will be supportive for the region. This purchase was funded through the sale of an equal amount of Canada 2029 bonds.

The other buy was Canadian National Railway (CNR) 2050 bonds financed from the sale of an equal amount of Canada 2045 bonds. CNR has been a long-term holding in equity portfolios, and we like its vital position in the economy and wide competitive moat supported by a best-in-class network, rational competition, and high barriers to entry. The bonds typically price equal to the best quality corporate utility bonds since CNR generates a consistent cash surplus. At the time of purchase the bonds were priced at a discount to peers due to its exposure to the economic cycle, but we believe those concerns will abate and the bonds' value will be realized.

Barrantagh

Investment Management

Barrantagh {manx gaelic} trustworthy *adj.*, dependable *adj.*

We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

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