BIM Barrantagh Review

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ECONOMIC & GEO-POLITICAL BACKDROP | OUTLOOK TRUMPED

The biggest surprise of this tumultuous year emerged in the fourth quarter with Donald Trump elected as U.S. President (along with the Republican domination of Congress). 2017 seems set to provide no shortage of market shaping events. To some extent 2016 feels like a film only half watched, with the 2017 outlook focused on the evolution of U.S. policy under Trump, likely intense Brexit negotiations and elections in key E.U. member states (Netherlands, Germany, France, and possibly Italy) amid rising global populist movements. The outlook will also be obscured by continued Middle East strife and strains as China seeks to solidify its position as a world power. Despite all of this potential noise related to policy and geo-politics, sentiment for the global economy remains positively biased, with global GDP growth expected to improve in 2017 relative to 2016.

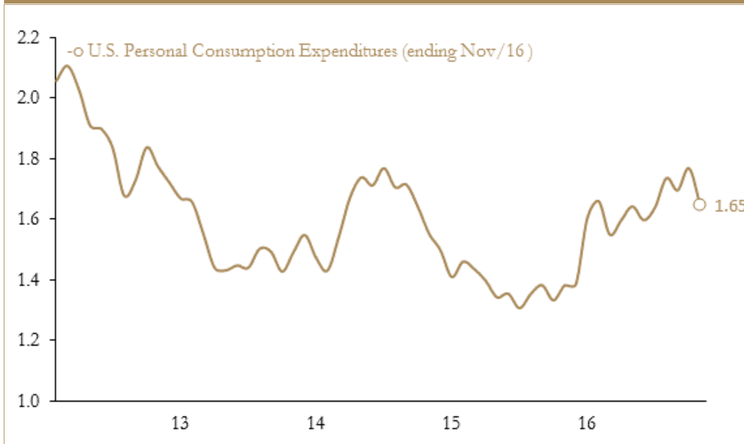
TRUMP, THE FED

The high degree of Trump / Republican political control is expected to end the deadlock that plagued the Obama administration. Markets have already priced in some of the pro-growth and inflationary aspects of Trump policy. Trump is bringing a largely novice (to political process) and less predictable team into office, and financial markets initially found themselves off balance. Since the election, equity markets have celebrated, while fixed income markets have fallen. With the U.S. economy already healthy (Q3 GDP growth recently revised to 3.5% with the outlook firming, while U.S. unemployment remains low at 4.6%), the bond market worries that Trump's plans to stimulate growth (via tax reform, less regulation and infrastructure spend) will also trigger a sharp rise in inflation (Figure 1), which would have to be combatted by raising administered rates.

A key plank in Trump's election platform was an intention to compel U.S. companies to bring jobs back to America and to provide protective international trade measures. Growth in protectionism is likely to be inflationary, and at the extreme recessionary. Clearly, Trump has no intention of signing the Trans Pacific Partnership, effectively constraining trade with Pacific Rim countries. His sights are also set on NAFTA, but it is not obvious whether his intention is a partial renegotiation of clauses (specifically those covering U.S. manufacturing offshoring to lower cost countries) or an abrogation of the pact altogether. The large U.S. trade deficit is dominated by China, but other significant contributors also include Germany, Mexico and Japan. Though the Canadian economic outlook is also somewhat clouded by Trump's trade rhetoric, rebounding oil prices and fiscal stimulus should be positive offsetting factors.

The FOMC did not disappoint in December, announcing a well-choreographed 25-basis point hike in the Fed Funds target rate. However, Fed expectations for three hikes in 2017 versus two previously, did surprise, with the incoming U.S. administration a factor. In voting to raise rates, the Fed cited the risks of nascent inflation indicators and effectively full employment. Market participants were yet again left asking themselves what the Fed saw in December that they had not seen in September or earlier. At the time of writing, the market is still only pricing in two hikes for 2017, once again lagging behind FOMC expectations.

Figure 1: U.S. Core Inflation (YOY %)



Source: Bloomberg

Another key theme is the interaction between Trump and Fed Chair Janet Yellen. Trump has been critical of Yellen, which leaves the markets nervous about who will be in control of U.S. monetary policy. During the election campaign, Trump missed no opportunity to attack her actions or track record at the Fed. Yellen's term in office ends in February 2018, and at this point it seems unlikely that she will be renewed past this date.

GLOBAL ECONOMIES

Around the world, major economies are looking steady to modestly brighter. Though economic data in Japan and the U.K. has been mixed, weaker currencies have boosted growth prospects. In the E.U., despite stubbornly high unemployment rates and looming election risks, the economy is progressing modestly, with the ECB (European Central Bank) remaining accommodative under its quantitative easing ("QE") program. Recent changes (effective April 2017) to the QE program allows the ECB to buy lower rated government debt (which addresses the shortage of qualifying paper), reduces the monthly debt purchases from EUR 80 Billion to EUR 60 billion, and extends the program at least through 2017. However, the ECB insists this is not the start of tapering and remains ready to respond to any threats to market liquidity.

Brexit has progressed very little. Theresa May has been settling into her new role as PM and a British high court ruled that the decision to leave must be debated in Parliament. The European Court of Justice has also thrown in a wrinkle into the plans of Brexit supporters, claiming "ultimate authority" in the debate.

As noted in our last letter, Chinese maritime activity is becoming more aggressive, and this was illustrated again in December with the seizure of a U.S. unmanned drone in the South China Sea. This region is becoming center stage for confrontation between China and the West. The rate of Chinese GDP growth is expected to be relatively stable in 2017 versus 2016 as Chinese policy makers balance the need for growth with a transition to a more consumption-driven economy and growing trade risks.

EQUITY MARKETS | REFLATION AND ROTATION

Strength in equity markets continued in the fourth quarter (Canada +4.5%, Global +2.0% or +4.6% in C$ terms), rounding off a very solid year (Canada +21.1%, Global +8.2% or +5.2% in C$ terms). However, the steady grind higher of equity indices this quarter concealed a furious sector rotation.

While some signs of reflation had already emerged in the latter half of the third quarter, the trend greatly intensified after Trump's largely unexpected U.S. election victory. Sectors that were viewed to be beneficiaries of Trump's platform (either directly or as a by-product) rallied at the expense those seen to be disadvantaged. The bifurcation in fortunes was largely drawn down the lines of interest rate sensitivity and cyclicality, with pro-growth sectors doing well, and perceived bond proxies struggling. Given the magnitude of recent moves, we expect markets to maintain a sharp focus on Trump's ability to execute and timelines to implement key aspects of his agenda once in office.

As we look into 2017, we are seeking companies that have yet to reflect improved fundamentals, or that maintain attractive prospects but have been unfairly punished by the ongoing sector rotation.

CANADIAN MARKET

Canada has long enjoyed a strong housing market, and in early October Ottawa once again intervened in an attempt to prevent it from overheating. Measures introduced included the closing of principal residence exemption tax loopholes for non-residents and stricter qualification guidelines for insured mortgages. This effectively increased the qualifying rate for 5 year, fixed-rate, high-LTV (loan-to-value) mortgages and disallowed portfolio insurance for low-LTV mortgages for houses purchased above $1 million. Unsurprisingly, specialty mortgage lenders initially sold off after the announcement, with banks having a much more muted reaction in light of diversified business models. We will be monitoring the impact of the policy changes in the coming months.

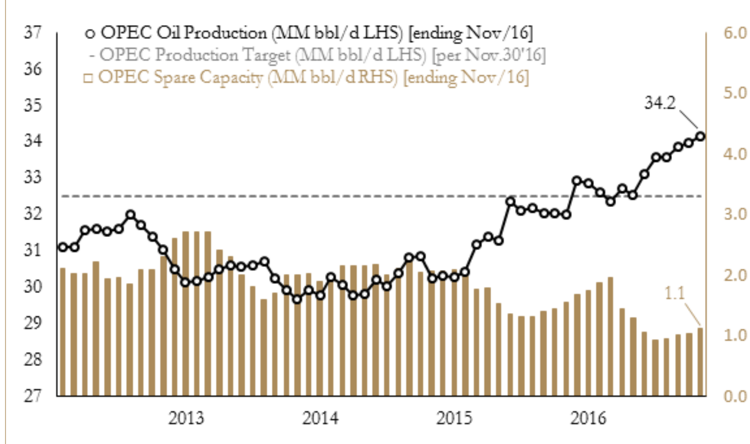
In the aftermath of the OPEC agreement (Figure 2), oil industry participants will be able to more confidently plan capital budgets, and investors can worry less about the potential for significant downside in the crude oil quote. Despite much posturing to the contrary leading up to the November 30th meeting, OPEC delivered a production cut of 1.20 MM bbl/d (from cartel reported reference levels) for a minimum six month period beginning January 1st 2017, and reintroduced individual member production targets. The cuts are collective, with the vast majority of members (Nigeria and Libya being special exceptions as each is producing well below capacity due to security issues) agreeing to reduce production. Furthermore, a group of non-OPEC nations (led by Russia) subsequently agreed to a ~0.55 MM bbl/d cut over the same time frame.

While compliance with the production cut agreement remains a key risk, the impact is meaningfully positive for the next six months or more even assuming some level of "cheating", which could be further enhanced if global demand is stronger than expected. Nonetheless, the materiality of the benefit to the crude markets could be diluted with improvement in either Libyan or Nigerian fortunes, or a faster than expected supply response (to improved pricing) from regions (particularly U.S. shale plays) external to the agreement.

GLOBAL MARKETS

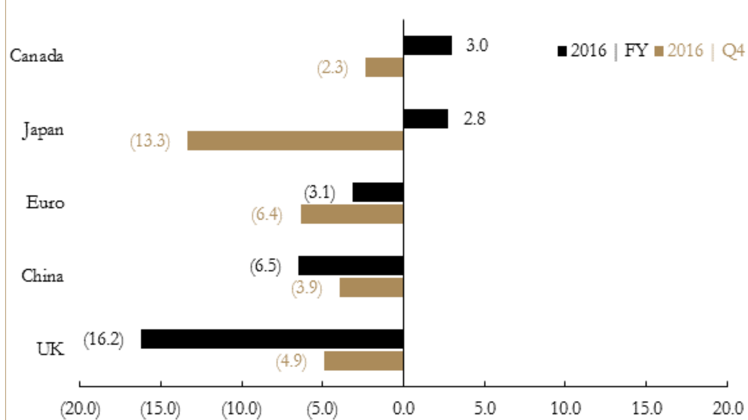
Global equity markets are in the midst of shifting from a low rate and modest growth scenario, to a more inflationary and higher growth outlook.

Figure 2: OPEC Oil Production & Estimated Spare Capacity



Source: Bloomberg, DOE

Figure 3: Global Currencies (% Chg. vs. US$) [2016 Yr & Q4]



Source: Bloomberg

Within this rotation from the less cyclical and interest sensitive stocks to the more cyclical names, global companies with greater exposure to the U.S. have performed best given the prospects of lower corporate income taxes, higher fiscal stimulus, and improved economic growth. However, valuations of companies expected to benefit from this shift have already started to reflect some of this improvement. Furthermore, a sharp appreciation of the U.S. dollar against most currencies (Figure 3) will potentially put near-term pressure on earnings growth for U.S. companies with foreign currency exposure. As such, we will continue to be selective when considering new investments, pursuing high-quality companies with healthy growth prospects trading at reasonable valuations.

One area where we are starting to see value emerge is in select high-quality Japanese equities, in part due to the sharp depreciation of the Yen. Japanese companies with strong technology, a global service network, and a bias towards exporting should benefit most as businesses globally continue to look to improve productivity. Also, Japanese companies continue to improve corporate governance and focus on shareholder returns.

PORTFOLIO INSIGHTS

During the quarter, we added to our holdings of Badger Daylighting, the largest pro-

vider of non-destructive excavation in North America, and a company well positioned to take advantage of an uptick in oilfield activity and U.S. related infrastructure stimulus. Badger deploys hydrovac trucks that use pressurized water to expose buried infrastructure in primarily the utility and petroleum sectors. The hydrovac process offers time and safety advantages over traditional excavation methods and continues to gain acceptance across the U.S. (at a measured pace) building upon a historically well established base in Canada. The company's leading market share, vertically integrated business model (the company designs and assembles its own hydrovac units) and extensive network of service centers is a source of competitive advantage, and results in superior margins and returns on capital versus industry peers.

We added a new position in Halliburton as clarity around OPEC's agreement began to materialize. Halliburton is a leader in oilfield services and has been a key enabler of productivity improvements in oil and gas extraction. Halliburton's North American division has experienced a particularly deep profit contraction as oil prices fell in dramatic fashion over the past two years. However, shale oilfield activity in the U.S. has started showing signs of rebounding, and given this region's relatively attractive positioning along the cost curve, we expect improvement in activity to continue for the next several years.

FIXED INCOME MARKETS | REPRICING RATES AND BETTER YIELDS

Interest rates moved dramatically in the fourth quarter largely driven by the U.S. election result, with November seeing the largest rise in long-term rates for a single month since 1996. Donald Trump's victory caught the market by surprise, and his pro-growth point of view, along with a Republican controlled Congress, has convinced the market that meaningful inflation is coming.

In the fourth quarter, interest rates in Canada jumped 70bps in the 10 and 30 year terms, and 5 year and shorter terms saw a more moderate 35-55bps increase. In fact, much of the Canadian curve began the quarter at or below where it started the year, while by the end of the quarter the entire curve had shifted above beginning of year levels (Figure 4).

Corporate credit spreads improved during the quarter, decreasing between 5bps and 10bps. The Energy sector led the way as oil prices rose due to OPEC's production cut agreement (which also notably helped to drive interest rates higher as oil has a significant impact on inflation). Energy holdings in BBB-rated Enbridge and Veresen outperformed other corporate bonds. Within the financials sector, spread compression for the life insurers bettered that of the banks amid rising long-term rates, although both were improved.

CANADIAN BACKDROP

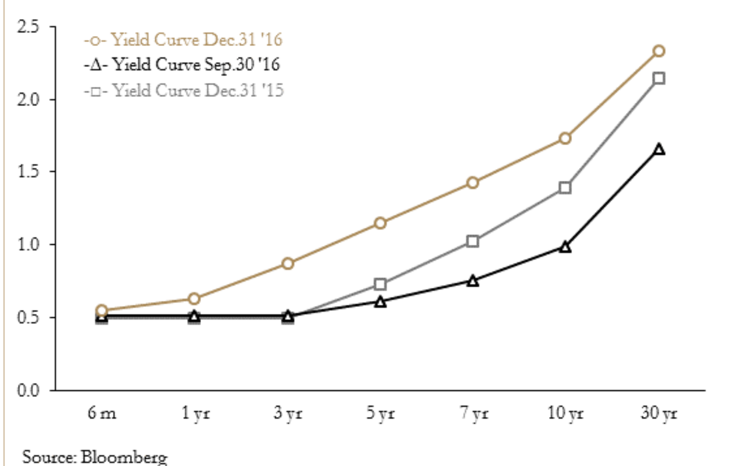
So far, Canadian fourth quarter economic data is showing that growth has not been as strong as expected. The Bank of Canada had conservatively estimated Q4 GDP growth at 1.5%, but this is now looking slightly optimistic. Despite a sharp jump in Q3 GDP (assisted by rebounding oil production following wildfires earlier in the year), October month-over-month GDP growth was negative 0.3% with widespread weakness, though most pronounced in the goods producing sectors.

While the U.S. Fed is hiking, the Bank of Canada is firmly on the sidelines with a chance of cutting, leaving interest rates in Canada with a term of less than 10 years looking more attractive.

The Bank of Canada's next meeting is on January 18th, and the economy's softness should be acknowledged. At the end of December, there is almost no chance of a rate cut priced in the market, but the Bank's statement is expected to be more supportive for the economy. Governor Poloz is consistently focused on non-energy exports, and this is the part of the economy that has underperformed lately despite a weak loonie. As recently as December 7th, Poloz stated that the output gap in the Canadian economy is about 18 months away from closing and the best plan for the Bank is to wait on the sidelines until this closes.

PORTFOLIO INSIGHTS

Figure 4: Canadian Yield Curve (%)



Source: Bloomberg

Reflecting the likely significant upward shift in U.S. economic growth and inflation, we expect there will be pressure for longer-term interest rates to rise, and consequently we made significant changes to the portfolio to protect from higher interest rates while also generating higher interest income.

We have sold out of both Canada 2033 and 2045 long bonds, and the longest maturity is now just under ten years, September 2026. We increased the portfolio's interest yield by adding some credit risk mostly in the form of Provincial bonds. We selected Alberta (AA rated) and Saskatchewan (AA) as oil prices likely have significant downside support due to the recent OPEC agreement and a general slowdown of investment in supply. Both of these energy-exposed provincial governments have proved willing and capable of dealing with their financial shortcomings, and their credit spreads offer good value. Manitoba (A high) was also added with its well diversified economy as a strength. All three provinces offer relatively better interest return than British Columbia (AAA), Ontario (A+), and Quebec (A+).

Canada and CMB 2023 and 2024 bonds were sold, and AAA rated Federal pension plan PSP Capital and AA+ rated Ontario Pension Board Finance were added in the same term providing additional interest income.

Some 3 to 4 year corporate bonds were sold and replaced with 7 to 9 year corporate bonds to take advantage of higher interest rates, with the confidence that credit spreads will be tighter in the future and interest rates in that term should be contained.

We believe these changes have made the portfolio more resilient against the backdrop of potentially higher interest rates.

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

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