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- Chair Yellen continues to describe the decision process as data dependent, but which data is not clear. There are few concerns on the employment side. Yellen's much favoured statistical measure, the JOLTS survey, which attempts to quantify the number of workers that quit voluntarily and also identify the number of jobs waiting to be filled, is still producing encouraging results.
- Another popular statistic, the PCE Core inflation indicator, remains persistently low, and together with a soft durable goods order measure for February adds to the opaque economic outlook. In particular, a drop in the non-defense capital goods shipments statistic, which is used as a proxy for corporate capital expenditure, is discouraging. The Fed also appears to be giving global economic conditions more weight in its deliberations, so watching the progress, or lack thereof, of economic growth measures in the domestic U.S. economy may not provide us with the key piece of data that triggers a rate hike.
- Conditions in Europe didn't change much. Economically, Europe has held steady which many consider a win. Unfortunately, we also continue to have a migrant crisis in the eastern Mediterranean, which is forcing the EU (Germany in particular) to negotiate a solution with Turkey. The terrorist attacks in Brussels added to the uncertainty in European markets, but had less impact on markets than many might have expected.
- China has seen a much anticipated slowing in economic performance. In 2015, China reported its slowest rate of growth in 25 years. This has resulted in the expected fallout. For instance, China announced the layoff of more than 5,000 government workers as the country moves to a more open economy, and plans to rationalize its State-owned enterprises.
- During the National People's Congress in March there were a number of initiatives introduced to hasten the transition from an economy built on exports to one based on domestic consumption. China has moved quickly to boost its economy, cutting the required reserves at banks.
- Equity markets started the year weak, though rebounded strongly as the first quarter progressed in large part due to weakness in the U.S. dollar and strong performance from the commodity complex.
- Base metals and bulk materials demand remains levered to China, where the future economy will be less metals intensive. Absent an unforeseen material uptick in demand or a supply-side shock, we expect the mining industry will bear the burden of rebalancing the current overcapacity in metals markets, which in most cases argues for subdued pricing for a protracted period. We do maintain a relatively more optimistic view on the crude markets given the prolonged (and accelerating) collapse in capital spending that is most apparent in North American shale oil development.
- The commodity driven equities that have enjoyed the largest moves off of the bottom have been those with the greatest financial and operational leverage (i.e. those with the weakest balance sheets and/or least efficient operations). However, empirical evidence suggests that "levered" stocks can significantly outperform during the initial stages of a recovery, but not necessarily thereafter.
- For the bond market, the beginning of 2016 continued the torrid pace of declining interest rates that started in early November 2015, but by the end of the quarter sentiment had changed.
- With economic uncertainty continuing in Canada, we reduced credit risk exposure in applicable accounts in order to better protect capital.

Barrantagh
Investment Management

Economic Backdrop – Opaque Outlook

The brave new world of U.S. monetary tightening expected after the Fed raised the Fed Funds target rate 25 basis points has come to pass, but not in the expected form. There have been two FOMC meetings since the end of the year with no change in policy or rates. Generally, markets have interpreted the latest moves by the Fed as a transition to a dovish stance with the Fed sufficiently concerned about a lack of inflation and weak economic growth. They are not prepared to risk further tightening. Given the Fed's mandate, they need to see inflation rise to a comfortable level that will boost consumer and business confidence.

The Fed also appears to be giving global economic conditions more weight in its deliberations.

Chair Yellen continues to describe the decision process as data dependent, but which data is not clear. There are few concerns on the employment side. In 2015, the U.S. created on average 235,000 new jobs each month. This was strong enough to meet the basic needs of the U.S. economy. However, the first quarter has showed evidence of a slowing pace of job creation, with job gains averaging (a still healthy) 207,000 during the first two months of 2016. Yellen's much favoured statistical measure, the JOLTS survey, which attempts to quantify the number of workers that quit voluntarily and also identify the number of jobs waiting to be filled, is still producing encouraging results. Job openings have climbed for the second month in a row, and "quits" (voluntary job leavers) are now in a sixth year of increases. Another popular statistic, the PCE Core inflation indicator, remains persistently low, and together with a soft durable goods order measure for February adds to the opaque economic outlook. In particular, a drop in the non-defense capital goods shipments statistic, which is used as a proxy for corporate capital expenditure, is discouraging. The Fed also appears to be giving global economic conditions more weight in its deliberations, so watching the progress, or lack thereof, of economic growth measures in the domestic U.S. economy may not provide us with the key piece of data that triggers a rate hike. The slowing housing market in the U.S., both new and resale, will add drag to the economy as well.

Economically, Europe has held steady which many consider a win. Unfortunately, other things in Europe didn't change much either. We continue to have a migrant crisis in the eastern Mediterranean, which is forcing the EU (Germany in particular) to negotiate a solution with Turkey. As the first quarter drew to a close, the European Union announced a deal with Ankara to curb the massive flow of migrants entering the Continent from Turkey, and Turkey has agreed to take back migrants who land illegally in Greece. In turn, Turkey will send approved migrants to Europe for resettlement. The EU will make a €3 billion payment to Ankara, and another €3 billion disbursement in 2018, to be spent on EU-approved projects. In addition, they agreed to accelerate Turkey's application to join the EU. The terrorist attacks in Brussels added to the uncertainty in European markets, but had less impact on markets than many might have expected.

China has seen a much anticipated slowing in economic performance. In 2015, China reported its slowest rate of growth in 25 years. This has resulted in the expected fallout. For instance, China announced the layoff of more than 5,000 government workers as the country moves to a more open economy. A large proportion of the job losses will come from shutting down, or selling off, "zombie" companies, which are State-owned enterprises that are in fact bankrupt, but haven't been forced to recognize it. They have been kept alive by steady injections of debt that they are unable to pay back. In the build up from 2008 to 2015, Chinese banks were ordered to increase lending to State-owned enterprises, which in turn poured funds into the construction of factories and infrastructure facilities regardless of commercial need. The resulting collapse hit hard. Financial conditions worsened sharply as institutions cut back lending, while company borrowing and local government debt rose steadily. In addition, the housing market cooled and infrastructure spending slowed. With these cutbacks in available credit, demand for raw materials worsened, and this oversupply negatively impacted Western economies. The Chinese premier is now calling for the development of "robust capital markets" as a defense against overleveraged companies and individuals. Gross debt has reached 230% of GDP.

During the National People's Congress in March there were a number of initiatives introduced to hasten the transition from an economy built on exports to one based on domestic consumption. China has moved quickly to boost its economy, cutting the required reserves at banks. Market participants are watching closely to see if this injection of liquidity is enough. As evidence of the impact of China's efforts to stimulate their domestic economy, the country's foreign exchange reserves declined by $28.6 billion to $3.20 trillion in February of 2016, following a $99.5 billion fall in January and a $107.9 billion decline in December, the largest drop on record. Reserves remained at their lowest level since the end of 2011.

Much will depend upon the economic health of China and the U.S. in the coming months. Greater clarity and consistency in policy from the Fed would help!

Equity Markets – Commodity Conundrum

Equity markets started the year weak, though rebounded strongly as the first quarter progressed with Canada (+4.5%) outpacing the Global market (-0.2%, but -6.3% in CAD$ terms) in large part due to weakness in the U.S. dollar and strong performance from the commodity complex.

The rebound in a majority of commodities (albeit from a low base) was driven by numerous factors including the lack of further deterioration in fundamentals, the weakening of the U.S. dollar, the partial reversal of extreme investor positioning, and improving sentiment related to communications from influential market participants (e.g. China stimulus, potential OPEC production freeze). Notwithstanding some encouraging developments, sentiment driven factors have likely pushed pricing ahead of fundamentals in some cases, leaving us cautious of the recent spike in pricing, particularly for base metals and bulk materials which appear technical in nature (i.e. a short covering rally).

Base metals and bulk materials demand remains levered to China, where the future economy will be less metals intensive given state ambitions to both address reforms of heavy industries and focus on growth exhibiting lower fixed asset intensity. Absent an unforeseen material uptick in demand or a supply-side shock, we expect the mining industry will bear the burden of rebalancing the current overcapacity in metals markets, which in most cases argues for subdued pricing for a protracted period.

We do maintain a relatively more optimistic view on the crude markets given the prolonged (and accelerating) collapse in capital spending that is most apparent in North American shale oil development, where rig counts continue to decline to multi-year lows and U.S. onshore production has dropped well below the peak of 9.2 mm bbl/d reached in mid-2015. Additionally, the potential for a production freeze agreement amongst certain OPEC/Non-OPEC members indicates greater co-operation and dialogue amongst key market participants (even if an agreement may have limited fundamental impact). We therefore view the crude markets as being in the latter stages of a rebalancing process, but do expect continued volatility given the recent move in pricing, still elevated inventories, and uncertainty over the pace at which Iran will increase exports post the lifting of sanctions earlier this year.

Gold is often viewed as a form of financial insurance, and its strong performance this year has been attributed in the media to reset expectations for the path of future U.S. interest rate progression. We remind our clients that we are averse to gold equities given the ever changing drivers of the commodity that make it difficult to derive a fundamental view on value.

The chief benefit of operating a sustainable model is an ability to weather downturns without impairing optionality to better times.

The commodity driven equities that have enjoyed the largest moves off of the bottom have been those with the greatest financial and operational leverage (i.e. those with the weakest balance sheets and/or least efficient operations). This is intuitive as those companies under the greatest pressure in the downturn will get the greatest relief as the cycle turns. Empirical evidence suggests that "levered" stocks can significantly outperform during the initial stages of a recovery (but not necessarily thereafter), which in the absence of continued improvement in underlying fundamentals implies an unfavourable risk reward proposition for owning securities with marginal economics. Empirical evidence also suggests that commodity stocks with strong track records of execution, access to high rate of return projects, and prudently managed capital structures outperform their peers over the mid- and long-term. The chief benefit of operating a sustainable model throughout the cycle is an ability to weather downturns without impairing optionality to better times, and companies with such models represent the opportunities we seek out within the space. This also reflects our broader investment philosophy.

Two such (non-commodity related) opportunities we have recently purchased for clients include Intact Financial and Accenture. Intact Financial is Canada's largest, and best-in-class, property and casualty insurer whose scale, breadth of operations, and sophisticated underwriting and data analytics have enabled the company to continually optimize its pricing and risk exposures. These practices, and focus on customer experience, continue to generate peer leading profitability and growth, which we expect to be supplemented by the company's participation in further industry consolidation over the medium-term. Accenture is one of the largest management consulting, technology services, and outsourcing companies globally. The company's scale advantage allows it to build out deep expertise in each industry vertical, helping customers become more productive and migrate their businesses toward the new digital world. Accenture is a highly cash generative company currently experiencing very attractive growth rates, and has a strong shareholder return policy in place.

These two purchases highlight how scale can be used to leverage competitive advantage, which is of particular importance in a slow growth environment.

Fixed Income Markets – Credit Risk Reduced

The beginning of 2016 continued the torrid pace of declining interest rates that started in early November 2015. 30-year rates in Canada went from 2.42% in November to 1.82% by mid-February. This includes a 33bps drop from January 1, 2016 to February 10th, just over half of the total move, and a return of 6.8% on the Canada 30-year benchmark. This change was consistent with the overall risk off mood when stock markets declined. Credit spreads were also a big story with the 5-year index moving 33bps wider, reaching levels equivalent to the height of the Euro crisis in 2011 and 2012. The overall Canadian bond index had a return of 1.7% (ytd) by February 10th.

The impact of low oil prices is still being measured by the Bank of Canada, and market expectations for the Bank set overnight rate has seen large swings.

Since then, market sentiment has changed. Performance of the price of oil seemed to lift everyone's spirits oil rallied ~45% to above $39 at the end of March. The 30-year Canada rate reached 2.11% at one point and by the end of March left the year-to-date return at 2.4%, which was far milder than the February high. 5-year credit spreads also improved and tightened 44bps, and are now lower than where they started the year. By the end of the first quarter, lower credit spreads offset higher interest rates, and the Canadian bond index return year to date is 1.39%.

The impact of low oil prices is still being measured by the Bank of Canada, and market expectations for the Bank set overnight rate has seen large swings. In mid-January, the market suggested an 80% chance of a rate cut by the end of the year, only to see those odds consistently dwindle to about 20% at the end of March. When the Bank met on January 20th, the oil market was in a bearish mood, with oil at $26.50 (WTI). The fixed income market gave a slightly lower than 50/50 chance that the Bank would lower its rate during the meeting. Subsequently, the Bank slashed its GDP growth estimates and stated that it wanted to wait and see what fiscal stimulus from Federal Government spending would be in the budget to be released March 22nd. Post the release, the Bank of Canada continues to expect 2016 real GDP growth to be 1.4%, and 2.4% in 2017. In late-2015, the Bank estimated Q1, 2016 GDP to be 1.0%, and Q2 at 2.2%, and the Bank has not restated these short-term estimates thus far in 2016.

The next Bank of Canada meeting is April 13th, and they will convene once more during the second quarter in May. Ahead of the April meeting, Statistics Canada reported January Canada GDP growth of 1.5% year-over-year, a marked improvement from December +0.5% and November +0.2%. The market will be very interested in the Central Banks comments on the health of the Canadian economy and its assessment of economic support from the Federal budget. One fact the market can agree on is that the Bank is very unlikely to increase interest rates this year, and if it were to make any moves, it would be to lower interest rates.

As a result of global economic weakness and the continued impact of lower oil prices on the Canadian economy, we made a few changes to the portfolio during the first quarter. With the Bank of Canada on hold for the foreseeable future, we sold some short term bonds such as Government of Canada 2016 and 2017 maturities, and bought longer dated Government of Canada 2021. This allowed us to capture higher interest rates offered by the longer dated maturities.

For accounts holding corporate bonds, we also took advantage of currently steep credit curves. Corporate bonds with 2016 to 2019 maturity dates have become expensive, offering an attractive opportunity to achieve a better risk-adjusted return further out the yield curve. For example, in eligible accounts, we sold Greater Toronto Airport Authority (GTAA) 5.96% Nov 2019 bonds to buy GTAA 1.51% Feb 2021 bonds, resulting in a pickup of 30bps for only an additional 15-months of term.

With economic uncertainty continuing in Canada, we reduced credit risk exposure in applicable accounts in order to better protect capital. We sold consumer product names Loblaws and Saputo that have BBB credit ratings, and bought higher quality AAA rated bonds from the British Columbia Municipal Finance Authority, Quebec provincial pension plan manager Caisse de Depot, and the Federal Government of Canada. These transactions were done to improve the credit quality of the portfolio, as well as capitalize on the Bank of Canada keeping short-term interest rates unchanged for the foreseeable future.

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.

For more information contact: Barrantagh Investment Management Inc. (416) 868-6295