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ECONOMIC & GEO-POLITICAL BACKDROP | MODEST SYNCRONIZED GROWTH

The first quarter of 2017 proved relatively calm. We continue to see positive data points emerging from the global economy, with a modest acceleration of synchronized global GDP growth likely for 2017. Recent solid economic data underpins our positive outlook and continued preference for equities over bonds. However, financial markets in North America and Europe continue to exhibit some headline related volatility, and this will likely persist considering interest rate increases, Trump policy, Brexit negotiations, European elections and Middle East conflict.

TRUMP POLICY

Trump's administration got off to a rocky start, with legal challenges stalling his plans on immigration and an unsuccessful attempt to repeal Obamacare. This has led some market participants to question Trump's ability to execute on aspects of his pro-growth policy agenda. Markets are squarely focused on the prospects for lower income taxes, and it appears that support is waning for a border-adjusted tax (B.A.T. – effectively a tax on U.S. imports), which has been proposed as a means to help fund tax cuts. To-date, Trump has made progress on some aspects of his agenda, such as the federal approval of the Keystone pipeline and the cancelling of several pieces of Obama imposed Environmental Protection Agency rules. The Trump administration continues to send mixed messages on changes it expects to the North American Free Trade Agreement (NAFTA). At the end of March, the U.S unveiled a draft list of potential changes to NAFTA, which were more extensive than the "tweak" hinted at during Prime Minister Trudeau's visit to Washington. However, most believe the implications for the Canadian economy will ultimately be modest, with the U.S. administration more likely to target an unbalanced trade dynamic with Mexico. As expected, the U.S. government also cancelled participation in the Trans Pacific Partnership.

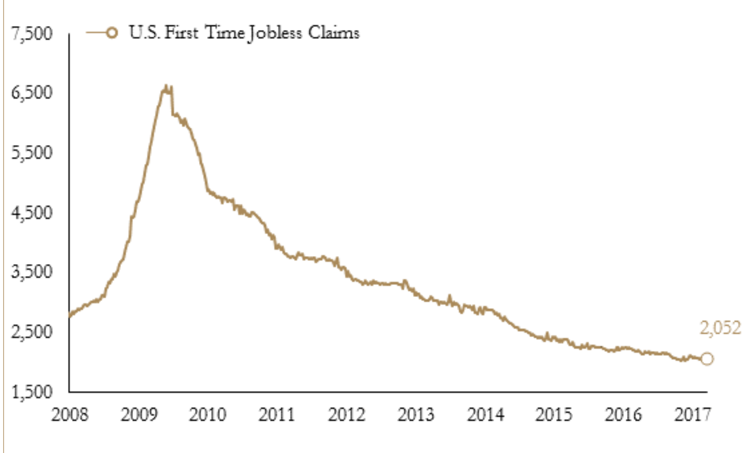
THE FED

In the past few editions of the BIM Review, we have discussed the lack of activity on the part of the U.S. Federal Reserve (Fed), and while welcoming the December 2016 and March 2017 rate hikes, we bemoaned the slowness to act and wondered what the Fed saw more recently that they hadn't seen earlier. January brought about a sudden transition at the Fed from dove to hawk. There was an abrupt transition from the market expecting little from the Fed before June, to the market suddenly being encouraged to realize there would be a 25-basis point rate hike at the March meeting, which was what the Fed delivered. Market participants seem to have been lulled into complacency by the slow pace of rate increases and the "only in December" pattern, having forgotten that the Fed can change paths even if it is not actually announced until the next meeting. Currently, the implied probability of a Fed hike in the next few months is slightly below 60%.

U.S. ECONOMY

On the U.S. economic front, prospects are looking brighter, with economic data points remaining supportive of moderate GDP growth in 2017. Consumer Confidence, as measured by the Conference Board, is rising steadily, while employment also continues to rise, as measured by stronger-than-expected growth in non-farm payrolls, and the decline in the unemployment rate and first-time jobless claims (Figure 1). Year-to-date the economy is doing well, capital goods sales are picking up, as are durable goods orders and shipments. This is drawing workers back into the economy, with a steady rise in the labour participation rate. Inflation remains solidly under control. Purchasing manager index (PMI) measures are also looking bullish. New and existing house sales continue to trend upward.

FIGURE 1: U.S. FIRST TIME JOBLESS CLAIMS (000s)



Source: Bloomberg

GLOBAL ECONOMIES

Outside of the U.S., economic indicators continue to suggest that growth prospects are improving. Key global economic surprise and purchasing manager indices are trending positively, and private sector economist forecasts for 2017 GDP growth were generally revised modestly higher during the quarter, most notably for the E.U., the U.K. and Japan.

The E.U. experienced one of the larger upward revisions to 2017 growth expectations, with economic data generally improving over the first quarter. Political risks continue to be elevated in the region, with 2017 potentially proving challenging for E.U. cohesion amid elections in France and Germany, compounded by demands for E.U. referendums in other member states. European Central Bank monetary policy remains highly accommodative, though the bank is looking ahead to establishing some form of tapering to assist in winding down the massive pool of liquidity created by the quantitative easing program.

In the U.K., Prime Minister Theresa May has managed to shepherd the implementation of the Brexit procedure through the high courts of the U.K. and the E.U., the House of Commons and the Lords, and before the end of the quarter, signed the letter triggering implementation of Article 50 of the Treaty of Lisbon. This started the official two-year countdown to the U.K.'s withdrawal from the E.U. Amid all of this, U.K. economic data points continue to be more resilient than most have expected, with economists generally revising 2017 GDP growth expectations higher throughout the quarter.

EQUITY MARKETS | SENTIMENT REMAINS UPBEAT

Equities enjoyed a strong first quarter, with Canadian and global benchmarks up 2.4% and 6.5% (5.4% in C$ terms) respectively. Canadian markets were led higher by the financial and materials sectors, with energy lagging. Global market strength was driven by information technology, consumer discretionary and health care, with telecom and energy lagging. Regionally, global market strength was broad based, but European and U.S. markets in particular were strong contributors.

Positive economic data, a strong reporting season, and generally optimistic corporate commentary underpinned good performance across many pro-growth sectors, though we note that certain bond proxies also performed well in a partial reversal of the "Trump Bump" from late last year. Given our positive view, much of our attention is focused on opportunities that benefit from an improving outlook, and when analyzing less economically sensitive sectors we are searching for names we believe to be misunderstood and offer a healthy margin of safety.

CANADIAN MARKET

The first quarter was a busy one for the Canadian energy sector given the start of the previously announced OPEC production cut agreement, noise regarding the potential implementation of a border-adjusted tax (B.A.T.) by the U.S., and some high profile oil sands transactions.

Despite strong compliance levels with the OPEC production cut agreement, crude inventories in the U.S. have yet to inflect towards normalized levels, resulting in weakness in the oil quote and energy equities (in part due to fears that rising U.S. production is contributing to the issue). Still elevated U.S. crude inventories, however, obscure some positive developments that would suggest near-term improvement is likely. Most importantly, many regions (ex-U.S.) have reported crude complex inventory draws post-January, and stateside product inventories (gasoline and diesel) have drawn below year-ago levels. Additionally, elevated refinery outages (now reversing) should serve to boost near-term U.S. crude demand (Figure 2). April could prove to be an important month given OPEC's technical committee will provide their opinion regarding any need to extend the production agreement past the initial 6-month term expiring at the end of June.

Within the backdrop of weaker crude prices, energy sector performance in the quarter was further impacted by concerns regarding the potential implementation of a B.A.T. by the U.S. Such a policy does not seem to make economic or political sense for the Trump administration (i.e. importing inflation via higher gasoline prices), though it does highlight Canada's need to source additional energy export markets. We viewed weakness in the sector as an opportunity to add weight in select oil producers with access to economically attractive plays, that can generate value even in a subdued crude environment.

Lastly, two high profile oil sands transactions were announced in the quarter, with Canadian Natural Resources acquiring assets from Shell and Marathon Oil, and Cenovus purchasing interests from ConocoPhillips. In our view, we see these developments as the selling corporations making good on debt reduction commitments, rather than any knock on the competitiveness of Canadian energy.

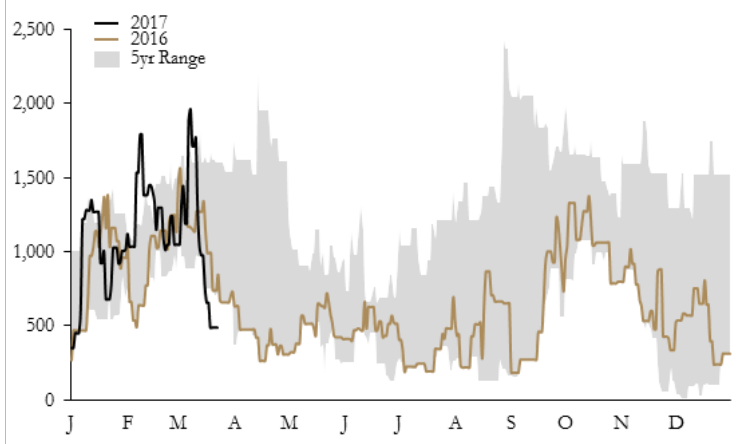
GLOBAL MARKETS

Global equity markets responded well to the improving macro environment as the first quarter progressed.

European economies continued to show gradual improvements, while emerging markets benefited from some early stumbles in Trump's proposed policies. Inflation indicators in Japan and Europe have shown acceleration in recent months, calming the deflation fears that have lingered over equity markets there for some time. And despite growing uncertainties in Trump's election policies, the U.S. markets continue to perform strongly, with confidence in the underlying economy showing further improvements. This is particularly encouraging despite the realization that Trump's pro-growth policies will likely take longer to enact than the market originally expected.

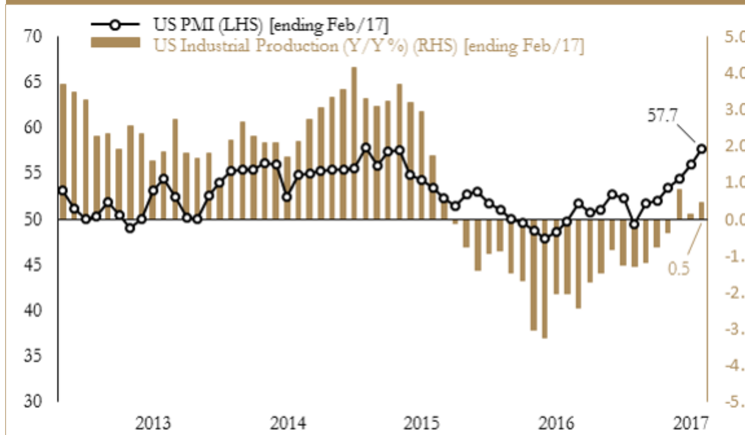
Companies also seem to be feeling more confident about growth prospects, as leading sentiment indicators such as global PMIs have shown. However, it is worth noting that underlying revenue trends are lagging the strong sentiment indicators (Figure 3). Although this presents a risk to markets should revenue growth fall short of rising expectations, our analysis of corporate commentary suggests companies will begin to spend more this year as they look to better position their businesses towards the future. Furthermore, companies appear more confident that the new U.S. administration remains committed to enacting business friendly policies over the near-term.

FIGURE 2: U.S. REFINERY OUTAGES (000 BBL/D)



Source: Bloomberg

FIGURE 3: U.S. PMI VS. INDUSTRIAL PRODUCTION



Source: Bloomberg

PORTFOLIO INSIGHTS

During the quarter, we added to our holdings of Cott Corporation, as we believe the market is underappreciative of the

company's rapid evolution into a leading provider of water and coffee to home and office delivery (HOD) markets across North America and Europe.

The company initiated a shift away from private label beverage manufacturing with an initial HOD acquisition in late-2014, establishing a broad distribution network that has been further leveraged by continued consolidation. Post this transformation, greater than 2/3 of cash flow is generated from growing segments with more attractive margins than the legacy Cott businesses.

Rapid growth within HOD recently created logistical challenges, but Cott is implementing an action plan that will aid in driving strong free cash flow across its capital light platform.

Our thesis for owning Apple is starting to show, with the company's outlook improved. First, the company is expected to introduce a major upgrade to the iPhone later this year, which should drive a strong replacement cycle. Second, they have returned to growth in mainland China following several quarters of declines. Third, the installed base of iOS users is becoming a large and rapidly growing source of services revenue, which comes with much higher profit margins. Services include items such as the App store, music, iCloud storage and Apple Pay. In addition, a reasonable valuation and significant cash on the balance sheet positions the stock well for the medium-term.

FIXED INCOME MARKETS | TIGHTER SPREADS AND FLAT RATES

After the monumental jump in interest rates in the final quarter of 2016, the first three months of 2017 were relatively quiet.

Rates 5-years and less finished the quarter nearly unchanged versus the start of the year, despite a U.S. Fed rate hike (with two more expected later this year) and stronger-than-expected Canadian economic data. This robust domestic economic data has driven strong upward revisions to GDP growth forecasts for 2017 and has also convinced economists to pull forward forecasts for a Bank of Canada rate hike (we currently sit at a stagnant 0.50% overnight rate) from the first quarter of 2019 to the second half of 2018. However, the Bank of Canada has been underwhelmed by recent strong data, still suggesting a chance of a rate cut due to concerns over the potential for sluggish business investment and non-energy exports, as well as uncertain future terms of trade with the U.S., our key trading partner.

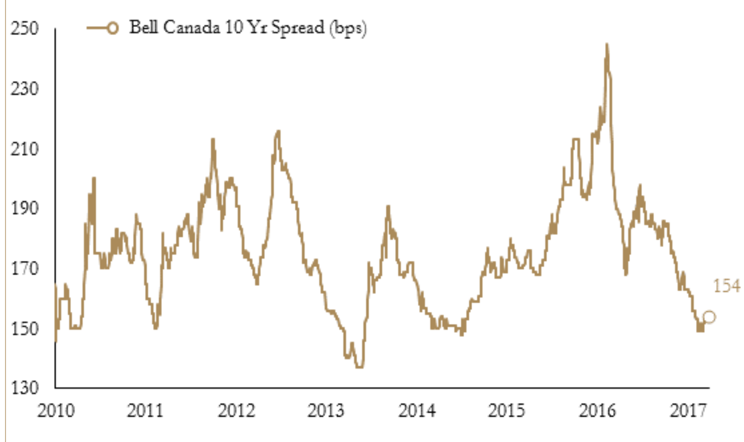
Looking at longer maturities, 30-year rates also remained roughly unchanged at about 2.30%. Meanwhile, 10-year rates, where a significant portion of the portfolio is invested, were lower by around 10bps to approximately 1.73%. We remain cautious of higher interest rates for longer maturities, though these maturities have been largely range-bound in 2017.

SPREADS TIGHTEN

The most notable change in fixed income markets in 2017 has been how well credit spreads have performed, tightening to the point where we are feeling a bit cautious.

For most corporate bonds, the extra interest paid above the Government of Canada rate (i.e. the credit spread) has decreased around 15bps, a significant move for three months. For example, on a 7-year bond this adds roughly 1% to the value of the bond. For most corporates, including Bell Canada, the last time spreads were this tight was in 2013/2014, and before that 2010 (Figure 4). Credit spreads are near historical lows, and although we are not yet convinced new records will be set, credit fundamentals generally remain solid and domestic economic prospects are improving.

FIGURE 4: BELL CANADA 10-YR CREDIT SPREAD (BPS)



Source: Bloomberg

PORTFOLIO INSIGHTS

During the quarter, we sold SunLife senior, Daimler Canada Finance and Heathrow airport bonds, all 4-year term bonds.

We like SunLife's credit quality, but it became too expensive with the spread being one of the top performers in the quarter, narrowing nearly 25bps. The bond returned about 1.10% in 2017 before our exit.

Daimler Canada Finance is the auto loan and leasing arm of Mercedes-Benz. We became cautious on the name due to the potential for deteriorating auto lease profitability from declining used car prices, as well as possible auto demand headwinds from higher financing costs. The Daimler bonds we owned saw their spread compress nearly 15bps, returning around 0.40% in the quarter before we sold.

Heathrow saw some volatility with Brexit, but came out the other side in good shape. Heathrow was another outstanding performer, with its spread declining roughly 30bps. The spread narrowed too far relative to alternatives, and we moved on to more attractive opportunities, locking in a return of about 1.22% for the quarter before our sale.

For most clients, we made two purchases in the quarter. We bought 6-year Industrial Alliance (IAG) subordinated debt and added to our 4-year Canada Housing Trust holdings.

The IAG bonds have a 2028 maturity, however, due to regulations and capital treatment, the insurance company must structure its sub-debt with the option to mature the bonds five years early, 2023 in this case. The bonds price to the 2023 date, and we believe they will be matured at that time. These bonds provide one of the highest A rated interest yields for client portfolios that can hold insurance company debt.

We saw good value in the Canada Housing Trust 2021 bonds, with credit spreads in-line with historical averages. Canada Housing Trust is guaranteed by the Federal government and is an extension of Government of Canada bonds. It is the second safest credit in Canada, after Canada bonds.

In aggregate, we believe these changes have made the portfolio more resilient against a possible widening of credit spreads and the backdrop of potentially higher interest rates.

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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