BIM Barrantagh Review

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ECONOMIC & GEO-POLITICAL BACKDROP | GLOBAL CENTRAL BANKS TURN HAWKISH

The global economy maintained its modest positive momentum in the second quarter of 2017, with the economic environment starting to feel normal again. We believe this strength will continue into the second half of the year, supporting our continued preference for equities over bonds. Despite the barrage of political noise in the quarter, including the start of Brexit and NAFTA negotiations, elections in the U.K. and France, and never-ending Trump headlines, equity markets exhibited limited volatility (as measured by the S&P 500 VIX index) in large part due to a benign economic environment and solid backdrop for corporate profitability. While our outlook remains positive and portfolios positioned accordingly, some economic data points suggest that we are nearing the later stages of the economic expansion. However, we continue to view this expansion as durable given historically accommodative global monetary policy, the measured pace of growth and gradual progression of the business cycle to date.

CENTRAL BANKS

The most notable change in the macro environment in the quarter came from the abrupt shift to a hawkish tone from key global Central Banks. Although the U.S. Fed long-ago started the process of tightening monetary conditions, including an as-expected 25 bps hike in June, the heads of the Central Banks in Canada and the U.K. have begun to talk administered rates higher, while the European Central Bank recently hinted it will start tightening its ultra-loose monetary policies. There has been a global shift in thinking and a realization that inflation, while currently muted (Figure 1) and below official Central Bank targets, is not going to remain so indefinitely (transitory factors seem to be helping to keep inflation low) if recent broad-based economic growth continues.

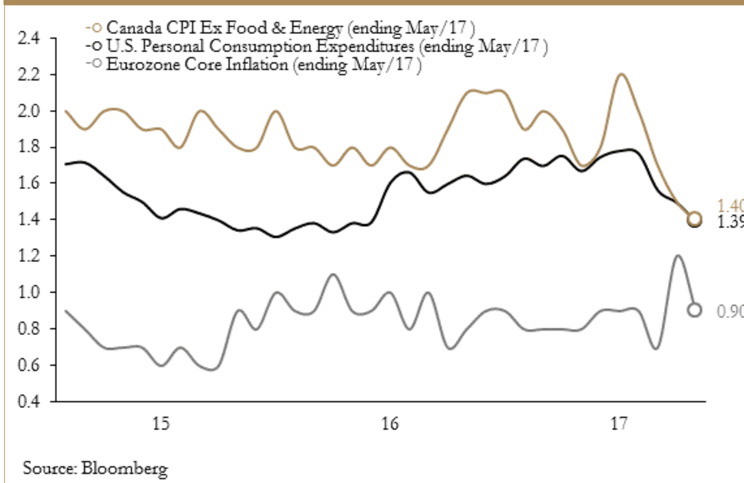
The general tone delivered recently by various members of the U.S. Fed suggests interest rates should rise at roughly the same pace and magnitude as common measures of inflation. However, the end magnitudes should be lower than prior to the 2008/2009 recession. The Fed is targeting a rate of inflation of 2.0%, and the market is not expecting aggressive moves on the inflation fighting front. The implied probability of a rate hike remains at or below 50% until the final weeks of December. This is consistent with the original expectation drawn from the Fed's June meeting dot charts of up to three rate hikes in 2017.

Janet Yellen's recent remarks have remained cautious, and understandably so, considering that she has no public guidance on whether or not she will still be the Chair of the U.S. Fed after February 2018. The White House has been very keen to keep this issue at the forefront, and going forward every comment from White House staffers will be parsed by the media and analysts. This uncertainty may prove to be one of the most important and disruptive issues in the coming months.

U.S. ECONOMY

Economic data points from the U.S. have been mixed in recent months, but are still indicative of moderate and sustainable GDP growth. The U.S. economy is nearing full employment, though this is not the only factor behind recently slowing job growth. During the second quarter, the U.S. economy saw a record measure of job openings (exceeding six million), while at the same time hiring declined indicating that a lack of skills is holding workers back. This information is nicely captured in the JOLTS (Job Openings and Labour Turnover Survey) index produced by the Bureau of Labor Statistics, and is watched assiduously by the Fed. Consumer Confidence, as measured by the Conference Board, remains high which bodes well for future spending. Purchasing manager index measures remain solidly in expansionary territory. However, capital goods orders excluding aircraft and defense, seen as a proxy for future capital spending, slowed and turned negative in the quarter. Companies could be deferring capital spending in favour of activities aimed at improving performance by way of expense reduction, or waiting for greater certainty around Trump policy.

FIGURE 1: CORE INFLATION DATA (Y/Y %)



Source: Bloomberg

GLOBAL ECONOMIES

Recent economic data points from Europe and Japan have generally been strong, with economic growth prospects continuing to show improvement. Anchored by Emmanuel Macron's landslide victory in the French presidential election, consumer and business confidence indices across Europe (most notably in Germany and France) have risen to multi-year highs. European purchasing manager indices also continue to increase, with strength building off of the region's solid Q1 GDP print.

Japan has also showed outstanding economic performance. This has been driven by the Japanese consumer awakening from a long slumber and discovering the benefits of a strong currency, which has given importers and domestic manufacturers the opportunity to lower prices.

Economic momentum has waned somewhat in the U.K. as consumers and businesses brace for Brexit negotiations in which the U.K. could have less leverage due to Prime Minister Theresa May's near loss in the general election. Following the election, Prime Minister May negotiated an alliance with the Northern Ireland Democratic Unionist Party (a right-wing party) to stay in power. This alliance will figure prominently in the negotiations as Ireland is the only European Union member country sharing a physical border with the U.K.

EQUITY MARKETS | ALL IS WELL ON THE HOME FRONT?

The second quarter produced a modest negative return in the Canadian market (down 1.6%), while Global equities continued in a strong vein, up 4.2% in USD terms (or up 1.8% in CAD terms). Canadian markets were held back by energy and materials, while Global performance was driven by the U.S. market and a strong Euro.

While some positive trends did moderate in the quarter, economic data continues to suggest we remain in an expansionary environment, and underpins our positive outlook on equities.

CANADIAN MARKET

Surging home prices, followed by government intervention designed to cool the market, and a crisis of confidence at alternative mortgage lender, Home Capital, served to exacerbate fears of a property bubble and kept housing related risks top of mind in the quarter.

Home Capital is one of Canada's largest alternative lenders, providing mortgages to those who have difficulty qualifying for financing from the big banks. The company's woes came to the forefront after the Ontario Securities Commission sought action against the company related to improper financial disclosure of mortgage broker misbehavior, and the subsequent remedial actions taken, from 2014 and 2015. This, along with management departures, led to a run on the company's deposit base (used to fund mortgages) and the acceptance of highly punitive financing to mitigate liquidity risks. Some market participants became fearful of Home Capital failing and the associated risk of contagion for not only other alternative lenders, but also for the big banks. However, strong additions to the board of directors, further progress on reducing liquidity risk, and the arrival of Warren Buffet as a financial backer has reduced Home Capital concerns. While we do not expect meaningful near-term issues for the housing market, we choose to maintain exposure to the sector via our bank holdings, preferred over alternative lenders, due to diversified business models, higher quality loan books, and secure deposit bases and balance sheets.

The energy sector was once again weak, as the pace of the crude market rebalance continues to lag expectations. While OPEC compliance with the production agreement (which was extended through Q1/2018) remains strong, certain members have "cheated" on exports (i.e. destocked inventories by selling volumes in excess of production). This, combined with reduced supply disruptions in Libya and Nigeria, and strong U.S. shale supply growth, has stalled progress on the U.S. petroleum inventory correction with inventories flat to year-ago levels (Figure 2) and remaining stubbornly above five-year averages.

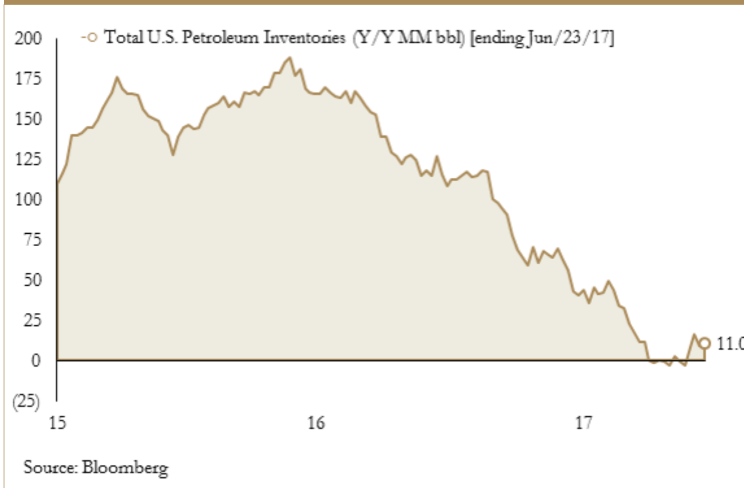
While an oil price around \$45/bbl is not anticipating an acceleration of stock draws in the back half of the year, tangible evidence of a tightening market will be required to take the quote higher. A number of energy producer valuations are discounting the current futures curve (or below), indicating that pricing improvement would be well received by the equities.

GLOBAL MARKETS

Global equity markets continued to perform well in the second quarter. Despite an escalation in Brexit discussions, European Union members appear to be getting more united with regards to the common market as the elections in France have shown. This was also seen in the currency markets, with the Euro strengthening over 7% versus the USD in the quarter.

In the U.S., equity market performance was solid despite Trump continuing to struggle with implementing his pro-growth policies. This has prevented the underlying economic indicators from accelerating further, while sentiment indicators have cooled somewhat during the quarter. Nonetheless, the U.S. economic growth outlook remains constructive, which bodes well for equity markets.

FIGURE 2: U.S. Y/Y CHANGE IN INVENTORIES



Source: Bloomberg

FIGURE 3: U.S. DEPARTMENT STORE SALES

Source: U.S. Census Bureau, Raymond James research.

The U.S. retail landscape continues to go through a transformation as on-line penetration and price discovery have taken a toll on retailers with heavy exposure to physical stores (Figure 3). A key development in the quarter was Amazon now setting its sights on the grocery industry with the announced purchase of Whole Foods. Although we don't yet know what Amazon's plans are for the asset, it appears the company will look to leverage its fulfilment and distribution skills to deliver groceries to more customers, who in turn may buy more general merchandise from Amazon. It is imperative that brick and mortar retailers exposed to e-commerce improve on-line offerings to maintain market share and help counter Amazon's growing threat. We prefer to be positioned in retailers and consumer product companies with either well developed omni-channel strategies or business models that are more resistant to on-line competition., like Dollar General and Adidas.

PORTFOLIO INSIGHTS

In Canadian portfolios, when investing in energy producers some of our criteria include a strong track record of operational execution, a deep in-

ventory of high rate of return wells, and a strong balance sheet. The rationale for seeking these attributes is not only because these factors are often precursors of value generation over time, but to ensure that a company can reasonably execute on its business plan should commodity prices retreat. **This criteria provides us with the conviction to retain names during a rough patch in the commodity cycle and reduces the risk of selling holdings at the bottom.**

One such producer we own is Spartan Energy. While many North American light oil business models are under extreme stress at $45 oil, Spartan should be able to post modest growth via the exploitation of its low decline S.E. Saskatchewan asset base, and without compromising its balance sheet. The company remains better positioned than the vast majority of peers in the current environment.

In the Global portfolio, American Tower was a solid performer in Q2. The company owns communication towers in the U.S. and emerging markets, whereby wireless carriers lease space on its towers to house large antennas and communications equipment. The company operates in a structurally growing industry driven by growth in wireless data communications. The company's tower assets have highly predictable revenues due to the long-term nature of the contracts, which include built-in escalators. This business model, combined with a strong management team, generated mid-teens growth in cash flows over the past decade.

FIXED INCOME MARKETS | BANK OF CANADA SET TO HIKE

After a quiet first quarter, activity in the fixed income market heated up. The biggest transformation in the Canadian market came from the Bank of Canada (BoC). In a public speech on June 12th, the second in command at the Central Bank commented that the two cuts to the overnight interest rate taken in 2015 to reduce the economic impact of falling oil prices had done its job. The speech went on to say that it may soon be time to reverse those cuts, giving the market the indication that the BoC is preparing to raise the overnight rate. On the day of the speech, short-term interest rates jumped 11bps, and rose an additional 6bps the next day after the BoC leader, Governor Poloz, confirmed the remarks with similar comments.

MARKET INSIGHTS

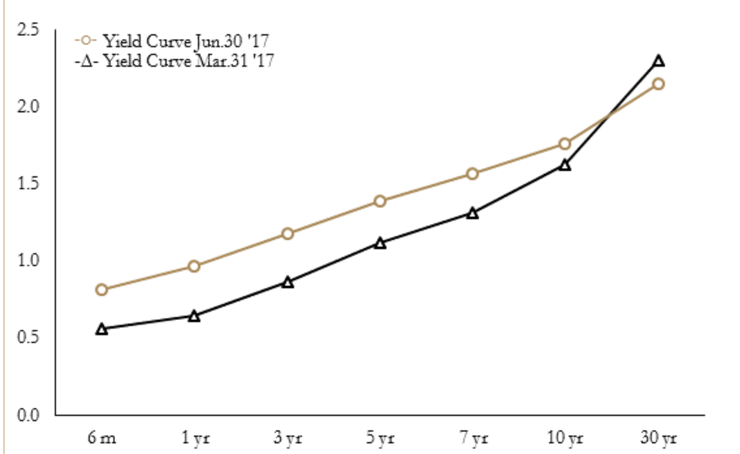
As the BoC prepares to raise the overnight rate, the interest rate curve has performed as expected (Figure 4). Rates in 0 to 5 year terms are up 30bps for the quarter, with 6-year rates up 27bps and the 10-year term higher by 14bps. Rates beyond the 10-year term finished lower by around 15bps. Part of the move lower in long-dated rates is from lower oil prices, but the biggest driver is a decline in inflation expectations coming from a lack of follow-through from President Trump. His first six months in office have demonstrated the difference between running a corporation and the U.S. Government. The U.S. Government has an elaborate system of checks and balances, and while Trump runs the executive branch, the legislative branch (congress) and judicial branch (legal courts) are not entirely under his control. **In the fourth quarter of 2016, 30-year inflation expectations increased from 1.75% to 2.10%. In the first three months of 2017, those expectations held on and did not change, but in the second quarter retreated by 25bps to match levels before the U.S. election last November, causing long-term interest rates to fall.**

Despite the change to Canadian interest rate expectations in June and the market now pricing in two forthcoming BoC overnight rate hikes, our bond portfolios still made a gain in the quarter. With the market having priced in the future actions of the BoC, there should be little impact going forward. What will mainly drive the market is actions by the U.S. government and its Central Bank, as well as general economic developments.

PORTFOLIO INSIGHTS

Leading up to the initial BoC speech, our analysis of Canadian economic data suggested that the time for the BoC to raise rates was near. Oil prices had stabilized between $40-55/bbl and economic growth had been steadily improving in the prior ten months, reaching 2.5% year-over-year in February. **In the second last week of May, we sold four corporate bonds, and a Canada Housing Trust bond all with 2021 maturities. We invested the proceeds into three bonds, Province of British Columbia 2025, Canada Housing Trust 2025, and Canada 2037. This was done in time to avoid the decline in value of the 2021 bonds from the BoC comments later in June. These trades moved almost a quarter of the portfolio, and relative to the market the portfolio is well underweight short-term bonds, which are most affected by the BoC.** There only remain a handful of holdings that mature within three years or less, which will be held to maturity, and all provide high interest income. This change also decreased corporate credit exposure as spreads remain near multi-year lows.

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

The Province of British Columbia is currently experiencing some political turmoil that began with the closely contested election held on May 9th, resulting in a virtual tie. The Liberal party has been in power for 20 years, but the NDP picked up enough seats to close the gap to two, leaving the Green Party with its three seats as the swing vote (an ideal outcome for the Greens). The Green Party appears ready to work closer with the NDP, but it seems that forming a government will be difficult for either side and a vote of confidence is in the cards. From there another election could be called. In the meantime, the province has one of the strongest economies in the country and its housing market remains intact. Buying B.C. credit was a good way to capitalize on some slightly better pricing caused by the political turmoil, and will help to avoid upcoming drama from the Ontario election. Client portfolios already own a healthy portion of energy-impacted Alberta and Saskatchewan credit, and while Quebec has been a good success story, it is currently too expensive.

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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