BIM Barrantagh Review

Volume 22 | Edition 3 | September 2017

ECONOMIC & GEO-POLITICAL BACKDROP | GLOBAL GROWTH ACCELERATION TAKES HOLD

There is little to complain about in regards to global economic growth, with the expansion picking up broadly during the third quarter. The current environment of accelerating global economic growth, modest monetary policy normalization and benign inflation remains supportive of equities over bonds, and our portfolios remain positioned accordingly. Although 2017 annual global GDP growth is expected to accelerate to about 3.5% (its fastest pace since 2011) from around 3.0% in 2016, we are not yet seeing the signs of over-heating economies and strong inflation that tend to accompany the final stages of the economic cycle. Additionally, global growth is nowhere near the heady 5.0-5.5% pace experienced in the final years of the last two economic cycles. Geo-political noise reverberated throughout the quarter, with U.S./North Korea tensions the most concerning. However, overall political instability has receded (particularly in Europe) this year, adding tailwinds to synchronized global growth. This positive backdrop is reflected in the global manufacturing purchasing manager indices uptick (Figure 1), as well as higher business and consumer confidence indicators.

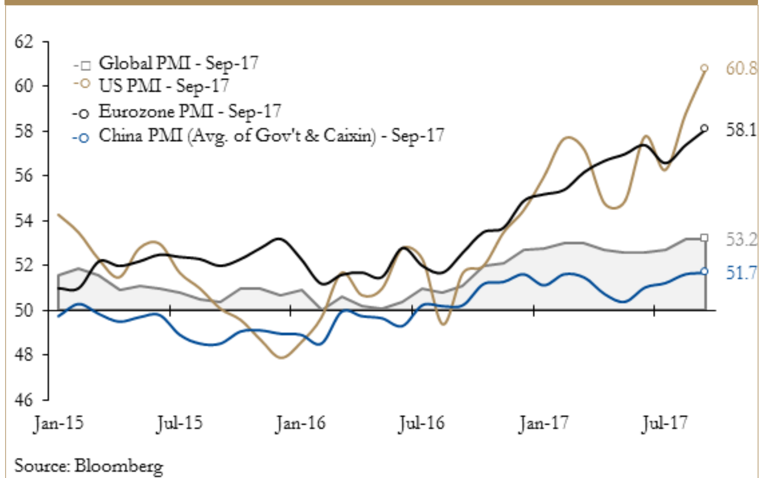
CENTRAL BANKS

Global central banks continue to proceed with monetary policy normalization, though at a pace not disruptive to growth. Although inflation continues to undershoot central bank targets for now, increasing capacity utilization in the global economy is providing incentive for global central banks to maintain a modestly hawkish stance. The recent lack of inflation across developed economies has puzzled central bank policy makers and professional economists alike, with technology seeming to play a dampening effect. Additionally, the continued appreciation and low volatility of certain financial assets likely indicates some market complacency, and central banks do not wish to see excessive risk taking.

In October, the U.S. Fed will start the unwind of its $4.5 trillion-dollar balance sheet accumulated during the Quantitative Easing (QE) era. The pace of the unwind will be very gradual, and most expect a muted impact on the bond market, though the unprecedented nature of QE (and its unwind) could create some anxiety among market participants. Adding to Fed-related uncertainty is the likely transition of the Fed Chair position, with Janet Yellen's current term ending in February 2018. The Trump administration has apparently narrowed its list of Fed Chair candidates, though its too early to anticipate the implications for future Fed policy.

After a robust first half of economic growth, the Bank of Canada (BoC) delivered two rate hikes during the third quarter, reversing the cuts made during the oil price downdraft. A recent speech from BoC Governor Stephen Poloz signalled further rate hikes, but not without BoC review of incoming economic data. Outside of the typical issues to monitor (e.g. economic capacity utilization, inflation, wage growth, household debt levels), Governor Poloz also highlighted that the BoC was closely watching the potential impacts of the recent Canadian dollar strength and the sharp rise in longer-term interest rates.

FIGURE 1: GLOBAL MANUFACTURING INDICIES



Source: Bloomberg

U.S. ECONOMY

Although recent U.S. economic data contains some hurricane-related noise, the strengthening of key economic indicators is likely sending a positive signal about future growth. U.S. ISM purchasing manager index (PMI) data for both services and manufacturing recently hit decade highs, though some of this strength may moderate as weather impacts normalize. Capital goods orders excluding aircraft and defense, seen as a proxy for future capital spending, saw a meaningful rebound during the quarter. Wage growth has been less robust than expected, but the U.S. consumer (whose spending represents two thirds of U.S. GDP) remains in good shape. Business and consumer confidence is high despite U.S. policy uncertainty related to trade, taxes and fiscal spending.

GLOBAL ECONOMIES

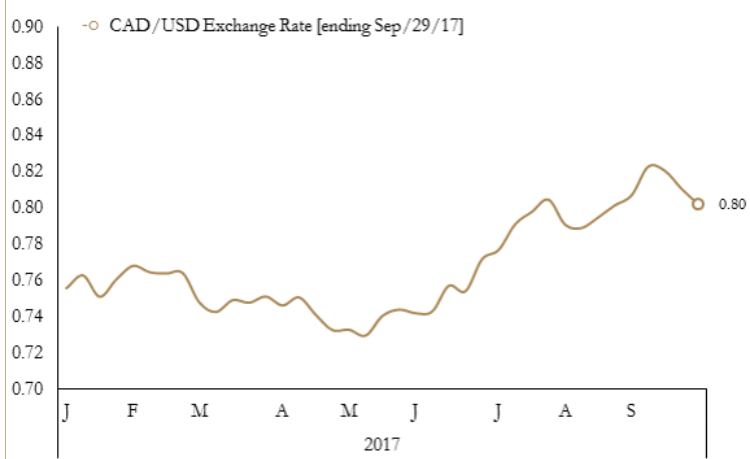
Leading economic indicators in Europe, China and Japan all maintained positive momentum during the quarter. In Europe, the surge in support for the far-right party in Germany's recent federal election and Chancellor Angela Merkel's lessened grip on the German parliament, as well as progress in Catalonia's push to declare independence from Spain, could increase worries about Eurozone stability on the margin. However, European business and consumer confidence is strong, and manufacturing PMIs continue to hit fresh multi-year highs.

In China, the political leadership transition taking place this fall may induce some policy uncertainty in the near-term, but the fundamentals supporting China's economic growth remain solid. The Chinese government reported manufacturing PMI recently rose to its highest level in over five years, and annual GDP growth in China continues to stabilize in the 6% range. China continues to demonstrate that it can balance the transition to a retail consumption based economy, while maintaining strong economic growth.

Japan has continued to grow strongly, outpacing most other western economies. The country has reported six consecutive quarters of GDP growth, a noteworthy feat after several years of uneven economic performance. Additionally, the Tankan Large Manufacturing index (a measure of general business conditions) recently reached a ten-year high indicating further momentum in the economy.

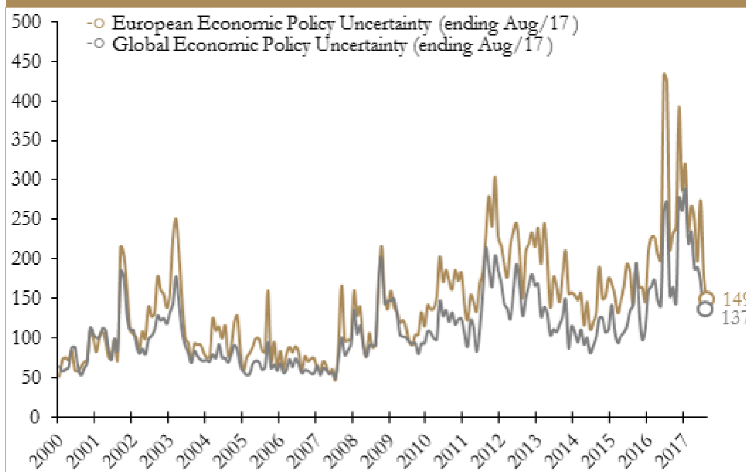
EQUITY MARKETS | BETTER GROWTH AND MODEST INFLATION SETS THE TONE

FIGURE 2: CAD VS. USD



Source: Bloomberg

FIGURE 3: POLICY UNCERTAINTY INDICIES



Source: Bloomberg

The third quarter produced positive returns for both the Canadian (up 3.7%) and global markets (up 5.0% in USD, but a more modest 0.9% in CAD terms). Much of the strength in the Canadian market occurred in September in tandem with rebounding energy sentiment, while Global equities benefited from positive returns across all major regions.

As discussed, global economic data continues to suggest we remain in a broad-based expansionary environment, and coupled with modest inflation and a solid backdrop for corporate profitability, we remain positive on the outlook for Canadian and global equities.

CANADIAN MARKET

The Canadian dollar began climbing higher in May of this year, and continued its ascent versus the greenback in the third quarter (Figure 2). While this news is ostensibly positive for Canadian consumers, the impact on equities is more nuanced.

Simplistically, Canadian-centric and/or import businesses benefit the most in a rising CAD environment and more global businesses and/or exporters with Canadian domiciled costs experience currency headwinds. However, one must not blindly follow currency trends, because industry and company specific factors have the potential to play a much larger role in stock performance, even in the short-term. For example, when reviewing Canadian focused retailers potentially exposed to the Amazon effect, we place greater emphasis on omni-channel and/or e-commerce positioning versus the benefit a company might receive from a stronger CAD.

When evaluating companies as investment candidates, we must assess both the near and long-term prospects for the business in the context of the current valuation. Clearly, businesses that stretch beyond our borders have a greater market opportunity than those that do not, and include many of the high-quality companies of scale in which we seek to invest. Given our long term investment bias, we employ purchasing power parity when incorporating currency assumptions in our analysis, with decision making driven on the basis of a company's overall merit and factors within its control, and not a call on currency exposure.

Energy markets rebounded with particular strength in September as progress towards oil inventory normalization played out during the quarter. Positives included inventory draws, upward revisions to oil demand estimates by international forecasting agencies, discussion regarding potential extensions to the OPEC supply agreement, and a rise in geopolitical tension in select oil producing regions in the Middle East and elsewhere.

Also of note was the change in market narrative related to future unchecked U.S. supply growth that was called into question given some high-profile stumbles in the Permian basin, accompanied by generally more cautious commentary from the sector during the reporting season (i.e. espousing more of a focus on sustainable growth versus maximizing absolute production growth). While prudent energy producers have positioned for the current commodity environment, further improvement in fundamentals would allow investors to contemplate "what if" scenarios inclusive of upside potential for crude prices, rather than myopically focussing on downside concerns as had been the case until recently.

GLOBAL MARKETS

Global equities performed well in the third quarter, with particular strength from emerging markets and Western Europe. One of the key drivers of this performance has been the diminished threat from political instability within Europe, and throughout most of the world (Figure 3). This has allowed companies to feel more confident with their hiring and spending intentions, which has resulted in stronger growth this year. Furthermore, economic growth is now more synchronized with several regions participating, which can be evidenced by the strongest global trade that we've seen in several years. In fact, during the recent quarterly results, many logistics companies commented on the acceleration in volume growth in both airfreight and sea freight, and referenced an improved economic backdrop as one of the reasons.

With a better growth environment now in place, a key question becomes just how durable is this growth. Certainly, there are risks on the horizon which require attention. These risks include an unexpected sharp rise in political instability, a slowdown in China's growth, and enacting protectionist policies, just to name a few. But given a moderate inflationary backdrop, slightly higher interest rates and relative calm on the political front, we are cautiously optimistic that this favourable environment for growth will continue.

PORTFOLIO INSIGHTS

In Canadian portfolios, this past quarter we purchased CGI Group, a global IT services firm increasingly focused on digital transformation and intellectual property (IP) opportunities (purpose built software and related services in partnership with clients). We expect the company to sustain its trend of organic growth, supplemented by targeted acquisitions to further the digital and IP strategy that should continue to drive high margins and value creation. Our entry point into the name occurred post reporting of fiscal Q3 results, when shares retreated on announcement of expected restructuring charges related to the acceleration of the company plan. This provided us with a greater margin of safety for the investment.

In Global portfolios, one of the companies we added in the quarter was Schneider Electric. The company manufactures and services important electrical products necessary for customers as they migrate towards a more digital and energy efficient world. Over the years, Schneider has built out a very strong global footprint with revenues evenly split between Europe, North America and emerging markets. The company experienced very little growth over the past few years, with one region or another always underperforming. However, Schneider is now seeing the benefits of a synchronized global recovery and is currently experiencing a noticeable improvement in revenue growth across most regions. Furthermore, the company has a disciplined management team focused on margin improvement, free cash flow generation and growing shareholder value. Lastly, the stock trades at an attractive valuation when considering the return to revenue growth Schneider is starting to experience.

FIXED INCOME MARKETS | A TIME OF RISING RATES

It was a volatile quarter for the fixed income market. Bonds sold off in July as the Bank of Canada raised the overnight rate for the first time since 2010, by 0.25% to 0.75%. Longer-term interest rates increased 0.20% to 0.30%. Credit spreads were modestly tighter by 3bps, with higher yielding corporate bonds, such as Pembina 3.54% 2025, outperforming the comparable Canada bonds.

In August, the market rallied with the largest change coming from maturities six years and beyond, where rates declined about 0.20%. This was partially the result of international events such as the back and forth between President Donald Trump and North Korea leader Kim Jong-un. Canadian long bonds rallied, reversing part of the declines experienced in July. Corporate credit spreads were slightly wider by 3bps, reversing July's gain.

In September, Bank of Canada Governor Stephen Poloz caught the market off guard and raised the overnight rate by another 0.25% to 1.00%, causing rates in all maturities to rise by 0.20% to 0.30%. Credit spreads tightened by about 2bps and again, higher yielding corporate bonds outperformed lower yielding Canada bonds with the same maturity.

In all, during the third quarter the benchmark index lost 1.8%, with the long index (10 years to maturity and longer) underperforming, falling 4.1%. We remain underweight the long-end, overweight the middle portion (5-10 years), and about neutral the short-end (<5 years).

Client holdings of short-term maturities (<5 years) are focused in the 2-3 year term, avoiding the 4-5 year space and reducing the impact from higher short-term rates. In addition, the extra yield between the two and five Canada rate is about 0.25%, one of the lowest in the world. In comparison, the 2/5s spread in the U.S. is 0.45%. This suggests that the Canadian 5-year term is more susceptible to rising rates.

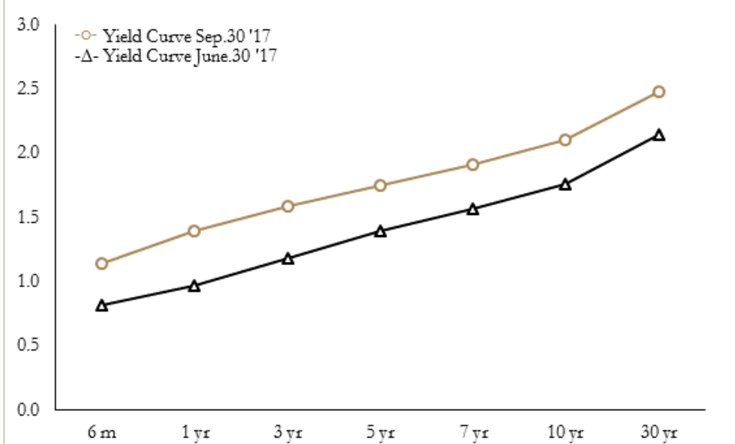
PORTFOLIO INSIGHTS

Several portfolio changes were made during in the quarter. At the end of July, Intact Financial, AltaGas, and Province of Manitoba 2026 bonds were sold and reinvested into shorter dated securities, namely CDP Financial 2019 (funding arm of Quebec Pension Plan, Caisse de depot), and two 2024 maturity bank bonds (expected to be called and matured in 2019). This shortened client portfolio duration.

Near the end of August, Lower Mattagami 2024 (a hydroelectric project owned by Ontario Power Generation), AltaLink 2024 (Alberta electrical utility), and Telus 2025 bonds were sold. More short-term bonds were purchased in replacement, specifically with Ford 2019, RioCan 2019, CPP Investment Board 2020, and Province of Manitoba 2040 bonds purchased to manage overall duration.

In addition, a new type of bond was purchased for clients, Floating Rate Notes (FRNs). FRNs are different because the amount of interest paid to the holder resets on a periodic basis during the life of the bond. In the case of the purchased BMO and RBC FRNs, the interest rate resets every three months based on the 3-month CDOR (Canadian Dollar Offered Rate - the rate banks pay to borrow for <1 year) plus a credit spread. Since the interest rate resets, the FRNs have a duration of less than 3 months regardless of actual maturity. FRNs offer an attractive way to make a positive return in a time of rising interest rates. In September, when short-term interest rates rose 0.20%, these bonds saw a positive return of about 0.12%, while the fixed rate counterpart lost about 0.25%.

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

Finally, in mid-September two more portfolio changes were made. The holding of Canada 5% 2037 with a 2.42% yield to maturity (YTM) as of Sept 30th, was trimmed. Part of the proceeds were invested into corporate bonds with about the same maturity, but offering higher interest income. This income will be helpful during periods of rising rates, and with our view of a strong economy, credit spreads should remain stable. The bonds purchased were Canadian Utilities Inc 2041 (3.82% YTM), Highway 407 Toll Road 2041 (3.84% YTM), AltaLink 2040 (3.79% YTM), and North West Redwater Partnership 2039 (4.12% YTM).

The other portion of the proceeds from the trim of the Canada 5% 2037 were invested in additional short-term bonds, EnerCare 2020 and H&R REIT 2020. Overall, these changes were made to preserve capital in a likely rising rate environment, while trying to capture as much upside as possible should rates decline.

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.

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