BIM Barrantagh Review

Volume 22 | Edition 4 | December 2017

ECONOMIC & GEO-POLITICAL BACKDROP | GLOBAL INFLATION REMAINS MODEST

Canadian economic data continues to be outstanding. Recall in the second quarter Canada's real GDP grew at an annualized rate of 4.5%, well above the sustainable level of 2%. That blistering pace slowed in Q3 to 1.7%, and forecasts for Q4 are calling for close to 2% growth. This leaves the average rate for 2017 at around 3%, an impressive number. In fact, this leads all G7 nations. The Bank of Canada believes that the economy is firing on all cylinders and the output gap (the difference between what the economy can produce and what it is producing) closed in the second half of this year.

Job growth and quality for Q4 has been exceptional, with full-time jobs in the private sector representing most of the additions. **As a result, the latest Canadian unemployment rate at the end of November was 5.9%, matching a record set in 2007.** The ensuing question is, if Canada is approaching full employment, where is the wage growth? Recent numbers suggest that wage growth is starting to pick up, with October and November coming in at 2.4% and 2.8% year-over-year, respectively. These numbers are better than any of the past 17 months, but only about equal to the long-term average of 2.6%. However, this is much improved considering that April 2017 wage growth was only 0.7%.

Better wage growth is beginning to trickle into inflation. Headline inflation, including volatile food and energy prices, reached 2.1% in November. The Bank of Canada has three internal measures of core inflation and two of those saw meaningful upticks in November. The Weighted Median Index reached 1.9% for the first time in over twelve months. **It is a bit early, but it appears that inflation in Canada may be finally approaching the 2% mark.**

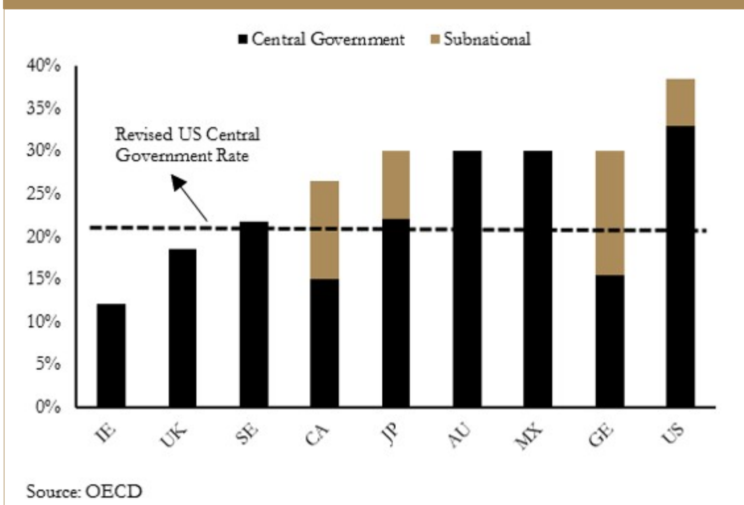
U.S. ECONOMY

The U.S. is on pace for real GDP growth of 2.3% in 2017, the second best in the G7 and slightly ahead of Germany. Similar to Canada, it is estimated that the U.S. closed its economic output gap in Q4. **Job growth in October and November was solid with each month adding over 200,000 jobs, though part of this was catch-up after the hurricanes that hit Texas and Florida. Notably, the unemployment rate of 4.1%, reached at the end of November, is lower than the lowest point in 2007.** U.S. wage growth remains near the post-financial crisis average of 2.5% year-over-year. With the U.S. labour market at full employment, stronger wage growth should ensue.

Inflation remains surprisingly muted. The core measure, excluding volatile food and energy prices, remains at 1.7%. The last time the year-over-year change was close to 2% was in March. The U.S. Federal Reserve also looks at the Core Personal Consumption Expenditure Price Index for a measure of inflation, which sits at 1.5%. This measure has only surpassed 2% once (early-2012) since the financial crisis. The U.S. Fed is raising interest rates based on full employment and prospects for continued solid economic growth, but market participants are eagerly watching incoming inflation data to see if it will approach 2%.

Going into 2018, close attention will be paid to how the recent changes to U.S. taxation (Figure 1) will affect the economy. The major tax changes recently signed by President Trump are expected to increase GDP growth by 0.3% to 0.5% in 2018. Time will tell if these changes will spur businesses and consumers to invest and spend. Notable was China's response to the U.S. tax change, with the Chinese government announcing a temporary exemption of foreign companies from paying tax on earnings that are directed to Chinese government approved sectors (mainly related to infrastructure in China). This is a clear attempt to keep American companies from removing profits from China in light of the U.S. tax code overhaul. Up next for the Republican party is pursuing more infrastructure spending, tackling welfare reform, and the Affordable Care Act.

FIGURE 1: GLOBAL CORPORATE INCOME TAX RATES



One overhang on Canada/U.S. relations is the ongoing negotiation of the North American Free Trade Agreement (NAFTA). The original deadline for negotiations of December 31st was extended to March 31st, 2018. If an agreement cannot be reach by the end of March, negotiations are likely to be placed on hold due to elections in Mexico and the U.S., as the governments involved may see significant change. Mexico has a presidential election in July and the U.S. has congressional elections in November.

GLOBAL ECONOMIES

2017 is one of the few years in recent history when most countries experienced positive economic growth at the same time. **The Eurozone has seen increasingly positive real GDP growth in 2017, with the latest publication of 2.6% in Q3 an improvement from 2.4% in Q2, and the second-best quarter since the financial crisis.** France is growing very well, while the U.K. is muddling along with continued concerns over Brexit. The European unemployment rate continues to improve, reaching 8.8% in October, the lowest level since early-2009. **Inflation in the Eurozone remains far from the 2% target, with back-to-back prints of 0.9% in October and November.** Even in China, with its high growth rate (6.5 to 7.0%), the reported inflation was a manageable 1.9% in October and 1.7% in November. **While global economic growth and the labour markets are the best in years, inflation remains well below 2% and is being closely watched.**

EQUITY MARKETS | OPPORTUNITIES IN OLD ECONOMY BUSINESSES

A strong fourth quarter capped off a good year for Canadian equity markets (up 4.4% in Q4 and 9.1% for the year), and a great year for global markets (up 5.6% in Q4 and 23.1% for the year in USD, or in CAD terms up 6.0% and 14.7% for Q4 and the year).

The solid global economic backdrop, coupled with modest inflation, continues to provide good visibility into corporate profitability as we head into 2018. We maintain a positive outlook for Canadian and global equities.

CANADIAN MARKET

It is notable that both the energy and materials sectors underperformed the broader Canadian index this year, and were in large part responsible for the performance divergence between Canadian and global markets. Furthermore, these sectors failed to exhibit the customary leverage to underlying commodity prices, which was most acute in the energy sector. This could lead one to conclude that either commodity prices are soon to roll over, or there is an interesting value opportunity in the energy and materials sectors, with commodity prices also having significantly lagged equity market returns over the past several years (Figure 2). Our view is aligned with the later for a number of reasons. In past reviews we have written extensively about the steadily improving supply, demand, and inventory picture for crude oil markets. Our narrative on the subject remains much the same at this time, with the most recent quarter providing confirmation that OPEC will extend its production agreement through 2018 and will commit to a managed return of supply upon expiry. The ongoing production ramp-up of U.S. shale will continue to be closely monitored, but we believe this can be accommodated in the context of a robust demand environment and greater U.S. producer company focus on sustainable growth rather than growth at all costs. At the equity level, Canadian energy producers continue to trade at attractive metrics whether looking at cash flow multiples, recycle ratios, or net asset values that imply very little credit for future drilling inventory.

Beyond energy, many other commodities have also broadly benefited from robust global growth, in addition to other more specific developments. Following the capital spending largesse at the previous market peak, several years of underinvestment has helped to rectify the oversupply in certain base metals markets. Furthermore, the disciplined implementation of Chinese supply side reform (i.e. the reduction of industrial over capacity to improve both competitiveness and the environment) has served as a net positive to-date, whereby raw material supply has been impacted to a greater degree than demand (lending further support to commodity pricing).

Lastly, commodity sectors historically have been outperformers during the mid and late periods of global business cycles. While the post financial crisis business cycle has been anything but typical (in both length and its highly managed nature), the U.S. now appears to be leading us past the quantitative easing phase which should enable a relatively more normal maturation of the economy, also providing happy hunting grounds for stock picking within old economy businesses.

GLOBAL MARKETS

Equity markets globally posted another strong quarter, capping a year of very strong gains. The more cyclical sectors such as information technology and consumer discretionary significantly outperformed the more defensive sectors such as utilities, healthcare and real estate. Geographically, local politics played a large role in equity markets this quarter. In particular, Japan had a snap election which cemented Abe's leadership, and due to his policies being considered very pro-growth, this resulted in meaningful outperformance of Japanese equities. In the U.S., optimism regarding passage of the tax bill helped the region to outperform in the quarter due to expectations for higher corporate profits and an improved outlook on consumer and corporate spending. On the other end of the spectrum was the tepid performance of European equities driven by political instability in Spain (due to a separatist push in Catalonia), as well as the impact of a weakened German government after a poor election showing for Angela Merkel.

FIGURE 2: COMMODITY RETURNS LAGGING S&P 500

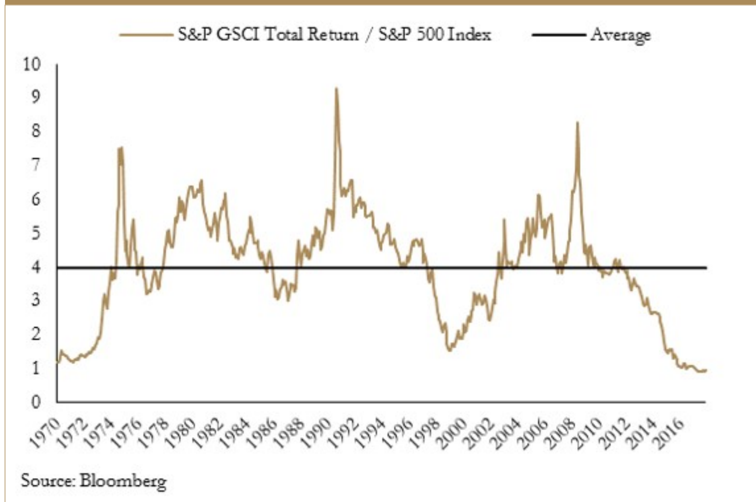
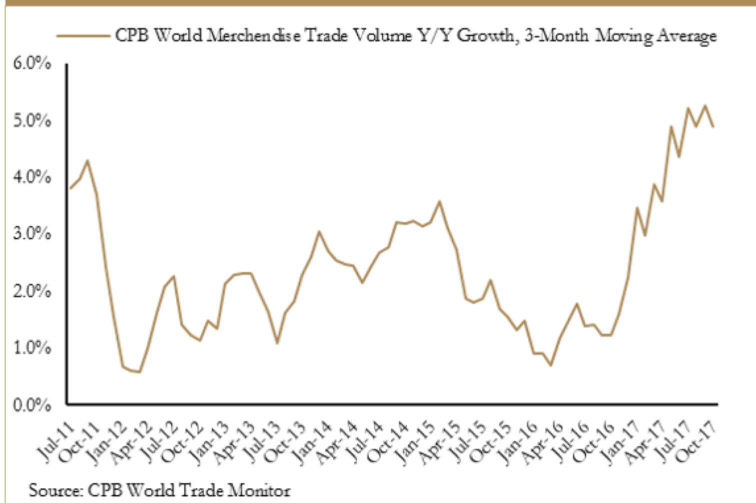


FIGURE 3: GLOBAL TRADE GROWTH RISING



During the quarter, companies continued to report gradually improving trends in final demand, which helped to provide more confidence in corporate medium-term outlooks. This can also be seen in the strong readings of various sentiment indicators globally, such as the manufacturing PMI (Purchasing Managers' Index) surveys. Though some worry that demand growth remains subdued compared to past business cycles, this does provide a better environment for a more prolonged growth period. This is partly due to more modest inventory builds, and therefore a lower likelihood of a significant inventory destocking event that would hurt demand. Furthermore, companies have not been reporting many supply chain bottlenecks that usually come with high levels of growth. Growth in global trade has seen a solid recovery in 2017 (Figure 3). This is particularly encourag-

ing given the relatively long period of lackluster growth experienced in earlier years. Furthermore, with the continued improvement in economic growth across a greater number of regions, we expect growth global trade trends to remain robust.

PORTFOLIO INSIGHTS

In Canadian portfolios, this past quarter we purchased Lundin Mining, a leading mid-tier copper and zinc producer. We appreciate the company's returns based focus towards capital allocation, financial discipline and adherence to strict criteria when evaluating M&A opportunities. A revised mine plan for the company's principal growth asset caught the market by surprise, resulting in a significant share price reset that provided an attractive entry point. We met with management and gained comfort with the revised capital spending profile and its long-term benefits. We purchased our position with a sizeable margin of safety in what can be a volatile sector.

In Global portfolios, we recently added Deutsche Post, a company well positioned to take advantage of strength in global trade. The company's DHL express parcel business has dominant market share in Asia, where trade growth is particularly robust. In addition, Deutsche Post has been a key beneficiary from the shift to eCommerce in Germany. Lastly, the company is in the early stages of turning around its troubled Supply Chain division, which is expected to become a material contributor to earnings growth in future years.

FIXED INCOME MARKETS | FLATTENING YIELD CURVE

One of the central themes in the fixed income market for the fourth quarter was the flattening of the yield curve. In the past three months, short-term interest rates in Canada rose about 15bps (basis points), while the 30-year rate declined 20bps. At the end of December, the difference between 2-year and 30-year rates in Canada was 57bps. In the U.S. the same 2/30s slope was 85bps, down 50bps during the quarter. Looking forward, one section of the yield curve that is likely to flatten further is the slope between the 5-year and 10-year rates. In Canada, this spread was only 17bps at the end of December, with the U.S. curve exhibiting a similar differential.

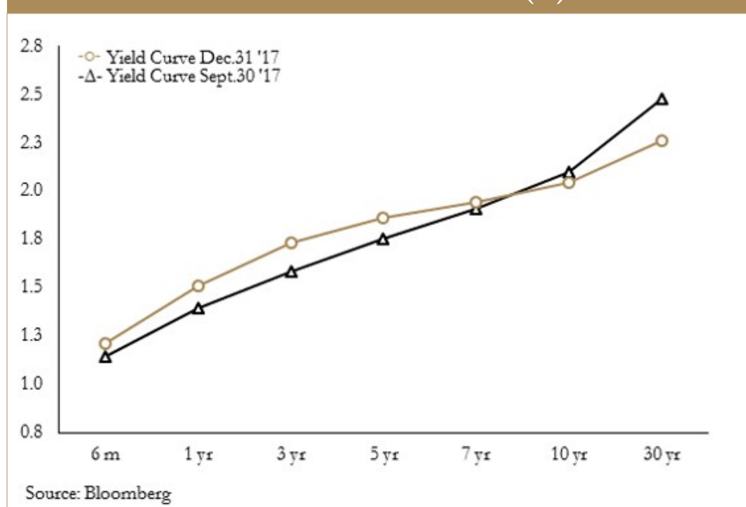
The flattening of yield curves is closely watched by market participants. Historically, when a country's yield curve is perfectly flat, or short-term rates are higher than long-term (making it inverted), an economic recession soon follows. In that scenario, the fixed income market is saying that the central bank has made a mistake by raising short-term rates too high and the country's prospects have weakened. **While the curve has flattened recently, it still has some ways to go before giving this signal and today the economy remains in great shape.** Should we see a return of inflation, longer-term interest rates may rise adding steepness to the yield curve.

The other influence on low long-term interest rates is the European Central Bank (ECB) continuing to buy bonds in its market through its quantitative easing program. As well, the Bank of Japan is employing a strategy of fixing the Japanese 10-year rate near 0%. The ECB influence is particularly acute as it is buying more bonds than are being issued, resulting in a net negative supply of new bonds in Europe and driving long-term bond yields lower. In September, the ECB announced its intention to scale back purchases to €30Bln per month beginning January 2018, from €60Bln.

After raising the Canadian overnight rate to 1% in September, the Bank of Canada (BoC) decided to take a pause in the fourth quarter. In the U.S., the Fed raised to 1.50% in December. Traditionally, the BoC raises rates at about the same pace as the U.S. Fed, and is usually one 25bp hike behind. After strong Canadian CPI and retail sales data in November, there is pressure on the BoC to raise rates at the January meeting. The market will be closely watching economic data ahead of this meeting. Should the BoC keep rates unchanged in January, the next scheduled meeting is in March. Concerns about NAFTA, and higher minimum wage and tighter mortgage rules in Ontario, are factors in favour of waiting until March to hike.

In November, President Trump announced that Fed Chair Janet Yellen would not be appointed to a second term and selected Board member Jerome Powell as the new leader. Powell has been part of the Fed since 2012 and his nomination is mostly considered to be a continuation of Yellen's policies. The Fed meets next in January, where no action is expected, and the subsequent meeting in March will be Powell's first as Fed Chair. The pressure will be elevated as the market currently places high odds of a hike in March.

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

PORTFOLIO INSIGHTS

As mentioned, the long-end of the fixed income market continues to perform well. In the fourth quarter, the long index returned 5.2% led by the Provincial and Municipal sectors. Despite higher short-term interest rates, the short index also generated a positive return of 0.3% as tighter credit spreads and interest income provided an offset.

Early in the quarter several purchases were made to manage interest rate and credit risk. A Telus long-term bond was purchased, as well as a Lower Mattagami hydroelectric project bond. The investment in Pembina Pipeline changed as the 2025 bond was sold to buy the 2043 maturity. In the middle part of the curve, a new position in Ontario Pension Board Finance with a 2027 maturity was purchased. Finally, in the short-end a 2021 Laurentian Bank senior deposit note was added.

The Enercare 2020 holding outperformed its peers as solid earnings reported in November and a cheap credit spread enticed investors to buy its debt. The rally in oil prices and solid fundamental performance helped Suncor 2026 bonds outperform peers. Finally, in the long-end, the safer corporate credits Highway 407 and Canadian Utilities outperformed, along with the relatively cheaper names in the provincial sector, Manitoba and Nova Scotia.

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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