Barrantagh Review

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ECONOMIC & GEO-POLITICAL BACKDROP | FUNDAMENTALS SOLID, TRADE RHETORIC NOISE

The **Canadian economy remains resilient, with GDP growth near the long-term sustainable 2% level.** Recently reported Q4 GDP growth was 1.7%, matching Q3. This was helped by a strong month-over-month increase in November of 0.4%, the highest since the robust first half of 2017. In December, the Canadian economy continued to expand adding another 0.1%. The latest reading for January had several temporary influences that led to a month-over-month contraction of -0.1%, including a slow-down in real estate and mining. Economists are estimating Q1 growth between 1% to 1.8%, below the Bank of Canada's estimate of 2%.

Overall, recent job creation has been strong. November and December saw some of the highest monthly additions in the past ten years. A large number of part-time jobs were lost in January, but February saw more typical job gains of 15,500 and continued strength in full-time jobs. Canadian unemployment remains steady at around 5.8%.

Headline CPI inflation eclipsed 2% in February at 2.2%, and the three core measures calculated by the Bank of Canada (which back out volatile food and energy prices) also reached 2%. These levels are expected given that the economy is growing solidly and is at full employment. **The pace of core inflation is not causing any alarms as it remains comfortably within the Bank of Canada's mandate of between 1% and 3%.**

In January, the Bank of Canada raised its overnight lending rate from 1% to 1.25%. Following two successive hikes in July and September of last year, the Bank waited to gauge the economy's reaction. After observing continued strength, the Bank raised rates in January to prevent the economy from overheating. The decision was also helped by the U.S. Federal Reserve raising its rate to 1.5% in December, amid expectations for a follow-up hike in March to 1.75% (which was delivered).

U.S. ECONOMY

Fourth quarter U.S. GDP growth was 2.9%, a touch slower than Q3 at 3.2%. Overall, the U.S. economy grew 2.3% in 2017, with first quarter growth of 1.2% holding back the annual number.

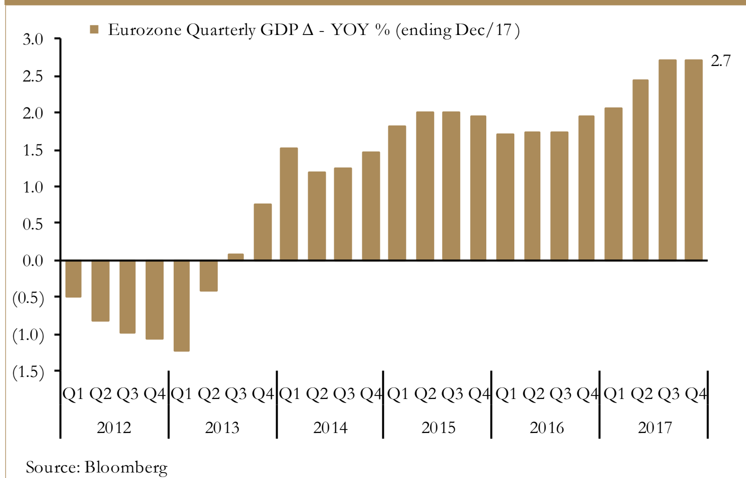
The U.S. economy has grown above potential over the past three quarters. U.S. job creation has been strong, with the February report showing that 313,000 new jobs were added. More people re-entered the workforce as the participation rate increased by three tenths to 63%. Higher participation is the only way to continue to fill job openings with the unemployment rate at 4.1%. Higher wages will continue to encourage people to return to the workforce, and hourly earnings are rising each month at an annual rate of around 2.7%.

In each of the past three months, core CPI has risen, but not enough to move the year-over-year needle from 1.8%. The core PCE measure has told a similar story. However, expectations for higher inflation are mounting. **With above potential economic growth, the lowest unemployment in over 15 years and wage growth above 2%, inflation should be around the corner.**

As noted above, the U.S. Federal Reserve, and new chair Jerome Powell, felt confident enough about the economy and inflation to raise rates in March, which was widely expected. The key focus was on guidance for future rate hikes, with most expecting three or four hikes for 2018. At the meeting, the only guidance change the Fed provided was to expect an additional hike in 2020.

Adding fuel to U.S. growth is the Federal Government. In December, the government reduced personal and corporate income taxes. **As well, in early-2018, a new budget was passed raising the annual budget deficit, as a percentage of GDP, to an even larger amount than the 3.5% reported for 2017.** These fiscal policies are expected to add a few tenths to near-term U.S. GDP growth.

FIGURE 1: EUROZONE GROWTH REMAINS STRONG



Source: Bloomberg

EUROPE & CHINA

The economic story in Europe remains strong. **Q4 GDP growth was 2.7% (Figure 1), one of the best quarters in ten years. Full-year 2017 growth was 2.3%, the highest since 2007.** Unemployment has been improving modestly every quarter and sits at 8.7%. Inflation, however, remains muted, hanging around 1%. **For central bankers, this is the ideal scenario with solid economic growth, improving employment, and low inflation.**

For 2017, Chinese GDP growth performed at target (just below 7%) and is expected to remain a source of strength for the global economy. Chinese inflation was surprisingly slow in January, but rebounded strongly in February to 2.5%, the highest print on record going back to 2006. Given the structure of the economy, we expect inflation will be managed lower in the months ahead.

The potential for strains in global trade relations warrants close attention given recent posturing. **However, we note the main hot button trade issues have either been resolved at less fractious terms, or are proceeding in a more conciliatory tone than when first announced.** This can be seen when looking at the final terms of the more targeted U.S. steel/aluminum tariffs, the warmer tone in the NAFTA (North American Free Trade Agreement) talks recently, and reports of behind the scene discussions between U.S. and Chinese representatives. As such, it is unlikely that trade war concerns will accelerate significantly, but these concerns may continue to contribute to market volatility.

EQUITY MARKETS | NORMAL VOLATILITY RETURNS

Volatility is a normal and healthy part of equity markets. Breaks from extended periods of relative calm can result in a negative reaction, as evidenced by the correction experienced in the first quarter of 2018. Canadian and global equity benchmarks posted negative returns for the quarter of -4.5% and -1.2% (though +1.7% in C$ terms) respectively.

Markets are driven by company fundamentals over-time. However, corrections or pullbacks can be the result of any number of reasons, including a change in market sentiment, technical factors, or economic fundamentals. The majority of market prognosticators attributed the February correction to technical factors (i.e. a break from the trend of depressed volatility as shown in Figure 2), and we view the recent pullback in late-March as being sentiment driven around overblown fears of a global trade war. **Despite recent volatility, our fundamental views remain unchanged, and we continue to seek out companies that can benefit from later cycle economic dynamics and global growth.**

The potential for rising inflation is a topic that has received much attention in the financial press both from the perspective of what it may mean for equity valuations and which sectors stand to benefit. We do not view inflation as a near-term valuation risk for the majority of equities given that it should be rising for the right reasons (i.e. strong economic data as shown in Figure 3), and the current low absolute level of the metric itself (i.e. core U.S. CPI is still just under 2%). Select, safe haven stocks may have benefited from the recent market pullback (at least in relative terms), though we would envision struggles for rate sensitive sectors should inflation inflect higher.

Another factor supporting our conviction in moderately rising inflation is company comments on its impact on daily operations. The examples are numerous across many different sectors, centered around input costs inclusive of commodities, labour and logistics. To account for inflation, we place emphasis on our analysis of a company's ability to manage margins via pricing power (i.e. are they able to pass through cost inflation to customers via higher prices?).

CANADIAN MARKET

Our previous BIM Review touched upon opportunities in old economy businesses, which we view as even more compelling given improving fundamentals in the face of a market pullback. We continue to see good value in pockets of the materials, industrials and financials sectors (i.e. lifeco's), that offer positive exposure to either global growth or rising rates at reasonable valuations, with the potential for positive earnings revisions.

We have talked at length in the past about the disconnect between the crude oil price and energy producer share price performance, which further expanded this quarter. We note that bearish sentiment and bullish fundamentals (particularly for light oil) should eventually result in material upside. Catalysts to unlock this value likely revolve around progress related to export pipeline approval, NAFTA resolution and potentially some moderation in the backwardation of the crude forward curve.

GLOBAL MARKETS

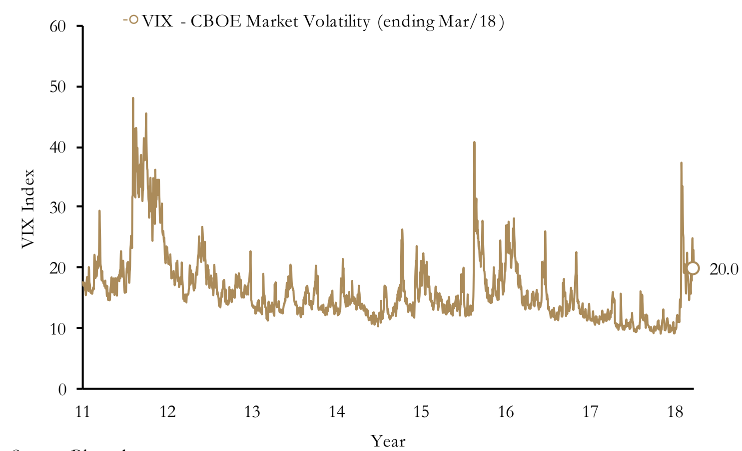
After a strong start in January, global equity markets gave back all early-year gains. Although the global index ended the quarter down -1.2% in USD terms, the decline was around -7.5% from the January peak. **However, amid the volatility, the earnings season and messaging from company management teams continued to remain relatively upbeat**, albeit with some commentary about cost inflation as a modest near-term challenge to margins. Interest rates also pulled back slightly from highs in February, which resulted in financial stocks retreating as well. Though investor concerns have grown, companies remain optimistic regarding growth, and view the risk of escalating trade barriers as unlikely. We expect this environment to remain favourable for freight transportation, construction and banking stocks, which tend to perform well in the later stages of an economic cycle.

Technology stocks came under increased scrutiny in the quarter, with regulatory concerns starting to weigh on social media and internet companies, like Facebook, in-light of lax privacy practices. Although this has resulted in more volatility within the tech space, the demand environment for most IT companies remains robust. Companies from various industries plan on focusing more resources on improving productivity by upgrading technology infrastructure, with investment also being driven by rapidly changing environments. Although the technology sector has performed very well over the past two years, we remain positioned in IT companies with secular growth drivers trading at attractive valuations. For instance, Microsoft has introduced several new cloud services over the past few years, and continues to benefit from its large base of corporate customers who are looking to transition more towards the cloud.

PORTFOLIO INSIGHTS

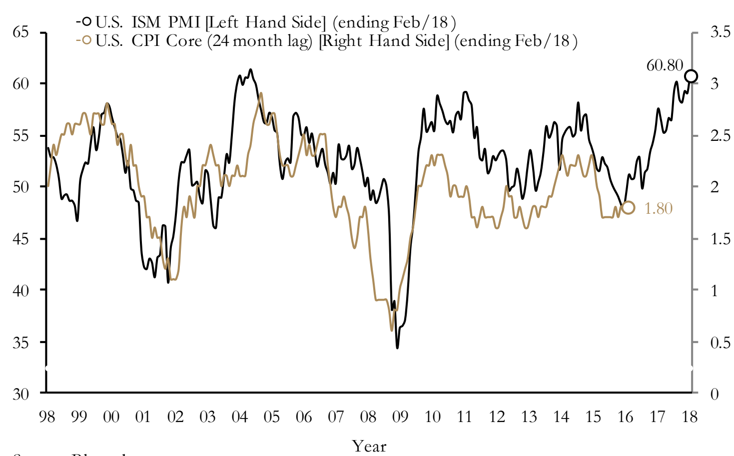
Sun Life Financial was recently

FIGURE 2: VOLATILITY RETURNS TO MARKETS



Source: Bloomberg

FIGURE 3: PMI LEADS INFLATION BY TWO YEARS



Source: Bloomberg

purchased in our Canadian portfolios. The company is well placed to grow earnings due to its leading Canadian business, margin enhancement opportunities in the U.S. group benefits business and improving U.S. asset management net flow trends. Sun Life also boasts excess capital that could be deployed across a number of business units, with Asia potentially being the most attractive given its current smaller scale and greater growth potential. While the company's earnings growth targets are not contingent upon higher interest rates, Sun Life would certainly benefit from this, which we view as a free option in the stock.

In Global portfolios, we continue to hold a position in Allegion plc, a leading manufacturer of security locks. The company is well positioned to take advantage of favourable construction end markets, as well as the growing trend toward smart digital locks in commercial and residential markets. Management has a strong track record of execution, particularly with rolling out new products and managing raw material inflation, which has become a concern for the industry more recently. The lock industry remains very fragmented, and opportunities for accretive acquisitions provide another option for future growth, particularly as smaller competitors struggle to introduce new digital products. Furthermore, Allegion is a strong free cash flow generator, with a management team focused on shareholder returns, and the stock trades at an attractive valuation.

FIXED INCOME MARKETS | YIELD CURVE FLATTENING CONTINUES

The yield curve flattening theme carried on into the first quarter of 2018. Short-term interest rates in Canada rose as a result of a hike from the Bank of Canada, while long-term rates fell slightly. The difference between the Canadian 2-year and 30-year rate fell by 12bps to 45bps.

After the U.S. government cut taxes in December, policy makers followed up by passing a large budget deficit for 2018, which caused interest rates to rise through mid-February. In addition, **the Bank of Canada raised its overnight rate in January after being on hold for four months.** The central bank is communicating that it is firmly on hold for the foreseeable future. However, the market is pricing about a 50/50 chance of a hike by the end of May and a 70% chance of a hike by July.

While the rate hike and optimism at the beginning of the quarter left short-term Canadian rates higher, long-term rates declined. The Canadian 30-year rate finished the quarter just slightly lower than where it started, while mid-term rates ended about 6bps higher. Canadian rates outperformed U.S. rates by a large margin (i.e. Canadian rates finished relatively lower), with U.S. mid-term rates 34bps higher and the 30-year rate up 23bps. This was mostly driven by increased confidence in long-term U.S. fundamentals, while the Canadian counterparts did not follow due to global investor concerns about Canada. Risks surrounding NAFTA, energy exports, consumer debt and housing remain top-of-mind in Canada.

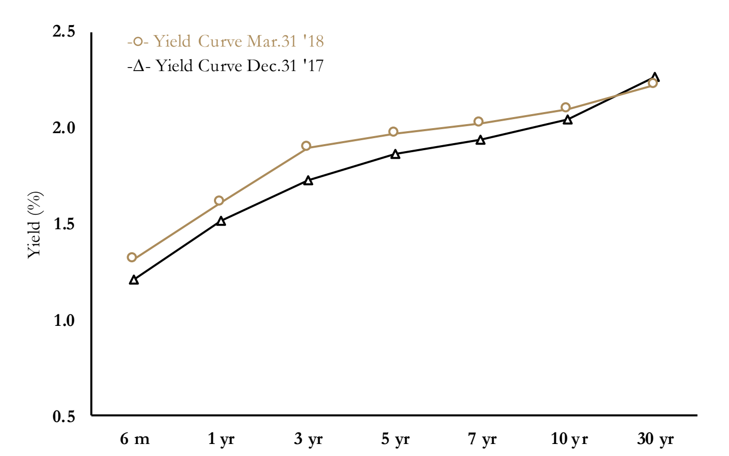
Credit spreads finished the quarter wider, the first quarterly increase since 2015. Government credit spreads widened by 9bps after tightening 10.5bps in Q4, and reaching levels not seen since the financial crisis. The credit spread on a 30-year Ontario bond bottomed at 64bps in early January and finished the quarter at 79bps. Corporate spreads faired a bit better, widening 4.5bps and only gave back half of the fourth quarter gains. For comparison, 30-year Telus spreads ended the first quarter at 220bps.

Overall, short-term bonds outperformed by a small margin as interest income offset higher interest rates and wider credit spreads.

PORTFOLIO INSIGHTS

Our credit selection helped relative performance this quarter, and we also maintained a duration that is more than one year underweight. **Holdings in long-term debt of Pembina Pipelines and North West Redwater Partnership outperformed during the quarter.** Pembina was undervalued compared to peers AltaGas and InterPipe, and the quarterly earnings releases highlighted this difference. The North West Redwater project is nearing completion, with parts of the refinery already operating. Once fully up and running, operating cash flow will more than adequately service the debt, and credit spreads are expected to tighten to match more established peers. In the short-end, holdings with the highest yield-to-maturities, such as H&R REIT, EnerCare and Pembina, had the best returns.

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

In early-January, our holding of PSP Capital 3.29% 2024 was reduced by half to lower duration. At the end of the month, **BBB rated RioCan 3.85% 2019 was sold and replaced with A rate Nissan Canada Finance 1.584% 2019.** At that time, RioCan credit spreads were very low and at a level where the company has an option to call the bonds early, providing a floor on spread performance. The Nissan bonds are an upgrade in credit quality, do not have a call option limiting spread performance and had only a slightly lower yield. Nissan Canada Finance has an excellent history of risk management and is the Canadian financing arm of the auto manufacturer, which also guarantees this debt.

In late-February, **OPB Finance 2.9% 2023 bonds were sold and replaced with Bell Canada 2.9% 2026.** The 2026 maturity moves further away from the short-end of the yield curve that is more heavily influenced by the Bank of Canada. This change also picked up additional yield as Bell credit spreads are wider than OPB, and our expectation is that credit spreads will tighten in the future. Also, in late-February the **Canada 5% 2037 holding was trimmed, with the proceeds used to add to Province of Saskatchewan 4.75% 2040.** This change was made to add yield and credit risk, as we expect credit spreads to perform well going forward.

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