BIM Barrantagh Review

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ECONOMIC & GEO-POLITICAL BACKDROP | FUNDAMENTALS FINE AMID TRADE TENSIONS

The impact from the B-20 mortgage rules, which made it more difficult for Canadians to qualify for uninsured mortgages, persisted in the second quarter with the number of home sales down by double digits versus the second quarter of 2017, while home prices declined by a lesser degree. Lower resale housing volumes have a wide reaching impact on the economy, and this is mostly focused in Ontario and British Columbia. Additionally, the sluggish pace of progress on securing incremental oil export transportation from Western Canada has been limiting overall Canadian growth prospects. Finally, trade concerns with the United States are also a modest headwind to the outlook. Canadian GDP growth for the first quarter of 2018 was reported as 1.3%, down from 1.7% in the fourth quarter of 2017. Estimates for the second quarter of 2018 call for a sequential improvement at 2.5% driven by gains in industrial production and exports.

Job growth in Canada stalled in April and May with a small net loss of jobs, but the unemployment rate held steady at 5.8%, as it has for all of 2018. Average hourly wage growth has been very strong, reaching 3.9% year-over-year in May, but a good part of that can be explained by the jump in minimum wage in Ontario.

Inflation in Canada remains stable, with core inflation at 1.9% and headline CPI at 2.2%. The Bank of Canada continues to be cautious about raising interest rates after the last hike to 1.25% in January. It appears that the Bank has been encouraged by business investment so far in 2018, but recognizes that rising interest rates have a larger impact on the Canadian consumer than in past cycles due to higher debt levels. As economic data for the second quarter is reported, the Bank of Canada and investors are looking for an increase in business investment and improved international trade to offset a slow down in consumer spending and housing.

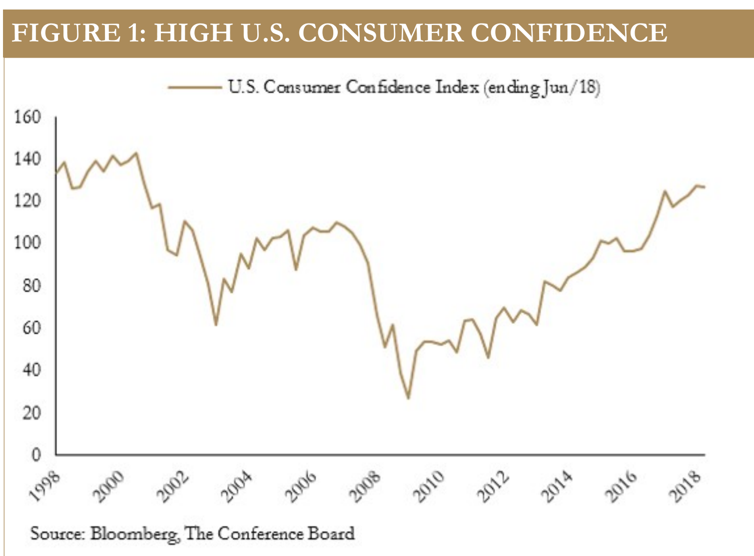
U.S. ECONOMY

The U.S. economy had an exceptional second quarter with GDP growth tracking well above 3%. The tax cuts and fiscal spending are having a meaningful impact after more tepid first quarter GDP growth of 2.0%. Job creation has been solid, with nonfarm payrolls adding 159k jobs in April and 223k in May. A consistent theme is that skilled employees are difficult to find. The unemployment rate is declining and reached 3.8% in May, a historic low. This low level of unemployment was last touched for one month in 2000, and hasn't been lower since the early 1970s. Each Thursday morning, the weekly initial jobless and continuing claims are analyzed to look for any warning signs regarding a turn in the labour market, as these metrics also remain at historically low levels.

Pressure for higher U.S. employee wages are still not appearing and annual wage growth remains around 2.6%, where it has been for about two years. While recent wage growth remains some of the best since the financial crisis, growth could be higher considering the more than three percent pace experienced in the later stages of the last economic cycle. Moderate and manageable wage growth suggests that there is room for continued economic expansion and corporate earnings growth.

The U.S. consumer, by far the largest driver of U.S. economy, continues to enjoy a strong job market, rising wages, and lower income taxes. U.S. consumer confidence (Figure 1) remains near its highest level since 2000.

FIGURE 1: HIGH U.S. CONSUMER CONFIDENCE



Between February and March, U.S. core PCE inflation rose from 1.5% to 1.8%, then held steady at 1.8% in April and ticked up to 2.0% in May. Core CPI for May was 2.2%. The U.S. Fed remains confident that the current pace of one rate hike per quarter is appropriate.

There was no shortage of political tension in the last three months emanating from the U.S. Presidential Office. **It's important to remember that the U.S. is a mostly closed economy, with international trade only having a moderate impact on its economy relative to other major global economies.**

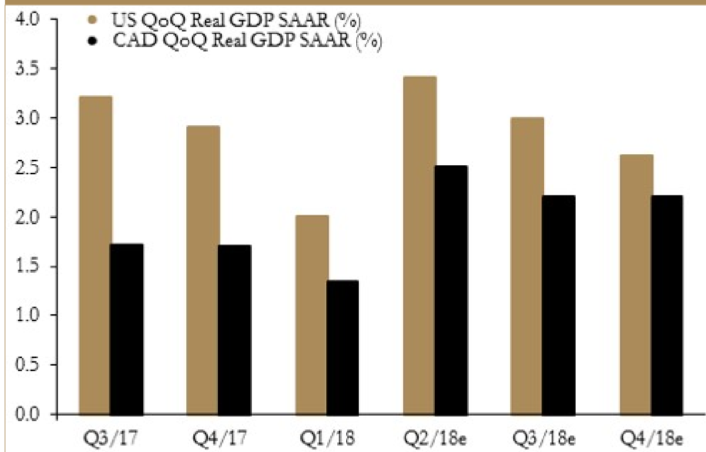
EUROPE & CHINA

European GDP growth remains solid, but is moderating from strong levels, with the first quarter of 2018 at 2.5% versus 2.7% for the fourth quarter of 2017. Second quarter growth is expected to be 2.3%, and slowing to around 2.0% as the year progresses. Nationalism continues to be a key theme (as evidenced by the recent Italian election), as well as immigration policy, and the uncertainty is a drag on growth. Rising international trade barriers have a relatively larger impact on Europe where the strongest nations depend on exports. Unemployment is declining steadily and registered 8.6% at the end of the first quarter. Core inflation has yet to show a consistent increase, staying close to 1.0%. In June, the European Central Bank (ECB) expressed its confidence in the European economy and indicated that its quantitative easing program would finish at the end of 2018. The ECB will wait until after the summer of 2019 to consider raising administered interest rates.

China's official reported economic growth for the first quarter of 2018 was 6.8%, but there are signs of a modest slowing. May retail sales growth of 8.5% was the slowest in about 15 years and lower than the +10% growth for most of 2017. The Chinese Central Bank and government have taken steps to ease monetary policy, while cracking down on shadow banking, to foster sustainable growth.

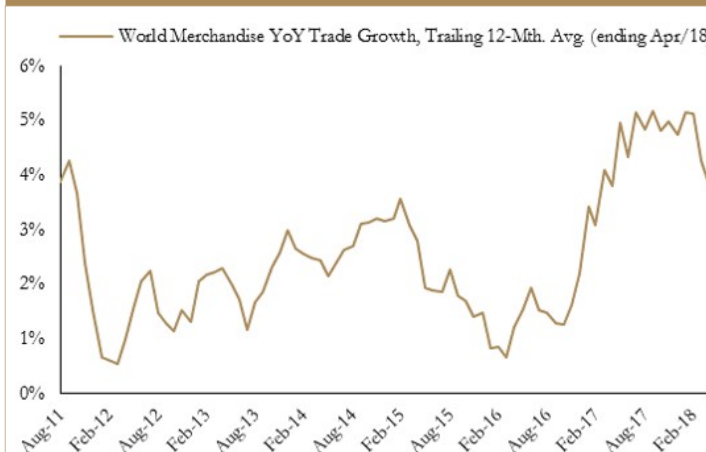
EQUITY MARKETS | STOCKS SHAKE OFF TRADE RHETORIC

FIGURE 2: U.S. GROWING FASTER THAN CANADA



Source: Bloomberg

FIGURE 3: GLOBAL TRADE REMAINS SOLID



Source: CPB World Trade Monitor

Trade related headlines dominated the newswires in the latter part of the quarter causing some to question if we are at the precipice of a global trade war. Our base case remains that cooler heads will prevail, resulting in negotiated outcomes from the current trade disputes. Despite the headlines, Canadian and Global benchmarks rose 6.8% and 1.9% (or 3.9% in C$ terms) in the quarter, respectively.

We maintain a favourable view towards equities as we enter the later stages of the global economic cycle, in an environment of above trend economic growth. The possible near-term imposition of additional tariffs (in the magnitudes as currently contemplated) could limit the potential of this growth at the margin, though could also act as a catalyst for trading partners to re-engage in constructive discussions. The trade relationship between the U.S. and China remains in sharpest focus, and we view the most outlandish rhetoric as a negotiating ploy. Recent developments related to the Chinese telecom device maker ZTE potentially regaining access to U.S. components signals a rational White House that is determined to make a point without unduly harming a key trading relationship. This issue, however, remains unresolved. We believe that there is a deal to be made and that the potential for material trade disruption remains an outlier outcome. However, it is clear that the U.S. is expecting concessions from China in particular, and that the margin for error shrinks the longer we progress without a resolution. We continue to closely monitor the trade situation and await commentary by companies in the upcoming earnings season regarding the potential impact from the trade disputes. We believe that trade related market volatility could result in attractive investment opportunities.

CANADIAN MARKET

The Canadian benchmark performed well in the quarter with strength across many sectors, while a weaker Canadian dollar provided an added boost.

While NAFTA remains unresolved, we note that there are many Canadian listed businesses that have meaningful exposure to the U.S. in industries that are not the focus of trade discussions. The U.S. economy is expected to expand faster than our own (Figure 2) and offers opportunities for Canadian companies to post solid organic growth while earning profits in a strong currency. This is not to say that purely domestic Canadian businesses cannot perform well, though these companies would be more reliant upon either a favourable competitive advantage, industry structure or secular trends. Whether looking north or south of the border for ideas, we continue to emphasize companies generating organic growth.

Securing additional oil takeaway capacity will be required for Canadian energy firms to fully benefit from rising crude pricing. Subject to a few conditions, Enbridge's receipt of approval for the Line 3 replacement project, scheduled to come online in late 2019, was a positive development in this regard. Updates on the Trans Mountain pipeline expansion were mixed, as the Federal Government agreed to purchase the project from Kinder Morgan with a mandate to drive the construction forward and pursue an eventual sale. While some progress on future pipeline expansion was achieved this quarter, we expect crude-by-rail to remain an important outlet for energy producers over the intermediate term.

GLOBAL MARKETS

Global equity markets managed to eek out modest gains during the quarter due to strength in U.S. equities and the technology sector in particular, while European and Emerging Market benchmarks were impacted by the growing tensions surrounding global trade. Furthermore, the Italian election brought the spotlight back onto some of the weaknesses in the European political system, as Italy continues to grapple with the influx of asylum seekers on its shores.

Despite recent solid global trade growth (Figure 3), negative sentiment towards trade has been a headwind for the equities of companies that are exposed to global markets, including multinational industrial and consumer companies headquartered in the U.S. Also, a growing number of companies are dealing with rising input cost inflation, mostly from steel, energy and logistics, adding another variable to short-term earnings growth.

Our stock selection continues to focus on companies with a differentiated product offering and a track record of innovation, such as Thermo Fisher Scientific (a company we profile within the Portfolio Insights section). This is important when facing an environment of cost inflation, which makes it more difficult to maintain operating margins without pricing power. In the short-term, we have seen the share price of these differentiated companies suffer as a result of this margin pressure and the trade war concerns. However, we expect margins of these particular companies to recover as cost inflation is more than offset by pricing actions and productivity initiatives.

PORTFOLIO INSIGHTS

In Canadian portfolios, Waste Connections is an example of a

name we own that does not meaningfully participate in global trade, benefits from strong U.S. economic growth and has pricing power. The company provides waste collection services across both Canada and the U.S., with a focus on either exclusive or secondary markets that prioritizes cash flow generation and margin expansion over revenue growth. The industry continues to offer up numerous consolidation opportunities that the company can generally fund from cash flow, with the profitability of acquired firms improving upon adoption of the Waste Connections operating model.

As noted above, we continue to own Thermo Fisher in Global portfolios. The company is a global leader in scientific tools and consumables, with a particular focus on the pharmaceutical and healthcare industries. Thermo has a strong track record of product innovation, which has enabled its customers to accelerate R&D efforts in areas such as drug development, patient diagnostics and laboratory productivity. This has allowed Thermo to grow revenues consistently over the years, while also expanding profit margins. Given the fragmented nature of Thermo's industry, the company has been very successful in acquiring companies and expanding the product and geographical offerings of the acquired businesses. This can be seen in the company's most recent acquisition of Patheon, which provided Thermo with a more complete biopharma service offering, while doing so at a very attractive return on invested capital.

FIXED INCOME MARKETS | INTEREST RATES LITTLE CHANGED

The first half of the quarter saw interest rates making new highs on market optimism based on economic strength, with Canadian rates 30 to 40 bps higher. However, as political concerns heated up, interest rates declined to finish the quarter only modestly above end of March levels. Year-to-date, the Canadian yield curve has flattened with 2- and 5-year rates up about 20 bps, 10-year up 10bps and 30-year rates 7 bps lower. At the end of the quarter, the yield spread between the 2-year and 30-year rate was only 30 bps (Figure 4). The 2-year rate finished the quarter at 1.9%, implying about three Bank of Canada hikes for this period. Meanwhile, the 30-year rate at 2.2% is the same as headline CPI and just above core inflation of 1.9%.

Canadian interest rates are currently much lower than U.S. rates. The difference between the 10-year rates is 70 bps, near the widest point seen since the Bank of Canada started raising interest rates a year ago. The 3-year average for this spread is 60 bps. This suggests that Canadian interest rates could be too low, with the market pricing in a downbeat view on the Canadian economy and trade prospects.

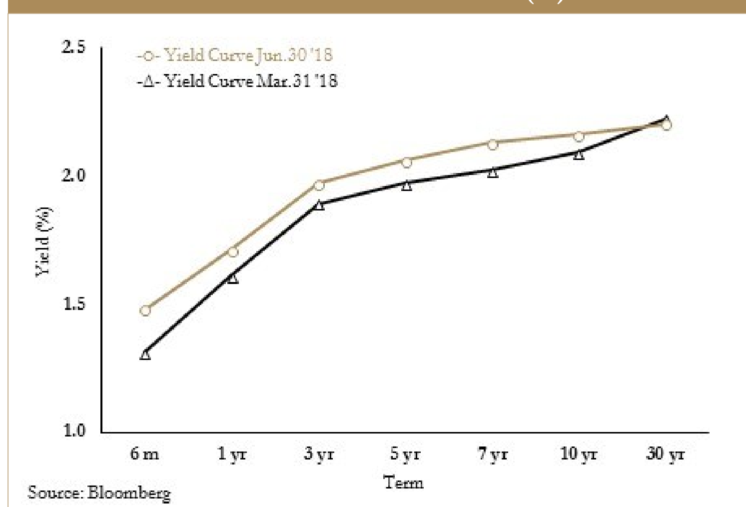
The U.S. Federal Reserve continued its campaign of raising its overnight rate by 25 bps per quarter. The most recent hike in June moved the upper bound to 2.0%, now 75 bps above the Canadian overnight rate. The Fed communicated that it intends to stay on this path, weighing strong economic growth, moderate inflation and historically low unemployment. The end of the U.S. Fed hiking cycle is within sight. One scenario suggests hikes in each of the next four quarters and then holding the rate at 3.0%. Most Fed members see the appropriate level in the long-term at just below 3%. This level would also leave the rate about 1.0% above trend inflation, resulting in a tightening of monetary policy.

PORTFOLIO INSIGHTS

Our holdings in energy related bond issuers outperformed during the quarter. Suncor 3% 2026, Pembina 4.75% 2043, Alberta 4.5% 2040 and Saskatchewan 4.75% 2040 all did well partly driven by the recent rise in the price of oil. Alberta and Saskatchewan credit spreads were higher than Ontario after oil prices fell in 2015, but that changed this quarter with the rebound in crude prices and Ontario's rising debt levels. The outcome of the Ontario election helped its credit spreads, but we will wait for the new government to provide its views on the current fiscal situation and a long-term fiscal plan.

Suncor's performance was assisted by the company recently completing the development of its Fort Hills Oil Sands and Hebron Oil projects, which are now ramping to full capacity. Suncor maintains a strong balance sheet, coupled with rising free cash flow generation, resulting in credit ratings of A- to BBB+ from the various credit rating agencies.

FIGURE 4: CANADIAN YIELD CURVE (%)



Pembina's strong performance was helped by the company recently finishing several large energy infrastructure projects on time and on budget. These projects are now producing cash flow and the company's balance sheet is in great shape. About 85% of Pembina's revenue comes from firm contracts with limited to no volume and commodity price risk. Pembina also has several meaningful longer-term projects under assessment, but its disciplined management team continues to stress the importance of not stretching the balance sheet.

In late April, holdings of Pembina 3.06% 2019 and BMO 3.12% 2024 were increased to pick-up additional yield. The BMO bond is expected to be called in 2019. The investment in CPP Investment Board 1.4% 2020 was sold and replaced with CIBC 2.35% 2019, as the CIBC bond offered a higher yield and shorter maturity.

In mid-May, PSP Capital 3.29% 2024 and British Columbia Municipal Finance Authority 2.95% 2024 were sold, and Province of Nova Scotia 4.7% 2040 was trimmed. The proceeds were redeployed into Canada 1% 2027, Canada Housing Trust (CHT) 2.35% 2027 and Province of British Columbia 4.95% 2040. There were several impacts from these changes. Extending from a 2024 to a 2027 maturity, the longer maturity should outperform as the yield curve flattens. We shifted from the 2040 maturity to 2027 when the difference in the Canada rate was about 3 bps. Also, the moves reduced credit risk from a government pension plan and municipality whose pricing is impacted by Ontario spreads to the Federal government and its crown agency, CHT. Finally, British Columbia is the safest province in Canada with a AAA/AA+ rating, with the replaced Nova Scotia bonds less likely to outperform Ontario.

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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