BIM Barrantagh Review

Volume 23 | Edition 3 | September 2018

ECONOMIC & GEO-POLITICAL BACKDROP | GLOBAL ECOMONY PERFORMING WELL

The Canadian economy performed very well in the second quarter, with a 2.9% expansion in GDP beating lofty expectations. A big part of the strength can be attributed to income tax cuts in the United States, with a surging U.S. economy benefitting our domestic economy. Canadian trade was a positive contributor to quarterly growth for the first time in six quarters. Consumption remained steady and housing was no longer a drag. Going forward, real economic growth is expected to trend closer to the longer-term potential rate of roughly 2%.

Unemployment has been consistent, hovering just below 6%. Wage growth continues to be in focus, as finding qualified workers remains difficult. After peaking near 4% in the second quarter due to rising minimum wages, wage increases have settled in the 2.5% to 3.0% range in the third quarter, still strong by historical standards. More time is needed to find out if this level of wage growth will lead to a faster pace of inflation (Figure 1). For now, Canadians are using a portion of this recent wage growth on higher interest costs.

Strong economic growth and higher wages are translating into rising inflation, but only to a small degree. Headline CPI (Consumer Price Index) temporarily hit 3% in July due to higher energy prices, but the Bank of Canada sees this surge as transitory. Core CPI is inching up very slowly and reached 2% in the third quarter. In the coming year, the Bank of Canada is likely to follow the U.S. Federal Reserve's (the Fed) pace of raising rates.

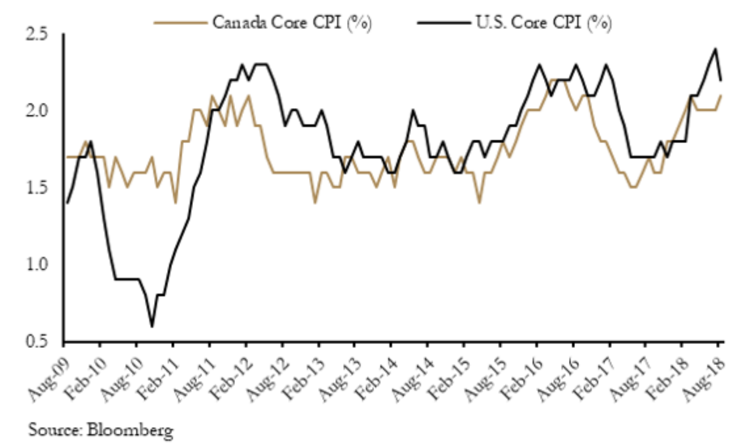
During the quarter, investor sentiment towards Canada remained apprehensive given worries about a lack of resolution on NAFTA (North American Free Trade Agreement) negotiations, energy transportation bottlenecks, and high tax rates. However, these concerns could quickly dissipate as a tentative NAFTA agreement (now called USMCA) and a major LNG (Liquified Natural Gas) project approval were announced just after quarter end, and the federal government will address business competitiveness in the 2019 budget early next year.

U.S. ECONOMY

Second quarter U.S. economic growth was exceptional at 4.2% thanks to tax cuts and a one time pull forward of demand related to expected tariffs. **The third quarter growth forecast is still very strong at 3% and growth is projected to remain above 2% for the next several quarters.** Job creation continues to be robust, with good non-farm payroll numbers each month, and average monthly job creation outpacing the previous year. The weekly jobless claims and unemployment rate hit new records with almost every update. Unsurprisingly, wages are increasing at a faster rate. The most recent data in August saw growth of 2.9% year-over-year, the fastest pace since the financial crisis. Availability of skilled workers is one of the key concerns of U.S. businesses.

Core CPI inflation reached 2.4% in July, which the Fed saw as temporary given the rapid economic growth from the one-time boost of tax cuts, and the measure came down to 2.2% in August. The Fed targets inflation between 1% and 3%, so temporary levels above 2% are not alarming if it appears inflation is under control, as it seems currently. The measure of prices for consumer goods and services, core PCE, is still below 2% and is only trickling upwards very slowly after a sharp up-tick in the first quarter. The Fed continues to remain comfortable with its pace of raising interest rates once per quarter.

FIGURE 1: INFLATION REMAINS BENIGN



Source: Bloomberg

The overall data indicates that tariffs have yet to meaningfully impact the U.S. consumer, though some industries have been hit harder than others. Time will tell if this becomes more impactful, but for now neither the Fed, nor the markets, seem particularly worried. However, tariffs are starting to have an impact on those countries that count on the U.S. as a large market for exports.

The U.S. midterm elections are coming up in November, which will be a good measure of confidence in President Trump. Our base case is a divided Congress that likely slows President Trump's agenda without meaningfully altering the U.S. economic outlook.

EUROPE & CHINA

European economic growth is returning to its 2% potential. Second quarter growth of 2.1% followed a 2.5% print in the first quarter and a peak of 2.7% in the fourth quarter of 2017. The third and fourth quarters of 2018 are forecasted at 1.9% and 1.7%, respectively. Core inflation remains steady around 1%. One bright spot is employment, which continually improves with the unemployment rate at the end of second quarter of 8.3%, down from 8.7% at the beginning of the year. Wage growth has been consistent around 1.8% and does not appear to be picking up. Expectations are for European growth to continue to trudge along.

In China, officially reported economic growth remains in the mid-6% range. Retail sales growth held steady at 9% in Q3, but is down from over 10% historically. The mainland stock index, CSI 300, is having a rough year down about 15% YTD (in CNY) on concerns of slower economic growth and deteriorating terms of trade. The Chinese government is focused on strengthening its banking sector and shifting growth away from government spending to the consumer, but trade tensions and rising interest rates have complicated this transition. However, expectations remain that the Chinese government can meet its targeted growth objectives.

EQUITY MARKETS | STOCKS CONTINUE TO NAVIGATE TRADE NOISE

Trade risks were once again front and centre in the news, though geographies and industries not in the line of fire of the U.S. administration generally performed well in the quarter. Global benchmarks gained 3.5% (or +5.1% in USD terms), with Canada just below flat at -0.6%.

In our previous BIM review, we noted that we viewed the most outlandish trade rhetoric between the U.S. and China as a negotiating ploy, that there was a deal to be made, and that the margin of error would gradually shrink the longer the impasse remained unresolved. Since then, the U.S. has softened its stance towards the E.U., Mexico, and now Canada, while it has imposed additional import tariffs on China, albeit in a lower quantum and rate than threatened (10% on $200 billion, scaling to 25% beginning in 2019). Our view remains that the U.S. position regarding trade is politically motivated and an acceptable middle ground will eventually be found. Closer to home, reports of a tentative NAFTA agreement were released at quarter end, and confirmed in the days following as a compromise was found on the dispute resolution mechanism and access to Canada's dairy market.

Valuations for companies most at risk from trade tensions have become more attractive, though the timeline for de-risking (particularly as it relates to China) remains unclear and the risk of escalation cannot be discounted.

CANADIAN MARKET

The Canadian benchmark posted a modest negative return of -0.6% in the quarter, with strength in the financial and industrial sectors offset by weakness in the materials and energy sectors (where equity performance once again diverged from the strong rally in global crude pricing).

Uncertainty regarding future market access for Canadian oil increased when the federal court of appeal quashed the government's approval of the Trans Mountain pipeline expansion. While the decision does not condemn the project, at a minimum it delays construction with the required re-initiation of consultations with Indigenous groups and an expected 5½ month timeline to complete a thorough marine life environmental analysis. The court's announcement was near coincident with a widening in the discount for Canadian oil versus the WTI benchmark, highlighting the future potential opportunity cost should additional infrastructure not proceed. Current oil differentials (Figure 2) are exasperated to some degree by transient factors. However, the pipeline and storage system remains tight, and forward discounts are projected to be greater than in the recent past. Differentials will remain sensitive to crude-by-rail activity levels in advance of the commissioning of the Enbridge Line 3 replacement. The current conditions are favourable for refiners, such as Parkland Fuel, given a discounted feedstock, while the silver lining for the remainder of Canadian energy is that global crude benchmarks continue to march upward, with Brent pricing north of $80/bbl at quarter end.

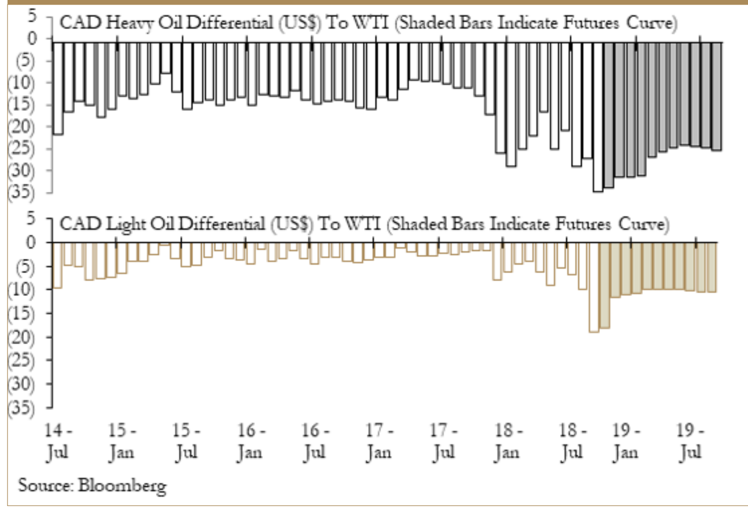
Canada needs to make progress on infrastructure constraints to improve sentiment towards the energy sector. One encouraging new development was a positive final investment decision for a Shell led LNG export terminal.

GLOBAL MARKETS

Global markets had a solid third quarter, with the health care sector particularly strong and solid performance from the cyclicals as well. Geographically, U.S. markets continue to outperform, while emerging markets experienced negative returns. The main factors driving performance this quarter continue to be a healthy economic backdrop and strong earnings growth, with sentiment dampened somewhat by inflationary pressures and the ongoing trade rhetoric. The strength of the U.S. economy has resulted in record low unemployment rates, which has triggered labour shortages across many sectors. This shortage is particularly acute in the transportation and service industries (Figure 3), which could moderate growth and squeeze inflation higher over the near-term.

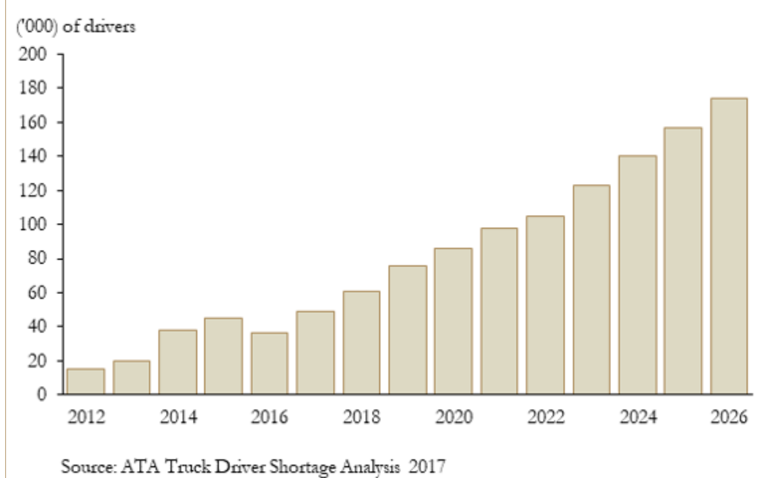
The ongoing trade negotiations have had minimal impact on economic growth thus far, but near-term uncertainty persists. Business sentiment remains relatively upbeat and has aided in navigating these headwinds so far. Although some companies have slightly moderated spending and hiring, the majority continue to plan for an environment of steady growth.

FIGURE 2: CANADIAN OIL DIFFERENTIALS



Source: Bloomberg

FIGURE 3: U.S. TRUCK DRIVER SHORTAGE ANALYSIS



Source: ATA Truck Driver Shortage Analysis 2017

PORTFOLIO INSIGHTS

In Canadian portfolios, we recently added Kinaxis, a highly profitable software-as-a-service (SAAS) provider of a disruptive supply chain management product that continues to gain acceptance with a growing blue chip customer base. The company's key point of differentiation is a concurrent planning solution that enables customers to optimize their supply chains much more efficiently than with legacy silo based software alternatives. Trade and tariff disruptions highlight the growing complexity of supply chains and the value for a business to be able to quickly respond to changing circumstances. Kinaxis' growth rates have been impressive in recent years, and could yet accelerate via investments in new geographies, penetration of new market verticals and an expanding set of management consultant and service partners.

In Global portfolios, one of the companies we continue to hold is Union Pacific (UP) railroad. UP benefits from the tight transportation market that has been building in North America over the past year due to steady GDP growth and tight trucking capacity. Given low levels of unemployment and seemingly limited interest in a career as a long-haul trucker, an escalating shortage of truck drivers is becoming more severe and is expected to persist for the foreseeable future. **Union Pacific is well positioned to benefit from this trend as they have the capacity to move some volumes off the road.** Furthermore, the company is about to implement a new efficiency focused operating plan, like those in place at other railroads. Visibility on the significant longer term margin opportunity is enhanced even as management will phase in the plan gradually so as not to disrupt service levels. This new operating plan should also result in meaningful service improvements enabling UP to charge more for delivering a better product. Though escalating trade tensions could potentially dampen volume growth in the short-term, Union Pacific's network is among the most diversified from a revenue perspective, which helps to limit volume uncertainty.

FIXED INCOME MARKETS | STRONG ECONOMIC DATA LEADS INTEREST RATES HIGHER

Strong economic data resulted in interest rates finishing about 25bps higher to end the third quarter. In July, the Bank of Canada raised the overnight rate for the second time this year, which now sits at 1.50%. With recent economic strength, the Bank is likely to raise rates again in October to 1.75%. Corporate credit spreads were little changed for the quarter.

The Bank of Canada overnight rate has consistently been 50bps lower than the U.S. Fed, which sets a guideline for longer dated maturities. However, due to overhanging concerns such as NAFTA, the difference between longer dated Canadian and U.S. interest rates was just above 60bps. With the resolution of NAFTA, Canadian rates are expected to rise and close the gap with the U.S.

At the end of the quarter the difference between the Canadian 2 and 30-year maturities was only 23bps (Figure 4). This doesn't leave much room for short-term rates to rise before the yield curve completely flattens out. Additionally, the Canadian 30-year rate is relatively high as it started the quarter at 2.20%, almost equal to where the 2-year rate is today.

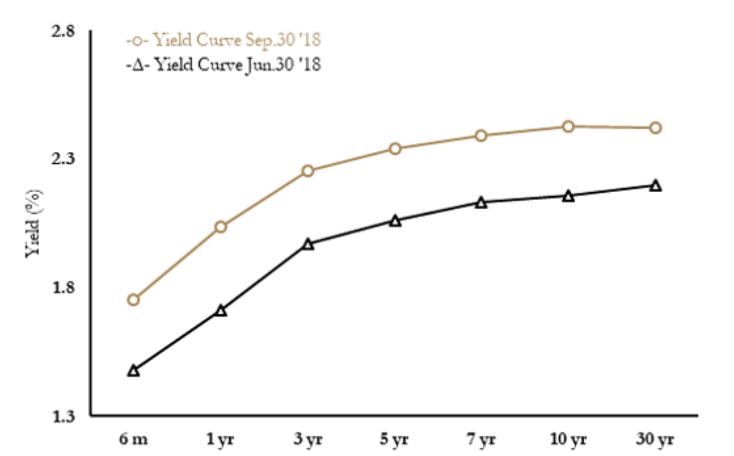
As the Canadian and U.S. central banks further raise interest rates, the yield curve will likely have a difficult time maintaining some positive slope. The central Banks will be faced with the decision of pausing their rate hiking cycle or potentially risk inverting the yield curve.

PORTFOLIO INSIGHTS

Overall, as mentioned previously, the change in the credit spreads for the quarter were minimal. However, there were two holdings that outperformed, AltaLink 2040 and Telus 2043. **The market became increasingly interested in AltaLink, with its solid "A" credit rating and the company is becoming the premier investable utility in the Canadian market, a crown Hydro One once held and continues to slip away.** The success of Telus' spreads is the result of demand for high-quality, higher-yield bonds, and the recognition of the discount Telus offers to its peers, Bell and Rogers.

With the change in Ontario's government, we have been waiting for the new administration to reveal an assessment of the finances. **Late in the third quarter, the Progressive Conservative Ford government announced its findings, with a deficit for the 2017-18 fiscal year and a larger deficit for 2018-19.** However, nothing new or unknown was really presented. It appears we will have to wait until the 2019 budget is announced in the first quarter of 2019, before we will find out the government's long-term plans. Most important is when Ontario will return to a balanced budget and how much debt will be incurred before that milestone. Two of the four credit rating agencies have the Province on negative outlook and it will be difficult to avoid any rating downgrades. While waiting for more details, we added one Ontario bond in the 10-year term at an attractive price and are confident in the new government's fiscal responsibility.

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

After many years of planning and consulting, a new form of Canadian bank senior debt was issued and sold in the market. Senior notes, or junior seniors, are replacing deposit notes. The new senior notes have many of the same qualities as deposit notes, but with the added risk that in the highly unlikely event that the regulator determines that the bank is no longer a going concern, it can force bondholders to convert into common equity. Similar forms of debt have been issued by banks around the world stemming from Basel III and we are finding out that the added risk is worth about 15bps in additional credit spread over legacy deposit notes.

In client portfolio's in July, a 2-year government bond and a 1-year bank deposit note were sold and replaced with 3-year & 5-year bank deposit notes. Moving out of the 2-year term to the 5-year captured about half of the overall difference in short-term and long-term interest rates, is better positioned for the yield curve to flatten, and added a meaningful amount of yield to the overall portfolio.

In early August, the remaining holding of Nova Scotia 2041 was sold in preparation for the events in Ontario as Nova Scotia's spread generally performs inline with Ontario. In its place, Canada 2045 was purchased to maintain the interest rate exposure. Finally, Pembina 2043 was sold in late August as its spread was no longer at an attractive valuation, however, we continue to hold Pembina 2019 as fundamentals at the company remain solid.

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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